Estate Planning To Do Before the Clock Strikes Midnight on 12/31/2025

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Mr. Blum founded The Blum Firm, PC over 40 years ago. The firm specializes in estate and tax planning and the related specialties of asset protection, business planning, business succession planning, charitable planning, family legacy planning, fiduciary litigation, and guardianship. The Blum Firm has grown to be one of the premier estate planning firms in the nation, known for creating customized, cutting-edge estate plans for high-net-worth individuals.

Mr. Blum serves on the Editorial Advisory Committee for *Trusts & Estates* magazine, as Treasurer for the Texas Cultural Trust, and on the national TIGER 21 Board.

Mr. Blum earned his BBA (Highest Honors) in Accounting from The University of Texas and received his law degree (High Honors) from The University of Texas School of Law.

Federal Estate Tax Overview

- 40% federal estate tax on all assets to extent the total value exceeds the estate tax exemption (currently $13,610,000, but exemption sunsets in half at midnight December 31, 2025).

- Tax is due 9 months after date of death. Can be postponed until death of spouse if qualify for marital deduction.

- Tools to reduce estate tax:
  - Transfer assets into **entities** that achieve a valuation discount and also provide asset protection (such as Family Limited Partnerships and LLCs)—known as **"squeeze" planning**.
  - Transfer assets (including ownership interests in entities) by making gifts and/or sales to **trusts** to remove assets from being subject to estate tax—known as **"freeze" planning**. Trusts include a SLAT, DGT, 678 Trust, GRAT, ILIT, CRUT, CLAT, QPRT, etc.

Golden Age of Estate Planning

- Doubled Estate Tax Exemption – Sunsets 12/31/2025 (**“Use It or Lose It”**)
- “Squeeze” Planning with Valuation Discounts (Family Limited Partnerships and LLCs)
- “Freeze” Planning with gifts and sales to Grantor Trusts
- Stepped-Up Basis at Death— “Buy, Borrow, Die”
- Warning: Given the current political climate, the Golden Age won’t last forever. Learn lessons from 2021 legislative proposals (which grandfathered planning completed prior to passage of new tax laws).

Origin of the Sunset Provision

- The 2016 election had a “triple R” outcome [Republican White House (Trump), Republican House of Representatives, Republican Senate] paving the way for legislation to lower taxes.
- The Tax Cuts and Jobs Act was enacted in 2017 without a single Democrat vote, passing the Senate by a vote of 51-48.
- The estate and gift tax exemption temporarily doubled from $5 million to $10 million (plus inflation adjustments), sunsetting back to $5 million (plus inflation) at midnight on December 31, 2025.
- Why the sunset? The Byrd Rule requires a 60-vote Senate approval for legislation that increases the deficit beyond a 10-year period. To avoid the Byrd Rule, the law made tax cuts temporary.

Will the Doubled Exemption Be Extended?

- The sunset is already baked into the law. For the exemption to remain doubled, Congress would have to pass a new law extending it, and the President would have to sign it.

- In 2012 when the $5 million exemption was supposed to sunset but was extended, there was bi-partisan support for a $5 million exemption. However, today there isn’t bi-partisan support for a doubled exemption.

- The only plausible scenario that could result in extending the doubled exemption is a “triple R” outcome in the November 2024 election.

- Even if that were to happen, there is no assurance. We are living in an era with record low passage of new laws.

How Much Is the Exemption Now?

- Due to annual inflation bumps, the doubled exemption is now $13,610,000 per person ($27,220,000 per couple).
- Inflation adjustments are based on a look-back. The 1/1/2025 inflation bump will be based on comparing average inflation over 12 months from 9/1/2023-8/31/2024 to average inflation from 9/1/2022-8/31/2023.
- Since much of that inflation adjustment is already baked in, the projected exemption for 1/1/2025 ranges from $14,070,000 to $14,160,000.
- For simplicity, let's assume a 2025 exemption level of $14 million ($28 million per couple).

How Much Do I Need to Give Away in Order to Lock In the Doubled Exemption Before It Sunsets?

- The $14 million exemption is comprised of two parts:
  - $7 million “base” exemption
  - $7 million “bonus” exemption
- The “bonus” exemption goes to zero at midnight December 31, 2025.
- Gifts you make first come from the “base” exemption. You only eat into the “bonus” exemption for gifts above $7 million.
- To avoid wasting the “bonus” exemption, an individual has to transfer $14 million ($28 million for a couple).
- For example, if an individual makes a gift of $10 million, he eats up all of his “base” and $3 million of his “bonus” exemption, leaving him with $0 “base” exemption and only $4 million “bonus” exemption. After the “bonus” exemption sunsets to zero, his remaining exemption will be $0, and he wasted $4 million of exemption.

What If a Couple Wants to Give Only $14 Million Instead of $28 Million?

- Make the gift entirely from one spouse. If the gift is community property, enter into a partition agreement to generate $14 million of separate property for one of the spouses.
- When that spouse makes the gift, do not elect "gift-splitting" on the gift tax return. You do not want the gift treated as if it came half from each spouse.
- Compare the outcomes:

	Gift from One Spouse		Gift from Both Spouses	
	Gift from H	**Gift from W**	**Gift from H**	**Gift from W**
Amount of Gift	$14M	$0	$7M	$7M
Post-gift Base	$0	$7M	$0	$0
Post-gift Bonus	$0	$7M	$7M	$7M
After Sunset Bonus	$0	$0	$0	$0
After Sunset Base	$0	$7M	$0	$0

“We Already Used All Our Exemptions in 2020”

- Be aware that clients who made gifts a few years ago used up all their exemptions in that year, but they have not used the inflation bumps since that year.
- Inflation bumps since 2020:

	Per Person	Per Couple
2021	$120,000	$240,000
2022	$360,000	$720,000
2023	$860,000	$1,720,000
2024	$690,000	$1,380,000
	$2,030,000	$4,060,000

- If a couple who made 2020 gifts of $23,160,000 to use up their 2020 $11,580,000 exemptions makes no more gifts, they will waste $4,060,000 of exemption after sunset (plus a likely additional $1 million from the expected 2025 inflation bump).

Annual Exclusion Inflation Bumps

- Annual exclusion gifts also benefit from annual inflation bumps:

	Per Person	Per Couple
2021	$15,000	$30,000
2022	$16,000	$32,000
2023	$17,000	$34,000
2024	$18,000	$36,000

- Accordingly, in 2024, each couple can make gifts of $36,000 to as many donees as they wish, free of estate and gift tax.

“If I Make Gifts Now and Die After Sunset, Will the IRS ‘Clawback’ My Exemption?”

- The way the math works on Form 706 Estate Tax Return is that you add back taxable gifts you made during life and then subtract the exemption in effect for the year of death.
- Without a special rule, you’d add back $14 million of gifts and only subtract $7 million of exemption, generating estate tax on the $7 million of bonus exemption you gifted before sunset.
- In 2019, the Treasury published “anti-clawback” regulations adopting a special rule that allows the estate to subtract the exemption that was used when the gift was made if that amount is higher than the exemption in the year of death.

Example of How Clawback Works

- Assume Joe made gifts of $14 million in 2025 (when the exemption was $14 million) and dies in 2026 (when the exemption is $7 million) with an estate of $50 million.

	With Clawback	Without Clawback
Assets Owned at Death	$50 M	$50 M
Add back 2025 Gifts	$14 M	$14 M
	$64 M	$64 M
Less: Exemption at Death	($7 M)	($14 M)*
Taxable Estate	$57 M	$50 M

*under special rule from anti-clawback regulations

Exception to Anti-Clawback Rule

- In 2022, the IRS issued proposed regulations adopting an **"anti-abuse" exception to the anti-clawback rule**, indicating there WILL be clawback for certain gifts where the donor retained a level of benefit or control of the assets:
  - Gifts subject to a retained life estate or subject to other powers or interests as described in Sections 2035 through 2038 and Section 2042.
  - Gifts made by an enforceable promise, to the extent they remain unsatisfied as of the date of death.
  - Transfers of certain applicable retained interests in corporations or partnerships (Section 2701) or trusts (Section 2702).
  - Releasing control or access to such assets (or paying off the promissory note) within 18 months of death.
- To date, these proposed regulations have **not yet become final**.

Ideas to Lock in the $13,610,000 Exemption

- Outright Gifts
- Gifts to Non-Grantor Trusts
- Gifts to Defective Grantor Trusts (DGTs)
- Gifts to Spousal Lifetime Access Trusts (SLATs)

Note: There is a trade off. These tools remove assets from client's estate but at client's death, there's no basis step-up.

Outright Gifts

- Gift $13,610,000 outright to descendants (or anyone you wish to benefit)
- Drawbacks:
  - Assets subject to descendants' creditors and divorces.
  - Fails to take advantage of GST (Generation Skipping Tax) Dynasty Trust planning, so assets will be subject to estate tax when descendants die.
  - Fails to take advantage of leveraging and optimal use of discounts [unless assets were first transferred to an entity such as a Family Limited Partnership (FLP)].

Gifts to Non-Grantor Trusts

- Assets protected from beneficiary's creditors and divorces.
- Beneficiary pays income tax on trust income distributed to Beneficiary.
- Trust pays income tax on trust income not distributed to Beneficiary.
- For income tax purposes, this type of trust is also called a **"complex" trust**, as opposed to a "Grantor Trust."
- Trusts can be designed to be GST Exempt Dynasty Trusts which last from generation to generation, avoiding estate tax when next generations die, lasting for as long as allowed by the Rule Against Perpetuities (now 300 years for Texas trusts created on or after September 1, 2021).

Gifts to Defective Grantor Trusts (DGTs)

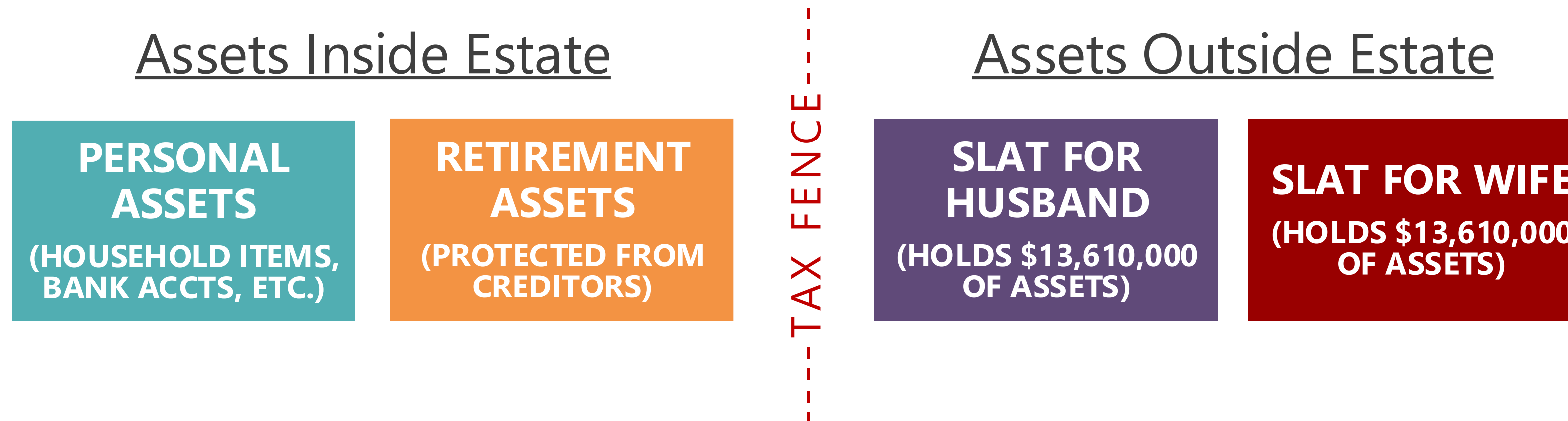
- Trust includes a provision known as an “intentional defect” to cause the **trust income to be taxed to the grantor** rather than to the trust and/or the beneficiary.
- The most common “defect” is a swap power, giving the grantor the power to remove assets from the trust and substitute assets of equal value.
- Gift is “supercharged” by grantor’s payment of income tax on trust income, which is not deemed a gift by the grantor, allowing the trust to grow faster since it is not burdened with income tax.
- Can toggle off grantor trust status later, if desired, converting the trust to a non-Grantor Trust.

Drawbacks of Trusts for Heirs

- Client loses access to the assets.
- Client loses ability to modify how assets pass down the road.

Spousal Lifetime Access Trusts (SLATs)

- The most popular way for married couples to use each spouse's gift/estate tax exemption is for each spouse to create a trust for the benefit of the other because doing so preserves the resources for the spouses' benefit. This type of trust is often referred to as a Spousal Lifetime Access Trust (SLAT).
- The two SLATs **must be substantially different** to avoid violating the Reciprocal Trust rule.



- Benefits:
  - Uses both spouses’ gift/estate tax exemptions.
  - Assets owned by Dynasty SLATs not subject to estate or GST taxes for generations.
  - Assets owned by SLATs not subject to creditors.
  - Spouses continue to have access to assets in SLATs.

- Drawbacks:
  - At first death, survivor loses access to SLAT for benefit of deceased spouse.
  - Upon divorce, each spouse is taxed on income from other spouse’s SLAT.

"Use It or Lose It" Planning for a Single Person Desiring Continued Access to Assets

- The easiest way for a single person to lock in the doubled exemption is to make gifts to a trust benefitting others. The problem is the donor loses access to the assets.
- The donor could borrow from the trust on arm's length terms.
- Alternatively, to retain access, consider creating a **Special Power of Appointment Trust ("SPAT")**. The donor makes a gift to a trust for others but gives an independent party a special power of appointment ("SPOA") to make distributions to a class of donees that includes the donor. For example, the class of donees could be "the descendants of the donor's mother."
- The hope is that, if the donor needs assets, the independent party would exercise his discretion and appoint assets to the donor.

How to Lock in Both Exemptions When One Spouse Has Wealth and the Other Doesn’t

- Assume Husband has separate property assets of $50 million and Wife has a modest estate.
- Husband makes a gift of $14 million to Wife. Wife now has $14 million of separate property.
- Husband can also make a gift of $14 million to a SLAT for Wife or to a trust for kids, using up his exemption.
- Wait a while so Wife’s gift is “old and cold.” Perhaps make the gift to Wife in 2024, then wait at least 6 months, ideally into 2025.
- Once the gift is “old and cold,” Wife can make a gift of $14 million to a trust for the kids or a SLAT for Husband, using up her exemption.
- Caveat: *Smaldino v. Commissioner* (T.C. Memo 2021-27): When the gifts from Wife to a kids’ trust were made too close in time after Husband’s gift to Wife, the Tax Court deemed it a “step transaction” and treated it as if all $28 million of gifts came from Husband, generating a 40% gift tax liability on Husband’s excess gift of $14 million.

Gift Planning Challenges with IRA Assets

- The bulk of wealth in the U.S. is in qualified retirement plans and IRAs.
- A transfer of such assets to a trust would constitute a withdrawal, triggering income tax.
- In some cases, it may be worth it to withdraw the retirement assets, pay the income tax now (instead of later), and transfer the assets to a trust to remove them from the estate.
- You have to do the math and determine if the estate tax savings exceeds the cost of paying the income tax earlier than you would have otherwise paid it. Tax savings result from two sources:
  - Removing the retirement assets from the estate, saving the 40% estate tax on them.
  - Paying income tax now removes the income tax dollars from the estate, saving the 40% estate tax on those dollars. Otherwise, the income tax dollars would still be in the estate and subject to estate tax at death (eligible for an IRD (income in respect of a decedent) income tax deduction when the income tax is later paid, which provides some benefit but not a full offset).

“Squeeze” Planning By Transferring Assets to an FLP (Family Limited Partnership) Prior to Making Gifts

- Limited partnership interests are less marketable than assets held outright or assets traded on an exchange, such as stock of public companies or bonds.
- By virtue of the partnership form and standard restrictions in partnership agreements, a partnership interest is worth less than the underlying assets of the partnership.
- For minority, non-controlling interests, discounts for lack of marketability and lack of control are routinely recognized by the courts when the partnership is formed and maintained properly.
- For example, if a partnership is formed and funded with $1,000,000 in investment assets, the limited partnership interests associated with such assets might be valued at only $650,000 (representing a 35% discount for lack of marketability and lack of control).

Disclosing the Gifts to the IRS

- File Gift Tax Returns (Forms 709) to disclose the gifts.
- The IRS has 3 years from the date a Gift Tax Return is filed to challenge the valuation. Once the 3-year statute of limitations has run, the IRS can no longer challenge the valuation. (Note: The statute of limitations is 6 years if the value omitted is over 25% of the reported gifts.)
- For the statute of limitations to begin, the disclosure must meet the requirements of Treasury Regulations Section 301.6501(c)-1(f)(2) for “adequate disclosure” which includes a copy of the trust agreement, the trust’s EIN, the identities and relationship of the transferor and transferee, a description of the property, any consideration received in return, and a detailed description of the method and financial data used.
- In place of the detailed description of the method and data used, an appraisal report can be attached to the Gift Tax Return.

A Word to the Wise

- A recent *Business Insider* article warns: “In the next two years, estate planning will rev up into high gear as the end of the Trump tax cuts approaches.”
- **Don’t wait until 2025 to start “Use It or Lose It” planning.**
- Learn from the 2021 work crunch when the anticipation of tax law changes created a flood of work for estate planners. Estate planning lawyers were swamped trying to juggle the expanded workflow.
- Even if sunset is extended, doing this planning will likely yield good results for your family.

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