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PRODUCT & SERVICE GUIDE

Estate Planning in an Uncertain Time

Taxpayers should of course carefully consider whether to engage in a lifetime gifting strategy, which has other considerations beyond just estate taxes (such as the tradeoff with the "step-up" in basis, and non-tax family related considerations).

Nov. 17, 2021



The House Ways and Means Committee recently released an extensive tax package that would have resulted in enormous changes for estate tax planning. The package proposed reducing the current \$11.7 million estate/gift tax exemption by 50% on January 1, 2022, eliminating the use of valuation discounts for non-operating

businesses, and eliminating the use of “intentionally defective grantor trusts,” or “IDGTs” (a type of irrevocable trust commonly used in estate tax planning).

The elimination of IDGTs was to be effective as of the date the bill was enacted, which at the time was thought to be perhaps only weeks away. Because the bill would have “grandfathered” in IDGTs that were created and funded before the effective date, estate planners around the country launched into a dead sprint to implement lifetime gifting strategies before what was believed to be an imminent deadline.

In the meantime, members of Congress were negotiating the size of the “Build Back Better Act” and the tax measures needed to pay for it. On October 28, a new version of the Build Back Better Act was introduced, which dropped the estate tax provisions in original proposal. This was of course a welcome change for taxpayers (and estate planners who were tired of working nights and weekends). However, uncertainty over the final contours of infrastructure legislation continues, and future legislation could again upend the estate tax landscape. Taxpayers are therefore faced with an uncertain legislative environment.

Many taxpayers were prompted to use lifetime gifting strategies by the estate tax provisions in the September 10 legislation. However, even with these provisions dropped from the current proposal, taxpayers should continue to strongly consider lifetime gifting strategies, for several reasons. First, the current \$11.7 million estate/gift tax exemption is still scheduled to be reduced by 50% on January 2026, even if Congress does nothing.

Taxpayers who have not used the “extra” exemption before then will lose it forever. Second, any post-appreciation transfer on gifted assets accrues outside of the taxpayer’s estate. This is especially salient for younger individuals and for transferred assets with high potential for appreciation. Finally, for taxpayers who live in states with a state estate tax but no stage gift tax (such as Illinois), lifetime gifting may have the effect of reducing state estate tax liability.

In addition, for individuals who have already used all of their estate/gift tax exemption, the current low interest rate environment makes certain advanced estate tax planning techniques more likely to succeed. These strategies, which include sales to IDGTs, intra-family loans, and grantor retained annuity trusts, or “GRATs,” are more effective when interest rates are low.

The relevant interest rates for these strategies are the federal “Section 7520 rate” and the short-term, mid-term, and long-term “applicable federal rate,” or “AFR.” With these strategies, if transferred assets appreciate faster than the benchmark interest rate (sometimes referred to as the “hurdle rate”), any excess appreciation passes without any estate/gift tax exemption being used. While interest rates have increased somewhat in recent months (with the Section 7520 rate, for example, now at 1.6%, up from 0.6% in January of 2021), they remain very low by historical standards.

IDGTs will likely continue to remain the vehicle of choice for making lifetime transfers. IDGTs are a type of trust that are outside of the taxpayer’s estate for estate tax purposes but are considered to belong to the grantor for income tax purposes. The grantor is responsible for paying the income tax of the trust, essentially allowing the grantor to make a “tax-free” gift and let the assets of the IDGT (which are outside of the grantor’s estate) grow without the “drag” of income taxes.

Additionally, the grantor can sell assets to an IDGT without creating a realization event for income tax purposes. The recent proposals suggest that at least some members of Congress consider this technique to be “too” effective for estate tax purposes. Thus, many individuals should consider taking advantage of IDGTs while they are still available.

Taxpayers should of course carefully consider whether to engage in a lifetime gifting strategy, which has other considerations beyond just estate taxes (such as the tradeoff with the “step-up” in basis, and non-tax family related considerations). However, lifetime gifting remains very effective for anyone who may be subject to estate tax. For many, the now-dropped proposals may have provided a spur to engage in planning that will be beneficial even if those proposals are not enacted.

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