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PERSPECTIVE

Preparing for sunset

What lawyers need to know about the gift and estate tax

By Elizabeth A. Bawden

The Tax Cuts and Jobs Act passed at the end of 2017 doubled the estate and gift tax exemption. With much aplomb, it was announced that the average American (and even the average lawyer!) could pass wealth to their children and beneficiaries without paying a 40% tax. The reality, though, is more nuanced. Whether advising clients on their estate and tax planning strategies, or considering how to handle your own wealth, here is what you need to know:

How the gift and estate tax works. Each person has an exemption amount, which is the amount of non-charitable gifts they can make before the gift and estate tax goes into effect. These gifts can be made during life, at death, or through a combination of lifetime and testamentary transfers. Every non-charitable gift above the exemption amount is subject to a 40% tax, payable by the giver (rather than the recipient). The gift and estate tax is a federal tax. California does not currently have a state estate tax (though recent unsuccessful legislation proposed one), while some other states do.

Who pays gift and estate tax now. The current exemption amount is $10,000,000 per person, adjusted for inflation in 2019 to $11,400,000. This means that few families pay the estate and gift tax, and a married couple with less than $22,800,000 (the two spouses' combined exemptions) can leave all of their assets to their children or other beneficiaries without paying estate tax.

What about sunset. The new tax law doubled the exemption amount, but this provision expires, or sunsets, after 2025. Unless Congress changes the law sooner, the result is a $5,000,000 exemption amount per person, adjusted for inflation, starting on Jan. 1, 2026.

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What my clients (or I) should do before sunset. There is a lot of discussion about how to "lock-in" the increased gift and estate tax exemption before sunset. To do this completely, a person needs to give away his or her entire current exemption amount now, but does this make sense? The answer depends upon the level of wealth.

• **$5,000,000 or less.** Families with assets worth less than $5,000,000 do not generally need to consider special planning for the estate tax sunset. Exceptions may exist if those assets are likely to highly appreciate, or if there is significant life insurance (which is taxable for estate tax purposes unless special planning is done).

• **$5,000,000 to $50,000,000.** Sunset puts families with assets worth between $5,000,000 and $50,000,000 in the most difficult position. Giving away $11,400,000 is the only certain way to lock-in the higher exemption, but this level of giving may materially affect ongoing income or lifestyle, and in estate planning we never want tax savings to outweigh practical considerations.

• **$50,000,000 plus.** With $50,000,000 or more in assets, taking advantage of the increased exemptions before sunset generally makes sense. Bear in mind that gifts do not need to be made directly or with cash; assets can be gifted inkind to trusts managed by trusted friends that protect beneficiaries until they reach designated ages or milestones. Dynasty trusts that continue for multiple generations are particularly attractive with this increased exemption. Forming dynasty trusts in a way that avoids California income tax can further add to the benefit.

Significantly, gifts of the increased exemption amounts before sunset will not later be subject to gift or estate tax (also referred to as "clawback") when the exemption is reduced.

Next steps. Before sunset, review and ensure estate plans still accomplish all intended objectives. Changes in the law prior to the new tax law created increased flexible options, and going forward income tax planning is likely to be a bigger focus of estate planning than it was in the past. This is especially true for families that do not have taxable estates.

If a taxable estate post-sunset is likely, consider valuable gifting opportunities that work any time. These include:

• **Making annual exclusion gifts.** Without using the exemption amount, each person can make annual exclusion gifts to as many people as they want. This provision, while designed to ensure that people could give birthday and wedding gifts, and treat friends to meals, without worrying about gift and estate tax, currently allows much more than this with a 2019 annual exclusion amount of $15,000.

• **Prefunding education.** Section 529 plans are a great option for tax-deferred savings for education, and the plans can be front-loaded with up to five years' worth of annual exclusion gifts in the first year, which maximizes tax free growth within the plan.

• **Paying tuition and medical expenses directly.** You can pay tuition or qualifying medical expenses directly to the school or medical care provider free of gift tax for anyone you wish without using any exemption.

• **Leveraging lifetime gifts.** There are various planning opportunities to leverage use of the exemption amount with lifetime gifts. These approaches also exclude future appreciation in gifted assets from the estate tax, and as mentioned above, can have effect for generations to come.

• **Income tax planning.** Income tax planning has a more significant role in estate planning now that capital gain rates (federal and California combined) are nearly in parity with the estate tax. Properly structured trusts can shift income tax burdens, facilitate various intra-family transactions, and maximize opportunities for assets to receive an income tax basis step-up at death.

• **Charitable giving.** Gifts to charity are always free from gift or estate tax, so supporting the causes and concerns you care about is always a great plan! Utilizing a donor advised fund for charitable giving offers many advantages, from the ability to give anonymously, easy opportunities to gift appreciated stock (thereby bypassing capital gain tax on the gift), and the opportunity to make charitable gifts today but defer the decision about how the funds are used.

Sunset may mark the end to a good day, but thoughtful planning beforehand will certainly make the evening more enjoyable for everyone involved.

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