Changes in Tax Planning Priorities in Light of Increases in Federal Estate Tax Exemption

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The significant increase in the federal estate/gift/GST tax exemption amount to $5,000,000 in 2011, which was made permanent in 2013, and then again increased to $11,180,000 in 2017, has substantially changed the focus of estate planning for many clients. Note that the exemption amount is available to each individual taxpayer, so that a married couple today can pass as much as $22,360,000 tax free to their descendants or other individuals. For the many wealthy families who now have no exposure to the estate tax, the focus is on income/capital gains tax planning through securing and maximizing an increased basis in appreciated assets passing to the next generation.

In general, an asset with a fair market value which exceeds its basis and that is included in a person's estate at death receives, for income tax purposes, a "step-up" in basis to the fair market value of the asset at the time of death. As a result, heirs can immediately sell the asset without generating any income/capital gains tax liability. Also, assets that are depreciable would receive a new tax basis and begin to generate larger deductions.

For families facing the certainty of estate tax, the emphasis of tax planning has been on removing assets from the estate. This strategy trades elimination of the estate tax [at a rate of 40% on the entire value of the asset], for imposition of an income/capital gains tax [at a rate of 20% ± on the difference between the asset's basis and the value of the asset at death]. In so doing, clients should still be mindful of basis considerations in planning transfers. But if there will be no estate tax, there is no reason to incur the income/capital gains tax by removing assets from the estate.

Should you shift the focus of your tax planning away from the estate tax to the income tax? Clients must decide whether they are in fact likely to have an estate that exceeds the exemption amount. For many clients, the answer is far from clear. To begin with, the most recent increase in the exemption amount is, at this point, only temporary – on January 1, 2026, the exemption amount reverts to $5,490,000 per person (increased for certain inflation adjustments). As a result, many families who appear to be well insulated from the estate tax based on current exemption levels could find themselves again subject to the estate tax in 2026 (or even sooner if the party controlling Congress and the Presidency changes).

Beyond the level of the exemption amount, there are many factors for clients to consider over the next few years in order to evaluate whether to transfer assets out of their estates in order to avoid federal estate tax, including: age and life expectancy; size of estate; expected growth rate of estate; lifestyle and consumption rates; and needs of potential beneficiaries. Many clients may feel that it would be prudent to defer any such decision until a final determination is made on whether the current $11,180,000 exemption amount is made permanent.

For those clients who have concluded that they can safely proceed with planning that prioritizes the income tax implications of estate planning, there are many strategies to consider. The basic strategy is to retain assets so that they will be included in the estate for tax purposes. Married couples will want to consider strategies that result in a step-up in basis for the assets of the first to die spouse at the death of the survivor – a “second step-up” - and even potentially strategies that result in a step-up in basis for all assets at both deaths.

Beyond that, clients should also consider assets from which they benefit but which would not presently be includible in their estate, such as trusts that have been established for their benefit. If a trust could be included in the client’s estate without causing the client’s estate to exceed the current or assumed future exemption amount, then consideration should be given to whether there is a way to cause the trust to be included in the estate. For example, is there a power of appointment under the terms of the trust that could be exercised by the client in a manner that will cause the trust to be included in the client’s estate? Could the trust be modified to include such a power to cause inclusion? Or could the trustee simply distribute the assets to the client? Does the client have a power to substitute low-basis assets in a “grantor trust” with cash or high basis assets?

Another example of an asset to carefully consider would be an interest in a closely held business entity, such as a “family limited partnership,” that would be subject to a discount for valuation purposes. Any such discount would limit the benefit of the step-up in basis. It may be possible to modify or eliminate restrictions in governing documents that cause the value of the business interest to be discounted. Other strategies may be available depending on the exact nature of the assets in question.

Please contact your Vorys attorney to discuss your individual situation and the potential strategies available to you.