The Legal Intelligencer

Will It be 2012 All Over Again?

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By **Rebecca Rosenberger Smolen and Amy Neifeld Shkedy** | September 03, 2020

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We started our law firm in spring 2012 and vividly (and gratefully) remember the extra boost we received from planning by many clients that year because the exemption from the federal gift and estate tax was scheduled to drop on Jan. 1, 2013, from $5.12 million to $1 million. At the moment, the exemption is again scheduled to drop from its current level of $11.58 million to $5 million indexed for inflation, but, not until 2026. However, many high net worth individuals are fretting that if there is a swing to the left in the federal government after the November election, the exemption could easily be reduced sooner, and very possibly below the $5 million level. It is widely recognized that as a technical matter, if there is the political will to do so, the exemption could be reduced in 2021, after a new president might be sworn in, effective as of Jan. 1, 2021.

After the exemption was increased to its current all time high beginning in 2018, our article in The Legal on Jan. 9, 2018, traced the history of the exemption from the 1990s to present. We noted that the change from $600,000 in the '90s to the then-current level reflected increases of about 90% per year. By contrast, a quick inflation adjustment calculation (Google sourced) reflects that $600,000 in 1996 dollars is equivalent to slightly

less than $1 million in 2020. A patently stark differential from the current exemption levels that certainly gives reason for concerns about potential retrenchment.

The tax differential for a $12 million estate with an exemption reduced by $6 million, would be $2.4 million if the effective tax rate remains at 40%, or $3.3 million if the effective tax rate is returned to its prior level of 55%. Those numbers could be doubled for married couples (with at least $24 million of assets). Obviously, if the exemption is reduced by an even larger amount, the tax differential would be even greater. So, a significant amount of tax dollars for family units is at stake should the law change to reduce the exemption and/or increase the effective tax rate. Note, these taxes do not usually become due until a client dies, or, in the case of a married couple, until the death of the surviving spouse.

In our Nov. 20, 2012, article published in The Legal we provided an overview of some planning options to lock in the exemption before it dropped. The same options currently exist today. Back in 2013, as it turned out, at the very last minute, the exemption was not reduced as scheduled. However, many folks nevertheless had engaged in planning and thus have structures in place that can be redeployed this year if desired.

For folks who are thinking about doing planning, it's important to get the ball rolling far before year end rather than be rushed to make potentially irreversible decisions at the very last minute. Not only is it a cause for potential regret for hastily made decisions on a client's part, but, also, it can be a huge challenge for planners to effectively advise a client and draft appropriate documents under tight time pressure. As a backdrop, the typical turnaround for a carefully drafted estate plan is between one and two months—and it often takes longer whether due to the attorney's schedule, or the client's.

The process will, of course, be somewhat less time consuming and simpler for folks who had already taken action in 2012, or had otherwise already engaged in significant wealth transfer planning. For those clients, it will often just be a matter of planning what (if any) additional transfers to make to existing trust structures.

For married couples, a popular way to lock in the higher exemption is to set up a spousal lifetime access trust (SLAT). This type of trust is designed to allow the couple to continue to have access to the funds if necessary during the lifetime of the spouse who is the beneficiary. It's also possible, with some risk, to allow the spouse who is the trust creator to benefit from the trust further down the road. The simplest way to lock in the exemption is to make outright gifts to children or grandchildren, or trusts for their benefit. However, many married clients are not ready to completely part with $23.16 million of assets (or $11.58 million if single), even if they can afford to do so. Another potential option for clients, but less "sure-fire," is a self-settled trust in a jurisdiction with creditor protection laws like Delaware, Nevada or South Dakota.

When selecting assets to fund a gift to try and lock in the exemption, clients should look for high basis assets. Cash being the most ideal, where possible. This is because, under long-established law, the tax basis of inherited assets is stepped up to the date of death values for beneficiaries. That capital gains tax savings opportunity is generally lost for assets gifted during a client's lifetime. Nevertheless, if the exemption does, in fact, go down significantly, in many cases there will be sufficient tax benefit from locking in a higher exemption to offset the lost savings from the forfeited capital gains tax benefit attributable to a basis step up.

Besides the opportunity to lock in the exemption before it is potentially reduced, clients should also be mindful of the historically low monthly applicable federal rates for interest rate sensitive gifting (i.e., GRATs and CLATs) and lending opportunities. The August and September 7520 rate has been set at .4%. The September rate for long term (i.e., nine years or longer) inter family loans is 1%.

Of course, none of us truly knows what the future holds. But for those high net worth individuals who are inclined to minimize the taxes on their estates at death, and subscribe to the better safe than sorry school of thought, we may be at another crossroads in the federal gift and estate tax arena and there may be little time remaining to benefit from today's lofty exemption levels. Recognizing that the exemption could potentially

drop back to $1 million, although not likely, it may also be a time to consider acting for those far below the $10 million-plus net worth levels as well.

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