

ACT NOW BEFORE THIS VALUABLE ESTATE TAX SAVING OPPORTUNITY

EXPIRES

As we have all heard it said many times in many contexts, there are only two things in life that are certain: Death and Taxes. Those realities come together in the form of state and Federal estate taxes. United States estate taxes apply to the worldwide assets of U.S. citizens, as well as non-citizens living in the United States at the time of their death. In addition, the District of Columbia, Maryland and 16 other state have some form of estate or inheritance tax. (Maryland is the one state with both.) The current maximum Federal estate tax rate is 40%. Throughout much of the history of the Federal estate tax the rate has been much higher: as much as 55% as recently as 2000; 70% in 1992. However, throughout its history, Federal estate taxes have not been a concern of most U.S. citizens and domicillaries because of a generous exemption which makes the estates of most individuals estate tax free. Because of indexing and, more importantly, a temporary increase in the base amount on which the Federal gift and estate tax exemption is based, U.S. citizens and non-citizens living in the United States can transfer up to \$11.58 million in assets in 2020 without paying a Federal gift or estate tax.

The current United States gift and estate tax exemption is a result of a temporary doubling of the base exemption amount from \$5 million to \$10 million.¹ This increase will expire at midnight on December 31, 2025. It is applicable only to gifts made prior to January 1, 2026 or estates of decedents dying prior to that date. Nothing prevents Congress from accelerating the sunset of the increased exemption, nor does anything prevent Congress from reducing the amount

¹ § 2010(c)(3)(C). The increase in the base amount combined with indexing produce the \$11.58 million gift and estate tax exemption amount for 2020. To the extent taxable gifts were made in prior years and sheltered from gift tax by the exemption, the \$11.58 million amount for 2020 is reduced by the amount of those prior year gifts.

of the exemption or increasing the Federal estate tax rate. There is concern that a change in the political composition of Congress as a result of the November 2020 elections will result in either or both of these taxpayer unfriendly actions. Consequently, there is an urgency to use the increased exemption prior to the end of 2020.

The current exemption may be used in one of two ways: either by dying and making testamentary transfers or by making gifts prior to death. In both cases (death perhaps considerably more obvious), unless the entire exemption is exhausted by the testamentary or inter vivos transfer; as the case may be, any unused portion of the increased exemption amount which is currently available will be forfeited when the exemption reverts to the pre-2018 base amount. Since most taxpayers prefer less dramatic steps than death to enjoy a tax benefit, gifts prior to death will likely be the preferred strategy. Gifts may be made directly or in trust. The beneficiaries of the trust must be someone other than the transferor for the gift to be immediately effective to prevent inclusion of the transferred assets in the transferor's gross estate. Post-transfer appreciation and revenue generated by the transferred assets is shifted to the transferee free of further gift or estate tax.² Trusts are typically preferred as the means of making significant gifts because trusts enable the transferor to retain control of the transferred assets either directly by acting as trustee or indirectly by selecting the trustee.

For most taxpayers, the most significant impediment to making gifts – substantial gifts, the kind of multi-million-dollar gifts which are necessary to use an \$11.58 million gift tax exemption – is the loss of financial benefit from the assets which were the subject of the gift. This is not necessarily the case with respect to every gift. For example, a gift may relieve a parent of a

² To fully appreciate the importance of this statement, it must be understood that a gift sheltered by the transferor's gift tax exemption does not save estate taxes at the transferor's death because the fair market value of the assets transferred reduce the transferor's gift and estate tax exemption on a dollar-for-dollar basis. A gift is only tax-effective when accompanied by post-transfer appreciation or income.

financial obligation the parent would otherwise incur, such as a gift used by a child to pay educational expenses. The closer the relationship to the transferor, the more likely an indirect financial benefit will inure to the transferor. In the case of many married couples, the least financially consequential way to use both spouses' gift tax exemptions is to make gifts to one another.

In a context in which the objective is to transfer significant wealth yet retain the benefit of the transferred assets, few solutions are as elegant as the creation of a trust for the benefit of one's spouse (particularly if it is anticipated that the transferee will create a similar trust for the benefit of the transferor). Direct gifts result in no reduction in the couple's net worth or gross estates at death.³ In contrast, gifts with a total value equal to each spouse's exemption amount to a properly designed irrevocable trust for the other (commonly referred to as a Spousal Lifetime Access Trust or "**SLAT**") can reduce the couple's net worth and assets subject to estate tax by over \$23 million. SLATs are customarily drafted to provide the beneficiary spouse with the broadest possible access to the Trust assets without crossing the line at which the assets of the SLAT would be included in the beneficiary spouse's gross estate. The tax objective (a completed gift that will not be included in the transferee's gross estate) must be balanced with the financial objective (preserving the couple's enjoyment of the transferred assets). That balance requires limiting the beneficiary spouse's access to trust assets.⁴ Nonetheless, the beneficiary spouse's access can be quite broad.

- All of the net income realized from investment of the trust assets may be paid to the beneficiary spouse.

³ While spousal gifts are often designed to qualify for the gift or estate tax marital deductions of §§ 2523 or 2056, such gifts do not reduce the amount of estate taxes the couple will pay. The *quid pro quo* of the marital deduction is inclusion in the transferee's gross estate. As an example, compare §§ 2056(b)(7) and 2523(i) with §2044.

⁴ See generally, § 2041

- Alternatively, net income can be distributed as necessary to pay for the beneficiary spouse's living, medical, and educational expenses.
- Similarly, principal may be freely distributed to the beneficiary spouse as required for living, medical, and educational expenses.
- Finally, the beneficiary spouse may withdraw up to 5% of the trust assets each year (in addition to distributions required for the beneficiary spouse's living, medical, and educational requirements).

When the parameters set forth above govern distribution of income and principal to the beneficiary spouse, either the beneficiary spouse, the transferor spouse, or both may act as trustees. Doing so enables the couple to invest assets of the SLATs in ways which benefit the beneficiary spouse (and indirectly the transferor spouse) by purchasing primary or seasonal residences or making debt or equity investments in privately held businesses in which either the beneficiary spouse or the transferor spouse participate as a principal. As long as the residences and business interests are retained by the SLAT, the desired estate tax effect is achieved: the residences and business interests will not be subject to inclusion in either the transferor or recipient spouse's gross estate nor subject to U.S. estate taxation at their deaths.⁵

The lawyers at WardChisholm, LLP are recognized as national experts in planning to reduce and eliminate state and Federal estate taxes. Our lawyers have taught tax and tax planning classes as adjunct faculty members at George Mason School of Law, Catholic University School of Law, the University of Baltimore School of Law, and the graduate tax program at Golden Gate University. We frequently lecture in continuing education programs for practicing attorneys and have published numerous articles on United States taxes and tax planning, many of which appear

⁵ Success in this endeavor requires avoiding the reciprocal trust doctrine. *See* Estate of Grace v. U.S., 395 U.S. 316 (1965)

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