2020: A Year of Uncertainty Resulting in an Ideal Time for Year-End Gifting

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End of Year Landscape

As we approach the end of 2020, several factors in this historic year signal an opportune time for year-end gifting. First, the federal government likely will need to raise taxes in 2021 in order to support the CARES Act passed in response to Covid-19. Congress may use gift, estate, and/or GST taxes to do so given the perception that such taxes only affect the wealthy.

Second, temporarily depressed asset values resulting from the pandemic are ideal candidates for gifting. Such assets will be valued on the date of gift for gift tax purposes, and any subsequent appreciation will not be subject to further gift or estate tax.

Third, interest rates have declined as a result of the pandemic. Such low rates promote the use of grantor retained annuity trusts, charitable lead annuity trusts, and intrafamily loans, as such strategies are more likely to successfully transfer wealth free of tax under such conditions.

Finally, it is an election year with many contested congressional seats and, of course, a presidential election. Although Joe Biden has not provided many specifics about his policy regarding transfer taxation, we can expect that if the Democrats win control of Congress and the presidency, the estate and GST tax exemption, discussed further below, could be reduced to $3-5 million per person and the gift tax exemption could be reduced to $1 million per person. Further, the estate tax rate may be increased from 40% to 45-55%.

Current Transfer Tax Exemptions

Currently, any U.S. citizen may gift up to $15,000 per beneficiary, per year, free of gift tax. A married couple may gift a total of $30,000 each year to the same beneficiary before the gift tax rules apply. In addition to the $15,000 annual exclusion, each U.S. citizen

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currently has a $11.58 million gift tax lifetime exemption. The gift tax lifetime exemption is not a per beneficiary exemption amount, but rather a per donor exemption amount. The gift tax laws and estate tax laws are currently unified, in that they apply the same tax rates to lifetime gifts and transfers of property at death. To the extent a gift to any third party (other than a spouse) exceeds the $15,000 annual exclusion amount, the donor's $11.58 million exemption amount will be used to preclude the payment of gift tax for a lifetime transfer, i.e., the $11.58 million estate tax exemption is reduced dollar-for-dollar by the amount of gift tax lifetime exemption an individual uses.

The Tax Cuts and Jobs Act provides that the gift and estate tax exemption will revert to $5 million (adjusted for inflation) on January 1, 2026. Should a Democratic administration be installed before 2026, that administration's tax policy could result in an earlier reduction of those exemptions. Nevertheless, the IRS has clarified that if any of the gift or estate tax exemption amount in excess of $5 million is used prior to 2026, a taxpayer will not lose his or her use of the higher exemption amount, no matter the exemption amount at the time of his or her death. However, any unused exemption over $5 million could be lost if not used before 2026, or possibly January 1, 2021, if the legislation is revised by Congress next year.

Year-End Gifting: Significant Benefits in 2020

Given the historically high exemption amounts and depressed asset values and low interest rates as a result of Covid-19, the end of 2020 is an ideal time for gift planning. Of course, the question often asked is whether you benefit by not using any part of the lifetime gift tax exemption, thereby retaining intact the estate tax exemption amount at death. The primary concern with this approach at this time is that the $11.58 million estate tax exemption likely will not be available at the time of your death if you die after 2026 (or possibly 2021 depending on the result of the election). The tax effect of failing to utilize the $11.58 million exemption amount before it is reduced is that a smaller amount of assets (up to $8 million less of assets) will be able to pass estate tax free to

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your family than otherwise would have been possible if the larger exemption had been fully used through lifetime gifting. Obviously, your amount of lifetime gifting needs to be consistent with your retention of assets sufficient to fund your standard of living. However, if you are married and your estate is worth more than $6 million, or if you have wealth concentrated in a single asset, like a residence or closely held business, it is very important to consider gifting assets this year to avoid the 40%+ estate tax and to avoid the possibility that your heirs will be forced to sell assets to generate cash to pay the estate tax.

Further, tax savings can generally be achieved through lifetime use of the gift tax exemption due to the fact that future appreciation and income on the transferred property is not included in your estate. If you give away $1 million today and use your gift tax exemption to avoid paying gift tax, and the value of the property grows to $2 million by the time of your death, you have effectively transferred $1 million gift tax-free and saved approximately $400,000 in estate taxes (40% of $1 million).

If you conclude that it makes sense to utilize some portion of the available gift tax exemption in 2020, the question becomes how to use the exemption effectively for transfers to the next generation or other beneficiaries. Some of the available transfer techniques are discussed further below.

Outright Gifting

The simplest and most cost-efficient form of transfer to use your lifetime exemption is an outright gift. For example, a married couple could give each of their desired beneficiaries $45,000, thereby using $30,000 of their annual exclusion ($15,000 for each spouse) and $15,000 of gift tax exemption ($7,500 for each spouse). Because the gift exceeds $15,000, the couple would need to report the gifts on a Form 709 U.S. Gift Tax Return, but there would be no other legal or accounting requirements.

There are two shortcomings to this approach. First, the beneficiary receives the gift outright and the couple loses control over how the property is managed. Second, the couple gained no leverage in the

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transaction, i.e., they gave a dollar away and they used a dollar of gift tax exemption. The only significant tax advantage to the couple occurs if the property earns income and/or appreciates in value over the years. For that reason, gifting marketable securities, shares of a closely held business, and real estate, often is more tax efficient.

Finally, it should be noted that if the couple's goal is to use the available exemption in 2020, it will be more advantageous to not split the gifts. If gifts are split by a married couple, all gifts made by either spouse during the course of the year will be treated for gift tax purposes as though they had been made 50% by each spouse, regardless of who actually made the gifts. However, a married couple can use more of the available exemption by not splitting gifts. Of course, to use the full exemption, an individual with two children, for example, could gift $5,805,000 to each child, thereby using $30,000 of his or her annual exclusion, and $11,580,000 of gift tax exemption. It likely will make more sense to make such a large gift to a trust set up for the benefit of the child, as discussed below.

Gift Trusts and Intrafamily Loans

The control issue discussed above for outright gifts is solved by making the gifts in trust. Instead of giving the cash or other assets outright to your desired beneficiaries, you may utilize a trust that places limitations on distributions. Typically, such a trust will require the trustee to apply standards, i.e., distributions of income or principal may be made if needed for the beneficiary's health, education, support, and maintenance. The trust may be written to terminate once a beneficiary attains a specified age or it may continue for future generations. The latter kind of trust is called a generation-skipping trust or a dynasty trust. There are some limitations on generation-skipping trusts, but the general idea can be incorporated into a lifetime gift planning program as well as your estate plan.

Gift trusts can also be a useful planning option given the likely uncertainty of the election until the end of 2020. You could loan your available exemption amount or sell assets valued at that

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amount for a promissory note to gift trusts for your descendants or other beneficiaries. If the Democrats win the election, you could forgive the loan, thereby making a gift of the exemption amount in 2020. If the Republicans win the election, the loan could stay in place and could be a useful tool in helping your descendants take advantage of currently low interest rates by using such funds to pay down other debts with higher interest rates.

Irrevocable Life Insurance Trusts

Another planning technique is to use the high exemption amount to fund a life insurance policy insuring your life held in an irrevocable life insurance trust (ILIT). Upon your death, the insurance policy proceeds would be held in further trust for your children or other beneficiaries.

As long as the life insurance policy is acquired by the ILIT, the proceeds will not be included in your estate for estate tax purposes and the value of the death benefit in excess of the premium will pass to your beneficiaries free from transfer taxes. If you transfer an existing life insurance policy to the ILIT, the cash value of the policy, if any, will be treated as a gift to the trust beneficiaries, and the death benefit will be includible in your estate for estate tax purposes if you die within three years of the transfer.

Spousal Lifetime Access Trusts

For individuals who do not wish to lose complete access to their assets, a great option to take advantage of the available gift tax exemption is to gift assets to a spousal lifetime access trust (SLAT). A SLAT is an irrevocable trust created by one spouse for the benefit of the other spouse, as well as additional family members, most commonly children and/or grandchildren. Although the donor spouse would need to give up his or her right to the property transferred into the trust, the non-donor spouse would maintain access to the property, with certain limitations. Any appreciation in the gifted assets will pass free of transfer tax to the trust beneficiaries.

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The SLAT could be structured to allow only the non-donor spouse to have access to the funds during his or her lifetime and have their children benefit after the non-donor spouse's death. Alternatively, the SLAT could be structured to permit distributions to the non-donor spouse and the children throughout the initial term of the trust. The donor spouse cannot serve as trustee, but the non-donor spouse may serve as trustee with proper drafting parameters.

If both spouses intend to create SLATs, it is very important that the SLATs be as materially different as possible (i.e. different trustee, different beneficiaries, different contributed assets, different retained powers, different distribution standards, and different times of execution). If the two trusts are identical or "too similar", the IRS will treat the trusts as reciprocal and the gifted assets will be included in each spouse's estate.

While the SLAT is an excellent tool for using the current exemption amount, if the spouse needs continual distributions from the SLAT, such distributed assets will be included in the spouse's estate and the exemption will have been wasted. It is therefore ideal for a spouse to place assets in a SLAT that should not be needed by the couple to maintain their lifestyle, knowing, however, that the assets will be available if necessary.

Grantor Retained Annuity Trusts

A planning tool that takes advantage of low interest rates is a grantor retained annuity trust (GRAT). In brief, a GRAT is created by transferring assets into an irrevocable trust and retaining the right to receive an "annuity" for a fixed term of years, after which any remaining trust assets (in excess of those required to pay the annuity) pass to your named beneficiaries (or to a separate trust for the benefit of the beneficiaries). You must outlive the annuity term in order to receive the tax benefits, and, for that and other reasons, shorter term GRATs are commonly used.

When the GRAT is established, you would be treated as making a gift to the remainder beneficiaries equal to the difference between the value of the contributed property and the value of the retained annuity. It is possible to almost "zero out" the GRAT, so that you are

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treated as having made only a very small gift, by specifying annuity payments that have a value almost equal to the value of the contributed property.

A GRAT provides tax benefits if assets placed in the GRAT have better investment performance than IRS assumed performance, based on the Applicable Federal Rate (October 2020 rate is 0.4%). If a GRAT portfolio established in October appreciates in amounts greater than 0.4%, the assets remaining in the GRAT at the end of the term will be distributed to the remainder beneficiaries free of federal gift taxes.

Charitable Lead Annuity Trusts

If you are charitably inclined, another technique that uses the high exemption amount and low interest rates is a charitable lead annuity trust (CLAT). Such an arrangement is very similar to the GRAT arrangement except the charity receives the trust's annuity payments for a term (such as your life). After the term, you or, more commonly, your beneficiaries (such as your children) will receive the remainder interest outright or in further trust.

The transfer tax advantage of a CLAT is that the taxable gift (to which the annual exclusion is inapplicable) to a beneficiary at the time the trust is created is only the difference between the value of the gifted property and the present value of the retained annuity, so assets can pass to children or grandchildren, after a term, at a low transfer tax value. With low interest rates, the IRS is assuming that the trust principal will grow very little, when, in fact, a decent investment strategy could outperform the Applicable Federal Rate by quite a bit, allowing a sizable remainder value to eventually pass to children or grandchildren for a disproportionately low gift tax value.

If you have any questions about any of these gifting techniques or how to best align your gifting goals with your current estate plan, please contact Audra E. Loomis, Patricia D. Laub, or any attorney in Frost Brown Todd's Estate Planning & Administration Practice Group.

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