Planning for Exemption Reduction:

WHY BUSINESS OWNERS NEED TO CONSIDER ADVANCE GIFTING AHEAD OF 2026

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Upcoming changes in the combined federal estate and gift tax exemption allow different possibilities for taking advantage of current exemptions. Such possibilities include advance gifting, arrangement for sales, and general estate planning updates.

The federal estate tax was previously "sunset" in 2010. However, Congress moved (relatively) quickly to reinstate it. At that time, Congress combined the lifetime gift exemption with the estate tax exemption. It then set the lifetime limit at $5,000,000, indexed to inflation. In 2017, for tax years 2018 onward, Congress doubled the exemption. The 2023 exemption is $12,920,000, adjusted for inflation. Moreover, a spouse has the same exemption. A married couple can exempt up to $25,840,000 of assets with the combined exemption.

The problem (and opportunity) is that in the 2017 bill, Congress included another "sunset" provision wherein as of January 1, 2026, the "doubled" exemption ends and reverts to the 2011 $5,000,000 exemption (plus inflation). The current estimate is that the 2026 exemption will fall to between 6 and 7 million dollars.

As the 2024 and 2025 levels continue to increase, individuals may leave millions of dollars of exemptions on the table. The estate tax rate is progressive, maxing out at 40% of the taxable estate over $1 million. How will the decrease affect potential taxpayers? Suppose that our taxpayer has an estate of $14 million. Suppose we presume that the 2025 exemption ends up at $14 million and the 2026 exemption ends up at $7 million. In that case, the taxpayer's estate will pay no taxes if the taxpayer passes away in 2025 and nearly $2.75 million if the taxpayer passes away in 2026.

The opportunity for clients is that the estate tax exemption is combined with the lifetime gift tax exemption. Therefore, the question was posed, "What happens if the higher gift exemption is used up before 2026?" "Would there be a penalty later?" "Would the IRS allow the exemption to be

used?" In November 2019, the IRS clarified its position in final regulations related to the Tax Cuts and Jobs Act.[1] In those regulations, the IRS provided that individuals utilizing the higher gift tax exemptions through 2025 would not be adversely affected. The IRS offers an example on one of its FAQ pages, "Before 2018, A had never made a taxable gift. In 2018 when the [basic exclusion amount "BEA"] is $11.18 million, A makes a taxable gift of $9 million. A uses $9 million of the available BEA to reduce the gift tax to zero. A dies in 2026. Even if the BEA is lower that year, A's estate can still base its estate tax calculation on the higher $9 million of BEA that was used in 2018."[2]

This clarification by the IRS allows taxpayers to take advantage of these higher exemption amounts before the sunset in 2026. This also gives practitioners a reason to reach out to their clients, particularly business owners.

Part of the problem with estate planning is that individuals can be slow to act. This can be especially true with business owners as they generally have other, more pressing matters to address. At the same time, gifting and estate planning strategies for business succession can be time-consuming. It is worthwhile to begin planning now, even though we are more than two years away from the sunset.

One of the aspects that will take some time is having a business valuation performed. By having such a valuation done, one will better understand the benefits of early gifting. Further, the business valuation will allow you to consider splitting up the gift to secure a minority interest discount. Such valuation will also assist in responding to any challenges by the IRS.

Although a professional business valuation should be secured, preliminary work can begin to determine a rough value. By having a rough valuation, you can better plan the structure of the final plan. IRS Revenue Ruling 59-60 provides insight into how to value closely held companies. The ruling states that balance sheets for two or more years and detailed profit-and-loss statements for the last five years should be obtained. With that information in hand, you can start to determine if you have a potential estate or gift tax issue.

The actual mechanism of gifting the business can be simple or complicated. At the most basic level, an assignment of shares and membership interest can complete the transaction. Even in such a situation, some due diligence should be done. One primary example would be to determine what personal guarantees, if any, exist and then work to release the owner from those.

Gifting the business presumes the owner wants a family member to have the company. Some owners may be looking to sell. That does not prevent the gifting strategy. If the business is sold, something still has to be done with the proceeds. Now, the newly liquid assets can be gifted to the next generation, and the exemption can be used up. With the liquidity in place, other options are available. One straightforward possibility is a spousal lifetime access trust, which allows the business owner to gift assets to a trust and provide an income stream for their spouse. Presumably, the business owner will then benefit from that income stream. The remainder can then pass on to their children.

There are, of course, downsides to advanced gifting. The biggest hurdle for many will be the loss of control. The owner will lose some or perhaps all control by gifting the company. They may also be concerned about their finances. Will they have enough money to live on? What kind of hit will their quality of life take? The planner needs to help address those concerns.

Different methods can be used to retain some level of control and stream of income. For example, some types of trust may be utilized. However, those will have a tradeoff between the level of control and taxation. Another potential avenue is recapitalizing the business and creating voting and nonvoting stock. The business owner could retain the voting stock and gift the nonvoting stock, thereby retaining control of the company.

When discussing the sunset, the political climate must be discussed. Nothing is stopping Congress and the president from removing the sunset provision and retaining the doubled exemptions. And because the sunset does not occur until the end of 2025, we may have a new president and a new controlling party in Congress. However, in many cases, the gifting plan does not have to be carried out yet. If the business owner plans to convey the business to their children, then the practitioner can prepare the succession plan. Then, it is ready to go if it appears that the sunset will happen. If Congress and the president act, then much of that drafting and planning will not be wasted because the succession still has to occur.

Due to this uncertainty, flexibility is going to be key moving forward. For example, often simple wills were prepared for clients that were comfortably under the estate tax exemption. In recent years, clients with appreciable assets have been guided into creating revocable trusts and pour-over wills. With revocable trusts, one can build in disclaimer trusts and provide the trustee and beneficiaries some leeway in allocating assets.

This uncertainty can also lead to using some tools that have fallen out of favor with the higher exemptions. For example, using irrevocable life insurance trusts can be appealing to clients. By having an irrevocable trust own the life insurance policy, the client minimizes the policy's estate tax issues. The client is also less concerned than with other gifts because the asset the client is losing control over is one that control is not necessarily needed.

Using irrevocable life insurance trust also provides the opportunity to further educate clients on a misunderstood concept – the annual gift tax exclusion. With the life insurance trust, the client will "gift" the trust the policy premium each year. The current annual gift tax exclusion is $17,000, and that amount can be gifted to any number of people. Moreover, it will not count against the combined federal estate and gift tax exemption. This provides another mechanism for avoiding taxes down the road.

Advanced gifting is not going to be for everyone. For business owners, it should at least be a consideration. If an owner is reaching a point where he or she is thinking about "winding down," now is a good time to consider doing it. With the double-exemption sunset approaching, considerable tax savings are available. Perhaps more important is meeting an owner and discussing succession planning. A good plan now will pay dividends later, even if one decides to forego advanced gifting.

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1 See IRS Treasury Decision 9884, available at https://www.federalregister.gov/documents/2019/11/26/2019-25601/estate-and-gift-taxes-difference-in-the-basic-exclusion-amount

2 IRS, *Estate and Gift Tax FAQs*, https://www.irs.gov/newsroom/estate-and-gift-tax-faqs, (last updated October 18, 2022)