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Dear Clients and Friends:

I wanted to review with you some 2022 developments in the area of estate and gift tax planning, as well as developments regarding the impact of the SECURE Act on estate planning for retirement accounts.

<u>TAX CHANGES WHICH IMPACT ESTATE AND GIFT TAXES (AND GENERATION-SKIPPING TRANSFER TAXES)</u>. 2022 has been a relatively quiet year for the area of estate and gift tax planning, with most changes arising due to the automatic inflation adjustments provided for under federal law. Here are the main points you should know:

- Every taxpayer has a federal estate & gift tax credit (the "E&G Tax Credit") which can be used to shelter both lifetime taxable gifts from gift tax and the remaining estate from estate tax at the taxpayer's death. The "basic exclusion amount" of the E&G Tax Credit is adjusted for inflation each year. For taxpayers dying in 2022, the inflation-adjusted E&G Tax Credit is <u>$12,060,000</u> (less any E&G Tax Credit used in prior years to shelter prior gifts from gift tax).

- Effective as of January 1, 2023, the inflation-adjusted E&G Tax Credit is scheduled to rise to <u>$12,920,000</u>, which means that a married couple could have a combined E&G Tax Credit of $25,840,000 (less any E&G Tax Credit used in prior years to shelter prior gifts from gift tax) as of the start of 2023.

- As a reminder, current law provides that the E&G Tax Credit is scheduled to be cut in half, effective as of January 1, 2026. Effectively, this means that the E&G Tax Credit will be reduced to <u>not less than $6,460,000</u> (plus one-half of any inflation adjustments made in 2024 and 2025) as of January 1, 2026. High-net worth taxpayers should consider making gifts to use most or all of their remaining E&G Tax Credit before 2026. Taxpayers who previously made large gifts to use up their E&G Tax Credit in prior years may be able to make significant additional gifts as a result of inflation adjustments.

- Taxpayers should note that the IRS previously adopted regulations to protect the value of gifts made using the larger pre-2026 E&G Tax Credit from "claw back" into the taxpayer's estate for taxation at the taxpayer's death. However, the regulations essentially adopt a "use it or lose it" rule. The regulations provide that, for taxpayers dying in 2026 or later, the taxpayer's E&G Tax Credit will be the greater of (i) the E&G Tax Credit in effect at the time of the taxpayer's death (less any E&G Tax Credit used in prior years to shelter prior gifts from gift tax), or (ii) the E&G Tax Credit actually used in prior years to shelter prior gifts from gift tax. This means that taxpayers who want to use up some or all of their larger pre-2026 E&G Tax Credit must give more than the E&G Tax Credit that they anticipate will be in effect at their death to reap the benefit of the larger pre-2026 E&G Tax Credit. Married couples who can afford to give a combined gift which is more than the estimated 2026 E&G Tax Credit for a single taxpayer should consider carefully-structured gifting to have the combined gift attributed to a single spouse so that they can use that spouse's larger E&G Tax Credit before 2026.

- As an added complication, earlier this year, the IRS issued proposed regulations to exclude certain types of pre-2026 gifts from the "anti-clawback" protections discussed above and to cause such excluded gifts to be pulled back into the decedent's estate for estate tax purposes. The IRS takes the position that these excluded gifts are "painless gifts" where the taxpayer didn't truly part with enjoyment or control of the asset and that the taxpayer shouldn't receive the benefit of the higher E&G Tax Credit in effect at the time of the "painless gift" if the taxpayer dies in 2026 or later. Per the proposed regulations, these types of excluded "painless gifts" include:

    - Transfers where the taxpayer retains an interest which is includible in the gross estate under a variety of estate tax provisions (including retained life estates, transfers taking effect at death, revocable transfers and certain life insurance transfers);

    - Transfers made by enforceable promise to the extent the promise remains unsatisfied as of the date of death;

    - Transfers of interests in entities where the taxpayer's retained interest is valued at zero under IRC Section 2701 (a "defective estate freeze"); and

    - Transfers that would have been described above, but for the transfer, relinquishment, or elimination of an interest, power, or property, performed within 18 months of the date of the decedent's death by the decedent alone, by the decedent in conjunction with any other person, or by any other person.

  Taxpayers who want to use their increased E&G Tax Credit for gifts prior to 2026 can, with a modicum of attentive gift tax planning, easily do so without running afoul of these "painless gift" proposed regulations.

- Finally, in addition to the federal estate and gift tax, federal law imposes a "generation-skipping transfer tax" (or "GSTT") on transfers during lifetime or at death, including trust distributions, to "skip beneficiaries" [beneficiaries who are two or more generations younger than the transferor or settlor of the trust (e.g., grandchildren or more remote generations)]. The GSTT is a flat 40% of all non-exempt transfers or trust distributions to a "skip beneficiary"). However, each taxpayer is entitled to a GSTT Exemption, in an amount equal to the Estate Tax Credit. As a result, the current GSTT Exemption for 2022 is $12,060,000, will rise to $12,920,000 as of January 1, 2023, and is slated to be cut in half in 2026.

INCREASED AMOUNTS FOR "ANNUAL EXCLUSION" GIFTS.

- Every taxpayer can give annual gifts to an unlimited number of recipients, up to a specified maximum value, each year without the gift counting as a "taxable gift". These so-called "annual exclusion" gifts are an excellent method to slowly transfer significant wealth to your desired beneficiaries without using your E&G Tax Credit. For 2022, the maximum "annual exclusion amount" which could be given to any recipient is $16,000, but the "annual exclusion amount" will rise to $17,000 per recipient for 2022.

CHANGES IN RETIREMENT ACCOUNT PLANNING UNDER THE SECURE ACT.

The Setting Every Community Up for Retirement Enhancement Act (SECURE Act) was signed into law on December 20, 2019 and is landmark legislation that significantly affects many clients' estate planning for retirement accounts. Most of the provisions impacting individuals went into effect on January 1, 2020.

The most significant, and potentially adverse, change of the SECURE Act was the elimination of the ability to "stretch" out the distribution of employee retirement accounts and IRAs (collectively "Retirement Accounts") over the lifetime of most non-spousal beneficiaries. Instead, the SECURE Act provides that "designated beneficiaries" (generally, identifiable individual beneficiaries, but not charities, probate estates, or trusts which have any non-identifiable beneficiaries) must fully distribute the Retirement Account by the end of the 10th year following the year of the decedent's death (the "10-Year Period"). Special rules apply to permit "eligible designated beneficiaries" to "stretch" distributions of the Retirement Account over the lifetime of the "eligible designated beneficiary". The term "eligible designated beneficiary" includes spouses, the decedent's minor children, disabled and chronically ill beneficiaries and beneficiaries who are not more than 10 years younger than the decedent.

Tax practitioners had questions about some of the more adverse provisions of the SECURE Act. In 2022, the IRS finally issued proposed regulations on how to apply the Secure Act. The proposed regulations are a mixed bag, in that they provided welcome clarity in certain areas but additional complications in other areas. Specifically, the proposed regulations provide that:

- For taxpayers who die before starting required minimum distributions ("RMDs") (i.e., before reaching age 72), "designated beneficiaries" do not have to take any RMDs during the 10-Year Period, but must simply fully distribute the Retirement Account by the end of the 10-Year Period.

- For taxpayers who die after starting their RMDs (i.e., after reaching age 72), "designated beneficiaries" must take RMDs each year after the decedent's year of death through the end of the 10-Year Period (when the Retirement Account must be fully distributed).

- Special rules are provided for Retirement Accounts inherited by the decedent's minor child(ren), or a trust for a minor child's benefit. First, the proposed regulations provide that a decedent's child will be treated as a minor until the child's 21st birthday. The minor child (or trust) is required to take RMDs based on the minor child's life expectancy (or in certain cases, the oldest minor child who is a beneficiary of the trust). After the minor child attains majority (at age 21), the child must continue his or her RMDs and complete distributions of the Retirement Account by the end of the 10th year following the child's 21st birthday.

- Disabled beneficiaries can qualify as "eligible designated beneficiaries" who are entitled to "stretch" distributions from a Retirement Account over their life expectancy. A safe harbor treats beneficiaries as disabled if they are deemed disabled for Social Security purposes. Because this criterion is difficult to apply to children, the proposed regulations would apply a modified but comparable standard for beneficiaries under age 18.

- The proposed regulations also provide welcome guidance and clarity regarding when beneficiaries of a trust can be treated as "designated beneficiaries" or "eligible designated beneficiaries" of the decedent for purposes of the SECURE Act, especially in the area of designing trusts for minor children and other "eligible designated beneficiaries".

Although the proposed regulations provided welcome clarity, they also raised alarms for taxpayers who had inherited Retirement Accounts after 2019 but who had not (in reliance on certain early IRS pronouncements) taken RMDs in 2021 and who were uncertain whether they would be required to take RMDs in 2022. The IRS recently issued guidance that the proposed regulations will not go into effect until January 1, 2023 and that taxpayers will not be penalized if they do not take RMDs in 2021 or 2022.

In light of the SECURE Act and its proposed regulations, all taxpayers with Retirement Accounts should carefully review their beneficiary designations and the terms of any trusts designated as beneficiaries of Retirement Accounts to ensure that their estate plan still qualifies for the maximum "stretch" possible or desirable (given the risks of inadvertently distributing assets to too-young beneficiaries), while minimizing potential adverse income tax consequences.

SOME FINAL THOUGHTS ON WHAT THE FUTURE MAY HOLD. Although no significant estate and gift tax legislation was proposed in 2022, proposals continue to be discussed in Washington. Some of these proposals seek (i) to accelerate the reduction of the E&G Tax Credit, (ii) to eliminate the adjustment of the tax basis of a decedent's assets to their date-of-death values (the so-called "stepped-up tax basis"), (iii) to restrict or eliminate the use of annual exclusion gifts for certain types of gifts, (iv) to include the assets of grantor trusts in a decedent's estate or to treat grantor trusts as separate taxpayers for the recognition of taxable gain or loss for asset sales between the grantor and the grantor trust, or (v) to restrict or eliminate the use of valuation discounts in the valuation of partial interests in businesses or real estate for estate and gift tax purposes. There is still a risk that some or all of these proposals might be added back into pending or future legislation in 2023.

If you or your accountant would like more details about any item discussed in this letter, please do not hesitate to call.

Very truly yours,

Linda Slider

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