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WEALTH MANAGEMENT

Trust Planning for the Increased Estate Tax Exemption

The Tax Cuts and Jobs Act (TCJA) doubled the federal gift, estate and generation-skipping transfer (GST) tax exemptions to $11.4 million per person in 2019. As a result, affluent individuals now have the opportunity to pass on a significant amount of wealth tax-free — but only for a limited time.

These increased tax exemptions are scheduled to sunset on December 31, 2025. This means that after 2025, exemption levels are scheduled to revert to where they were before the passage of the TCJA (indexed for inflation). It's also possible that these provisions may be rolled back even sooner should the balance of power in Washington D.C. shift.

Individuals and couples interested in taking advantage of these exemptions may want to do so sooner rather than later. Using the exemption during life to gift assets not only removes the assets from the donor's taxable estate, it ensures that the appreciation on these gifts will be exempt from future gift, estate and GST tax. Per a recent U.S. Treasury proposal, gifts made under the current exemption amounts cannot be clawed back into the taxable estate if the exemption amounts are lowered in the future.

While there are significant advantages to gifting assets before the exemptions revert to their pre-TCJA levels, transferring assets to (or for the benefit of) children, grandchildren or other family members is a complex matter that should be approached with care and thoughtfulness. There can be substantial ramifications for you and your descendants.

Here are a few questions to ask when considering using all or part of the transfer tax exemption:

CAN YOU AFFORD IT?

Gifting assets typically requires the gift giver to relinquish full control in order to remove the assets from their taxable estate. Will the assets remaining after the transfer support your current (and expected future) lifestyle?

For individuals who are uncomfortable gifting significant assets, there are planning strategies designed to "freeze" the value of assets for estate tax purposes. In one such technique, known as a Grantor Retained Annuity Trust (GRAT), the grantor gifts assets to a trust for children for a term of years and retains an annuity that is equal to the value of the transferred assets. As a result, only the appreciation of the transferred assets is removed from the grantor's taxable estate. Intrafamily loans may also be utilized to allow a trust or a family member to invest the borrowed assets, growing the balance outside of the grantor's estate. At a point in the future, the lender may consider forgiving all or part of the note as a gift.

A Spousal Lifetime Access Trust (SLAT) may also help alleviate concerns about access to gifted assets. A SLAT allows the grantor's spouse and descendants to be eligible beneficiaries, providing flexibility in the event the grantor's non-trust assets are insufficient to support their lifestyle.

WHAT SHOULD YOU TRANSFER?

Determining which assets to gift may be equally as important as the strategy employed. Consideration should be given to the probability that the transferred asset will appreciate. For this reason, the following assets may provide greater opportunity to leverage the transfer tax exemptions:

- Non-voting and minority interests in closely held businesses that may be entitled to receive a valuation discount
- Hard-to-value assets, such as LLCs, partnerships and tangibles (artwork, collectibles and antiques, etc.)
- Life insurance

SHOULD YOU TRANSFER ASSETS OUTRIGHT OR TO A TRUST?

If simplicity is the goal, you might consider making an outright gift of cash or other assets to family members. While this will provide an immediate financial benefit to the recipient, it may create issues for both the grantor and the beneficiary. A large, sudden windfall could create problems if not properly planned for. It's important to ensure that

mechanisms are in place to ensure descendants do not have their motivation for personal development and success stifled by an influx of inherited wealth. Additionally, the grantor may desire to impose a certain level of control over the gifted assets, such as appointing who is in charge of investing and distributing the assets, and specifying what should happen if the initial beneficiary should pass away.

In order to maintain such controls, the gift would need to be made to a properly structured trust. This would make funds available to the chosen beneficiaries in a considered and appropriate way, while also protecting the assets from potential creditors.

WHAT TERMS CAN YOUR TRUST HAVE?

Determining a class of beneficiaries should be the first step in establishing a trust. The class is often composed of the grantor's spouse and descendants, or just the descendants.

Selecting a trustee is next. This decision will be influenced by the terms and goals of the trust as established by the grantor. With trusts that permit distributions pursuant to an ascertainable standard, such as the health, education, maintenance and support of a beneficiary (the "HEMS" standard), the beneficiary is entitled to be his or her own trustee and make distributions accordingly.

Distributions made at the discretion of an independent trustee provide a greater level of asset protection and allow for larger distributions to be made.

An independent trustee — one who is not a beneficiary of the trust — may make discretionary decisions about whether or not a beneficiary's request for a distribution is appropriate. Such a trustee would make a judgment based on their understanding of the purpose of the trust as well as the available trust funds, taking into account both present and future beneficiaries. In some instances, a beneficiary trustee can serve alongside a corporate trustee. Corporate trustees, such as BNY Mellon Wealth Management, can provide experienced and objective guidance and a formal process for distribution requests.

It is advisable to incorporate the maximum amount of flexibility into a trust document. The grantor is unable to predict the future; circumstances surrounding the trust's beneficiaries and tax laws may change. One way to increase trust flexibility is through "power of appointment." Granting a power of appointment to a beneficiary may enable him or her to alter the ultimate disposition of trust assets based on information that was not available at the time the trust was established. This can be valuable when a beneficiary has a child who is incapable of receiving trust assets or it would be prudent to revise the terms under which such a child would inherit the assets. You can restrict the group of people the beneficiary may select to receive the assets by making this a limited power of appointment.

Because assets transferred to and held in an irrevocable trust will not receive a step-up in cost basis at the grantor's death, a grantor trust permits the grantor to exchange low-basis assets in the trust for cash or other high-basis assets held outside of the trust.

Swapping low-basis assets back into the grantor's taxable estate can provide a positive tax result for both the trust, which would otherwise be subject to tax upon the sale of appreciated assets, and the estate.

Allocating GST tax exemption to a gift made to a trust allows the trust to continue for multiple generations without being subject to estate taxes upon the death of a descendant.

WHAT ARE THE POTENTIAL DRAWBACKS?

As discussed, gifts, whether made outright or to a trust, are irrevocable. Consequently, the grantor should be confident that the beneficiary is capable of handling the gift, or that the appropriate trust structure has been put in place with trustees who are capable of carrying out the grantor's wishes.

Most of what has been discussed up until this point has focused on federal estate and gift taxes. It is important to understand that many states have state-level estate tax exemptions that are equal to or less than the federal exemption. For that reason, it is imperative to understand how a transfer will impact potential state estate tax liability.

As of June 2019, Connecticut is the only state with its own gift tax. For Connecticut residents, or those who make a gift of Connecticut property, a gift tax may be owed if assets in excess of the state exemption ($3.6 million, as of 2019) are gifted during life.

CONCLUSION

Given the evolving complexities of the tax law and the profound impact that the decision to transfer significant assets can have on the life of the grantor and the lives of beneficiaries, it's important to validate any assumptions and take action only when confident that a complete understanding exists of the potential benefits and consequences.

It is almost always prudent to gift sooner rather than later, to allow the growth and compounding to occur outside of the grantor's taxable estate. However, balancing tax minimization with family dynamics and multiple beneficiaries (each of whom has different needs and goals) requires that planning conversations be about more than just dollars and cents.

A discussion with your legal, tax and investment advisors regarding the possible strategies that might be best suited to your specific situation is recommended.

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