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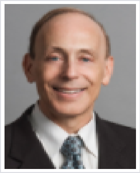
Use it or lose it: the newly doubled estate and gift tax exclusion

The possibility of a California estate tax is only one more reason to engage in sophisticated estate tax planning now, while the "doubled" exclusion is available.



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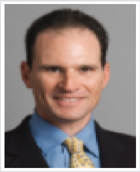

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In 2010, Congress enacted a $5 million lifetime transfer (estate, gift and generation skipping transfer) tax exclusion. That allowed each person to transfer $5 million free of gift, estate and generation skipping transfer tax. That figure has been increased by the cost of living after 2011. As a result, it became $5.12 million (2012); $5.25 million (2013); $5.34 million (2014); $5.43 million (2015); $5.45 million (2016); and $5.49 million (2017).

In the 2017 tax law Congress reached back to the 2010 law and doubled the exclusion from $5 million to $10 million per person.

Given the cost of living adjustments, effective Jan. 1, 2018, each person can transfer $11.18 million free of gift, estate and generation-skipping transfer tax (reduced by prior gifts reported on an IRS Form 709, gift tax return). This figure will continue to increase through 2025. However, effective Jan. 1, 2026, the individual provisions of the 2017 legislation "sunset." As a result, on Jan. 1, 2026, the lifetime transfer tax exclusion will fall back to one $5 million exclusion per person which, with cost of living adjustments, is expected to be $6.5 million per person.

What does this mean for planning purposes? Everyone with an estate that might conceivably become taxable should use the new exclusion, as soon as possible. In other words, *use it or lose it*. Why? The fact that the law will "sunset" is only one reason. There are three others.

The second reason is that, between now and the end of 2025, there will be four federal elections: 2018, 2020 (also for president), 2022 and 2024 (also for president). In theory a change in control of Congress could lead to reducing the exclusion sooner than the end of 2025.

The third reason is inflation. $10 million today becomes, in eight years, the following amounts at the indicated inflation rates: $15 million (5 percent); $16 million (6 percent); $17 million (7 percent); $18.5 percent (8 percent); $20 million (9 percent); and $21.5 million (10 percent). Since so much of the wealth in California is in real estate, a 10 percent rate of return is realistic.

The fourth reason may come to about in the November 2018 election. There is a move underway to put a proposition on the November ballot, the College for All Act of 2018. If enacted, it would impose a tax on decedent estates over $3.5 million. This would reverse what occurred in 1982 when California voters banned state-level inheritance and estate taxes. Estates valued between $3.5 and $4 million would be taxed at 12 percent; those between $4 and $4.5 million at 15 percent; $4.5 and $5 million at 17 percent; $5 and $5.49 million at 20 percent; and larger estates at 22 percent. The combination of a California estate tax with the federal tax means estates over the projected 2026 $6.5 million federal exclusion would be taxed at 62 percent! Taking steps to eliminate the *federal* estate tax will also prevent the *California* estate tax from applying.

There is a new meaning to a "moderate" size estate. Someone with a $5 million to $50 million estate is in the "moderate" size estate category. Why? Assume Husband and Wife, ages 55 and 50, are worth $40 million. You advise them to "Use" their combined $22.36 million lifetime transfer tax exclusion now due to the 4 factors discussed above. Their response would be that they can't afford to give away ($22.36 million / $40 million =) 56 percent of their estate. If they live to their life expectancy, they might need the other 44 percent. They don't want to give up "control" to their children.

The first response is that no parent would agree to engage in the planning if the parent did not feel comfortable the parent would remain in virtual, dictatorial control. There are five elements that make up the parents' continuing control over the trust to which the transfers are made. First, the parent chooses the trustee the parent trusts to do what the parent tells the trustee to do, simply out of loyalty to the parent. That is in contrast to the person the parent wants to be trustee after the parent is dead. When the parent is dead, the parent wants a trustee whose judgment the parent respects. However, while the parent is alive, the parent wants a trustee who will simply do as told. Second, the parent retains the right to remove the trustee and name a new one. Limit: the trustee cannot be "related or subordinate" as defined in Internal Revenue Code Section 672(c). That means the trustee cannot be a lineal ascendant or descendant of the parent, or an employee of a business in which the parent's ownership is significant. In contrast, the parent can name someone like that initially in the document.

Third, the trust can have a provision for the appointment of a "protector." This protector will not be a fiduciary, meaning the protector will not have a duty to the beneficiaries. Instead, the protector will have powers the grantors themselves cannot have. If the grantors had these powers, the trust assets would be included in the parents' estates for estate tax and creditor purposes. These powers are (i) to add or remove beneficiaries (limited to lineal descendants of the grantor); (ii) to change the allocation among beneficiaries; and (iii) to change the manner of distribution to the beneficiaries. Fourth, the assets transferred to the irrevocable trust are interests in LLCs and limited partnerships in which the parents retain interests as managers and as general partners. Finally, the irrevocable trust is set up under Nevada law so that, from the beginning, the parents can be beneficiaries. That sets the parents' minds at ease. It is also a great benefit when property tax reassessment is a concern.

"Use it or lose it" is now the way to go with all clients who might possibly have taxable estates. The possibility of a California estate tax is only one more reason to engage in sophisticated estate tax planning now, while the "doubled" exclusion is available.