Is This the Time to Transfer Wealth?

By Helena Jonassen

Families considering the enhanced gifting opportunities afforded by the Tax Cuts and Jobs Act should keep two factors in mind: Estate planning is never just about taxes – and the window to act under current law is scheduled to shut after 2025.

The doubling of lifetime estate, gift, and generation-skipping tax exemptions to approximately $11.2 million for individuals raises important questions, as well as opportunities. Should ultra high net worth families accelerate their gifting plans? Can families with more modest estates afford to use their increased exemptions to give more? And, most vexing for families and wealth advisors alike, will the gifts be clawed back if and when the increased exemption sunsets?

Weighing competing lifestyle, business and wealth transfer goals is the starting point for all families and their advisors. Generally, families with large estates should consider taking advantage of the increased exemptions now, assuming their other financial commitments could be maintained. Those with smaller estates should carefully consider if they could afford to make substantial gifts.

In either case, it would be a mistake to rush to unwind prior strategies or to forfeit further planning. Family circumstances are always changing, as are economic and market conditions, and planning needs to keep pace. Indeed, there may be a strong case for continued aggressive planning, to reduce estates using vehicles like Grantor Retained Annuity Trusts, or GRATs, which can pass the appreciation on assets to heirs without using exemptions in a rising stock market.

Cost basis planning remains an important component of wealth advisory.

For those willing and able to give now, an outright gift to a Dynasty Trust in Delaware or another jurisdiction in which there are no rules against perpetuity may also make good sense. The increase in the generation-skipping tax exemption, coupled with the increase in the gift tax exemption, allows families to move significant assets to an irrevocable trust in a favorable jurisdiction that can remain outside of future estate tax obligations in succeeding generations.

It may also be worth leveraging the exemption by using assets that may be discounted from a valuation perspective due to limited marketability or minority interest. Gifts could include partial interests in a Limited Partnership, real property, illiquid assets or even a family business. Asset protection benefits remain relevant, to protect families from overspending, imprudent investments, litigation and divorce. (Julio Castro writes about the continued importance of trusts on page 22.)

Any big gift is a leap of faith, both in the family's ability to give and the recipient's readiness to receive. A Spousal Lifetime Access Trust, or SLAT, can help provide some flexibility, as assets gifted during life into the trust continue to be available to the spouse and, therefore, indirectly to the grantor, even though they are no longer part of the grantor's estate. The grantor must be aware that changing marital circumstances or the death of the spouse will change the availability of this asset. Some couples may consider setting up a SLAT for each spouse to leverage both of their exemptions; however, care must be taken in drafting these trust agreements to avoid the terms of the trust being identical (which could cause potential estate tax inclusion under the reciprocal trust doctrine).

State estate and gift tax planning should also be considered. Some 18 states, plus the District of Columbia, still impose their own estate or inheritance taxes separate from the federal estate tax levy. These include Minnesota ($2.4 million estate tax exemption in 2018), Washington ($2.193 million estate tax exemption in 2018) and Connecticut ($2.6 million estate and gift exemption in 2018). Using the increased exemption for lifetime gifts will reduce estates for state estate tax purposes. However, this has to be carefully weighed against the loss of step-up in basis at the donor's death because heirs will inherit the donor's cost basis.

Residents of states that also impose a gift tax will be subject to state gift tax if they make a gift above the state exemption amount. For instance, gifts made by Connecticut residents during calendar year 2018 will be exempt to $2.6 million, up from $2 million in 2017. That figure rises to $3.6 million for 2019, and to the full applicable federal exemption amount for gifts made by individuals in 2020. Other high tax states, including New York, New Jersey and Minnesota, do not currently impose a gift tax.

Cost basis planning remains an important component of wealth advisory, as a trust created during a donor's lifetime inherits the donor's cost basis and will not receive a step-up in basis at the grantor's death. One solution may be to create a trust and give a trusted elderly relative with modest means a general power of appointment over the trust to obtain a step-up in basis at his or her demise. Alternatively, families can carefully draft trusts to allow the holder of the power of appointment to make the trust includible in his or her estate, assuming it is not taxable.

Another possibility is to make the trust an Intentionally Defective Grantor Trust, or IDGT. An IDGT is an irrevocable trust created by the grantor for the benefit of the grantor's spouse or descendants, and is designed to shift assets outside of the estate. The trust is, however, defective for income tax purposes, as the grantor continues to pay income taxes generated by the trust, thereby further reducing the grantor's estate and allowing the trust assets to grow. If the trust has a grantor trust provision, the trust can provide the grantor the special power to swap assets with the trust of equivalent value. This power would give the grantor the ability to swap high basis assets for low basis assets in the trust at a later time, effectively stepping up the basis of the trust assets for the benefit of future heirs.

It is important to review existing wills with formula bequests that create credit shelter trusts at death for the benefit of spouses and descendants. Credit shelter trusts or bypass trusts at death have been popular strategies to reduce the overall estate taxes payable at death. With the new federal exemption amount of $11.2 million per person, indexed for inflation, formulas should be reviewed to confirm that the credit shelter bequest is not overfunded, leaving the surviving spouse with too little in assets, and potentially generating state estate tax.

Generation-skipping tax, or GST, issues should also be considered. With an increase in the GST exemption, it may be a good time to consider a late allocation of GST exemption to protect an existing trust from future estate or generation-skipping tax.

Higher exemptions present real opportunities for some families – but decisions made in haste will be repented by generations. While no one knows at present what will happen in 2026, families should take the time now to fully define their wealth transfer goals with their advisors, and to plan and invest accordingly.

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