Fairhaven Whitepaper

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Gift and Estate Tax Planning in 2021

With a new White House administration and Democratic control of Congress, there are potential estate and gift tax changes being discussed that could have a meaningful impact on your existing estate plans.

As the law currently exists, each individual has a lifetime credit of $11.7 million — this figure is increased by inflation from 2020's limitation of $11.58 million. The current exemption will sunset on Dec. 31, 2025, and will return to the previous exemption of $5 million, adjusted for inflation. The adjusted exemption in 2026 is projected to be between $6 million and $7 million. The maximum gift and estate tax rate is 40% and will increase to 45% in 2026. The tax is imposed on the fair market value of all assets valued at death. Beneficiaries receive a step-up in basis to the fair market value — all capital gains are eliminated.

Current proposals being discussed include:

1. Reducing lifetime exemption to $3.5 million
2. Increasing rate to 45%
3. Eliminating step-up in basis to fair market value on death

The Fairhaven Solution

In order to reduce your taxable estate, you may want to consider different gifting strategies. The sooner you remove assets from your estate, the more likely it is your estate will not be subject to estate tax. Since the gifts are irrevocable, a donor needs to be sure their remaining assets will be sufficient to live off. Here are some options to consider if the current exemption is reduced:

1. **Direct gift of cash –** Everyone can give up to $15,000 a year to any beneficiary with no gift tax implications. This does not count toward your lifetime exemption discussed above. Giving more than $15,000 will go against your exemption and immediately remove assets from your taxable estate. This gives your beneficiaries maximum flexibility and control over the assets.

2. **Direct gift of securities –** This has similar tax considerations as gifts of cash. In this case, the cost basis and holding period of the securities will transfer to the beneficiary. They would then incur any capital gain taxes upon sale. The beneficiaries still retain maximum control over the assets.

3. **Gifts to 529 Plan Accounts -** A gift to a 529 plan account for the educational needs of a child or grandchild may be an option. A transferor can pre-fund up to five years of annual exclusion gifts (currently $15,000/year) in a single year per beneficiary (i.e., $75,000 in 2021). A married couple can fund up to $150,000 to a beneficiary in one year. This planning option would "use up" five years of annual exclusion gifts for that beneficiary.

4. **Gift to Irrevocable Trust –** This can be done with cash or securities. The advantage to this is the donor can control how and when the beneficiaries get access to the assets. This is more complex as it involves establishing a trust, which may need to file its own tax return. The holding period and cost basis of securities would transfer along with the gift as well. All future appreciation of the assets is excluded from the estate as well. A donor has different options for this strategy.

    a. <u>Irrevocable Life Insurance Trust</u> – You either transfer an existing life insurance policy to a trust or purchase a new life policy through the trust. All premium payments are paid by the trust and are gifts to the trust each year. Because the policy

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is owned by the trust, the eventual death benefit is excluded from the taxable estate.

b. **Intentionally Defective Grantor Trust (IDGT)** – In this case, the grantor creates a trust that is outside of their estate for estate tax purposes, but the grantor is still treated as the owner of the trust for income tax purposes. By continuing to pay the income tax on the trust, the assets in the estate are further reduced and the beneficiaries retain the full amount of the trust (plus appreciation).

c. **Spousal Lifetime Access Trust (SLAT)** – This is a version of the IDGT discussed above. A SLAT is an irrevocable trust created by one spouse to benefit the other spouse (and potentially other family members), while still removing the assets from their estate. The trust must be structured in a specific way, as the non-donor spouse can only have limited access to income and principal. However, this technique can alleviate concerns about whether the gifted assets will be needed in the future. Most attorneys recommend that the non-donor spouse not request distributions unless it is necessary, after exhausting other available resources.

Elimination of Step-Up in Basis

Another possible policy change includes the elimination of the basis "step up" at death, which has the potential to affect more taxpayers than the reduction of the tax exemptions. For decades, assets have been valued at the time of the owner's death, even if the value had increased or appreciated. For example, if your mother bought a stock for $50,000, but at the time of her death the stock is worth $200,000, the gain on that stock is $150,000. However, that gain is wiped out when that asset is passed on to her heirs because the basis has "stepped up" to $200,000. Thus, no capital gains tax is owed.

If this rule is eliminated, it can potentially cause significant tax consequences for people inheriting highly appreciated assets. In this case, individuals should look at their entire financial portfolio and strategize about which assets might benefit from being put into a trust. Assets with a greater embedded capital gain could be placed in the trust while other assets, like cash, could be gifted now or otherwise left directly to heirs. This could potentially help minimize the capital gains tax their heirs would pay.

Be Proactive

We will be monitoring the events in Washington as these proposals get put into new potential legislation. In the meantime, it is never too soon to discuss potential gifting strategies with your advisor. If you wait until after the legislation is passed, you could miss out on future tax savings.

About Fairhaven

Fairhaven Wealth Management is an independent, privately owned investment and wealth management firm serving select families and small to mid-sized businesses. At Fairhaven, our commitment is simple – we exist to serve our clients…period. Our culture of service and accountability combined with prudent risk management and tax-efficiency are the cornerstones of our client commitment. www.fairhavenwealth.com

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