Estate Tax Sunset Encourages Strategic Asset Retitling

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Current tax laws provide historically high exclusion amounts for the federal estate and generation skipping transfer tax. These exclusion amounts, however, are slated to sunset by roughly 50% at the end of 2025. If planning to use your exemption is consistent with your estate planning goals, doing so may require the careful retitling of assets now.

Introduction

Under 2023 tax laws, each U.S. citizen or permanent resident has $12.92 million federal estate tax and generation-skipping transfer (GST) tax exclusion amounts[1]. These are reduced by lifetime taxable gifts and lifetime allocations of the GST tax exclusion to transfers. The federal exclusion amounts will be adjusted to $13.61 million in 2024 and will grow further in 2025. However, the extraordinarily large federal exclusion amounts we currently have may soon disappear. Unless Congress acts, the sunsetting of the Tax Cuts and Jobs Act of 2017 in 2026 will cause a roughly 50% reduction of federal exclusion amounts as they are scheduled to go back down to $5 million adjusted for inflation.

Further, while the federal estate tax exclusion is portable - meaning that a surviving spouse can use their deceased spouse's remaining exclusion if it was not fully utilized -the GST tax exclusion and most state estate tax exemptions are not. This may pose problems for married couples if the first spouse to die has assets insufficient to take advantage of these exclusions. To maximize tax savings, taxpayers may want to lock in the current high levels of federal tax exclusions to increase the probability that their state and GST tax exclusions will be fully utilized regardless of the timing of deaths. One strategy - asset retitling - may facilitate both completion of these goals and provide other benefits aside.

Retitling: Quantity and Nature of Assets

If you are married, taking full advantage of your state estate tax exclusion and GST exclusion amounts requires that each spouse has sufficient assets to fund the applicable exclusion amounts. High net worth married couples who intend to make use of the GST and state estate tax exclusions may need substantial retitling to achieve optimal utilization of all of the available exclusions. In addition to ensuring each spouse has an appropriate amount of assets to utilize all exclusions, it is important that each spouse hold diversified

assets, if possible. In most circumstances, a mix of liquid and illiquid assets is best.

Timing of Asset Retitling

Timing is a thorny issue in estate planning as one can never be certain when death will occur. Accordingly, prudence dictates starting the asset retitling process as soon as practicable. This will ensure the ability to use both spouses' exclusions in the event of a death. It will also allow a couple to potentially use the higher federal exclusion amounts before the law sunsets.

Further, waiting until the last minute to retitle assets and then attempting to lock in the current exclusion by gifting may provoke an IRS challenge. Under the "step transaction doctrine," the IRS may ignore a series of transactions despite it consisting of numerous steps. For example, imagine Spouse 1 operates a successful small business while Spouse 2 is a full-time homemaker. To accomplish locking in the exclusion amounts, Spouse 1 may seek to transfer assets to Spouse 2 so Spouse 2 can use his or her exemption. If shortly after the transfer Spouse 2 creates a trust to benefit Spouse 1 and descendants to lock in the exclusion amounts before they sunset, the IRS might use the step transaction doctrine to unravel this plan and instead treat the transfer as if Spouse 1 had made a direct gift to the trust. If Spouse 1 is deemed to have made the gift, it could result in gift tax if Spouse 1 also used his or her exclusions on other transfers.

There is no amount of time that will definitively prevent the IRS from attempting to apply this doctrine. The IRS has applied it with a five-year gap between the first and subsequent steps. On the other hand, taxpayers have also defeated this theory as applied to steps with a much smaller gap of time. The focus is typically on if there was a shift in economic risk from one party to the other. As a general matter, it is safest to perform steps in separate tax years. For example, if a couple both wanted to establish spousal limited access trusts for each other, tax year 2024 may see the monied spouse retitling assets to the non-monied spouse and setting up a trust for the benefit of that spouse, while tax year 2025 may involve the spouse that had fewer assets before the 2024 transfer setting up a trust for the benefit of the monied spouse.

Between the step transaction doctrine and the impending sunset of the Tax Cuts and Jobs Act, prompt attention to this issue is required to achieve favorable tax outcomes.

Use of Retitled Assets: Spousal Limited Access Trusts

While retitling to lock in historically high exclusion amounts can be prudent tax planning, some may be wary of losing access to significant assets during their lifetime. One common solution to this problem is the establishment of spousal limited access trusts (SLATs), in which assets are transferred to a trust that does not qualify for the unlimited marital deduction but has the spouse as the beneficiary. The transfer locks in the use of the exclusion, but the terms of the trust provide lifetime support to the other spouse. This structure can allow both spouses to utilize their exclusion amounts and achieve favorable tax planning without unduly

disrupting the other financial goals and preferences of the transferring spouse.

If both spouses are establishing SLATs, it is important that the trusts be drafted in a way to avoid the reciprocal trust doctrine. If the two SLATs are too similar, the IRS will collapse the two trusts to include them in both spouses' estates because neither spouse is in a different economic position after the transfer. To avoid that, each trust needs to have substantially different distribution terms. An even better strategy to avoid the reciprocal trust doctrine is having one spouse set up a trust as a SLAT and the other spouse set up a trust solely for the benefit of descendants.

Ancillary Benefits of Asset Retitling

Asset retitling may also provide the benefit of asset protection as long as the primary goal is estate balancing to take advantage of both spouses' exclusion amounts. This is particularly beneficial where a spouse operates a business. While businesses can generate substantial wealth, they also expose owners to greater liability. Properly executed asset transfers to an individual with lower levels of risk can shelter the assets from liability so long as the transfer occurs before there are pending claims against the transferor and if the primary purpose behind the retitling is tax planning and not asset protection.

Conclusion

Planning for the efficient use of estate tax exclusion amounts requires careful timing and drafting. However, if executed correctly, asset retitling can facilitate massive tax savings and other incidental benefits. If you have any questions about asset retitling and strategic estate planning, please reach out to anyone on the Lathrop GPM Trusts, Estates & Legacy Planning team.

[1] The exclusion amounts are actually $10 million, but they are adjusted for inflation annually.