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Estate planning update

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This client update highlights certain considerations that may be relevant to estate planning clients looking ahead to year-end, including information about 2023 federal estate, gift and GST tax exemption increases, state transfer tax developments, certain wealth transfer strategies that could be advantageous in a rising interest rate environment and a first look at the Corporate Transparency Act.

As the 2022 election cycle draws to a close, with no new transfer tax legislation on the horizon, we anticipate that estate planning clients will, where feasible, continue to make lifetime gifts to take advantage of the federal gift and generation-skipping transfer (GST) tax exemption amounts while they remain available at historically high levels. This strategy can be particularly effective if gifts are made using assets with depressed values. It is uncertain what, if any, impact the midterm elections may have on existing estate planning opportunities.

2023 federal transfer tax inflation adjustments

Exemption amounts and rates

In 2023, the inflation-adjusted federal estate, gift and GST tax exemption amounts will increase to $12.92 million for an individual (up from $12.06 million in 2022) or a combined $25.84 million for a married couple. The highest federal marginal estate, gift and GST tax rate will continue 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.

In the current market environment, individuals who have not yet fully used the increased gift and GST tax exemption amounts may be able to maximize their unused exemptions by making lifetime gifts of assets while market values are depressed. Those who have previously exhausted their exemptions might "top up" existing structures in 2023 to take advantage of the substantial inflation adjustment. Lifetime gifts, perhaps combined with loans or other leveraged transactions, continue to provide an opportunity to remove significant amounts from a donor's estate, including post-gift earnings and appreciation, 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. 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.

Clients who wish to take advantage of the increased exemption amounts but have concerns with financial security in the context of additional lifetime giving could consider including a spouse as a beneficiary of a "SLAT" (spousal lifetime access trust) or exploring the creation of a "self-settled asset protection trust" in a jurisdiction that permits such a trust, such as Delaware, so that they might still have access to the gifted funds (either directly or through spousal beneficiaries).

Before making significant lifetime gifts, donors should weigh the loss of the income tax basis step-up at death with the transfer tax savings achieved by the gifts.

Annual exclusion gifts

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In 2023, the federal gift tax annual exclusion amount will increase to $17,000 (up from $16,000 in 2022), which will allow donors to exclude from taxable gifts the first $17,000 of qualifying gifts to or in respect of a particular donee.[1]

For gifts by a U.S. citizen or domiciliary to his or her non-U.S. citizen spouse, the available annual exclusion amount will increase from $164,000 to $175,000 in 2023.[2]

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.[3]

State transfer tax developments

New York

The New York estate tax exemption equivalent is currently $6.11 million in 2022, with the inflation adjustment for 2023 to be announced later this year. With current rates of inflation, we expect this adjustment to be significant and perhaps as much as $6.58 million, based on our internal calculations. This exemption equivalent will continue 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.

Estate taxes paid to New York may be deducted for federal estate tax purposes, to the extent a federal estate tax would otherwise be payable (resulting in a lower effective rate).

There is currently no New York gift or GST tax.

Connecticut

In 2023, the Connecticut estate and gift tax exemption amounts will increase to match the federal estate and gift tax exemption amounts of $12.92 million per individual. Likewise, in 2023, the Connecticut gift tax annual exclusion amount will increase to $17,000.

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 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.

Wealth transfer strategies

In a rising interest rate environment, wealth transfer strategies such as QPRTs and CRTs may be attractive.

Qualified personal residence trusts

A qualified personal residence trust (QPRT) can be an attractive estate planning vehicle for giving a residence to children, and it can be particularly effective when interest rates are high. This strategy is one way to take advantage of the current exemption amounts without giving up commensurate 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 spouse and children. If the donor dies during the specified term, the residence reverts to the donor's estate (putting the donor in the same position as if the QPRT had never been established). The initial transfer of the residence to the trust is treated, for gift tax purposes, as a taxable gift of an amount 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. The applicable rate for this November is 4.8% compared with 1.4% for November 2021. To illustrate the significance of this rate increase, a 15-year QPRT created by a 65-year old grantor with a residence valued at $4 million would have resulted in a $2.007 million gift if created in November 2021, but would result in a $1.224 million gift if created this November.

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Charitable remainder trusts

A charitable remainder trust (CRT) is a tax-advantaged trust which provides for payments to one or more non-charitable beneficiaries for a specified period of time, after which the remaining trust property is distributed to one or more charitable organizations.

A CRT is typically structured as either an "annuity trust," which pays a fixed dollar amount each year, or as a "unitrust," which makes payments each year equal to a fixed percentage of the fair market value of the trust's assets as calculated each year. Most often, a CRT is structured to pay the annuity or unitrust amounts to the person who created the trust (the "Donor") for a term of years or life, or to the Donor for life and thereafter to the Donor's spouse for his or her life. Upon the termination of the annuity or unitrust payment period, the remaining trust assets must pass to one or more charitable organizations. The Donor may designate one or more so-called "public charities" (including a donor-advised fund at a community trust) or private foundations as the charitable recipients in the trust instrument. The Donor may also retain the power by his or her Will to name or change the charitable recipients.

There are two tax advantages of a CRT. First, the trust is ordinarily exempt from income tax. Thus, the capital gains realized upon selling assets transferred to the trust, as well as subsequent gains from reinvestments during the term of the trust and other income earned by the trust, are not taxed to the trust. Instead, the annuity or unitrust recipient is taxed on the annuity or unitrust payments made to the recipient.[4] This factor can be especially valuable if the Donor funds a CRT with low-basis stock. This enables diversification of trust assets while deferring the gains, thus allowing for some tax-advantaged growth.

The second tax advantage is that, upon creating a CRT, the Donor is generally treated as having made a charitable contribution in an amount equal to the present value of the remainder interest in the property contributed to the trust which is expected to pass to charity. A higher applicable interest rate is beneficial because it increases the assumed growth rate of the charitable remainder and thereby results in a larger charitable contribution. The Donor may claim an income tax charitable deduction for the amount of this contribution, subject to the usual contribution limits.

Corporate Transparency Act implementation

Entity reporting requirements to take effect on January 1, 2024

On September 30, 2022, the U.S. Treasury's Financial Crimes Enforcement Network (FinCEN) published final regulations implementing certain beneficial ownership reporting provisions of the Corporate Transparency Act, enacted on January 1, 2021, which require certain entities to submit to FinCEN specified personal information on their beneficial owners, *i.e.*, the individual natural persons who own or control them. These new beneficial ownership information reporting requirements may affect estate planning clients who use family LLCs and LLPs.

Effective January 1, 2024, corporations, LLCs, and other similar entities created by a filing with a secretary of state or similar office, which generally includes limited partnerships and business trusts, are required (subject to certain exceptions) to disclose to FinCEN certain information on their beneficial owners. Other types of entities which are not created through a filing with a secretary of state or similar office, such as most types of trusts, general partnerships and sole proprietorships, as well as specified exempt entities, such as tax-exempt entities, are not subject to the new reporting requirements.

In this context, a beneficial owner of a company generally includes anyone who, directly or indirectly, either (1) exercises substantial control over such company or (2) owns or controls at least 25% of the ownership interests of such company. For a trust that holds such ownership interests, the term "beneficial owner" would include the individual trustee or other individual with authority to dispose of trust assets, a beneficiary who is the sole beneficiary of the trust or has a right to demand a distribution of or withdraw the trust property, and a grantor who retains the right to revoke the trust or withdraw the trust property.

For each beneficial owner, the reporting entity must provide the individual's name, birthdate, current residential street address, unique identifying number from a passport, driver's license or other ID document, and an image of the ID document.

Minors and individuals whose only interest in an entity is a future interest through a right of inheritance are not subject to the reporting requirements outlined above.

Willful violations of these reporting requirements may result in civil penalties (or criminal penalties, in extreme cases) imposed upon the reporting entity, its senior officers or other involved persons.

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[1] Spouses who elect to split certain gifts can claim a combined exclusion of $34,000 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.

[2] 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.

[3] The types of gifts that qualify for treatment as gifts of present interests include outright gifts of cash or marketable securities to, and similar contributions to a 529 account, custodial account or minority trust for the benefit of, a particular individual donee or gifts to a "Crummey" trust which provides the particular donee with a power to withdraw property that lapses over time.

[4] Each payment is characterized in the hands of the recipient first as ordinary income, then capital gain, then other income (*e.g.*, tax-exempt income), in each case to the extent of the trust's current and accumulated income in such category, and finally as a nontaxable distribution of corpus.

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