LEGAL UPDATES

History and Outlook of the Federal Estate Tax

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At the end of 2025, the federal estate and gift tax exemption will dramatically decrease unless Congress affirmatively passes a law saying otherwise. This event is the "sunsetting" of a 2018 federal tax law and is leading many people to engage in wealth transfer planning now. Understanding the history of the estate tax helps explain the context of this issue as you consider whether to take action on your planning.

The federal estate tax has been around in the United States in one shape or form since 1916. The estate tax (and the interrelated gift tax on lifetime transfers, here referred to collectively as the "estate tax") imposes a tax on the transfer of assets to others by gift. For the last hundred-plus years, the amount that is sheltered from estate taxes (the estate tax "exemption amount", "unified credit", or "applicable exclusion amount") has consistently increased. In fact, that exemption amount has not gone down significantly since it was implemented. However, the current estate tax environment is somewhat uncertain. In 2018, the federal exemption amount was raised to $10,000,000 and indexed annually for inflation; as a result, the 2024 exemption amount is $13,610,000. If Congress does not act before the end of 2025, the federal estate tax exemption will decrease to $5,000,000 (adjusted for inflation). Some believe that if Congress is under Democratic control after the 2024 election, Congress might act to reduce the estate tax exemption even further before 2026.

Recent History of the Estate Tax

This is not the first time in recent history that there is a fiscal cliff or potential significant changes to the estate tax. The history of the tax is somewhat tortuous.

Economic Growth and Tax Relief Reconciliation Act of 2001: In 2001, the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) dramatically changed the landscape of transfer tax (estate, gift, generation-skipping transfer (GST)) planning. As a result of EGTRRA, the estate tax exemption increased from $675,000 in 2001 to $3,500,000 in 2009, the top tax rate reduced from 55% to 45%, and the estate tax and GST tax were repealed in 2010 – for a period of just one year. When this bill was passed, there were not enough votes in Congress to make it a permanent tax cut, so the tax cuts were to sunset at the end of 2010. As

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the deadline approached, we experienced tremendous uncertainty about the future of the federal estate tax because unless Congress acted, the exemption was scheduled to return to 2002 levels in 2011.

Taxpayer Relief Act of 2010: On December 17, 2010, Congress passed the Taxpayer Relief Act of 2010 (TRA 2010). TRA 2010 set the maximum estate tax rate at 35% and set the estate tax exemption at $5,000,000 for 2010, 2011 and 2012, with the exemption indexed for inflation after 2010. Again, because there were not enough votes in Congress to make the tax cut permanent, TRA 2010 was effective until the end of 2012. Thus, if Congress did not act before January 1, 2013, the estate tax exemption and rates would go back to 2002 levels.

Leading up to the expiration of TRA 2010, many wealthy taxpayers decided to lock in the higher estate tax exemption amount of $5,000,000 by making large gifts to "use up" the exemption. This flurry of planning resulted in many families establishing spousal lifetime access trusts (SLATs) and other irrevocable generational trusts. Some families regretted making such large irrevocable gifts, while other families benefitted from this great wealth transfer strategy by sheltering millions of dollars of appreciation on the gifted assets from future estate taxes.

American Taxpayer Relief Act of 2012: At the last minute, Congress passed permanent changes to the estate tax exemption. On January 1, 2013 (after the provisions of TRA 2010 had expired), Congress passed the American Taxpayer Relief Act of 2012 (ATRA 2012) with sufficient support to avoid a sunset on those changes. As a result, the estate tax exemption amount was set at $5,000,000 (indexed for inflation) and the tax rate went from 35% to 40%.

Tax Cuts and Jobs Act of 2017: In 2017, Congress passed a significant increase in the federal gift, GST and estate tax exemptions in the Tax Cuts and Jobs Act (TCJA), which doubled the exemption amount and continued to adjust each year for inflation. For 2024, the exemption amount is $13,610,000. However, with too few votes supporting that bill, these changes are not permanent, and, absent additional legislation, the federal exemption amount will revert to $5,000,000 (adjusted for inflation) in 2026.

Estate Tax: Where We Stand Today

Today is similar to 2012. Although history shows that Congress has consistently raised or maintained the estate tax exemption amount, we cannot count on that occurring again and cannot predict how Congress will address the potential sunset of the TCJA. The exemption level and tax rate have different importance to different elected officials and are sometimes used as political leverage to achieve other Congressional priorities. This could occur again with the estate tax as a bargaining tool—or this tax law could just quietly sunset under the current laws. We don't know what will happen to the estate tax exemption; we only know that the current law has the exemption reverting to $5,000,000 (adjusted for inflation) at the end of 2025.

Given the uncertainty, many people are debating whether to make gifts to "use up" the current higher estate tax exemption amount before the end of 2025. Many factors affect this decision, but a primary consideration should be whether irrevocably gifting the exemption amount will cause financial hardship for the donors. Another consideration is whether the donor will regret making large irrevocable gifts if Congress ultimately keeps the higher estate tax exemption. On the other hand, if making gifts is a good strategy for the donor regardless of whether the higher exemption is extended, then it may make sense to make the large gift now, with the benefit of excluding future appreciation from the donor's estate and using today's higher exemption amount should Congress lower it for 2026.

If Congress acts to retain the higher estate tax exemption amount, it is not likely to happen in the first part of 2025. If history is any indication of the future, any changes will happen in the latter part of 2025. As a result, donors should consider using the exemption well before the end of 2025. As the end of 2025 approaches, it will be increasingly difficult to complete complex trust and transfer transactions; many financial institutions will have cut-off dates for transfers early in December or even earlier for special assets like private equity investments, and lawyers and accountants may not be available for new projects in the fourth quarter of 2025 given the anticipated volume of planning that the Congressional uncertainty will yield.

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Planning for changes in the estate tax exemption requires careful timing and structuring of legal and tax strategies. If you are thinking about making a large gift to use the federal exemption amount, you should act as soon as possible—and well before the end of 2025. To discuss whether estate tax exemption planning makes sense for you and your family and to implement any planning, please contact a member of the Lathrop GPM Private Client Services team.