# A closer look at the current estate and gifting tax rules

## Tax reform changes the landscape for planning

Passage of the Tax Cuts and Jobs Act (TCJA) represented the most sweeping tax law changes in decades. For instance, the unified, lifetime exclusion for estates and gifts was doubled, which significantly reduced the number of taxable estates. Under the new rules, roughly 1,900 estates are taxable, according to the Tax Policy Center. Based on the previous exemption amounts, about 5,500 estates would have owed estate taxes.

The estate and gift tax exemption is the dollar amount per individual that can be sheltered from federal estate or gift taxes. Individuals may choose to use this exemption by gifting wealth during their lifetime, leaving assets to heirs upon death, or a combination of both.

In 2021, the exemption amount increases to $11.7 million per individual. Taxable gifts made over a lifetime will also reduce the exemption amount left upon the death of an asset owner. For 2021, the annual limit for gifts for an individual remains at $15,000. This means an individual can gift that amount to any number of individuals without having to report a taxable gift. Gifts larger than that amount must be reported, will reduce the lifetime exemption amount, and may ultimately trigger the federal tax. The maximum estate and gift tax rate is 40%.

The "portability provision," which was made permanent in 2013, still applies. With portability, a surviving spouse can utilize any unused portion of the deceased spouse's estate tax exemption — up to the maximum individual limit — to reduce his or her own taxable estate. The spouse must choose this provision upon the death of the first spouse by filing a federal estate tax return (IRS Form 706). It is also important to note that a surviving spouse who remarries and survives his or her second spouse cannot use both spouses' unused exemptions. Only the exemption of the most recently deceased spouse is portable.

Note that provisions within the TCJA impacting federal gift and estate taxes will sunset after 2025. This means that if Congress does not take action before then, federal gift and estate tax law will generally revert to rules in place in 2017.

### Key estate tax figures for 2021

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| Unified estate and gift tax exemption = $11.7 million/individual |
| Maximum tax rate = 40% |
| Annual gifting exemption = $15,000/individual |

Not FDIC insured | May lose value | No bank guarantee

## Estate planning remains critical

While most estates will fall below the increased exemption level, this does not mean that only individuals and families with significant wealth need to focus on estate planning. The reality is that proper estate planning extends well beyond minimizing or preparing for federal estate taxes. Here are some important areas to consider:

- Orderly transition of wealth to heirs or charitable concerns through wills or other means.
- Plans to address potential state estate or inheritance taxes. There are approximately 20 states that have different rules involving taxation on estates, including exemption amounts below the federal threshold of $11.7 million.
- Actions to avoid a lengthy and costly probate process. Beneficiary designations on retirement accounts and insurance contracts should be updated regularly. Establishing a revocable trust may also be useful in transferring other property (such as real estate or brokerage accounts) to heirs outside of the probate process.
- Planning for minors or other extended family members around successor guardianship or support.
- Steps to transfer decision-making responsibilities in case of unforeseen circumstances. These steps may include establishing a durable power of attorney.
- Living will or health-care proxy declarations, which can facilitate decisions around medical treatment or end-of-life wishes.
- Documenting wishes for final arrangements.

## Planning considerations under the new law

- **Plan for low cost-basis property.** Maximize the continued benefit of stepped-up cost basis when property is transferred at death. For example, careful consideration should be made around lifetime gifts that may jeopardize a step-up in cost basis on property at death. When property is gifted, the party receiving the gift generally assumes the original cost basis.
- **Certain trusts may help mitigate state income tax liability.** Consider certain trusts (such as incomplete gift non-grantor trusts) that may help those living in high-tax states shift income to states without state income taxes.
- **Utilize trusts to take advantage of deductions.** Trusts may own certain property and utilize deductions that may be eliminated or reduced for individual taxpayers, such as the deduction for investment advisory fees.

It is critical to work with a qualified estate planning professional to determine if any of these strategies are appropriate for your particular financial situation.

## Gifting considerations

The Internal Revenue Service (IRS) defines a gift as the transfer of property — or any type of asset — while receiving nothing or something less than equal value in return. The IRS imposes a tax on gifts and limits the amount of assets that can be transferred between individuals without being subject to the tax. The maximum annual exclusion amount is currently $15,000 per individual donor per year, or $30,000 per couple. If the gift exceeds the annual exemption, the amount is applied to the donor's lifetime gift limit. Ultimately, the amount applied to the lifetime limit will affect the calculation of the donor's estate tax.

**Certain transfers are not considered taxable gifts:**

- Tuition payments or medical expenses
- Gifts to your spouse
- Gifts to a political organization for its use
- Annual transfers that do not exceed the maximum allowed ($15,000 per individual for 2021)

### Tax advantages of a 529 plan

For those wishing to make gifts toward higher education and contribute to a 529 savings plan, there are additional tax advantages. A donor may elect to treat up to $70,000 of contributions as though those contributions had been made ratably over a five-year period. As long as the transfers per recipient do not exceed the $15,000 annual exclusion amount (or $30,000 for spousal gifts), the total amount is not affected by taxes.

## Choosing to gift during lifetime

Assets may be transferred during an individual's lifetime as well as upon death. The following table outlines several considerations for making gifts while living.

### Case for gifting while living

- ✓ **Help heirs** while you are still living.
- ✓ **Reduce estate assets now** to avoid or minimize estate taxes in the future.
  - — The gift plus its future appreciation is removed from the estate of the donor.
- ✓ **Minimize income taxes now.** The gifting of income-producing assets can shift the tax burden to family members in lower tax brackets.
- ✓ **Ability to use certain valuation discounts** in transferring family-owned businesses and farms.
  - — For example, gifts of closely held businesses may be eligible for significant discounts in value, up to 30% in some cases, due to the fact that these ownership shares are not readily transferable in the open market. This is considered a "lack of marketability" discount. Also, these gifts may have limited rights attached, which may trigger a "lack of control" discount.
- ✓ **Certain states tax estates but not gifts.** Lifetime gifts may help minimize certain state-imposed estate taxes.
- ✓ **Asset protection.** Gifting can shift assets to family members with less creditor risk.

### Case against gifting while living

- X **Donors lack control** over the assets after the gift has been completed, although trusts can help donors maintain some level of control over gifted assets.
- X **Loss of assets.** There is the possibility that there will be a future need for assets previously gifted to meet significant costs such as medical expenses, surviving spouse income needs, or helping settle future estate-related costs.
- X **Loss of step-up in cost basis** on appreciated assets at death. With gifting, the recipient typically assumes the original cost basis while heirs receiving assets at death generally assume date-of-death cost basis on inherited assets.
- X **Potential for asset value(s) to decline** after a gift has been made.
- X **Potential that federal estate tax may be repealed** in the future.
  - — This scenario may be unlikely due to the need for additional revenue to combat rising federal budget deficits.

## IRS clarifies potential impact of sunset provision on certain large gifts

Since the unified estate and gift tax exemption is slated to revert back to 2017 levels ($5,490,000 indexed for inflation) after 2025, taxpayers have questioned whether large gifts made after 2017 and before 2026 could be subject to a "clawback" provision. For example, let's assume a taxpayer utilized their entire lifetime gift tax exemption prior to the new law taking effect in 2018. The doubling of the lifetime exemption under the TCJA allows the taxpayer to gift an additional $5 million (plus an inflation allowance) without owing federal gift taxes. However, if the law sunsets after 2025 and the lifetime exemption reverts to 2017 levels, would the additional $5 million gifted under the TCJA be "clawed back" into the estate of the taxpayer? On November 20, 2018, the IRS issued proposed regulations to address this issue, proposing that a so-called "clawback" provision would not apply. Since these are proposed regulations subject to potential amendment, taxpayers should consult with a qualified estate planning professional when considering a lifetime gift.

## Tax law changes require attention

To understand how the estate tax and gift tax rules may affect your personal financial plan, it is important to consult a financial advisor. Individuals considering advanced planning strategies around estates and gifting should work with a qualified estate planning attorney who has knowledge of their financial situation and goals.

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