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Estate planning in 2022

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This update summarizes certain federal and state transfer tax developments and reminds clients of certain wealth transfer strategies that could be advantageous in the current environment.

The Build Back Better Act passed by the House of Representatives last November ultimately did not include a number of provisions that had been of particular concern to estate planners (discussed in our September 22, 2021, client update). With discussions continuing in Washington as to what, if any, elements of the Build Back Better Act might ultimately find sufficient support for passage, and with no new transfer tax legislation on the horizon, at least for now, we anticipate that clients will continue to stay focused on making gifts to take advantage of any increased exemption amounts while they are still available and on gift tax free wealth transfer strategies that take advantage of low interest rates while they remain.

Federal transfer tax developments

Exemption amounts and rates

For 2022, the inflation-adjusted federal estate, gift and GST tax exemption amounts are $12.06 million for an individual (up from $11.70 million in 2021) or a combined $24.12 million for a married couple. The highest federal marginal estate, gift and GST tax rate continues to be 40%. Absent legislative action, these increased exemption amounts are scheduled to expire on December 31, 2025, after which they will revert to $5 million, plus the relevant inflation adjustments.

For individuals with estates in excess of the available exemptions who have not yet fully used their exemptions, gifts of their remaining exemptions, perhaps combined with loans or other leveraged transactions, will continue to provide an opportunity to remove very significant amounts from their estates in a manner that may permit property to pass to descendants free of any additional estate or gift tax, and in some cases GST tax, and remove post-gift earnings and appreciation from their taxable estates. It is also advisable for donors to consider the relative benefits of making gifts to a "grantor trust" rather than outright or to a "non-grantor" trust.

Those who previously exhausted their exemptions might "top up" existing structures in 2022 and in future years as additional inflation adjustments are made to the relevant exemption amounts.

Before making significant lifetime gifts, donors should consider any applicable state level transfer tax considerations (described below) as well as income tax consequences, such as the loss of the income tax "basis step-up at death" with respect to the transferred property.[1]

Annual exclusion gifts

For 2022, a donor may now exclude from taxable gifts the first $16,000 of qualifying gifts to or in respect of a particular donee.[2] This is the first increase in the annual exclusion amount since 2018. For gifts by a U.S. citizen or domiciliary to his or her non-U.S. citizen spouse, the available annual exclusion amount is now $164,000.00.[3]

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When consistent with other family goals and financial considerations, it is a best practice to make use of the federal gift tax annual exclusion amount each year by making a "present interest" gift to or in respect of a particular donee.[4]

Direct payment of tuition and certain medical expenses

For 2022, direct payments to the relevant service provider of certain qualified tuition and medical expenses on behalf of the individual receiving the related goods and services will continue to be exempt from gift tax.

State transfer tax developments

New York

The New York estate tax exemption equivalent increased from $5.93 million to $6.11 million, effective January 1, 2022, but continues to be phased out for New York taxable estates valued between 100% and 105% of the exemption amount, with no exemption being available for taxable estates in excess of 105% of the exemption amount.

Although the top New York estate tax rate continues to be 16% for estates over $10.1 million, the effective rate can be lower due to the continued deductibility for federal estate tax purposes of any New York estate tax paid. However, estates that are no longer subject to federal estate tax by reason of the increased federal exemption will no longer benefit from the deduction.

There is currently no New York gift or GST tax. However, gifts made within three years of death are brought back into a New York taxable estate for purposes of determining New York estate taxes.

Connecticut

The Connecticut estate and gift tax exemption amounts increased to $9.1 million effective January 1, 2022. These exemption amounts are scheduled to match the federal estate and gift tax exemption amounts (approximately $12.06 million, plus any relevant additional federal inflation adjustments), starting January 1, 2023.

For 2022, the Connecticut gift tax annual exclusion amount is $16,000.

The Connecticut estate and gift tax rates currently range from 11.6% to 12% (for taxable estates and gifts exceeding $9.1 million). Beginning in 2023, a flat tax rate of 12% will apply to the value of Connecticut taxable estates and gifts that exceed the federal exemption amount. The maximum amount of Connecticut gift and estate taxes that may be imposed is now capped at $15 million.

Estate taxes paid to Connecticut may be deducted for federal estate tax purposes (resulting in a lower effective rate), but there is no corresponding federal gift tax deduction.

Connecticut does not impose a GST tax.

New Jersey

Although New Jersey no longer has an estate tax, it has retained its separate inheritance tax.

The inheritance tax does not generally apply to transfers to a spouse, civil union or domestic partner, child or grandchild and certain other close family members. The New Jersey inheritance tax rates depend on the amount received and the relationship between the decedent and the beneficiary receiving assets from the decedent. Under the inheritance tax, transfers to siblings are generally taxed at a rate beginning at 11% (top rate is 16%) and transfers to others are taxed at a rate of 15% or 16%. New Jersey inheritance tax is also deductible for federal estate tax purposes, to the extent a federal estate tax would otherwise be payable.

There is currently no New Jersey gift or GST tax.

Wealth transfer strategies

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While the strategies described below do not involve payment of gift tax, the first three may be particularly attractive now, before anticipated interest rate increases – depending on one's own expectations for interest rates and market returns.

Intra-family loans. An intra-family loan is a simple technique for transferring future appreciation on assets free of gift or GST tax. Typically, a parent would make a loan to a child or grandchild for a note of a fixed duration. To avoid making a gift, the parent-lender must charge interest at the applicable federal rate ("AFR") published by the IRS. The relevant AFR for January 2022 ranges from 0.44% to 1.82% depending on the duration of the loan. If the child-borrower can invest the loan proceeds for a return in excess of the AFR, the excess will effectively be transferred to the child-borrower free of gift tax. Interest on the loan is generally taxable income to the parent-lender. However, if the loan is instead made to a "grantor trust" the parent has created for the child (a trust for which the grantor is subject to tax on the trust's taxable income, including capital gains) the interest payments should not be taxable to the parent since transactions between the grantor and the grantor trust are generally disregarded for federal income tax purposes. The child or child's trust would be responsible to repay the note in full, however, even if the invested loan proceeds generated no or negative investment returns.

Installment sales to grantor trusts. Individuals who have previously made gifts to a grantor trust may be able to leverage those gifts by selling assets expected to appreciate significantly to the trust in exchange for a note with fixed principal and interest payments at the AFR. If the growth of the assets sold to the trust exceeds the AFR, the excess return inures to the trust without any gift or GST tax. Additional leverage can be achieved if, for example, the sales price for the transferred assets can be determined using relevant valuation discounts. So long as the sale is structured properly, it should not result in a taxable gain to the grantor or be treated as a taxable gift. The trust would be responsible to repay the note in full, however, even if the asset declines in value.

Zeroed-out GRATs. A GRAT (grantor retained annuity trust) is another vehicle for gifting future appreciation on assets with no (or nominal) gift tax. In creating a GRAT, the grantor transfers assets (e.g., publicly traded securities) to a trust and retains the right to receive annuity payments for a specified term of years, after which the remaining trust property passes to the trust's remainder beneficiaries (typically children or trusts for their benefit). The retained annuity is structured so that its present value using an IRS assumed rate of return (the "7520" rate) is equal to the value of the assets transferred to the trust, thus resulting in no (or nominal) gift tax on the funding of the trust. If the trust is able to outperform the 7520 rate (1.6% for January and February 2022), the excess appreciation may pass to the trust's remainder beneficiaries free of gift tax. In addition, annuity payments can be back-loaded to allow additional time for the assets to grow in the GRAT.

QPRTs. Unlike a GRAT, a qualified personal residence trust ("QPRT") can become more attractive when interest rates are high. This strategy is a potentially effective way to make a gift of a personal residence in order to take advantage of the current exemption amounts without giving up liquidity. Under this arrangement, an individual transfers a personal residence to a trust and retains the right to use the residence for a specified number of years, after which the residence typically passes to or in further trust for the donor's children. If the donor dies during the specified term, the residence reverts to the donor's estate. The initial transfer of the residence to the trust is a taxable gift equal to the fair market value of the residence *less* the value of the donor's retained interest, based on the donor's age, length of trust term and IRS applicable interest rate in effect for the month of the gift. The higher the interest rate, the lower the value of the gift.

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[1] The current federal income tax rules provide for the income tax basis of a decedent's assets to be reset to estate tax values (sometimes referred to as a "step-up" in basis) and the non-recognition of gain on appreciated property transferred at death or by lifetime gift. Due to the continued availability of a "step-up" in income tax basis at death, income tax basis planning should be considered before making significant lifetime gifts, which generally receive "carry-over" basis treatment. The "carry-over" basis rules for gifts create the potential for taxable gain on a subsequent sale by the donee of appreciated property.

[2] Spouses generally may elect to split gifts and claim a combined exclusion of $32,000 with respect to a particular donee, even if one spouse funds more than half (or the whole) of that combined exclusion in respect of the same donee.

[3] There is a larger annual exclusion for such gifts because, unlike gifts to a U.S. citizen spouse, gifts to a non-U.S. citizen spouse that exceed the annual exclusion cannot qualify for the unlimited gift tax marital deduction.

[4] The types of gifts that qualify for treatment as gifts of present interests (and whose aggregate value counts towards the applicable limitation in respect of a particular individual) include outright gifts of cash or marketable securities to a donee and similar contributions to a 529 account, custodial account or minority trust for that particular donee or to a "Crummey" trust which provides that particular donee with a power to withdraw property that lapses over time (which may be exercisable for a limited period of time).

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