

RESOURCES

The Estate Tax Exemption May Go Down Drastically (Either Immediately or in a Few Years) - Should You Take Action Now to Reduce a Potential Estate Tax?

In the past, the amount that a person could transfer exempt from the estate tax at his or her death was fairly steady for many years. Starting around 2002, the exemption started increasing at a faster rate, going to \$5 million in 2011 and then doubling in 2018. The exemption amount currently sits at \$11.58 million per person and is slated to go to \$11.7 million in 2021.

The exemption has never been reduced in the history of the tax, although we came close a couple of times (remember the “fiscal cliff” days?). We are currently faced with a short-term and longer-term potential reduction of the exemption:

- a. The short-term potential change, which could swing the estate tax exemption dramatically, depends on the final outcome of the election, *e.*, if the Democratic party controls the White House and Congress. Biden has expressed a desire to change the estate tax law and rates back to 2009 levels: a \$3.5 million estate tax exemption (and \$1 million gift tax exemption). Moreover, there is some concern that a Congress controlled by the Democratic party might try to make a new tax bill retroactive to January 1, 2021.
- b. The long-term potential change is that the 2017 law that doubled the exemption to the current level of \$11.58 million is subject to a “sunset” provision, such that if Congress does not make the law permanent, then at the end of 2025, the estate tax exemption will automatically revert back to 2017 levels: a base exemption of \$5 million, adjusted for inflation.

If the estate tax exemption is reduced, there are at least two potential negative consequences from inaction:

First, lifetime gifts to family members or trusts for their benefit remove future appreciation on the gifted assets from the gift-maker’s estate. If such gifts are made before appreciation occurs, doing so might either avoid the estate tax or reduce what it would be without the gift. Thus, not acting before the assets appreciate could result in unfavorable estate tax consequences.

Second, there is a “use it or lose it” opportunity for high net worth families. When the exemption was increased substantially, there was understandably a question of what would happen if someone used up their exemption during their lifetime, but by the time of their death the exemption was much lower (*e.g.*, the exemption amount was \$11 million at the time of the gift, but had been reduced to \$5.5 million when the person died). The question was answered in 2018 regulations, which provided that there would be no “clawback” in such a situation. As an explanation, consider the following hypothetical:

- i. Couple A has a \$28 million estate. Assume an estate tax exemption of \$11.5 million per person. The couple gives away \$23 million to trusts for family members (which under certain circumstances could include one or both spouses). Thus, they used up all of their exemptions during their lifetimes. Then, assume that by the time they pass away, the exemption has dropped to \$3.5 million. In this example, only Couple A’s remaining \$5 million – and not the \$23 million they gifted during their lifetimes – will be subject to estate tax. Assuming a hypothetical 50% tax rate, then their estate would be subject to \$2.5 million in estate tax.
- ii. Consider, on the other hand, Couple B who also has a \$28 million estate, but took no action when the exemption

was \$11.5 million and dies with a \$28 million estate when the exemption has dropped to \$3.5 million. In that case, they would each have a \$3.5 million exemption for a total of \$7 million. Thus, the excess of \$21 million would be subject to a 50% estate tax, or \$10.5 million.

While we do stress the importance of considering making gifts sooner rather than later, we also realize that the uncertainty of the future gives people pause, both as to the future changes to tax laws, as well as the future value of someone's estate and their future needs for assets and income. One increasingly popular technique that provides flexibility in light of these uncertainties is a Spousal Lifetime Access Trust (or "SLAT"). As its name indicates, a SLAT is an irrevocable trust that benefits the spouse of the donor for his or her lifetime. A gift to a SLAT gets the value of assets transferred to the SLAT out of the donor's estate now (therefore using up the exemption before it is reduced and/or shielding future appreciation of the assets from the estate tax). Simultaneously, the SLAT provides continued benefits to the spouse from the gifted assets. There are a number of issues to consider and address before determining whether a SLAT is an appropriate technique in any particular situation, but it might be a good choice in light of today's uncertain environment. In addition to the SLAT, there are many other strategies to reduce or even eliminate the impact of the estate tax, including using lifetime transfers, charitable planning and the use of life insurance.

There is an additional, very important consideration for individuals thinking about making gifts of family business interests. Many of these family businesses borrowed money under the SBA PPP loan program and are hopeful to have those loans forgiven in the near future. The SBA recently released rules providing that transfers of more than 20% of the ownership interests in a PPP borrower require lender and/or SBA consent before the transfer. Failure to receive consent in advance could constitute a default of the PPP loan and result in rejection of the PPP borrower's forgiveness application. Thus, if an interest in a family business that has an outstanding PPP loan is one of the assets that an individual is considering giving away, then consent may be required before making the gift.

If you or someone you know might be affected by a reduction of the estate tax exemption, then action should be taken as soon as possible. We don't know whether exemptions could be reduced as early as January 1, 2021, so individuals should not put off assessing whether planning is needed. Carruthers & Roth is here to advise and assist our clients in making the best decisions possible during these uncertain times. Please contact Greg Williams if you have any questions or would like to discuss your particular situation.

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