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For Trusted Advisors

Life Insurance Planning

The transfer-for-value rule: An often-overlooked life insurance tax trap.

By Eva Stark, JD, LL.M.

Estate planning, whether simple or complex, often incorporates life insurance. Life insurance death benefits can help support a deceased individual's family, pay off debt, provide funds to equalize inheritances where the bulk of the estate is tied up in a closely held business, create liquidity for the payment of estate taxes, and help achieve numerous other planning objectives. In addition to helping resolve many estate planning challenges, life insurance also may offer tax benefits.

Tax-free death benefit

One notable tax benefit of life insurance is that death proceeds are generally received by a beneficiary free of any income taxation. Public policy has favored this treatment as life insurance is regularly relied upon by families to support children and surviving spouses where a primary incomer earner dies prematurely.

The transfer-for-value rule

In contrast, those transferring life insurance contracts for profit are not considered as sympathetically, and Congress sought to limit speculators' ability to take advantage of tax-free treatment. The "transfer-for-value" rule was created to limit income tax benefits with respect to any policy that is sold or transferred for valuable consideration. Under the rule, the amount of a death benefit that may be excluded from gross income is limited to the value of the consideration paid plus any premiums and other amounts subsequently paid by the transferee (i.e., by the buyer or recipient of the policy). Any death benefit above such amount is generally taxable as ordinary income.

The "trap" in this rule is that ordinary individuals who may transfer policies for estate or business planning purposes may not recognize that consideration is being provided for a policy that is transferred. Consideration obviously encompasses money paid in exchange for a policy, but it also may include non-cash benefits, whether tangible or intangible, or even a mutual agreement or promise.

For example, suppose that each of the two co-shareholders in a corporation owns a policy on his own life. After executing a cross-purchase buy-sell agreement, the shareholders decide to exchange with each other their existing policies

to fund the agreement and forego purchasing new policies (perhaps an owner may not be insurable). Shareholder A transfers the policy on his own life to shareholder B and vice versa. Following the transfer, shareholder A owns a policy on the life of shareholder B, and as the new owner, names himself beneficiary. At shareholder B's death he will collect a death benefit and use it to buy shareholder B's interest from shareholder B's estate. Because the policies were transferred in exchange for valuable consideration (i.e., for a life insurance policy and a mutual agreement to buy-sell), the rule has been triggered and a portion of the death benefit may now be subject to income tax at ordinary income rates.

Exceptions

Fortunately, the transfer-for-value rule offers five exceptions where death benefits remain income-tax free despite a transfer for valuable consideration. These exceptions include transfers:

1. To the insured under the contract;
2. To a partner of the insured;
3. To a partnership in which the insured is a partner;
4. To a corporation in which the insured is a shareholder or officer (note that there is not a transfer to a co-shareholder exception); and
5. Where the transferee's basis in the policy is determined in whole or in part by the transferor's basis.

Even if a policy is "tainted" because it has been transferred for valuable consideration where no exception applied, it may be possible in certain circumstances to "remove" such taint by subsequently transferring the policy in a manner that an exception does apply.

Applying the transfer-for-value rule and its exceptions is complicated and individuals should explore with a qualified attorney or certified public accountant how the rule or any of its exceptions may apply in their particular circumstances.

Conclusion

Whenever a policy is transferred, planners, tax advisors and policyholders should be vigilant to ensure that no consideration exists, or if consideration may exist, that the transfer falls within one of the five exceptions to the transfer-for-value rule. Such precautions may help avoid unexpected tax outcomes and help ensure that the policy's death benefit may remain income-tax free.

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Lifetime Gifting

Optimizing lifetime gifts for the 99%.

By Jeff Chadwick, JD

As advisors, if we knew when clients were to pass away, who was to survive them, the assets included in their taxable estates, and what the tax laws would be at the time of their deaths, we could all design perfect estate plans. We could also advise clients, with absolute accuracy, when and how to make lifetime gifts to minimize taxes and best effectuate their non-tax objectives. Of course, we cannot know any of these things, so we must simply do the best we can with what we have. In many cases, doing so requires building flexibility into the client's gifting strategy in anticipation of potential changes to the tax laws or a client's family or financial circumstances.

This article, part one of a two-part series, focuses on the 99.8% of Americans without taxable estates. Advisors should work with these clients to identify their non-tax objectives, while also planning to minimize income taxes and reporting obligations.

Part two will address transfer tax planning in light of legislative uncertainty. Although each of these articles discusses a wide array of planning techniques, all techniques are highly fact-specific, and clients should consult with legal and tax counsel prior to making any gifts.

Preliminary Gifting Considerations

At its core, lifetime gifting begins with a client's basic desire to benefit others. Consequently, advisors should first focus on a client's non-tax motivations for gifting, which may include the following:

- To satisfy a beneficiary's current health, educational, or other need;
- Beyond basic needs, to permit a beneficiary to enjoy assets or a certain lifestyle now, particularly while the client is alive and has a chance to enjoy the impact of the gift;
- To equalize prior or current gifts among family members;
- To forgive prior loans;
- To provide a beneficiary with an opportunity to learn how to manage finances;
- To help a beneficiary start a business or invest in an entrepreneurial endeavor;
- To supplement the income of a beneficiary who wishes to enter into a lower-paying, but socially impactful, profession;
- To provide a beneficiary with access to capital without exposing the assets to the claims of the beneficiary's actual or potential creditors;
- To facilitate business succession planning and/or motivate younger family members to participate in a family business; and
- To provide the client with insight regarding how a beneficiary handles gifted assets.

Once a client communicates the desire to make a lifetime gift, the advisor should confirm that the gift is appropriate and help structure the gift to achieve the client's objectives. Below is a non-exhaustive list of preliminary considerations when structuring a client's lifetime gift:

- The client's financial needs, including the client's living expenses and required cash flows;
- The client's desire, if any, to maintain control over the gifted asset;
- The client's desire to protect the transferred assets from the

donee's creditors, divorcing spouses, or even the donee's own spending habits and other vices;

- The client's ability to handle complexity or, in contrast, the client's desire to keep things simple;
- The client's willingness to adhere to best practices to reduce tax and creditor risk;
- The donee's age and station in life, family and financial circumstances, and ability to handle complexity; and
- The assets available to gift, including each asset's fair market value, income tax basis, appreciation potential, and administrative ease.

CLIENT'S FINANCIAL CIRCUMSTANCES

Before advising any client to make a lifetime gift, the client should confirm that, after the gift is made, the client will retain sufficient resources to provide for his or her needs, both now and in the future. This analysis will be unique for each client, and should include the client's financial team.

The client's lifestyle also should be examined, including the client's spending habits, desire for future gifts, potential health care costs, and other factors.

CLIENT'S FAMILY DYNAMICS

While the discussion may be uncomfortable, advisors should press clients to be honest and introspective when considering a substantial gift. For example, would the gift incentivize or disincentivize the donee to be a productive member of society? Is the donee financially responsible, or would this gift contribute to the donee's already poor financial decisionmaking? Does the donee have substance abuse issues or other addictive tendencies? How strong is the donee's marriage? These are tough questions, but good advisors will ask them.

MAKING GIFTS OUTRIGHT OR IN TRUST

There are two basic ways to make a gift—outright or in trust. The biggest advantage to an outright gift is simplicity. With an outright gift, however, the client may lose control of the gifted asset and will forfeit the opportunity to provide the donee with added creditor protection and tax savings. Instead, the client can transfer property to an irrevocable trust for the benefit of the donee, and if the client desires to retain some control, can serve as trustee. A properly structured trust should provide the donee with creditor and divorce protection. Creating and administering an irrevocable trust, however, may increase transaction costs and add complexity, which may not be appropriate for certain clients or certain gifts.

Gifting to Minimize Federal Income Taxes

Historically, many clients made lifetime gifts to minimize federal transfer taxes. With drastic increases to the federal gift and estate tax exemption amount (the "Estate Exemption"), however, the estate tax is no longer relevant to most taxpayers and is significantly less relevant to the remaining few. The table below illustrates the diminishing impact of the estate tax.

Year	Estate Tax Exemption Amount	Estate Tax Rate	Number of Estate Tax Returns	Number of Estate Tax Returns for Taxable Estates	Percentage of Decedents with Taxable Estates
2001	$675,000	55%	109,600	50,500	2.16%
2008	$2,000,000	45%	29,000	15,100	0.69%
2013	$5,250,000	40%	11,300	4,700	0.18%
2018	$11,180,000	40%	4,000	1,800	0.06%

In 2020, the Estate Exemption is $11.58 million per person and the tax rate is 40%. Although the Estate Exemption is scheduled to decrease to $5 million per person in 2026 (indexed for inflation with a base year of 2016), most taxpayers will still not have an estate tax issue, absent a monumental change in the transfer tax system. For most taxpayers it will be more important to plan for reducing income tax than for reducing transfer tax.

To optimize lifetime gifts for income tax purposes, advisors must understand how income tax basis is determined in the wealth transfer context. Section 1015 of the Internal Revenue Code (Code) provides a "carryover" basis for gifted property, meaning that the donee's income tax basis is generally the same as the donor's income tax basis at the time of the gift. By contrast, for most assets included in a client's taxable estate, Code §1014 provides an income tax basis adjustment, either up or down, to fair market value at the client's date of death. Thus, appreciated property receives a "step-up" at death, while depreciated property receives a "step-down." For clients in community property states, Code §1014(b)(6) enhances the potential step-up by providing that both halves of any community property, and not just the one-half interest passing through the deceased spouse's estate, receive an income tax basis adjustment.

For the 99% (and really, the 99.94%) of taxpayers who would not be subject to estate tax under current law, planning should typically focus on preserving

the basis step-up for appreciated assets at death, rather than avoiding the estate tax. Income tax basis planning generally falls into one of two categories—"downstream" planning or "upstream" planning.

DOWNSTREAM PLANNING

Downstream planning refers to techniques designed to ensure that a client's assets are included in his or her own taxable estate before being passed on to family members in the next generation. In this regard, advisors should consider the following for clients who do not have taxable estates:

- Avoiding lifetime gifts of highly appreciated assets that would not generate estate tax;
- Preserving capital losses by gifting depreciated assets;
- Swapping high basis assets, such as a cash, for low basis assets from an irrevocable grantor trust that contains a power of substitution;
- Unwinding valuation discounts for client-owned assets;
- Causing inclusion of irrevocable trust assets in the estate of a settlor, a beneficiary, or a third party's estate;
- Converting separate property to community property to facilitate a "double" basis adjustment at each spouse's death; and
- Changing ownership of spousal assets to achieve a new income tax basis for appreciated assets and preserve the income tax basis of loss assets, particularly for clients with a shortened life expectancy.

UPSTREAM PLANNING

Upstream planning can potentially benefit a client who owns assets with substantial appreciation and has an older family member, such as a parent, who has "excess" Estate Exemption. The client can create an irrevocable trust for the benefit of a parent and fund the trust with the appreciated assets. The appreciated trust assets should be includable in the parent's estate by granting the parent a testamentary power to appoint the assets among the parent's creditors.

Upon the parent's death, the lapse of the parent's general power of appointment should cause the assets to be included in the parent's taxable estate under Code §2041, entitling the appreciated assets to a basis step-up. The default beneficiary upon the lapse of the parent's general power of appointment is generally a trust for the benefit of the client or the client's family members, which is often designed to be protected from the claims of creditors and divorcing spouses.

While upstream planning is not without risk, it may be a viable option in certain circumstances given today's focus on income tax planning for many clients.

Taking Advantage of the "Freebies"

Many clients prefer to keep their gifts simple by eliminating the need to file annual gift tax returns. For these clients, it is important to understand the "freebies," or gifts that do not consume Estate Exemption.

MARITAL AND CHARITABLE DEDUCTION

A taxpayer's gifts to a U.S. citizen spouse (or certain marital trusts) receive an unlimited marital deduction from federal gift tax and do not consume a taxpayer's Estate Exemption.

Similarly, gifts to a qualified charity (or certain charitable trusts) receive an unlimited charitable deduction.

HEALTH AND EDUCATION EXCLUSION

Certain "qualified transfers" are not treated as transfers for tax purposes. Therefore, they do not consume Estate Exemption, regardless of the donee or amount of the transfer. Code §2503(e)(2) defines qualified transfers as any amount paid on behalf of an individual:

(i) as tuition to an educational organization described in Code §170(b)(1)(A)(ii) for the education or training of such individual; or

(ii) to any person who provides medical care, as defined in Code §213(d), with respect to such individual as payment for such medical care.

In other words, a client may make unlimited direct payments of qualified health and education expenses (the "Health and Education Exclusion") on behalf of any number of persons without utilizing any portion of the taxpayer's Estate Exemption or annual gift exclusion, discussed below.

Transfers intended to qualify for the Health and Education Exclusion, however, must meet several requirements.

- First, the payment must be made directly to the medical service provider or educational institution. Payments made to a 529 plan or directly to an individual, who then utilizes the payment to cover medical or education costs, do not qualify.
- Second, if the payment of a medical expense is reimbursed by insurance, it does not qualify.
- Third, the Health and Education Exclusion only includes payments made to prevent or treat a physical or mental defect or illness, and do not include payments for cosmetic or elective treatments. For education

expenses, qualified transfers only include tuition, and typically exclude payments for room and board, books, and other supplies.

Despite its limitations, the Health and Education Exclusion should not be overlooked when advising clients. For example, a wealthy grandparent could fund all of her family member's educations and provide for all of their medical needs, without utilizing any Estate Exemption or filing any gift tax returns.

ANNUAL GIFT EXCLUSION

In 2020, a donor may make annual gifts of up to $15,000 to as many individuals as the donor chooses without utilizing any portion of the taxpayer's Estate Exemption (the "Annual Gift Exclusion"). If the donor is married and the donor's spouse consents to split the gift, or if the gift is of community property, the donor (and the donor's spouse) may give as much as $30,000, per donee, using the Annual Gift Exclusion.

When used systematically, the Annual Gift Exclusion can be a powerful tool to transfer substantial amounts of wealth over a period of years, especially for a large family with many beneficiaries. Clients who desire to retain control of the gifted assets may consider transfers to trusts, Uniform Transfers to Minors Act accounts, or 529 plans, with the ability to "front-load" contributions to a 529 account by contributing up to five times the annual exclusion amount (currently $75,000 per donor, per donee, or $150,000 per married couple).

Note that a transfer only qualifies for the Annual Gift Exclusion if it is a gift of a "present interest," which requires special planning for transfers to trusts or gifts of closely held business interests.

Note also that a gift may qualify for the Annual Gift Exclusion, but not necessarily for the annual exclusion from federal generation-skipping transfer tax, so gifts to grandchildren's trusts require careful consideration.

Conclusion

If we knew when clients would pass away, who would survive them, the assets included in their taxable estates, and what the tax laws would be at the time of their deaths, we could advise clients, with absolute accuracy, when and how to make lifetime gifts.

Of course, we cannot know any of these things, so we must do the best we can with what we have. The best approach involves learning as much about the client as possible, starting with the client's non-tax motivations for gifting, as well as the client's ongoing financial needs.

For most clients, it is more appropriate to plan for income tax savings, rather than transfer tax savings, and planners must learn to adapt to this new planning paradigm.

No one approach fits all, and each client's lifetime gifting strategy should be specifically tailored to that client's unique financial and family situation. Flexibility is key, balanced with a heavy dose of practicality. Planners should take comfort that, regardless of the future of the transfer tax system, good advice will always be in demand.

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Optimizing lifetime gifts in light of legislative uncertainty.

By Jeff Chadwick, JD

Part 2 of 2

This article is the second part of a two-part series that explores how to optimize lifetime gifting strategies. The first part focused on 99.8% of Americans without taxable estates. This part addresses transfer tax planning in light of legislative uncertainty. Although this article provides an overview of certain planning techniques, all such techniques are highly fact-specific, and clients should consult with legal and tax counsel prior to making any gifts.

Sunset of Increased Transfer Tax Exemptions

The Tax Cuts and Jobs Act of 2017 doubled the basic exclusion amount from federal gift and estate taxes (the BEA) and the generation-skipping transfer (GST) tax exemption amount (the GST Exemption). In 2020, the BEA and GST exemptions are each $11.58 million per person ($23.16 million per married couple).

If the double BEA and GST exemptions were permanent, it would be easier to plan for clients. The double exemptions are set to expire in 2026, however, and the tax laws could certainly change before then depending on the results of the next election cycle. In 2026, the BEA and GST exemption are both set to return to $5 million per person ($10 million per married couple), indexed for inflation with a base year of 2026. Factoring in inflation, it is estimated that the BEA and GST exemption in 2026 will be approximately $6.4 million per person ($12.8 million per married couple).

Three Groups of Clients

Explaining the current transfer tax laws to clients can be challenging, and it can be even more challenging to structure lifetime gifting strategies in the face of such uncertainty. The best place to start, however, is to gain a comprehensive understanding of the client's current net worth, appreciation potential, and remaining BEA and GST exemption. This information should enable the advisor to classify the client in one of three categories - "affluent" clients, "wealthy" clients, and "super wealthy" clients.

AFFLUENT CLIENTS. "Affluent" clients are unlikely to have a taxable estate, regardless of the exemption amounts. Affluent clients, therefore, are projected to have a net worth in 2026 of $6.4 million or less (or $12.8 million or less for married couples). Taxable gift planning for affluent clients is relatively straightforward.

Because the client is unlikely to have a taxable estate, the client's gifts are not typically motivated by transfer tax savings. Rather, the client's non-tax objectives usually dictate the planning.

SUPER WEALTHY CLIENTS. At the other end of the spectrum, "super wealthy" clients currently have a taxable estate, and are likely to have a taxable estate as long as the estate tax exists. Super wealthy clients, therefore, have a net worth today in excess of $11.58 million (or in excess of $23.26 million for married couples). Planning for super wealthy clients is, in many respects, business as usual. Advisors should continue to recommend traditional lifetime gifting strategies, such as transfers of appreciating assets to grantor trusts, grantor retained annuity trusts, family limited partnerships, and others, but perhaps with more urgency given the scheduled expiration of the double BEA and GST exemption in 2026.

WEALTHY CLIENTS. "Wealthy" clients do not have a taxable estate under the current law, but are likely to have a taxable estate once the doubled exemptions expire in 2026 or if the tax laws change before then. Wealthy clients, therefore, have a net worth today between $6.4 million and $11.58 million (or between $12.8 million and $23.16 million for married couples), which means that they should have a net worth of $6.4 million or more (or $12.8 million or more for married couples).

Wealthy clients are the most difficult group of clients for which to plan. Unlike super wealthy clients, they generally cannot afford to make large taxable gifts and unlike affluent clients, they face a looming estate tax obligation if they die after 2025 without having engaged in active tax planning. Adding to the challenge, the doubled exemptions are "use it or lose

it" amounts. For example, assuming the BEA drops to $6.4 million in 2026, if a taxpayer makes a $5.4 million gift in 2025, and has made no other taxable gifts in prior years, the taxpayer would only have $1 million of BEA remaining in 2026. Thus, the taxpayer would have to make gifts in excess of $6.4 million before 2026 to receive any benefit from the temporarily doubled exemptions. We call this the "wealthy client gifting threshold."

Creative Gifting Strategies for Spouses

For two reasons, more planning options are available for wealthy clients who are married, compared to a wealthy client who is single. First, a married couple has two BEAs and two GST exemptions at their disposal (instead of just one).

Second, and more importantly, many clients are comfortable naming spouses as beneficiaries of irrevocable trusts, with the hope (or, perhaps more accurately, the expectation) that if the client or the client's family has a financial need, the client's spouse will be able to receive a trust distribution to satisfy the need.

UTILIZE ONLY ONE SPOUSE'S BEA AND GST EXEMPTION. One simple solution for married couples is to have only one spouse make gifts, rather than both spouses. That way, the wealthy client gifting threshold is only $6.4 million, instead of $12.8 million.

Consider, for example, a husband and wife with a net worth of $20 million. The couple wishes to take advantage of the currently doubled exemptions, but they are only comfortable making a total gift of $10 million. If each spouse gifts $5 million, the spouses would not exceed the wealthy client gifting threshold. If the doubled exemptions expire in 2026, the spouses' combined BEA would total only $2.8 million.

In contrast, if the husband made a gift of $10 million, and his wife made no gifts, the husband's gift would exceed the wealthy client gifting threshold by $3.6 million. If doubled exemptions expire in 2026, the husband would have $0 of his BEA (and potentially GST exemption) remaining, but the wife would have her entire $6.4

million BEA and GST exemption. In this example, therefore, if only one spouse made gifts, the couple could make total tax-free transfers of $16.4 million, compared to the $12.8 million if the couple made gifts using the more traditional split gift method.

SPOUSAL LIFETIME ACCESS TRUSTS. A common planning technique for married couples involves at least one spouse creating an irrevocable trust for the primary benefit of the other spouse and possibly other beneficiaries, such as children and more remote descendants. These trusts are often referred to as Spousal Lifetime Access trusts, or "SLATs." By funding a SLAT during his lifetime, a client can take advantage of the doubled BEA and GST exemption amounts set to expire in 2026, while also removing appreciating assets from the transfer tax system. Moreover, if the donor spouse is concerned he may lack sufficient funds in the future, he may take some comfort that his spouse is the primary beneficiary of the SLAT and presumably could receive a discretionary distribution that is sufficient to support the client's family (and indirectly, as a result, the client himself).

Many married couples desire that each spouse create and fund a SLAT so that both spouses are permissible beneficiaries of transferred assets, instead of just one spouse. If each spouse creates and funds a trust for the benefit of the other spouse, the IRS may attempt to apply the "reciprocal trust doctrine." Where applicable, this doctrine allows the IRS to uncross each trust for his or her own benefit. Accordingly, if both spouses seek to create and fund a SLAT, the SLATs must be substantially different in their structure and funding to avoid application of the reciprocal trust doctrine.

Although SLATs have existed for many years, they became extremely popular in 2011 and 2012, when the $5 million BEA was set to be replaced in 2013 with a $1 million BEA and a 55% estate tax rate. With the same dynamic at play in the years leading up to 2026, many wealthy clients are likely to consider funding SLATs with gifts in excess of the wealthy client gifting threshold. Thankfully, through the issuance of Treas. Reg. §20.2010- 1, the IRS has clarified that if a taxpayer makes gifts utilizing the doubled BEA, but later dies at a time when the BEA is less than the amount gifted, the taxpayer's prior gifts will not be "clawed back" into the estate to produce a higher estate tax liability.

Gifting Strategies for All Clients

Some wealthy clients do not have a spouse, or even if they do, a SLAT may not be appropriate planning vehicle. These clients should consider other planning techniques, all of which are designed to utilize the doubled BEA and GST exemption while providing the client with some opportunity to access the gifted property in the event of financial need. In other words, some wealthy clients may need to "eat their cake and have it too."

SIMPLE METHOD TO PRESERVE ACCESS TO FUNDS. Sometimes, providing a donor with access to funds may be relatively easy. For example, if a wealthy client wishes to fund an irrevocable trust for the benefit of his family members but wishes to retain some access to funds, the trust agreement could grant the client a swap power to reacquire trust assets for assets of an equivalent value, or an ability to borrow assets from a reliable source of liquidity during a time of financial need. Many wealthy clients may be comfortable relying on this borrowing power, with nothing more.

A wealthy client may also favor estate planning transactions that provide the client with a steady cash flow. The most common example is an installment sale to a grantor trust, in which the client sells assets to a trust in exchange for a promissory note (or in some cases, a private annuity). Interest and principal payments on the note (or annuity payments) should provide the client with liquidity, while any future appreciation in the transferred property should occur outside of the transfer tax system as to that client. Moreover, for wealthy clients who are not ready to consume their entire BEA and GST exemption now, but may wish to give more prior to 2026, a current installment sale would facilitate a quick and easy future gift through the client's forgiveness of all or a portion of the outstanding promissory note.

DOMESTIC ASSET PROTECTION TRUSTS. Some wealthy clients may consider funding an "asset protection trust," which, if it works as intended, consumes the client's expiring BEA and GST exemption, is protected from the client's creditors, is excluded from the client's taxable estate at death, and yet still permits the client to be a permissible beneficiary. Asset protection trusts can be formed offshore in jurisdictions such as the Bahamas, Bermuda, and the Cayman Islands, or in 1 of 19 states currently authorizing some form of "domestic" asset protection trust, or "DAPT."

A DAPT, in its purest form, permits an independent trustee to make discretionary distributions of income and principal to or for the benefit of the grantor. A more conservative approach, however, would be to create a DAPT that does not name the grantor as a beneficiary but authorizes an independent power-holder to add the grantor as a discretionary beneficiary at a later date. This approach should provide

another layer of insulation between the grantor and the trust, which may help if the trust is challenged by a creditor or the IRS.

SPECIAL POWER OF APPOINTMENT TRUSTS. Some wealthy clients may believe DAPTs are too risky, despite their potential benefits. An alternative technique involves the creation of an irrevocable trust for the benefit of one or more beneficiaries, not including the grantor, in which a beneficiary or non-beneficiary is given a limited power to appoint the trust assets among a class of persons, including the grantor. Trusts with this feature are sometimes referred to as special power of appointment trusts, or "SPATs." SPATs offer considerable appeal for wealthy clients given the possibility that the trust assets could pass to a trust for the donor's benefit through a third party's exercise of a lifetime or testamentary limited power of appointment.

RETAINED INTEREST GIFTS. Under the estate tax "string provisions" contained in Sections 2035 - 2039, and 2042 of the Internal Revenue Code, a taxpayer can make a completed taxable gift during lifetime, but the gifted asset can still be included in the taxpayer's gross estate upon death.

This basic concept, combined with the anti-clawback provision in the Treasury Regulations and the exception of assets included in the gross estate from adjusted taxable gifts, may enable wealthy clients to make use of the doubled BEA by making completed taxable gifts prior to 2026, while still enjoying the property during their lifetimes.

While it exceeds the scope of this article to discuss specific techniques, wealthy clients may consider taking advantage of this interplay by engaging in more complex gifting strategies prior to 2026.

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Conclusion

Designing a comprehensive gifting strategy has always been hard. It is even harder now in the face of legislative uncertainty and constantly changing exemption amounts. The right approach requires learning as much about the client as possible, including the client's tax and non-tax motivations for gifting, as well as the client's ongoing financial needs and cash flow. For most clients, it is more appropriate to plan for income tax savings, rather than transfer tax savings, and planners must learn to adapt to this new planning paradigm.

Clients and their advisors should be familiar with and take advantage of lifetime transfers that do not consume gift tax exemption. When considering a transfer that will consume gift tax exemption, advisors may group clients into three categories—affluent clients, wealthy clients, and super wealthy clients—in order to suggest techniques that are appropriate for each client group. Wealthy clients are the most challenging group to plan for because they are stuck in the middle of the expiring exemption amounts.

Transfer tax planning for wealthy clients may require creative solutions designed to utilize the client's increased BEA and GST exemption prior to 2026, while potentially permitting the client to access the gifted property directly or indirectly in the future.

As a result of the Tax Cuts and Jobs Act of 2017 (TCJA) the estate, gift and generation skipping transfer (GST) tax exemption amounts increased to approximately $11.18 million per person (approximately $22.36 million for a married couple). For assets transfers in excess of the applicable exemption amount and otherwise subject to such taxes, the highest applicable federal tax rate remains at 40 percent. While the exemption amounts are indexed for inflation, current law provides for an automatic sunset of these increased exemption amounts after 2025. As a result, the exemption amounts available in 2026 and beyond could be reduced to a level provided under prior law ($5.49 million/single and $10.98 million/couple in 2017, indexed for inflation) absent further action by Congress. In addition, under different rates, rules and exemption amounts (if any), there may be state and local estate, inheritance or gift taxes that apply in your circumstances. Please consult your own tax or legal advisor for advice pertaining to your specific situation. This material includes a discussion of one or more tax related topics. This tax related discussion was prepared to assist in the promotion or marketing of the transactions or matters addressed in this material. It is not intended (and cannot be used by any taxpayer) for the purposes of avoiding any IRS penalties that may be imposed upon the taxpayer. Any third party material in this newsletter represents the views of its respective author and the author is solely responsible for its content. Such views may not necessarily represent the opinions of New York Life Insurance Company or its subsidiary companies. Winstead, PC, is not owned or operated by New York Life Insurance Company or its affiliates. The Nautilus Group® is a service of New York Life Insurance Company. Nautilus, New York Life Insurance Company, its employees or agents are not in the business of providing tax, legal or accounting advice. Individuals should consult with their own tax, legal or accounting advisors before implementing any planning strategies. SMRU 1863541-B Exp. 12/31/2020