
Folks:

Take-Away: To sound like a ‘broken record,’ now is a good time to start to talk to individuals about using their bonus applicable exemption amount before it disappears in 2026. There are plenty of things to talk about including why funding a Trust now using the donor’s applicable exemption amount can provide more benefits than just using their exemption while it lasts.

Background: To state the obvious, an individual’s applicable exemption amount is scheduled to be cut in half starting in 2026. For 2024, an individual’s applicable exemption amount used against federal transfer taxes is \$13.61 million. If the 2026 *sunset* arrives with no change, the applicable exemption amount will drop to about \$6 to \$7 million per individual. Many commentators believe that Congress will, probably at the eleventh hour if history is any indication, decide to extend the large applicable exemption amount well beyond 2025. Then there are the doubters who correctly point to the increased publicity about the massive federal deficit that continues to grow, along with the estimates that the Social Security and Medicare trust funds will rapidly run out of money in the next decade, and that no one in Congress wants to vote to curtail those governmental entitlement programs that benefit seniors (all of whom tend to vote.) It is anyone’s guess whether the applicable exemption amount will be extended, be permitted to be cut in half, or perhaps cut even more deeply to address the looming federal deficit. Suffice it to say that waiting and watching how Congress will act (or it chooses not to act and permits the *sunset* to take place) may not be the best way to plan for the future. Back, yet again, to the mantra

you no doubt are tired of reading, which is that individuals should *use-their-bonus exemption-before-they-lose it*.

Why would individuals fund a Trust now, and not adopt a 'wait-and-see' approach to what Congress *might* do to the applicable exclusion amount?

Future Appreciation: A transfer of assets now to the Trust, using the settlor's available applicable exemption amount to shelter the transfer from gift taxes, removes from the settlor's gross estate any future appreciation in the transferred assets along with the value of the transferred assets.

SLATs: This strategy has been covered at length over the past few years. A married couple can fund a spousal lifetime access trusts (SLAT), use their currently available applicable exclusion amount, and have their spouse receive the income from the SLAT for the spouse's lifetime. Thus, assets are transferred outside the marital estate and are not included in the settlor's estate for federal estate tax purposes, while the marital unit will still enjoy access to the SLAT's income, preserving the marriage's cash flow. For SLATs to work the spouses must be in a different economic position after the SLATs are funded. Care must be to avoid the IRS's *reciprocal trust doctrine*, which means that if each spouse creates a SLAT for his/her spouse, the two SLATs need to be dissimilar in their provisions, e.g., created at different times, with different assets, and with different terms, e.g., the right to income in one SLAT, a 5+5 annual principal withdrawal right in the other SLAT; a limited power of appointment in one SLAT, a retained power in the other SLAT to direct investments.

DAPT: If the individual is not married and thus not a candidate to create

and fund a SLAT for his/her spouse, they could fund a domestic asset protection trust (DAPT) using a Michigan's Qualified Dispositions in Trust. Again, the settlor would use his/her available applicable exemption amount now, and could still be named as a discretionary trust beneficiary, if there is an independent trustee, in order to remove assets from their estate while still having indirect access to the transferred assets.

Creditors: With either a SLAT or a DAPT creditors cannot access the assets transferred by the settlor to the Trust. Funding an irrevocable non-grantor Trust now, before a particular creditor claim is anticipated, makes it much easier to avoid future arguments that funding the Trust results in a fraudulent transfer by the donor. In fact, with the scheduled *sunset* date with respect to the applicable exemption amount, funding an irrevocable Trust now, before that *sunset* date, can easily provide an explanation when a challenge later is made by a future creditor that that the transfers to the Trust were neither fraudulent, nor voidable, transfers, but were intended to take advantage of the transfer tax law's bonus exemption amount while it existed. Similarly, making annual exclusion gifts to the non-grantor Trust, so that no single annual exclusion gift is a significant portion of the settlor-donor's net worth, makes these gifts less susceptible to challenge by future creditors as being fraudulent conveyances; a long history of annual exclusion gifts over a period of years, instead of one large one-time gift to the Trust, will go a long way to deter creditor arguments that the transfers were intended to hinder or delay creditor claims.

Income Taxes: A funded non-grantor Trust can also be used to reduce current state income taxes. A Trust is at the highest marginal federal income tax bracket in 2023 when its accumulated income exceeds \$14,450. If that income is distributed to individual trust beneficiaries,

assuming that there is *distributable net income* (DNI) in the Trust, then the trust beneficiaries will pay the income taxes on the distribution at their much lower marginal federal income tax brackets. Similarly, the Trust could be established in a jurisdiction like Delaware with a very low (or *no*) state income tax when its beneficiaries are outside of the state, and thus avoid paying any state income tax on the Trust's accumulated income.

Save State Income Taxes: A SLAT can also take advantage of avoiding the state income tax on accumulated SLAT income if the trustee's distribution of income to the spouse-beneficiary must be approved, in advance, by an adverse party, i.e., "*....any person having a substantial beneficial interest in the trust which would be adversely affected by the exercise or no exercise of the power which he possesses respecting the trust.*" [IRC 672(a).]

Facilitate Charitable Giving: Or, a non-grantor Trust can be used to facilitate charitable giving. While individuals are restricted by percentage income limitations as to the amount that they can deduct for federal income tax reporting purposes, an irrevocable non-grantor Trust is not subject to those income limitations, so long as the Trust instrument authorizes distribution of trust income to charities. Unfortunately the IRS takes the position that a charity cannot be added as a beneficiary at a later date to the Trust; as such, the trustee's discretion to make discretionary distributions of trust income to charities needs to be in the original Trust instrument.

Free-Basing: : As has been covered in the past, an irrevocable Trust can also be used to gain an income tax basis adjustment of assets held in a Trust on the death of a general power of appointment holder. [IRC

2041.] This is humorously called ‘free-basing with grandma.’ The settlor creates an irrevocable Trust, naming his/her parent or an elderly relative along with the settlor’s children as the discretionary trust beneficiaries. Distributions of income or principal are made to the settlor’s parent or elderly relative on an as needed basis. Because the elderly beneficiary holds a testamentary power of appointment over the Trust’s assets, upon the powerholder’s death, and assuming that they do not have a large taxable estate in their own name, results in the deceased elderly beneficiary’s estate including the value of the Trust’s assets, subject to that testamentary power of appointment, with the assumption that the decedent’s then-available applicable exemption amount will be available to cover any federal estate taxes due. In short, while no federal estate taxes are actually paid by the decedent’s (grandma’s) estate the Trust assets used to benefit the grandchildren receive a full income tax basis adjustment (*free-basing.*) This testamentary power of appointment can be described as a formula so as to not expose the elderly beneficiary’s estate to unwanted federal estate taxes. [Heads the taxpayer wins, tails the IRS loses.]

Word of Caution: When spouses decide to fund non-grantor Trusts they need to be wary of the IRS’s *step-transaction* doctrine. This ‘trap’ was on display in a recent federal Tax Court decision. In *Smaldino v. Commissioner, Tax Court Memo 2021-127 (November 10, 2021)*. There the husband gave his wife interests in a family limited liability company. The very next day the wife gave those LLC interests to a Trust that the husband created, a Trust that benefited the husband’s children from a prior marriage. The Tax Court found that the husband was actually the donor of the LLC interests to the Trust, not his wife, and it imposed the gift tax on the husband. The problem for the husband was that he had already fully used his applicable exemption amount in making earlier transfers of LLC interests to the same Trust. In short, the wife was

viewed as acting as an agent for her husband in making gifts. Needless to say, the longer the period of time that elapses between the husband's gift of assets to his wife, and the time that she finally makes a gift of 'her' assets to the Trust, the more likely it is that the IRS will be unsuccessful arguing that a *step-transaction* was involved.

Conclusion: Most clients would prefer putting off as long as possible technical discussions about estate planning, and they certainly do not want to incur legal expense when they don't have to. Yet there are plenty of good reasons to start talking about steps that they can take now and 'avoid the rush' come late 2025 when everyone decides to use their bonus applicable exemption amount before they lose it. There plenty of other lifetime benefits associated with funding a Trust now beside using their bonus applicable exemption amount before it is lost.

If you would like to read additional missives, [click here](#).