Taking Advantage of the Increased Estate and Gift Tax Exemption – May 24th, 2019

A common misconception in financial planning is understanding the difference between the estate and gift tax. Simply put, these are taxes on the transfer of property from one individual to another with the main difference being that the estate tax is incurred upon death, while the gift tax is incurred throughout one's lifetime. Both taxes are currently at a rate of 40% and based off what is known as the "lifetime estate and gift tax exemption amount" which is currently at $11.4 million (adjusted for inflation) and set to revert to $5 million in 2026.

Introduction

The lifetime estate and gift tax exemption amount mentioned above is the amount that you are allowed to gift or pass on from your estate without incurring any estate or gift taxes. In addition to this exemption, there are two exclusions that allow for the transfer of property without any tax consequences:

1) Unlimited marital deduction

2) Annual gift tax exclusion amount

The unlimited marital deduction is a provision which allows married couples to transfer an unrestricted amount of property to one another throughout their lifetime or upon the death of the first spouse. Due to this deduction, estate taxes for married couples are deferred until the second spouse's death.

The annual gift tax exclusion amount is currently at $15k per recipient. This means that you can gift up to $15k to as many individuals as you want in any given year without impacting your lifetime exemption amount. However, keep in mind that any dollar over $15k gifted to one person within the same year will be deducted from your lifetime exemption amount.

Tax Cuts and Jobs Act

The 2017 Tax Cuts and Jobs Act (TCJA), which became effective on January 1st, 2018, included many changes to our tax laws which impacted individuals, businesses and tax-exempt entities. One of these changes resulted in a significant increase of the lifetime estate and gift tax exemption amount for individuals mentioned above. Prior to the TCJA becoming effective last year, the lifetime estate and gift tax exemption amount was $5 million per individual (or roughly $5.49 million in 2017 adjusted for inflation). In 2018, the exemption amount doubled to $10 million ($11.2 million adjusted for inflation) and this year increased to $11.4 million per individual or $22.8 million for married couples.

Sunset Provision and Potential Claw-Back

The TCJA includes a "sunset" provision, which means that many of the changes are temporary and therefore subject to potential legislative changes. Without further action by Congress, the changes provided by the TCJA will expire in 2026 and revert to the pre-2018 levels indexed by inflation) by January 1st, 2026.

Initially, there were some questions on whether or not there would be a claw back applied to the lifetime exemption amounts under the TCJA when the sunset provision takes effect in 2026. In essence, this would effectively erase the tax benefits of the higher exemption amount assuming the individual lives past 2026. However, in November of 2018, the IRS clarified that there will NOT be a claw back.[1] Assuming the gifts occurred within the 8 year period between 2018 and 2025, the applicable exemption amount will be based on the higher of the two amounts.

What Does This Mean?

Individuals with large estates can take advantage of the higher lifetime estate and gift tax exemption amount through gifting. To put these benefits into perspective, below we go over an illustrative example:

Mr. Doe is single and worth ***$30mm***. He has not used any of his lifetime exemption amount. He has two options:

1) Mr. Doe does not gift anything throughout his lifetime. He then passes away in 2026 when the TCJA exemption amount sunsets ('sunset provision') and reverts back to ***$5mm***. Upon his death, his estate uses up his exemption amount which brings him to a taxable estate of ***$25mm***. He now owes ***$10mm*** (40%) in estate taxes. His net estate to be passed down to his heirs is ***$20mm***.

2) Mr. Doe decides to take advantage of the higher TCJA exemption amount and gifts ***$10mm*** to his heirs prior to the sunset provision. He then passes away in 2026. Given he used his full exemption amount throughout his lifetime through gifting, Mr. Doe's estate will not have any deductions upon his death bringing his taxable estate to ***$20mm***. Mr. Doe will now owe ***$8mm*** (40%) in estate taxes. His net estate to be passed down to his heirs is now ***$12mm***. In this case, the family would've retained a total of ***$22mm*** from the original estate; ***$12mm*** + the ***$10mm*** he gifted throughout his lifetime.

By utilizing option 2 and taking advantage of the higher lifetime exemption amount provided under the TCJA, Mr. Doe's heirs received an extra ***$2mm***.

[1] Internal Revenue Service, Treasury, "IRS: Making large gifts now won't harm estates after 2025", IR-2018-229, November 20, 2018, https://www.irs.gov/newsroom/treasury-irs-making-large-gifts-now-wont-harm-estates-after-2025.

Review and Take Action

Considering the limited timeframe for taxpayers to take advantage of these changes, we highly encourage you to review your estate plan and gifting strategies with your tax and/or legal advisors to ensure that you take full advantage of the increased lifetime exemption and annual exclusion amounts.

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