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Trust UPDATE

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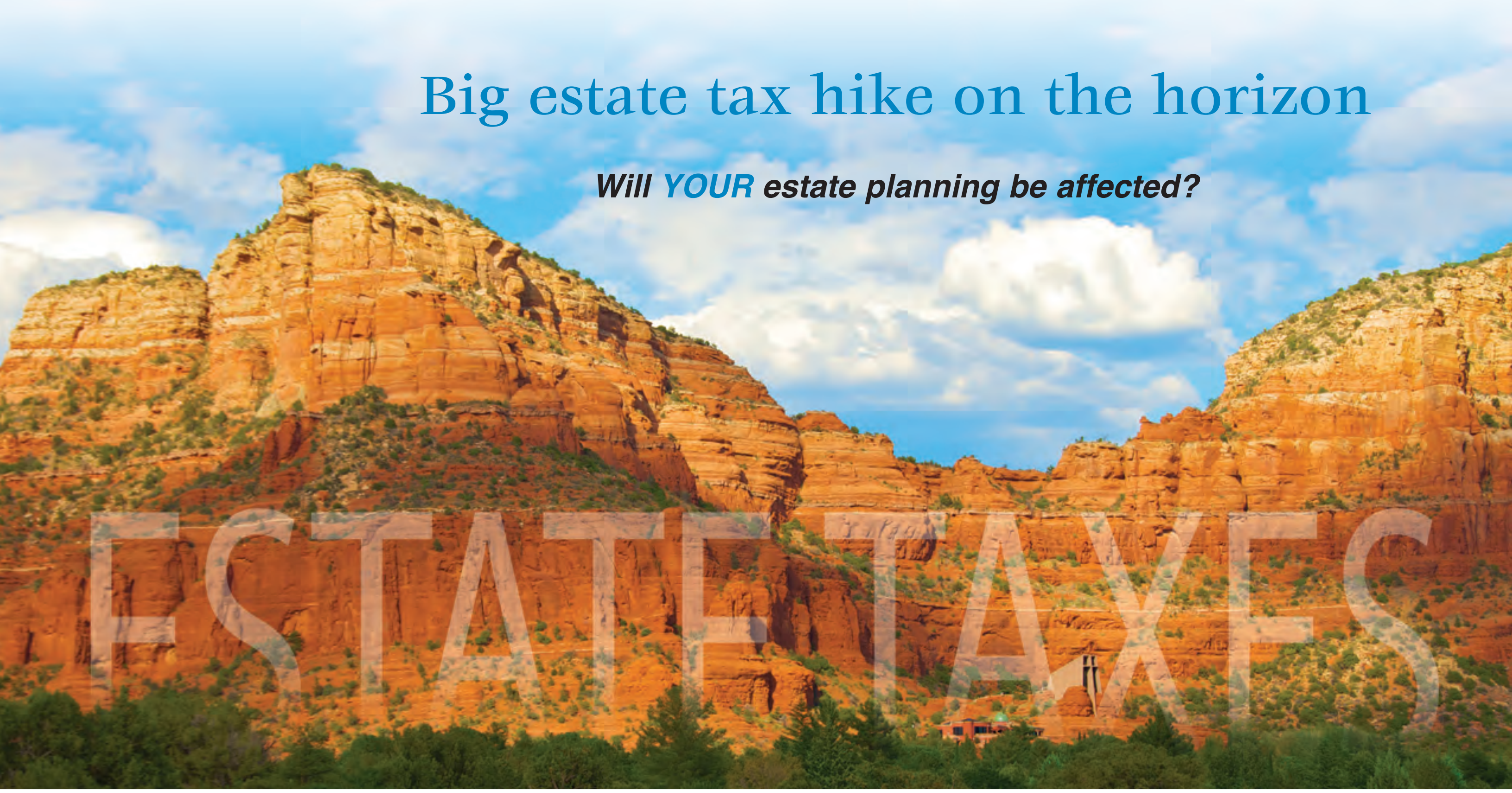
Big estate tax hike on the horizon

Will YOUR estate planning be affected?



On three occasions, Congress has legislated a temporary increase in the amount exempt from federal estate and gift taxes. Such increases were made temporary to reduce the projected loss of revenue from the tax change. In 2009, the exempt amount reached $3.5 million, and 2010 was the year without any federal estate tax at all. Under the prior law, the exempt amount was scheduled to fall to $1.0 million in 2011, but just before the change was to occur, Congress instead *increased* the exempt amount to $5.0 million.

However, that new exempt amount was itself also temporary, scheduled to expire after only two years. The temporary nature of this change led to many estate planners recommending strategies to "lock in" the larger transfer tax exemption while it remained available. As it turned out, Congress did *not* allow the exemption to fall after all, but instead made the $5.0 million transfer tax exemption permanent, and added inflation indexing for good measure.

The third occasion was the doubling of the estate and gift tax exemption in the 2017 Tax Cuts and Jobs Act. The exemption stands at $13.61 million for 2024 decedents, and it seems likely to exceed $14 million in 2025. Then, in 2026, under current law, the exempt amount will be cut roughly in half to about $7 million.

Is locking in the larger exemption now a good idea? Who should consider exploring that strategy?

Not for the small estates

Those with a projected estate of less than $7 million will remain free of federal estate tax obligations under current law, even if the scheduled reduction in the exemption does occur. Estate planners Beth Shapiro Kaufman and Meghan Muncey Federman argued that those with estates in the $15 million to $20 million range also are not good candidates ["Sunsetting Gift Tax Exemption Is No Reason for a Large Donation," Bloomberg Tax]. The reason is that

Continued on next page

in making lifetime transfers, one first uses any available deceased spousal unused exemption (DSUE), then one's basic exemption, and only then will additional transfers lock in the "bonus" exempt amount.

As an example, the authors offer a married couple with $15 million in assets. To obtain the desired lock-in, they will have to transfer about $14 million worth of their wealth, leaving them with just $1 million. That does not sound reasonable, especially given that even if the sunset of the larger exemption occurs, they will each still have a $7 million exemption to work with.

What if the couple has $25 million? At this level, the strategy may make better financial sense, but how many couples are willing to part with 60% of their wealth immediately for a speculative future estate tax savings after their deaths?

The widow

The authors also explore the case of a widow, late 80s, with an estate of $20 million, who is willing to make a transfer of $10 million to her heirs. The woman has a DSUE of $6 million from the death of her husband. Should the $10 million transfer go forward, the first $6 million avoids federal gift tax thanks to the DSUE, and the next $4 million is protected by the woman's own basic exemption. Nothing has been locked in, and it won't be until she makes gifts of roughly an additional $3.6 million.

The other tax consideration here is that the gifted assets do not get a basis step-up. If there has been substantial appreciation in value, the heirs will get a hefty capital gains tax exposure along with the gift. The basis step-up occurs only if the widow holds the assets until death.

Large estate

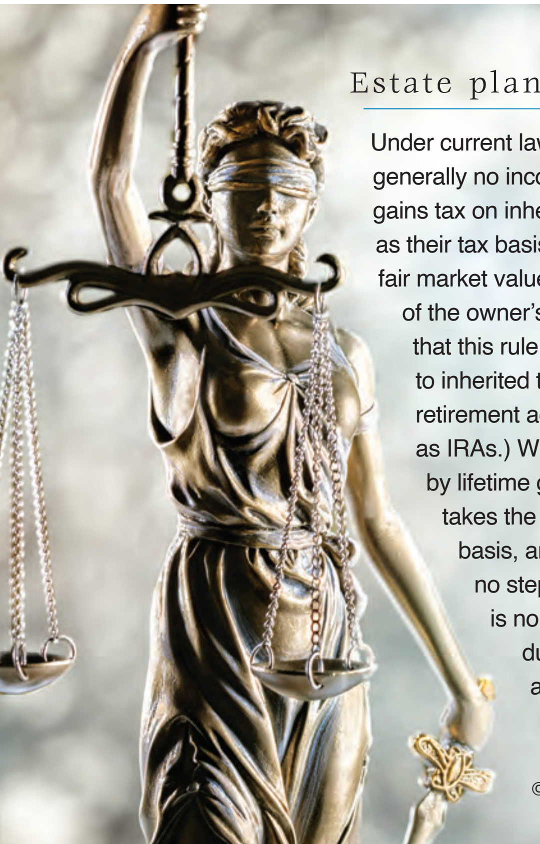
Now assume that a single person has a $60 million estate, so that a transfer of $14 million to lock in the tax savings is reasonable. The potential tax savings is 40% of the locked-in $7 million exemption amount, that is, $2.8 million. For some clients, the tax benefits may seem small compared to the assets they are gifting to obtain it. On the other hand, a program of transferring family wealth during life may already be part of a wealth management plan. In that case, locking in $2.8 million in tax savings may be most welcome.

Prospects

There will be a robust debate about extending the 2017 tax changes affecting individual taxpayers, which are scheduled to expire in 2026. Some of these changes helped lower- and middle-income taxpayers—such as the doubled standard deduction—so extension of some elements seems likely. Historically, the amount exempt from federal estate tax has only gone up, never down. At the same time, however, there is agitation in some quarters to increase the tax burden on the wealthiest, and the federal deficit has grown significantly because of higher interest rates for servicing the national debt. Estate taxes are an inefficient means of revenue collection, given the wide variety of strategies available to reduce or eliminate them. Nevertheless, there may be strong support for letting the larger transfer tax exemption sunset, or perhaps even reducing it further.

To learn more

To discuss your investment or wealth management concerns with one of our trust officers, please call to arrange for an appointment at your convenience. ☐



Estate planning for capital gains

Under current law, there is generally no income or capital gains tax on inherited assets, as their tax basis becomes fair market value on the date of the owner's death. (Note that this rule does *not* apply to inherited tax-favored retirement accounts, such as IRAs.) With a transfer by lifetime gift, the donee takes the donor's tax basis, and there is no step-up. There is no income tax due until the gift asset is sold, and then usually at long-term capital gain tax rates. Accordingly, estate planners may recommend holding substantially appreciated assets until death, so as to secure that tax-free basis step-up. This advice may be especially appropriate for those with estates that are smaller than the estate tax threshold.

President Biden's budget proposal for 2025 calls for a radical change in the income taxation of appreciated property transfers. Transfers of appreciated property at death or by gift will be deemed realization events, requiring the payment of taxes on the capital gains, even though without an actual sale there will be no cash to pay the tax. An exception is provided for transfers to spouses, and the first $5 million worth of appreciation would be excluded from the new tax rule. Additional complicated rules would apply to transfers to trusts and to the assets held by trusts.

Therefore, this is an issue that estate planners are watching closely. With the Congress closely divided, it is unlikely that any tax increases will be enacted during an election year. On the other hand, the growing federal deficit needs attention, and tax increases on "the rich" may be inevitable next year.

ESTATE PLANNING for SMALL BUSINESSES JUST GOT TRICKIER

Every closely held business must have an answer for two questions. First, what will happen to shares of an owner when the owner dies? Either the shares are purchased by other owners of the business, or the business itself acquires the shares through a stock redemption. A buy-sell agreement will typically be used to establish the plan, including a formula or method for valuing the shares of the company. Second question: How will that purchase be funded? Using life insurance to fund a stock redemption by a business has long been a routine estate planning and business succession strategy.

That was the approach used by brothers Michael and Thomas Connelly, the co-owners of Crown C Supply. For estate planning purposes, the brothers executed a buy-sell agreement, requiring the company to redeem the shares owned by the first one to die. The company was not cash rich, so life insurance was purchased to be able to meet the obligation.

Michael died in 2013, when the company was worth about $3.3 million. Pursuant to the buy-sell, $3.0 million of the $3.5 million in life insurance proceeds were paid to redeem Michael's stock, and a federal estate tax was paid. The IRS audited Michael's estate tax return, and it determined an additional $1.0 million was due. Thomas, as the executor, paid the tax and went to the District Court for a refund.

The essential question is whether the $3.5 million of insurance proceeds is included in the value of the family-owned business, doubling its taxable value, and whether the value is reduced by the obligation to redeem the shares from Michael's estate.

The U.S. Supreme Court speaks

In a unanimous June decision, the U.S. Supreme Court held that the insurance proceeds were owned by the company, and so boosted its value for purposes of the federal estate tax [Connelly v. U.S., June 6, 2024]. What's more, the obligation to redeem the shares from the estate of the deceased owner did not create an offset, because paying for the redemption did not reduce the value of the company to the surviving shareholder. In short, it was a complete loss for the taxpayer.

Next steps

Now that life insurance purchased by a company to provide funding for a redemption obligation will be subjected to the federal estate tax, much more insurance will need to be purchased to obtain liquidity for both the redemption and the tax payments. An alternative to consider that reduces the problem could be cross-purchase agreements, in which each partner owns insurance on the others, rather than have the company own it. In fact, the Court mentioned that strategy, and the fact that it would have had different tax consequences. Because the insurance would not be owned by the company, it would not boost the company's taxable value. But for businesses with more than three owners, this approach becomes unwieldy.

Owners of small businesses will want to schedule an early meeting with their estate planning advisors. Buy-sell agreements may need to be amended, and if life insurance is part of the arrangement, it may need a review. Increased estate tax exposure is not the only potential tax issue presented by the Court's decision. Important questions regarding basis consistency will need to be addressed, even with smaller businesses not large enough to trigger federal estate tax. State death tax implications will also require a review, as such taxes typically begin at much lower wealth levels than do the federal transfer taxes. ☐

A troubling projection

In June, the nonpartisan Congressional Budget Office (CBO) released a new forecast of revenue and expense for the federal government for the next decade. The trendlines are unsettling.

Taxes. Individual income taxes surged to a record high of $2.6 trillion in 2022, largely because of payment of taxes on capital gains. They are projected to fall to $2.4 trillion this year. Looking ahead, CBO sees 4% annual growth in individual income tax collections, unless the provisions of the 2017 Tax Cuts and Jobs Act are allowed to expire in 2026. In that event, individual taxes will jump 11% in 2026 and another 10% in 2027.

Federal estate and gift taxes are estimated to raise $32 billion in 2024. That may sound like a big number, but it is only 1.23% of the amount raised by the income tax. If the amount exempt from estate and gift tax falls roughly in half in 2026, as required under current law, these taxes will only raise an additional $12.8 billion in 2027.

Corporate income tax collections, running at roughly $500 billion annually, won't be directly affected by the sunset provisions of the 2017 legislation.

From 1974 to 2023, federal revenue as a percentage of Gross Domestic Product averaged 17.3%. In 2024, that figure is projected to be 17.2%, nearly the average. It jumps to 18.0% by 2034 if the various tax provisions expire in 2026, as current law requires.

Spending. The projected deficit for 2024 was increased by 25% since an earlier report issued in February. The new report pegs this year's federal deficit at $2 trillion, even though tax receipts are growing, because spending is growing even faster. Four factors account for some 80% of this increase, according to the CBO: White House revisions and a proposed rule regarding student loans, not recouping deposit insurance payments made by failed banks, legislation, and unexpected growth in Medicare payments.

Most of the growth in spending is categorized as "mandatory," that is, not requiring appropriations from Congress, such as Medicare, Social Security benefit payments, and interest on the national debt. Interest payments have risen dramatically with the rise in interest rates by the Fed to bring inflation under control. In fact, the CBO states that "Beginning in 2025, interest costs are greater in relation to GDP than at any point since at least 1940 … and exceed outlays for defense and outlays for nondefense programs and activities." Interest payments will be one-sixth of all federal spending by 2034.

Federal debt held by the public amounts to 99% of GDP in 2024, and is projected to rise to 122% of GDP by 2034. In making these projections, CBO assumes a steady economic growth rate of 2% and moderating inflation. There is no prediction of any recession, which would likely lower tax collections while boosting spending further. In other words, the CBO is presenting a best-case scenario. ☐