

## **McSwiney & Wood Law Firm P.C. Spring 2021 Newsletter**

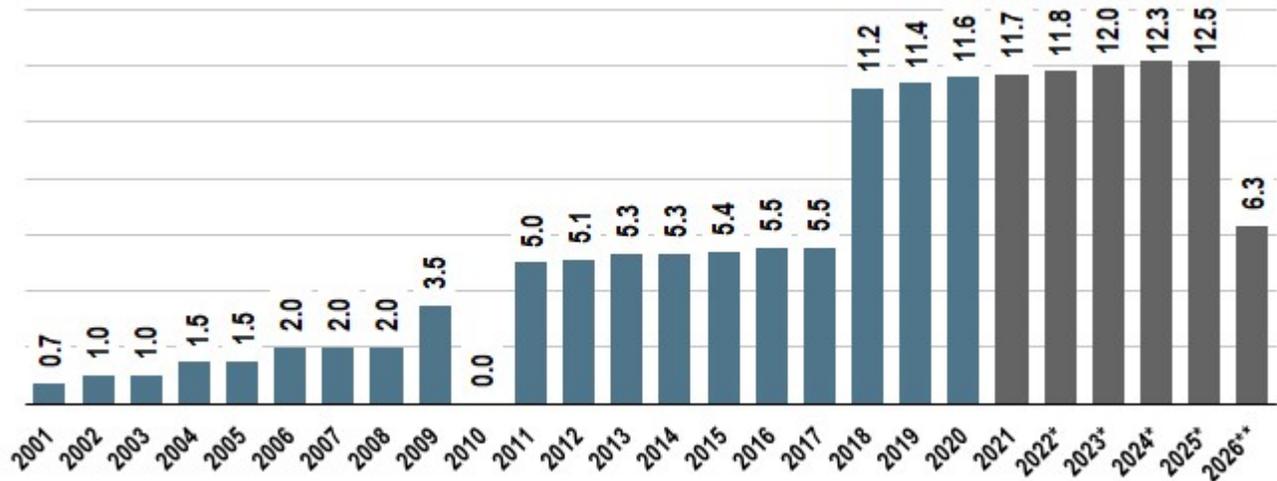
Federal gift and estate tax exemptions are currently at the highest levels since these methods of taxation were created in 1916. This means that this is the best opportunity in over a century to pass more of your estate onto your heirs. Any amount that is over the exemption is taxed at 40%. In 2021, an individual can give away up to \$11.7 million in assets during their lifetime or following their death without being at risk of paying the federal gift or estate tax. A married couple can give away double that amount, \$23.4 million dollars of assets to their beneficiaries.

### **Why Give Away Your Assets Now?**

In 2026, the gift and estate tax exemption is scheduled to be cut by nearly 50%. However, this could change before then, as President Biden will propose increasing taxes to pay for the country's debt, the 2021 Stimulus Package, and the Infrastructure Bill. Though less likely, Congress could also scale back or get rid of estate planning techniques that leverage the exemption amount or impose additional taxes on top of the existing federal estate tax.

### **Should You Use the Current Exemption to Make Gifts in 2021 or Wait and Risk Losing it?**

The chart listed below shows the tax exemption amounts trends over the past two decades and a projection of what it may look like in the next five years. Since 2010, where the federal estate tax was repealed for that year, the exemption amount has been trending upward. The most drastic increase was between 2017 and 2018 when the Tax Cuts and Jobs Act was passed. This trend of modest increase is why experts think Congress will act to break the cycle and roll back the exemption amount. Various legislative proposals have been introduced to eliminate the entire exemption altogether, adjusting it back to the rates seen in 2009 or 2017. The estate tax rate could potentially increase from 40% to somewhere between 45% and 77% if these proposals are successful.



Source: The IRS

Additional proposals from Congress that would ignore revising the federal estate tax exemption or, in addition to revising it include:

- Repeal of the “step-up” of income (Capital Gains) tax basis for a property that transfers at death.
- Shift to an inheritance tax system, which would require heirs to pay tax on assets they receive.
- Impose a “deemed realization” of capital gains at death, meaning capital gains tax would apply to assets when they transfer at death.

### Who Should Gift in 2021?

If you think that your estate and assets could exceed the federal gift and tax exemption in future years, now is the time to consider gifting. For those who have large estates and are presently above the current exemption, you could save more than \$4 million in estate tax simply by making lifetime gifts before the exemption amount is reduced. Therefore, if your estate is subject to the estate tax, the main challenge in the short-term will be deciding how much to give away without jeopardizing your own financial future. Here are the steps to consider before gifting...

#### 1. Set Aside What You Need:

First, determine how much money you and your spouse will need to live comfortably for the rest of your life. Make a list of the assets you or your loved ones will need in the future, and the ones you are willing to transfer soon. Set aside assets you are not ready to give up just yet, such as electronics, antiques, or an art collection. Also consider holding onto assets that

could be difficult and expensive to transfer, such as retirement account assets that trigger income taxes and private investments with illiquid investments.

## **2. Decide How Much You Want to Give Away:**

The next step is to determine what assets should be given away to minimize or avoid the 40% federal estate tax. If you already used up most of your federal gift and tax exemption amount, it should be easy to pinpoint the possible tax benefits of lifetime gifting. An example of this is when you and your spouse have a \$50 million dollar estate and have already gifted \$20 million dollars of your exemption, you would have \$3.4 million of the exemption amount left (\$23.4 million exemption minus \$20 million gifts you have made).

The question then becomes: Can you afford to give the remaining \$3.4 million and still live comfortably? If the answer is yes, your estate could possibly save \$1 million in tax payments.

In this instance, the question becomes whether you should give away \$23.4 million to take advantage of the entire exemption amount. Gifting can offer tax benefits that have nothing relating to the estate tax exemption amount. An example is your gift might shift the appreciation of certain assets and capital gains taxes to your beneficiaries, or you can take advantage of some estate-planning techniques that could soon be eliminated by Congress. If your estate is currently valued at less than \$10 million, giving away assets this year can help you take advantage of record-high exemption amounts for the federal gift and estate tax.

## **3. Consider Placing Gifts in a Trust:**

Trusts carry many advantages. Large gifts are usually made in trusts rather than being outright mostly because trusts allow individuals to specify when and how assets are to be transferred to their beneficiaries. This is important to do if your beneficiaries are young, or your gifts are designed to benefit multiple generations of family members. Trusts also ensure that the property in your estate is managed efficiently and protect assets from creditors faced by your beneficiaries, such as ex-spouses.

Most importantly, trusts can help you compound the estate tax savings of your gift by applying the generation-skipping transfer (GST) tax exemption to your trust. The GST tax exemption is the same amounts as the federal gift and estate tax (11.7/23.4 million). Assets held in a trust are not subject to either the federal estate tax or GST tax, but an outright gift

might be subject to the federal estate tax when your beneficiary dies. A professionally designed GST-exempt trust can help avoid this federal estate tax burden for multiple generations.

Trusts also offer flexibility. For example, if you are worried that your spouse might need access to funds in your trust, you could include provisions in the trust document to allow your spouse to access those funds. You could also give your spouse the ability to determine how the trust's assets pass to future generations—and extend the same ability to generations after that. In addition, your trust document can incorporate charitable giving into your estate plan and ensure that the right people are involved in making decisions, during the present and in the future.

### **Factors to Consider in Deciding to Give Away Assets Now:**

- The current value and income tax basis of your assets.
- What you think your assets will be worth in the future.
- The extent to which you think the federal estate tax will apply to your assets in the future.
- Gifting has clear tax benefits if your assets vastly exceed the current exemption amount. Gifting also provides benefits if you think your assets will grow substantially in the future, and those benefits may be amplified by changes in the tax rules. For example, gifting your interest in a closely held company now may yield massive tax benefits as the company grows and the appreciation falls in the hands of your beneficiaries and not in your estate.
- Gifting may additionally allow you to take advantage of valuation discounts and other estate planning techniques that might not be available in the future. Gifts could also bring advantages for estate taxes at the state level.

### **Which Assets You Give Is Just as Important as How Much You Give:**

Choosing the right assets is critical to maximizing the tax benefits of a gift. One of the main concerns with gifting an asset is that your beneficiary will receive it with the same income tax cost basis that you have, resulting in a big capital gains tax bill when he/she sells the property. This differs from what happens when beneficiaries receive assets following their death. In this instance the assets receive a “step-up” to their current market value—and the capital gains tax disappears.

For example, if you wish to sell an asset worth \$10 million and it has a tax basis of \$1 million,

\$9 million of it will be subject to the capital gains tax. This also applies to your beneficiaries if they sell the asset after you give them it during your lifetime. In contrast, if you retain the assets and transfer those to them as part of your estate at death, the capital gain goes away. Depending on the size of your estate, you may essentially trade a capital gains tax for an estate tax. Like the estate tax exemption amount, the “step-up” in basis rules is not set in stone and could be a tax benefit that disappears. Nevertheless, careful consideration of both the estate and income tax consequences of any proposed gift is critical.

### **What Assets Are the Easiest and Best to Give?**

In general, the best assets to gift:

- Are likely to appreciate in the future.
- Have a high-income tax basis relative to their current value.
- Will not be needed for personal use or living expenses.
- Offer the potential for valuation discounts.
- Are holdings you are comfortable giving up control of.

There are typically trade-offs among the various factors. Valuation discounts can result in significant appreciation potential out of the gates. It is important to evaluate the potential “tax cost” of sacrificing the step-up in basis. You also need to recognize when giving up control or the use of assets may cause complications.

The best assets are sometimes the easiest to transfer. Cash is an example, as there is no sacrifice of a capital gains step-up with cash. There is no sacrifice of a capital gains step-up with cash, and your beneficiaries can easily invest that cash in appreciating assets. Similarly, you can forgive promissory notes without sacrificing the step-up, and the emotional benefits of forgiving a loan can be significant. Second homes, such as a lake or beach properties, sometimes make for simple yet powerful gifts because the property is relatively easy to transfer a deed into a trust.

Gifting partial interests in real property can offer valuation discounts and can be especially helpful if the whole family is already sharing the use of that property. Another option can be recent investments in private holdings that offer the potential for considerable appreciation. Conversely, a recently acquired real estate investment may appear to be an attractive gift because it has a high-income tax basis and potential for a valuation discount. But if you want to retain control over the property, it probably is not an appropriate gift.

### **Gifts with a Trust Can Be a Good Idea:**

Remember that large gifts are usually placed in trust. For tax purposes, applying your generation-skipping transfer (GST) tax exemption to the gifts you place in trust could help your family avoid the federal estate tax on those assets for multiple generations. Locating your trust in a trust-friendly state like New Hampshire might also reduce or eliminate state-level income taxes for the trust. Trusts allow you to direct what ultimately happens with your gifts. You can craft the trust document to specify your intentions for the gift, set the timing and conditions for distributions, and create a framework to guide trustees and help them make the best decisions for you and your beneficiaries.

In many cases, assets placed in trust as a gift require special skills to manage and invest effectively. A professional trustee can ensure those assets are managed to effectively serve all beneficiaries, current, and future, over the long term. It is also possible to separate the responsibilities of the trustee by using a directed trust. With a directed trust, an independent trustee serves as the administrative trustee to handle all recordkeeping, custody of assets, and tax reporting requirements. You can appoint a separate trustee such as your investment advisor to make investment decisions. Directed trusts can be particularly useful with private holdings, like LLC interests or real property, because investment decisions can remain with the family instead of being subject to the normal requirement of a trustee to diversify the trust's investments. Finally, a trust can help beneficiaries protect assets from creditors and divorce claims.

### **Your Gifting Strategy:**

Making large gifts takes time, analysis, and careful planning. When done well, they can establish a family legacy that endures for many generations and saves millions in taxes along the way. Finally, decide on the assets you want to give and the structure of the trusts or other vehicles you may use to complete your gifts. While communicating with your beneficiaries is often an afterthought, it is also crucial. Try to see the gift through the eyes of the beneficiary and understand that his or her reaction can range anywhere from gratitude and joy to greed and distrust.

### **Explaining the Purpose of Your Gift:**

Thoughtful communication with your beneficiaries is essential when making larger gifts. If gifts are made in trust, the focus should be on the intended benefit of the trust and how the terms of the trust document help fulfill that intention. Too often, donors and beneficiaries alike focus on the dollar amounts of gifts and fail to place appropriate emphasis on the long-term purpose of a gift. Consider what a difference it makes to describe your gift as something that will provide your descendants with a college education and a down payment on their homes for multiple generations, versus describing it as a gift of \$23.4 million subject to restrictions and the trustee's discretion. Both descriptions are technically accurate. But the first description conveys your intentions in a much more meaningful way. It also creates a better platform for an ongoing conversation with beneficiaries about the purpose of the family's wealth.

Donors and beneficiaries also often make the mistake of not placing a gift in the larger scheme of the donor's estate plan. If a gift is made without reference to the estate plan, beneficiaries are often left to wonder what else they might expect to receive and whether the way they handle a gift today might be a test to determine how they might receive assets down the line. Sometimes that may be true. Yet other times the lack of communication and big picture perspective can breed uncertainty and distrust that corrodes relationships.

As an alternative, consider starting the discussion by describing the broader estate plan. Tell your beneficiaries about your big picture goals and general scheme for what happens with your assets and decision-making. You can then use that stage to explain how the current gifts begin to fulfill your goals and capitalize on the tax savings opportunities that are currently available. You do not need to share all the details of your estate plan but providing your beneficiaries with context gives them the chance to see themselves as both beneficiaries and partners in fulfilling the overall goals of your estate.

### **Keeping the Conversation Going:**

One important aspect of communicating with your beneficiaries about a gift is recognizing that the communication never stops. Checking in with your beneficiaries about the goals you have articulated for them reinforces the purpose of your gifts. Involving them in decisions

about property in the trust or a review of your investments, when appropriate, gives them a sense of responsibility. Urging them to develop their own estate and tax plans lets them see their role in the ongoing stewardship of your gifts. In addition, the way you live, how you oversee your family's financial affairs, and how you interact with financial professionals can serve as a power of example for beneficiaries to follow.

**Law Firm's Spring Hours:**

We remain closed to walk-in appointments while we wait for the opportunity of our staff to be fully vaccinated. We are still scheduling in-person appointments for document signings, along with phone calls and Zoom appointments.

For high-net-worth clients, please contact me to determine if using most or all of your estate and gift tax exemption in 2021 is something you should consider.

Sincerely,

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