GET READY FOR SUNSET: THE IMPORTANCE OF PREPARING NOW FOR THE DECREASE IN THE FEDERAL ESTATE TAX EXEMPTION AND HOW TO BUILD FLEXIBILITY INTO TRANSFER TAX PLANNING

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I. 2025 Sunset of TCJA:

a. Transfer Tax Ramifications

i. Current law provides historically high exclusion amounts for federal estate, gift, and generation-skipping transfer (GST) taxes.

ii. The exclusion amounts, currently $10 million, are adjusted for inflation annually and equate to $13.99 million per person in 2025. However, if the Tax Cuts and Jobs Act (TCJA) is not extended, those exclusion amounts will decrease to $5 million, adjusted for inflation (around $7 to 7.5 million per person), on January 1, 2026. Consequently, a married couple can protect over $13 million more from estate tax today than will be possible after the sunset.

iii. If the sunset occurs, a significant number of individuals who do not have federally taxable estates in 2025 will have federally taxable estates in 2026.

iv. The Tax Policy Center estimates that just over 7,000 returns will be federally taxable in 2025. If the TCJA sunsets, that figure is projected to nearly triple to around 19,000 federally taxable returns in 2026.

v. The estate tax exclusion amount has changed wildly throughout the modern era. The tax rate applied to taxable estates has also varied over time. For example:

1. 1977 – 2002: Slowly increased from $120,667 to $1,000,000
2. 2003 – 2011: Rose from $1,000,000 to $5,000,000
3. 2012 – 2017: Remained at $5,000,000, adjusted for inflation
4. 2018 – 2025: Rose to $10,000,000, adjusted for inflation
5. 2026 post sunset: Returns to $5,000,000, adjusted for inflation

vi. The good news for taxpayers is that the IRS has confirmed that they may use their higher exclusion amount in 2025 without risk that those transferred assets will be clawed back into their taxable estates should they die after the sunset occurs.

b. Deadline to Act

i. Without Congressional action, the deadline to take advantage of the higher exclusion amount is December 31, 2025.

ii. However, certain estate tax planning strategies require significant time to execute—either logistically or to avoid IRS scrutiny—meaning that individuals with taxable or potentially taxable estates should act now to avoid negative tax consequences after the sunset.

II. Pre-Transaction Planning:

a. Asset Balancing

i. Retitling assets between spouses. For married couples, significant flexibility may be gained from the retitling of assets between spouses. State estate tax exclusions and the federal GST tax exclusion are not portable, meaning that a failure to retitle assets between spouses can lead to lost tax savings opportunities. Asset retitling also has the benefit of providing some creditor protection.

ii. Asset retitling for SLAT planning. Asset redistribution is particularly important when one spouse intends to fund a spousal lifetime access trust (SLAT)—a sophisticated technique in which a donor spouse gifts assets to a trust for the benefit of the other spouse.

iii. Timing for asset retitling. If asset redistribution is required for an estate tax planning strategy, it should not be left until the last minute. One reason why is the "step-transaction doctrine." Under this doctrine, the IRS can collapse seemingly discrete transactions or steps into a single transaction, which can have devastating tax and legal consequences. For example, if Spouse 1 transfers assets to Spouse 2, who then quickly forms a trust with these assets for the benefit of Spouse 1, the IRS may treat that trust as self-settled by Spouse 1 (which would pull those assets back into Spouse 1's estate for estate tax purposes).

b. Transfer Restrictions

i. Purpose of transfers. Transferring an interest in a closely held business can be an effective use of exemption as the gift tax value of a business interest is often substantially less than its long-term appreciation potential.

ii. Potential roadblocks. However, such interests often carry restrictions limiting or delaying transfers. These restrictions should be determined well in advance to ensure that planning is not foiled by a surprise restriction. Restrictions might include: (a) right of first refusal/first option; (b) requirement of consents from other parties; (c) timing restrictions; (d) restrictions on eligible transferees.

c. Valuation Issues

i. Obtaining a third-party valuation is particularly important when gifting a business interest or real estate.

ii. IRS regulations require a contemporaneous valuation by a qualified appraiser. There will be substantial demand for appraisals before the sunset. Individuals who wait too long may be unable to find a qualified appraiser in time. Complex appraisals, such as closely held business appraisals, may take multiple months to complete.

III. Building Flexibility into Transfer Tax Planning

a. Flexibility for the Settlor

i. Give the settlor the power to remove and replace the trustee. The replacement trustee could be an individual, bank, or trust company; however, the settlor must not appoint a successor trustee that is related or subordinate to the settlor within the meaning of Internal Revenue Code ("IRC") § 672(c).

ii. Structure the trust as a grantor trust.

1. *Grantor trust powers*. There are certain powers that can be granted under the trust agreement to the settlor or to certain other individuals which cause the trust to be a grantor trust for income tax purposes, but do not cause the trust property to be included in the settlor's taxable estate for estate tax purposes.

2. *Payment of income tax*. Structuring the trust as a grantor trust can provide substantial transfer tax savings because the settlor is responsible for the payment of any income tax generated by the property held by the trust, but the payment of that income tax by the settlor is not an additional transfer to the trust for gift tax purposes.

3. *Transactions with the trust*. An additional benefit of structuring the trust as a grantor trust is that transactions between the settlor and the trust are disregarded for income tax purposes. Therefore, the settlor can sell property to the trust without recognizing capital gain.

4. *Power to substitute property*. The most commonly used power to create a grantor trust that is not includable in the settlor's taxable estate is the power to substitute property.

a. The settlor reserves the power, exercisable only in a nonfiduciary capacity, to acquire or reacquire trust property by substituting other property of an equivalent value.
b. This power may be exercised without the approval or consent of the trustee, but the trustee has a fiduciary obligation to ensure the property acquired and substituted by the settlor is in fact of equivalent value.
c. The settlor should be given the ability to irrevocably release the power to substitute property, so that the grantor trust status of the trust can be turned off at any time. However, there could be income tax issues if the grantor trust status is turned off during the settlor's lifetime, depending on the basis of the trust property and any underlying debt.
d. While the power to substitute property creates a grantor trust, it also has the added benefit of providing flexibility to the settlor, as the settlor could exercise the power for future planning opportunities. For example, the settlor could subsequently swap low basis property out of the trust and replace it with high basis property. The low basis property would then be included in the settlor's taxable estate and would receive a stepped-up basis to fair market value upon the settlor's death.

5. *Right of reimbursement*. Include a provision in the trust agreement to allow an independent trustee to annually reimburse the settlor for income tax paid by the settlor as a result of the grantor trust status of the trust. Consider, however, including an expiration date on the annual right of reimbursement in order to potentially avoid inclusion risk if the settlor dies with outstanding rights of reimbursement.

6. *Revenue rulings*:

    a. Rev. Rul. 2008-22 determined that the substitution power under IRC § 675(4)(C), by itself, does not cause the value of the trust property to be includable in the settlor's gross estate under IRC §§ 2036 or 2038 provided that: (1) the trustee has a fiduciary obligation to ensure that the property acquired and substituted by the settlor are of equivalent values and (2) the substitution power is held in a non-fiduciary capacity by the settlor and cannot be exercised in a manner that could shift benefits among trust beneficiaries.

    b. Rev. Rul. 2004-64 held that when the settlor of a trust, who is treated as the owner of the trust for income tax purposes, pays the trust's income tax, the settlor is not treated as having made an additional gift of the tax amount to the trust or to the trust beneficiaries.

    c. Rev. Rul. 2004-64 further held that if the trust agreement or applicable local law requires that the trustee reimburse the

settlor for the income tax paid by the settlor, the full value of the trust property is includable in the settlor's gross estate under IRC § 2036(a)(1). If, however, the trust agreement or applicable local law only gives the trustee the discretion to reimburse the settlor for the income tax liability, the existence of that discretion, by itself (whether or not exercised), does not cause estate tax inclusion of the trust property in the settlor's gross estate.

iii. Allow for the settlor to deliver to the trustee a non-binding letter of wishes. Include a provision in the trust agreement stating the settlor's hope that the trustee will follow any wishes that the settlor may express in writing concerning the investment of and distribution of trust property for the benefit of the trust beneficiaries. The provision must be non-binding and should not impose a legal obligation on the trustee.

iv. Give the beneficiaries Crummey withdrawal rights. Generally, a transfer to a trust does not qualify for the annual exclusion. However, if the trust agreement allows for one or more of the trust beneficiaries to withdraw up to the annual exclusion amount (or two times that amount if the donor is married on the contribution date) when a contribution is made to the trust, then a portion of that contribution should qualify for the annual exclusion. The annual exclusion amount in 2025 is $19,000.

v. Structure the trust as a directed trust.

1. *Directed trust*. Under a typical trust arrangement, the trustee is responsible for: (1) trust administrative items (e.g., filing tax returns and preparing trust accountings); (2) the investment of the trust property; and (3) the distribution of the trust property to or for the benefit of the beneficiaries of the trust. Under a directed trust arrangement, a different person could be named to serve in each of these three roles. Generally, with a directed trust, a bank or trust company will serve as the administrative trustee; however, the trustee is directed as to investment decisions by one or more investment trust advisors (also commonly referred to as an investment committee) and is directed as to distribution decisions by one or more distribution trust advisors (also commonly referred to as a distribution committee). Many states have directed trust statutes that outline the powers and duties of the different roles.
2. *Investment trust advisor*. The investment trust advisor directs the trustee (usually by providing the trustee with written instructions) regarding how the trust property should be invested and managed. The direction could include retaining, purchasing, selling, loaning, and pledging trust property. It also could include how to vote business interests held by the trust and the hiring of an investment manager. However, the investment trust advisor cannot direct the trustee to enter into any transaction that would violate federal, state, or local law, or the provisions of the trust agreement. The trust

agreement should provide that the trustee has no duty to review or monitor trust investments while the investment trust advisor is acting and, therefore, the trustee has no responsibility or liability exposure for the investment performance of the trust property while the investment trust advisor is acting.

3. *Distribution trust advisor*. The distribution trust advisor directs the trustee (usually by providing the trustee with written instructions) regarding how and when the trust property should be distributed to or for the benefit of the beneficiaries of the trust subject, however, to the provisions of the trust agreement. The trust agreement must provide that no distribution trust advisor may participate in making a discretionary distribution of trust income or principal if that distribution trust advisor has a beneficial interest in the trust, unless the discretion of that distribution trust advisor is limited by an ascertainable standard under IRC §§ 2041(b)(1)(A) and 2514(c)(1).

4. *Why use a directed trust*? Some states have more favorable trust and tax laws than other states. Therefore, in creating a trust that is designed to last for multiple generations (e.g., a dynasty trust) it may be prudent to administer the trust under the laws of a favorable jurisdiction. This is usually accomplished by selecting a bank or trust company that is located in that favorable state to serve as trustee. However, the settlor might not wish for a bank or trust company to control trust investment and distribution decisions and

instead would prefer for one or more family members or trusted advisors to control those decisions. A directed trust arrangement allows for the trust to take advantage of favorable state trust and tax laws, while ensuring that investment and distribution decisions are made by designated individuals. It is important to note that those designated individuals do not need to reside in the state that the bank or trust company is located.

vi. Allow for the appointment of a trust protector.

1. A trust protector can be granted certain powers under the trust agreement to amend the trust in certain situations to achieve favorable tax results and other powers designed to provide flexibility in the administration of the trust. For example, a trust protector could be given the power to remove and replace a trustee, an investment trust advisor, and a distribution trust advisor. Allowing for the appointment of a trust protector provides flexibility in the administration of the trust, as it potentially avoids the need to petition the court if subsequent changes need to be made regarding the administration of the trust or the terms and provisions of the trust agreement.
2. Some states have a trust protector statute that lists powers that can be granted to a trust protector. Those powers could be incorporated by reference into the trust agreement or expressly listed.

3. An individual or entity could be named in the trust agreement to serve as trust protector or, alternatively, one or more persons could be given the ability to appoint a trust protector at a later time (i.e., if and when needed).
4. The following persons should not be named to serve as trust protector: (1) the settlor; (2) the settlor's spouse; (3) the trustee; (4) any individual who has a beneficial interest in the trust; and (5) any individual who is related or subordinate to the settlor or to the settlor's spouse within the meaning of IRC § 672(c).
5. It is important to note that amending an irrevocable trust can result in significant tax consequences. Therefore, prior to any such amendment, a thorough tax analysis should be conducted. Extreme caution should be taken in amending a trust that is generation-skipping transfer ("GST") tax exempt, as such an amendment could cause the trust to forfeit its GST exempt status.

b. Flexibility for the Beneficiaries

i. Allow the beneficiary to become a trustee. There are many benefits to transferring assets to a trust, including but not limited to tax planning, creditor protection planning, and oversight over the management, investment, and distribution of the trust property. However, frequently the settlor wants the beneficiary to have as much access and control as possible over the property and the primary purpose of the trust arrangement is tax planning and creditor protection planning. In those situations, consider

allowing the beneficiary to become a cotrustee of the trust upon attaining a certain age and sole trustee upon attaining a certain age; however, the trust agreement must limit the ability for that beneficiary to participate in a distribution decision by an ascertainable standard under IRC §§ 2041(b)(1)(A) and 2514(c)(1). Such arrangement should not frustrate the trust's favorable tax and creditor protection attributes.

ii. Give the beneficiary a power of appointment. Circumstances and laws may change between when the settlor creates the trust and when the trust ends (e.g., at the death of the beneficiary). Therefore, it may be prudent to grant the beneficiary of the trust a lifetime and/or a testamentary power of appointment over the trust property. A power of appointment allows the beneficiary to direct the disposition of the property to one or more persons. The settlor, as set forth in the trust agreement, has the ability to restrict how and when the power of appointment could be exercised (e.g., only in favor of one or more of the settlor's descendants or charitable organizations). Granting a power of appointment could also be used as a tax planning strategy.

iii. Allow for the trust to be decanted.

1. Decanting is a powerful tool that can be utilized by the trustee to transfer the trust property to a new trust with different terms, provisions, and potentially even beneficiaries than the current trust.

2. It is important to note that not all states have decanting statutes. Therefore, it may be necessary to move the situs of the trust to a different jurisdiction in order to implement a decanting strategy.
3. In order to decant a trust, the trustee must have discretion under the trust agreement to make a distribution of trust property to or for the benefit of the trust beneficiaries (i.e., the trust cannot be structured as a support trust).
4. Generally, at least one person who is a beneficiary of the current trust must also be a beneficiary of the new trust and the new trust cannot have a beneficiary who is not also a beneficiary of the current trust.
5. The decision to decant the trust is made by the trustee in the trustee's sole discretion (i.e., beneficiary consent is not required).
6. The rules and requirements regarding how a trust is decanted is state specific. Some decanting laws are more flexible than others. The following are factors that may differ from state to state:
   a. Court approval;
   b. Notice to beneficiaries;
   c. Ability to decant a trust that is subject to an ascertainable standard;
   d. Ability to decant a trust that is subject to an ascertainable standard to a trust that has no ascertainable standard;
   e. Ability to accelerate beneficial interests; and

f. Ability to remove a mandatory income right.

iv. Allow for future modifications to the trust agreement. Many state statutes allow for a trust agreement to be modified or amended with the consent of all of the beneficiaries of the trust. However, the definition of a beneficiary might include a contingent remainder beneficiary (e.g., a potential beneficiary under an ultimate-takers provision). Therefore, a long list of beneficiaries in an ultimate takers provision (e.g., multiple charitable organizations) might make it difficult to modify the trust agreement without Court approval.

IV. Building Flexibility into the Structure of the Transfer

a. Advantages of Lifetime Transfers

i. Remove future appreciation from taxable estate. A significant benefit of lifetime gifting is the removal from the donor's estate for estate tax purposes of the appreciation on, and income from, the gifted property earned after the date of the gift. Although the value of the gifted property is added back to the donor's taxable estate as an adjusted taxable gift and factors into the estate tax calculation, the appreciation and income on the gifted property is not included in the calculation.

ii. Remove gift tax from taxable estate. Under IRC § 2035(b), if gift tax is paid on a lifetime gift, that paid gift tax is not included in the decedent's gross estate unless the gift was made within three years of the decedent's death. Therefore, if the decedent made gifts in excess of the exclusion amount and

paid gift tax, the gift tax paid is removed from the decedent's estate for estate tax purposes three years after the date the gift was made. The gift tax is calculated only on the value of the property transferred. The estate tax is calculated on both the value of the property transferred and the dollars used to pay the estate tax. The tax-inclusive nature of the estate tax results in a higher effective tax rate than the gift tax.

iii. Avoid state estate tax. Most states do not have a gift tax and do not impose a tax on prior gifts at death, so making a lifetime gift can potentially save substantial state estate tax (if the decedent resided in a state with a state estate tax – note that not many states still have a state estate tax).

b. Disadvantages of Lifetime Transfers

i. Loss of step-up in basis. The basis of property acquired by a lifetime gift is the same as it would be in the hands of the donor, increased by the amount of gift tax paid (if any). The basis of property acquired from a decedent at death is stepped up to the fair market value of the property as of the date of the decedent's death.

ii. Loss of income. The loss of income from gifted property is a significant reason why a client may be reluctant to make a lifetime gift. Some of this reluctance arises from a desire to leave core capital intact to provide for future uncertainties and to provide sufficient income to meet lifestyle needs.

iii. Loss of control. Control over a business, investment portfolio, or other property often will be relinquished in a gifting strategy in order to leverage the transfer. For example, the transfer of a closely held business interest

could be structured so that valuation discounts (e.g., lack of marketability and lack of control) are applicable to the valuation of the gifted interest. However, the desire to retain control can be a powerful impediment to gifting. Therefore, gifting strategies should be designed to account for the client's goals and objectives, while still accomplishing the tax planning goals (e.g., through the use of a trust arrangement).

c. Strategies to Retain an Income Stream for Client

i. Sell assets to an intentionally defective grantor trust. Settlor creates an irrevocable trust, which is structured as a grantor trust to the settlor. Settlor gifts property to the trust and then subsequently sells property to the trust in exchange for a promissory note. The trustee pays the settlor installments on the note until it is paid in full. Payments on the note provide an income stream to the settlor with a fixed rate of return. The interest rate on the promissory note must be equal to at least the applicable federal rate ("AFR") to avoid adverse tax consequences. The trust needs to have "economic substance" in order for the sale to be treated as a bona fide sale in the eyes of the Internal Revenue Service ("IRS"). Therefore, generally the gift portion of the transaction should be equal to at least ten percent of the value of the total transaction and should occur prior to the sale portion of the transaction with a significant gap in time between them.

ii. Structure the trust as a spousal lifetime access trust ("SLAT"). A SLAT is an irrevocable trust created by one spouse (the "donor spouse") for the benefit of the other spouse (the "beneficiary spouse") and descendants. During the

beneficiary spouse's lifetime, distributions of property held by the SLAT can be made to the beneficiary spouse. The donor spouse generally should not be a beneficiary of the SLAT, but distributions made to the beneficiary spouse likely will provide an indirect benefit to the donor spouse. Upon the beneficiary spouse's death, the SLAT generally should be structured so that the remaining trust property passes to or for the benefit of descendants (even if the donor spouse is then living). Therefore, if the donor spouse survives the beneficiary spouse, the donor spouse's indirect access to the SLAT property will end upon the beneficiary spouse's death.

iii. Implement a grantor retained annuity trust ("GRAT"). A GRAT is an irrevocable trust created by the settlor. The settlor transfers property to the GRAT in exchange for the right to receive a fixed annual payment (an annuity) from the GRAT for a term of years. The present value of the annuity payments is determined based on the IRC § 7520 rate at the time of the transfer. At the end of the term of years, the remaining trust property is distributed to one or more remainder beneficiaries (e.g., the settlor's children or trusts for their benefit). Consequently, to the extent the property transferred to the GRAT appreciates in value at a rate that exceeds the 7520 rate, the excess appreciation is transferred to or for the benefit of the remainder beneficiaries gift tax-free. It is also important to note that a GRAT is a relatively "risk-free" strategy, which means that if the GRAT fails to perform (i.e., the property transferred to the GRAT appreciates at a rate less than the 7520 rate), there are no adverse tax or economic consequences

other than the loss of the transaction costs (i.e., attorney fees and other expenses incurred to create and fund the GRAT). This strategy works especially well when the GRAT is funded with easy to value assets (e.g., marketable securities) or closely held assets that have significant growth potential.

d. Strategies to Use Client's Exclusion

i. Gifting all of one spouse's exclusion. Perhaps the best option for locking in the current estate and gift tax exclusion amount is to "use it before you lose it" by gifting assets equal to the remaining exclusion amount (i.e., in 2025, $13.99 million for an individual or $27.98 million for a married couple, reduced by any prior taxable gifts), whether outright or in trust. However, because not every couple is in a position to transfer $27.98 million of assets, an effective alternative is to use all of one spouse's exclusion in 2025 and leave the other spouse's exclusion untouched. Please note that, if the client implements this alternative strategy, the client and the client's spouse should not elect to "split" each other's gifts as reported on their 2025 gift tax returns.

ii. Hedging with a part-gift, part-sale transaction. If the client would rather wait until the end of the year (e.g., December 31st) to decide whether to use a significant portion or all of the client's remaining exclusion, an option to consider is a part-gift, part-sale transaction. Under this approach, a portion of the transfer would be structured as a gift (which would use exclusion) and the other portion of the transfer would be structured as a sale (which

would not use exclusion) evidenced by a promissory note. If at the end of the year it becomes apparent that the exclusion amount likely will go down in 2026, the client could then at that time forgive a portion or all of the promissory note to convert that portion of the sale into a gift.

iii. Forgiving an existing loan. If the client previously made loans to family members or to trusts for their benefit (e.g., as part of a previously executed estate planning strategy) consider forgiving a portion or all of those loans in 2025. The forgiveness of the loans will be a taxable gift that will use exclusion. However, the income tax consequences of the forgiveness of the loans will need to first be analyzed.

iv. Equalize gifts to family members. If the client previously made unequal gifts to the client's children, grandchildren, siblings, or other family members, consider making gifts in 2025 using exclusion amount to equalize those gifts. If the exclusion amount is reduced in the future, the client may not have the opportunity to equalize prior gifts without incurring tax.

v. Fund future life insurance premium payments. If the client created an irrevocable trust that holds a life insurance policy requiring large annual premium payments, consider having the client make a gift to that irrevocable trust to fund future premium payments.

e. Nonqualified disclaimer. If the client is the beneficiary of an irrevocable trust that will be included in the client's taxable estate for estate tax purposes on death, consider having the client make a nonqualified (i.e., taxable) disclaimer of the client's interest in the trust in 2025. Depending on the terms of the trust, the

disclaimer could leverage current gift tax exclusion amount to transfer trust property to the next generation, outright or in trust, before tax laws change

V. Recent Developments and Proposed Tax Law Changes:

- **a.** The incoming Trump administration will almost certainly extend TCJA permanently. President Trump proposed this, among various other tax policies, while on the campaign trail. With unified control of the legislature, this is likely to be a priority for the incoming administration.
- **b.** Project 2025, a project of the Heritage Foundation with some ties to the incoming administration, has endorsed making TCJA changes permanent and reducing the tax rate to maximum of 20%.
- **c.** It is unclear whether President Trump might eliminate estate/GST-tax entirely; he has pledged to do so in the past.