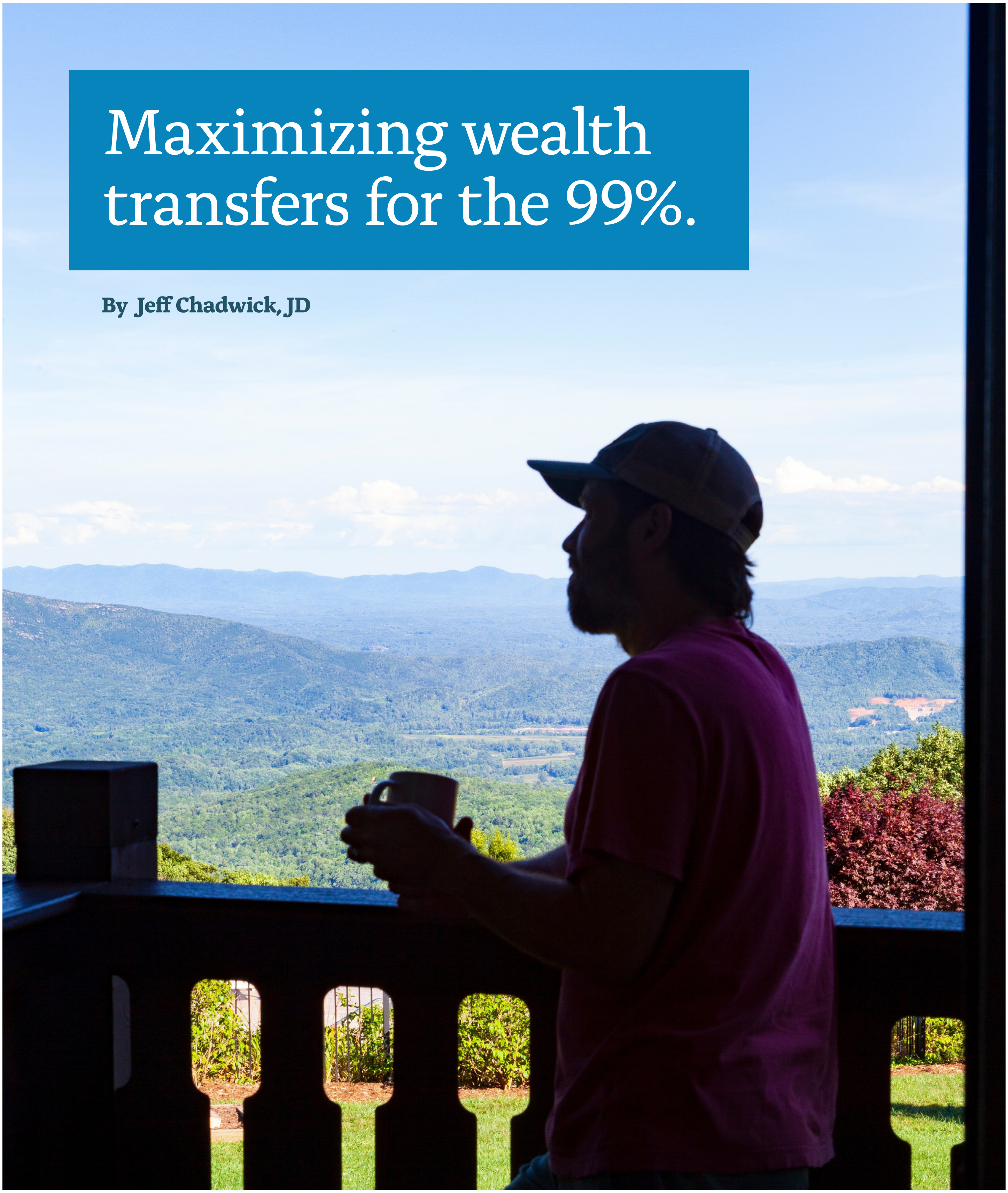
Maximizing wealth transfers for the 99%.

By Jeff Chadwick, JD



As advisors, if we knew when a client would pass away, who would survive them, the assets included in the client's estate, and what the tax laws would be at the time of the client's death, we could all design perfect estate plans. We also could 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, this requires building flexibility into the client's gifting strategy in anticipation of potential changes in the tax laws or the client's family or financial circumstances.

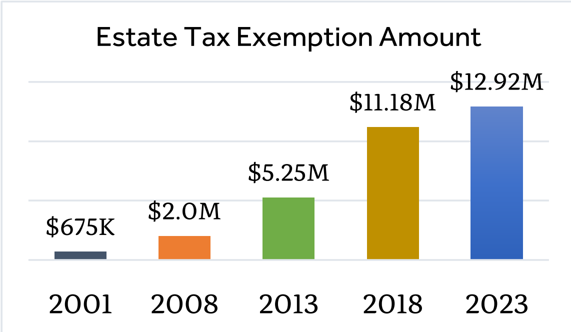
Historically, many wealthy clients made lifetime gifts to minimize federal transfer taxes. With drastic increases to the federal gift and estate tax exemption amount, however, the estate tax is no longer relevant to most taxpayers, and significantly less relevant to the remaining few. So for 99% of taxpayers, it's more important to plan for reducing income tax than for reducing transfer tax.

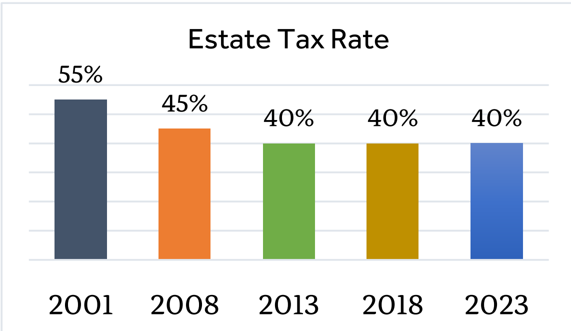
In 2024, the federal gift and estate tax exemption (the "estate exemption") is $13.61 million per person, or $27.22 million per married couple, and the tax rate on the excess is 40%. Although the estate exemption is scheduled to be reduced by 50% in 2026, most taxpayers will still not have an estate tax issue, absent a monumental change in the transfer tax system. The charts on the following page illustrate the diminishing impact of the estate tax.

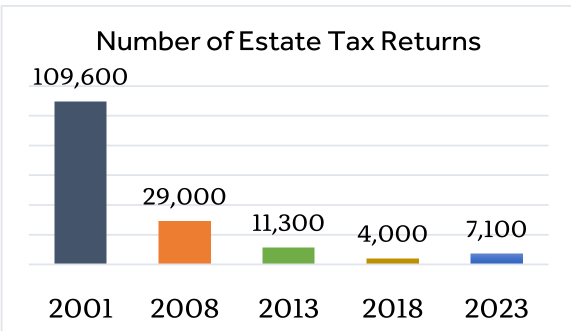
Preliminary gifting considerations

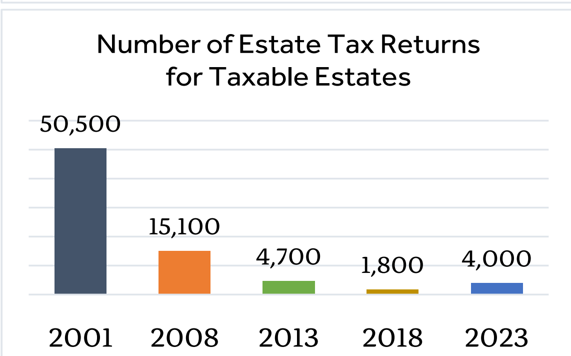
At its core, lifetime gifting begins with a client's basic desire to benefit others. Consequently, careful consideration should first be given to a client's non-tax motivations for gifting, which may include the following:

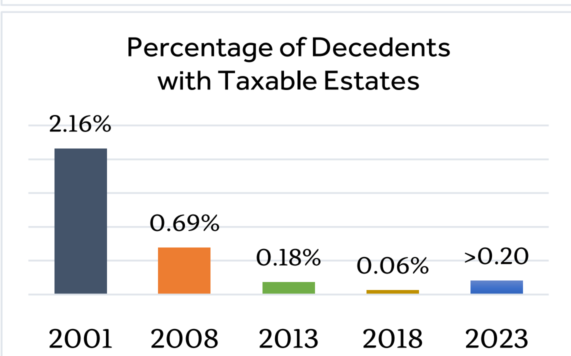
- To satisfy a beneficiary's current health, educational, or other need.
- Beyond basic needs, to permit a beneficiary to enjoy assets or a certain lifestyle now, particularly while the client











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.
- To provide the donor with insight regarding how a beneficiary handles gifted assets.

For charts at left: Numbers are approximate. Estate tax exemption amounts apply to U.S. citizens. The estate tax exemption amount for non-citizens remains at $60,000 per person, not indexed for inflation.

Sources: Internal Revenue Service, *SOI Tax Stats: Estate Tax Year of Death Tables*, available at https://www.irs.gov/statistics/soi-tax-stats-estate-tax-year-of-death-tables

Tax Policy Center, Urban Institute & Brookings Institution, *Key Elements of the U.S. Tax System: How Many People Pay the Estate Tax?*, available at https://www.taxpolicycenter.org/briefing-book/how-many-people-pay-estate-tax

Institute on Taxation and Economic Policy, *The Federal Estate Tax: An Important Progressive Revenue Source*, available at https://itep.org/the-federal-estate-tax-an-important-progressive-revenue-source/.

Once a client expresses a willingness to make a lifetime gift, he or she should consult with a professional advisor, as needed, to help structure the gift to achieve the client's objectives. Below is a non-exhaustive list of preliminary considerations when structuring a 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.
- The assets available to gift, including each asset's fair market value, income tax basis, appreciation potential, and administrative ease.

Making "simple" gifts

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. If appropriate, 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, typically increases transaction costs and adds complexity, which may not be appropriate for smaller gifts or certain clients.

Even if a client makes a gift in trust, instead of outright, most clients still 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. Internal Revenue 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.

Annual gift exclusion

In 2024, a donor may make annual gifts of up to $18,000 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 $36,000, 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. People 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 $90,000 per donor, per donee, or $180,000 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.

Gifting to minimize federal income taxes

To optimize lifetime gifts for income tax purposes, it is important to 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 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% 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 the client's taxable estate before being passed on to family members in the next generation. In this regard, it is important for clients without taxable estates to discuss and consider the following with their advisors:

- 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 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 may consider creating an irrevocable trust for the benefit of a parent and funding 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, at a minimum. 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 original donor (the parent's child) or the donor'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.

Conclusion

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. Before implementing any of the potential planning techniques mentioned above it is imperative a professional advisor is consulted to avoid any unintended tax consequences. A healthy discussion of a client's planning objectives with his or her advisor is key to maximizing wealth transfers for the 99%.

About the author.

Jeff Chadwick, JD, is a shareholder with Winstead, PC, and the chair of the wealth preservation practice group. Jeff focuses his practice on trust and estate planning for business owners, corporate executives, professional athletes, and other high net worth individuals and families. He strives to provide innovative and practical solutions to a wide range of legal matters, including wealth transfer planning, trust and estate administration, business formation and succession, asset protection, charitable giving, and premarital planning. Jeff is board certified in estate planning and probate law by the Texas Board of Legal Specialization.