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Federal tax legislation lays out estate tax regime through 2025

THE BUZZ

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Lindsey Paige Markus, a shareholder at Chuhak & Tecson P.C., draws on her early career in business, finance and clinically applied neuroscience to communicate with clients and develop creative solutions to fit their estate planning, wealth protection and corporate needs. Lindsey is a dynamic contributor to local news outlets such as NBC 5 Chicago, Fox News Chicago and WCIU, and has been recognized as one of the 40 Illinois Attorneys Under Forty, a Woman Making an Impact in the Law, an Illinois Super Lawyer and a Leading Lawyer. Lindsey is licensed in Illinois and Florida and has a national practice.

The Tax Cuts and Jobs Act contained dramatic changes to many provisions of the tax code and has drastically changed the estate and gift tax climate from now through 2025. A closer examination highlights planning considerations in the estate and gift tax arena for 2019 and beyond.

Increase in exemption amounts

Based on the year in which you die, the federal government allows a portion of your estate to pass estate tax-free, commonly referred to as the "exemption amount."

Individuals are also allowed the ability to gift portions of their exemption amount during their lifetimes, known as the gift exemption, a portion which can be considered generation-skipping transfer tax exempt, or GST-exempt.

Prior to the Tax Cuts and Jobs Act, the federal estate, gift and GST-exempt amount was $5 million, adjusted for inflation. Under the act through 2025, the federal estate, gift and GST-exempt amount doubled to $10 million, adjusted for inflation.

For 2020, this translates to approximately $11.58 million for individuals and $23.16 million for married couples (assuming a proper plan is in place). These exemption amounts will continue to be adjusted for inflation but by a different and less generous measure than applicable under the former law.

The increase in the exemption amounts is temporary. In 2026, the exemption amounts will revert to the 2017 levels ($5 million for individuals and $10 million for married couples, both adjusted for inflation). Although the federal exemption has increased to $10 million per person through 2025, the state of Illinois exemption remains at $4 million (with no inflation adjustments).

Estate tax rate

The estate tax rate remains unchanged. Estates in excess of the exemption amount are subject to a 40 percent tax at the federal level on all assets over the exemption amount. For clients who live in a state with its own estate tax regime like Illinois, state estate tax rates range from 10 percent to 28.5 percent.

For a decedent with a taxable gross estate at the federal level who is paying both federal and state level taxes, a credit is given at one level for paying the tax while at the other end the circular calculation translates to a marginal estate tax rate of 10 percent over the 40 percent, resulting in a combined estate tax rate of 50 percent for Illinois residents. However, when a decedent is only paying the state estate tax and no federal tax, the rate starts at approximately 28.5 percent and slowly tapers down.

The best way to estimate the effective tax is to run estimates on the Illinois attorney general's estate tax calculator. For clients who reside in states with an estate tax, the estate tax liability at the state level can be significant so it is important to be proactive with planning to minimize or even avoid the state estate tax liabilities.

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Increase in annual exclusion gift amount

Individuals may make unlimited gifts among married couples. In addition to the increased exemption amounts discussed above, the amount each person may give annually to as many individuals as he or she desires without incurring a gift tax and without using any of the lifetime gift tax exemption amount is $15,000 in 2020.

Similar to 2018, a married couple may make tax-free annual exclusion gifts of up to $30,000 per beneficiary. If a gift is in excess of the annual exclusion amount a gift tax return must be filed with the IRS for informational purposes, reporting that the individual has used a portion of their lifetime gift exemption, which also decreases the amount which can pass at death accordingly.

For example, if a married couple decides to gift $130,000 to a grandchild ($30,000 is their annual gift exclusion), a gift tax return would be filed with the IRS to report that they have used $100,000 of their lifetime exemption. The gift for the married couple could be a split gift (where each spouse uses $50,000 of their exemption) or one can use the entire amount.

Making annual gifts is an extraordinary way to move assets outside of your taxable gross estate. With advanced planning tools and when gifting interests in businesses (family limited partnerships, corporations, etc.) to gift trusts, discounts can be taken for lack of marketability or lack of control and additional wealth transfer opportunities can be realized.

Portability

The Tax Cuts and Jobs Act does not change with respect to "portability." The act continues to allow the executor, trustee or personal representative of an estate to make a "portability election" to transfer (or port) any amounts of the estate tax exemption that were not used for a decedent's estate to a decedent's surviving spouse.

If a client dies in 2020 using only $3 million of their lifetime exemption of $11.58 million, an estate tax return could be filed to capture the additional $8.58 million in unused exemption and port the amount onto the surviving spouse's exemption in the future.

A portability election must be made by filing an estate tax return following the first spouse's death. The amount of the estate tax exemption transferred from the estate of the first spouse may be used by the surviving spouse to offset any tax liability upon the surviving spouse's death.

Illinois does not offer a portability election similar to that under the federal estate tax regime. Because a client's future net worth and the future estate tax laws may vary, it is prudent to capture portability and potentially save millions of dollars in estate taxes.

Clawback?

The act instructed the Treasury Department to promulgate additional regulations which may be necessary or appropriate to carry out the purposes of the act and, specifically, to issue guidance with respect to differences between the exemption amount in effect (1) at the time of a decedent's death and (2) at the time of any gifts made by the decedent.

Imagine a client who gifts the full $11 million of lifetime exemption and dies after 2025 when the exemption has reverted to $5 million. This becomes an issue because any lifetime gifts are included in the taxable gross estate for purposes of determining estate tax liability.

If a client gifts $11 million of lifetime exemption this year and dies in 2026 with only $4 million, the value of the client's taxable gross estate would be $15 million with an exemption of only $5 million. The estate would owe tax at a rate of 40 percent on every dollar over $5 million which is in excess of the $4 million in the estate.

In November, the Treasury Department issued proposed regulations which eliminated concerns of "clawback." Specifically, that there would not be an estate tax on assets gifted when the exclusion covered the gift. The estate would only pay tax on the $4 million in assets. These regulations are considered to be favorable to the taxpayer.

Additional planning considerations

Estate tax considerations are merely one factor in engaging in proper planning. The other driving principles behind good estate planning include the following benefits:

• Avoid probate
• Avoid guardianship estates
• Incorporate asset protection for beneficiaries
• Income tax planning
• Maximize generation-skipping transfer tax planning to ensure the maximum amount can pass estate tax-free from generation to generation

In light of the increased exemptions, more and more estate plans are being customized to layer in income tax planning to help future generations save 23.8 percent in income tax.

For Illinois residents with Illinois estate plans that do not reflect the state's exemption amount, updating an estate plan to reflect changes in the legislation can save or defer more than $1 million payable to the state on the first spouse's death.

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