

# Your Trusted Counselor

## PREPARING FOR THE REDUCTION IN THE ESTATE TAX EXEMPTION

In late May of this year, the U.S. Treasury released a publication detailing a number of the proposed tax code changes that the Biden administration would like to usher through Congress in an ambitious effort to modernize the US tax system to meet its citizens' needs. While reasonable minds may differ strongly on the best way to stimulate the US economy and create wealth and security for the American people, one thing is certain: the need for individuals to engage in careful estate and tax planning to avoid paying more tax than necessary is not going away.

This IRS publication,<sup>[1]</sup> sometimes referred to as the Green Book, outlines a number of key proposals that—if ultimately passed—have the potential to significantly shake up the estate planning world as we know it today by sidelining a number of tried and true estate planning strategies while potentially increasing the frequency of use and usefulness of others.

As some commentators have observed, any direction to reduce the estate and gift tax exemption amount from its current historically high level of approximately \$11.7 million per taxpayer is noticeably absent from these proposals.<sup>[2]</sup> Although there is certainly no guarantee that such a proposal will not be made in the future, we can nevertheless focus for now on what we do know about the law as written today and what steps we can take to address the coming changes.

One of the first things to understand is that, even with no action whatsoever by Congress, estate tax laws passed under the Trump administration will expire and reset to the prior laws in 2026. This reset will restore the estate and gift tax exemption amount to \$5 million, as it was in 2016 (though it will be indexed for inflation, resulting in an exemption amount of approximately \$6.6 million in 2026). Again, this is the law as it stands today; without further action from Congress, it will remain the law.

It is therefore important to consider the average rates of return on your current investments, compounded annually, to determine what kind of return on your investments you can expect within the next 5-10 years. Using a basic calculator or spreadsheet, many of our clients and their advisors are surprised to see that, even with a moderately healthy return of approximately 7% annually, their net worth could easily double in 10-12 years. If the estate tax exemption amount is halved in 2026 and increases only with inflation at a rate of approximately 2.5% per year, you could very quickly find yourself at risk of paying significant estate taxes (currently at a 40% rate) if you are still in the mindset of having an \$11.7 million estate tax exemption (\$23.4 million for married couples) available when either you or your spouse passes away in the next one to two decades.

### **What should we be doing now?**

Given the current uncertainty, trying to predict the future and determine which strategies will best

accommodate your tax and estate planning goals can be frustrating. This is particularly true when we consider some of the other Green Book proposals:

- Raising the top income tax rates;
- Taxing capital gains as ordinary income for people who earn more than \$1 million per year;
- Treating any transfers of appreciated property (including gifts and inheritances) as a sale of the property, thus triggering capital gains taxes on the property, instead of allowing the traditional carryover basis for gifted property or stepped-up basis for property inherited at the death of the property owner; and
- Limitations on deferral benefits for like-kind exchanges of real estate.

You should still consider certain strategies, however, because these changes have not yet been implemented and may ultimately never be enacted. For example, the following strategies are still effective tools under current tax law, and if you implement them now, you could realize significant tax savings.

#### **Grantor Retained Annuity Trust**

A grantor retained annuity trust (GRAT) enables you to transfer appreciating accounts and property to chosen noncharitable beneficiaries (usually children or other family members) using little or none of your gift tax exemption (depending on the value of your retained interest in the trust). To accomplish this, you would transfer some of your property to the GRAT and retain the right to receive an annuity. After a specified period of time, the noncharitable beneficiaries will receive the amount remaining in the trust.

#### **Installment Sales to an Intentionally Defective Grantor Trust**

Another useful strategy that can still be used today is to gift seed capital (usually cash) to an intentionally defective grantor trust (IDGT) and then sell appreciating or income-producing property to the IDGT. The IDGT makes installment payments back to you over a period of time. If the account or property increases in value over the period of the sale, the accounts or property in the trust will appreciate outside your taxable estate and will therefore avoid estate taxes. Additionally, because you will pay income taxes on the income generated and accumulated in the trust, which is an indirect (nontaxable) gift to the trust (and, therefore, to its beneficiaries), the trust itself does not have to pay income taxes on the income that it retains.

#### **Spousal Lifetime Access Trust**

A spousal lifetime access trust (SLAT) strategy calls for you to gift property to a trust created for the benefit of your spouse (and potentially other beneficiaries like children or grandchildren). An independent trustee can make discretionary distributions to those beneficiaries, which can benefit you indirectly, while an interested trustee should be limited to ascertainable standards when making distributions (i.e., health, education, maintenance, or support). This strategy allows you to use the currently high lifetime gift tax exemption amount by making gifts to your spouse; pay income taxes for the trust, which allows for indirect, nontaxable future gifts to the value of the trust for the trust beneficiaries; and still benefit indirectly from the trust through your spouse. Because the trust is designed to avoid using the marital deduction, the money and property in the SLAT will not be included in either your or your spouse's gross estate for estate tax purposes.

#### **Irrevocable Life Insurance Trust**

Irrevocable life insurance trusts (ILITs) are still a tried-and-true method for leveraging life insurance to ease the burden placed on your estate if it will be subject to estate tax at your death. This type of trust is established by transferring an existing life insurance policy into the ILIT (or a new policy is purchased with money gifted to the trust). You would then make annual cash gifts to the ILIT to pay the premiums on the life insurance policy. At your death, the trust receives the insurance death benefit and distributes it according to the trust's terms. Because the trust receives the death benefit and the premiums gifted to the trust are completed gifts, your estate would not include any of the trust's value. This strategy can be a powerful method of leveraging relatively small gift tax exemption usage to create both liquidity for your taxable estate as well as significant accounts or property outside the estate to benefit your beneficiaries.

#### **We Are Here to Help You**

You can still implement these strategies today to significantly benefit yourself and your loved ones. If you feel that you can benefit from a deeper understanding and exploration of these and other strategies, please let us know. We would love to sit down with you and discuss whether any of these strategies make sense for your particular situation. Call us today!

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<sup>[1]</sup> Dep't. of the Treasury, General Explanations of the Administration's Fiscal Year 2022 Revenue Proposals (May 2021), <https://home.treasury.gov/system/files/131/General-Explanations-FY2022.pdf>.

<sup>[2]</sup> Allyson Versprille & Ben Steverman, *Biden Targets Two Weapons the Richest 0.1% Use to Avoid Taxes*, Bloomberg Tax Daily Tax Report (June 28, 2021, 7:06 AM), <https://news.bloombergtax.com/daily-tax-report/biden-targets-two-weapons-the-richest-0-1-use-to-avoid-taxes>.

## WHAT KIND OF LEGACY ARE YOU LEAVING YOUR LOVED ONES?

Your family will be dealing with a lot of concerns if you become incapacitated or when you pass away. Don't add extra stress by failing to prepare for them! O'Connor Law Offices can provide you with peace of mind by drafting your Will, developing a full estate plan or assisting you with all of your wealth transfer needs. Call us today to schedule an appointment with Mona O'Connor to learn more.

BROUGHT TO YOU BY:

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