BLANKROME

Trusts & Estates

FEBRUARY 21, 2023

Estate Planning Roundup: 2023 Updates and the Urgent Need to Utilize Exemptions

There are a number of tax changes that took effect at the beginning of the new year. Given these recent changes, as well as the lack of certainty regarding actions Congress may take this year and in the coming years, especially as it relates to the federal gift/estate and generation-skipping transfer ("GST") tax exemptions, it is of upmost importance for individuals to begin working with their advisors to review their current estate plans and implement any necessary changes and strategies.

This alert will outline the current state of the law relating to the federal gift/estate and GST tax exemptions, the need for individuals to put vehicles in place now to capture the present exemption amounts, new planning opportunities, and recent changes in tax and estate laws.

I. The 2023 Exemption Amounts and the Looming 2026 Reduction

Given the rampant inflation over the last year, the federal exemption amounts have increased by an unprecedented amount. Effective January 1, 2023, the federal gift/estate tax exemption and GST tax exemption increased from $12,060,000 to $12,920,000 (an $860,000 increase).[1] The federal annual exclusion amount also increased from $16,000 to $17,000.

The federal gift/estate tax exemption and GST tax exemption will continue to increase each year for inflation through December 31, 2025. However, under current law, on January 1, 2026, the exemption amounts are scheduled to be automatically cut in half. It is anyone's guess whether legislation will be introduced retaining the increase in the exemption amounts (eliminating the automatic sunset) or slashing the exemption amounts sooner.

Indeed, over the last few years, we have seen a number of unsuccessful proposals seeking to reduce the exemption amounts at an earlier date, and we are likely to see additional proposals over the next three years from both parties—the Democrats seeking to reduce the exemption amounts early and the Republicans seeking to eliminate the

1. In some states that impose their own estate tax, the applicable state estate tax exemption amounts have also increased. Effective January 1, 2023, the estate tax exemption amount in the State of Connecticut increased to $12,920,000, the estate tax exemption amount in the State of New York increased to $6,580,000, and the estate tax exemption amount in the District of Columbia increased to $4,528,000. The estate tax exemption amount in the State of Maryland has remained static at $5,000,000 since 2018. Pennsylvania, New Jersey, Florida, California, and Virginia do not impose a separate state estate tax, although some impose an inheritance tax in certain circumstances.

January 2026 sunset and retain the increased amounts (or perhaps even eliminating the estate tax altogether). Given the uncertainty of what might occur, the time is now for individuals to begin the process of putting vehicles in place to utilize the increase in the exemption amounts before the exemption amounts automatically sunset or before legislation can be introduced and passed affecting the exemption amounts prior to 2026.

This year's significant increase in the exemption amounts presents a prime estate planning opportunity not only for those individuals who have not previously engaged in significant gifting, but also for those individuals who previously made gifts to capture their exemptions. For individuals in the latter category, such individuals now have, at least, an additional $860,000 of exemption available for further estate planning.

When establishing vehicles to use the increase in the exemption amounts, one central question on many individuals' minds is whether use of the increased exemption amounts will have adverse tax consequences if and when the exemption amounts are reduced. In late 2019, the IRS released guidance regarding the use of the increased exemption amounts during this period. This guidance clarified that a taxpayer is permitted to utilize his or her increased exemption amounts between December 31, 2017, and December 31, 2025, without adverse tax consequences at death.[2]

Additionally, as most are aware, in late 2022, the Biden Administration announced plans to hire 87,000 new IRS agents. Whether these new agents will be hired is currently hanging in the balance- the House of Representatives recently approved a bill that would repeal the funding for hiring these new agents. Nevertheless, if and once these new agents are hired and trained, within the next few years, we can expect to see an increase in audits of gift tax returns. Under current law, the statute of limitations for the IRS to audit a gift tax return is three years from the due date of the return, or three years after the gift tax return was filed, whichever is later, provided that the return adequately disclosed all gifts and valuations. As such, to decrease audit risk, especially for those types of gifts where valuation discounts may be applied (i.e., gifts of minority interests in entities, such as limited liability companies or closely held corporations, and gifts of fractional interests in real estate), it would be best to make these gifts as soon as possible to begin the running of the statute of limitations.

There are a number of vehicles an individual can put in place to utilize his or her federal exemption amounts. The next two sections of this alert address specific exemption-utilization strategies ideal for the current economic environment; the remaining sections of this alert address recent changes in tax and estate laws.

II. Estate Planning in an Economic Downturn

A. Gifting Assets with Depressed Values

The current economic downturn is an ideal time for making both annual exclusion and lifetime exemption gifts. Gifting assets when values are depressed permits an individual to transfer additional property to his or her descendants (or others) at a lower transfer tax cost with future appreciation accruing outside of the individual's estate.

For instance, if, on January 1, 2022, 100 shares of X stock had a fair market value of $1,000,000 and now, given the downward trend in the market, the value of such shares is $850,000, an individual can gift such shares using $150,000 less of his or her federal gift/estate tax exemption.[3] Assets whose values are expected to rebound in the future are ideal candidates for gifting strategies in the current environment because all appreciation following the date of the gift will escape gift and estate taxation.

B. Making a Late Allocation of GST Tax Exemption to Prior Gifts

A down market also presents a prime opportunity for making a late allocation of GST tax exemption to prior gifts to trusts, which permits an individual to use his or her remaining GST tax exemption without having to make additional gifts.

2. Nevertheless, the IRS has recently proposed a regulation that provides that the lower exemption amounts may apply at death to certain types of gifts that were made while the exemption amounts were higher, such as gifts in the form of a promissory note and gifts under a partnership freeze technique. Specifically, under the proposed regulation, if a taxpayer made such a gift while the exemption amounts were higher and then dies within three years of the date of such gift and after the exemption amounts are reduced, the taxpayer would lose the benefit of the increased exemption amounts in effect at the time that the gift was made and be subject to estate tax on the difference.

3. Of course, an individual must weigh the benefits of gifting in a down market against the loss of the step-up in cost basis that such assets would receive upon the individual's death under current law.

The federal GST tax is in addition to the federal estate tax and it, generally, applies to transfers to beneficiaries (either outright or in trust) who are more than one generation removed from the donor or settlor (i.e., an individual establishing a trust) or more than 37½ years younger than the donor or settlor. Generally, GST tax exemption is allocated to a gift in trust on the settlor's federal gift tax return and, if reported on the initial return reporting the initial transfer to the trust, the allocation is based on the fair market value of the property on the date of the gift. If the settlor did not allocate GST tax exemption to his or her gift in trust on his or her initial gift tax return, whether by an inadvertent mistake or an intentional decision, the settlor has the ability to make a late allocation of GST tax exemption to his or her prior gift, to the extent that the settlor has GST tax exemption remaining.

When a late allocation of GST tax exemption is made to a prior gift in trust, the exemption is applied based on the value of the trust assets on the date of the late allocation, rather than the date of the gift. If asset values have declined since the date of the gift, making a late GST tax exemption allocation may result in a fully GST exempt trust using less exemption.

For instance, if, on January 1, 2022, a settlor gifted 100 shares of X stock to a new irrevocable trust that had a fair market value of $1,000,000, the settlor would have been required to use $1,000,000 of GST tax exemption to fully exempt the trust. If, however, given the depressed market, on February 1, 2023, such shares had a fair market value of $800,000, the settlor can make a late allocation (to the extent that he or she did not allocate GST tax exemption to the gift on his or her initial federal gift tax return) and use only $800,000 of GST tax exemption to fully exempt the trust.

III. Estate Planning in a High-Interest Environment

Many estate planning techniques are based on the interest rates set forth by the federal government. In recent years, we have seen historically low rates, which provided opportunities for various estate planning vehicles, such as intrafamily loans and grantor retained annuity trusts ("GRAT"). Although the significant increase in the rates, such as the applicable federal rates ("AFR") and the Section 7520 rate of the Internal Revenue Code of 1986, as amended (the "Code"), has hindered these types of vehicles, the increase has provided new estate planning opportunities.

Specifically, a high-interest environment presents unique estate planning opportunities to establish certain types of split-interest trusts, such as a qualified personal residence trust ("QPRT") for those individuals looking to utilize their federal gift/estate tax exemption in a transfer tax-friendly way, and a charitable remainder trust ("CRT") for those individuals that are charitably inclined.

A QPRT is a trust to which a settlor transfers his or her primary residence (or even one secondary residence), and after a term of years during which the settlor has exclusive use of the residence, the property will pass to the settlor's descendants (or others) free of transfer tax (assuming the settlor survives the trust term). At the time that the residence is transferred to the QPRT, the remainder interest that will ultimately pass to the remainder beneficiaries is a taxable gift and will use a portion of the settlor's federal gift/estate tax exemption amount. However, the settlor's retained interest for the terms of years, the value of which is calculated in accordance with the Section 7520 rate of the Code, is reduced from the fair market value of the property at the time the QPRT is funded to determine the value of the taxable gift of the remainder interest. The higher the rate, the higher the value of the retained interest, and, therefore, the lower the value of the gift of the remainder interest. As such, given the unprecedently high Section 7520 rate, a QPRT is an attractive estate planning strategy in this high-interest environment.

For those who are charitably inclined, CRTs are also prime estate planning tools in high-interest environments. A CRT lasts for a term of years or a lifetime, during which annual payments are made to one or more persons (which usually includes the settlor), and after the expiration of the CRT, the trust property remaining will pass to a designated charity (or charities). There are two types of CRTs: a charitable remainder annuity trust ("CRAT"), which pays a fixed income stream based on a percentage of the initial

fair market value of the gifted assets, and a charitable remainder unitrust ("CRUT"), which pays an income stream equal to a fixed percentage of the value of the trust's assets that are revalued annually. Upon the creation of a CRT, with certain limitations, the settlor may claim an income tax deduction on the charitable remainder that will ultimately pass to charity, which is valued at its present value also using the applicable Section 7520 rate of the Code. With respect to CRTs, the higher the Section 7520 rate, the higher the value of the remainder interest passing to charity, thereby providing a greater charitable income tax deduction for the settlor.

IV. New Planning Opportunities for Connecticut Residents

Given that Connecticut is the only state in the union that has retained a state-level gift tax[4] and the state's gift tax exemption amount has been historically lower than the federal gift tax exemption amount, Connecticut residents were hindered in prior years from taking advantage of the full amount of their federal gift/estate tax exemption amount without incurring a state gift tax liability.

As of January 1, 2023, the Connecticut gift/estate tax exemption amount now mirrors the federal gift/estate tax exemption amount, and it will continue to do so in future years. As such, as of January 1, 2023, Connecticut residents can now utilize the full amount of their federal gift/estate tax exemption using any property without incurring a Connecticut gift tax liability. This presents a prime estate planning opportunity not only for those Connecticut residents who have not previously made gifts, but also for those residents who only previously made gifts up to the amount of their Connecticut gift/estate tax exemption.

Of course, it is important to note that since the Connecticut gift/estate tax exemption amount now mirrors the federal gift/estate tax exemption amount, if and when the federal exemptions sunset on January 1, 2026, the Connecticut exemption amounts will also be reduced accordingly.

V. New Revenue Procedure Regarding Portability Elections

Under current federal law, the deceased spousal unused exclusion ("DSUE") provides that any federal gift/estate tax exemption that is unused at a decedent's death can be "ported" over to the decedent's surviving spouse by filing a federal estate tax return (Form 706) and making a portability election (unfortunately, portability does not apply to any unused federal GST tax exemption).

Portability essentially allows the deceased spouse's unused federal gift/estate tax exemption to be made available to the surviving spouse. For instance, if spouse 1, a New York resident, died on January 1, 2023, and only used $6,580,000 of his or her federal estate tax exemption, spouse 1's remaining $6,340,000 of federal gift/estate tax exemption can be ported over to spouse 2 (giving spouse 2 a total of $19,260,000 of federal gift/estate tax exemption in 2023- $12,920,000 in his or her own right and $6,340,000 from his or her deceased spouse) to use either during his or her lifetime or at death. The amount ported from spouse 1 to spouse 2 is locked in based on the exemption available at the time of spouse 1's death. As such, any ported exemption will not be affected by the January 1, 2026, sunset of the exemption amounts.

Under Section 2010(c)(5)(A) of the Code, a portability election is effective only if made on a federal estate tax return that is filed within the time prescribed by law (including extensions) for filing such return.[5] In 2017, the IRS issued Rev. Proc. 2017-34, which provided a simplified method for the executor of a decedent's estate that did not meet the threshold for filing an estate tax return to elect portability under Section 2010(c)(5)(A) of the Code within two years of the decedent's death. In 2022, to reduce the number of requests for private letter rulings, the IRS issued Rev. Proc. 2022-32, which extends the two-year time period to five years.

4. For a Connecticut resident, the Connecticut gift tax applies to any gift, except for a gift of real estate or tangible personal property situated outside of the State of Connecticut.

5. Although there is a cost involved in preparing and filing a federal estate tax return at the first death that may not otherwise be required, there is a significant benefit of electing portability, especially for those couples who have total assets near or exceeding the federal estate tax exemption amount (either the current federal estate tax exemption amount or the estimated federal estate tax exemption amount following the January 1, 2026, sunset).

VI. New FinCEN Reporting Requirements Effective January 1, 2024

On September 29, 2022, the U.S. Treasury Financial Crimes Enforcement Network ("FinCEN") issued a final rule implementing the Corporate Transparency Act, which imposes a reporting requirement for most corporations, limited liability companies, and other entities that do business in the United States. The implementation of this new rule is especially important from an estate planning perspective as many individuals establish entities as part of their estate planning.

The new rule will require "reporting companies" to file reports with FinCEN identifying two categories of individuals: (i) "beneficial owners" of the entity; and (ii) the "company applicants" of the entity.

The rule establishes two types of reporting companies: domestic reporting companies and foreign reporting companies. A domestic reporting company includes any entity that is established by the filing of relevant documents with a secretary of state or similar office in any jurisdiction within the United States. A foreign reporting company includes any foreign entity that is registered to do business in the United States.

Under the new rule, a beneficial owner would be any individual who meets at least one of two tests: (i) an individual who exercises substantial control over the entity; or (ii) an individual who holds at least a 25 percent ownership interest in the entity. A company applicant is any individual who filed a document to establish the entity.

Reporting companies that were established before January 1, 2024, will have one year to file their initial reports, while reporting companies that are established after January 1, 2024, will have 30 days from the date of establishment to file their initial reports. The initial reports must disclose sufficient information regarding the beneficial owners and company applicants, including their names, dates of birth, addresses, and a unique identifying number and issuing jurisdiction from an acceptable identification document (i.e., driver's license number, passport number, etc.).

For additional information, please contact a member of Blank Rome's Private Client Trusts & Estates team.

Sean R. Weissbart
212.885.5328 | sean.weissbart@blankrome.com

Haley B. Bybee
212.885.5552 | haley.bybee@blankrome.com

Lawrence S. Chane
215.569.5721 | larry.chane@blankrome.com

Kyle G. Durante
212.885.5310 | kyle.durante@blankrome.com

William Finestone
424.239.3868 | william.finestone@blankrome.com

Andrew J. Haas
215.569.5479 | andrew.haas@blankrome.com

Andrew M. Logan
215.569.5606 | andrew.logan@blankrome.com

Richard J. Miller, Jr.
212.885.5275 | richardj.millerjr@blankrome.com

James R. O'Neill
202.420.4702 | rick.oneill@blankrome.com

Sara K. Osinski
212.885.5137 | sara.osinski@blankrome.com

Michael I. Sanders
202.772.5808 | michael.sanders@blankrome.com

Peter C. Valente
212.885.5320 | peter.valente@blankrome.com

© 2023 Blank Rome LLP. All rights reserved. Please contact Blank Rome for permission to reprint. Notice: The purpose of this update is to identify select developments that may be of interest to readers. The information contained herein is abridged and summarized from various sources, the accuracy and completeness of which cannot be assured. This update should not be construed as legal advice or opinion, and is not a substitute for the advice of counsel.