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Lifetime exemption adjusted for inflation: some planning strategies for using the incremental increase

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The Internal Revenue Service (IRS) recently released the updated figures for the gift tax annual exclusion and the lifetime exemption (which is the amount an individual can transfer for gift and estate tax purposes without incurring any transfer tax) for persons who pass away in 2023.[1] Both of those figures are adjusted annually for inflation, which we know has been significant this year. In 2023 an individual may make gifts of $17,000 per person without incurring any gift tax or using any part of their lifetime exemption.[2] In 2023, an individual may also make transfers of up to $12.92 million either during their lifetime or at death without incurring any gift or estate tax on those transfers. This means that, even if an individual has fully used their $12.06 million exemption currently available in 2022, they may make an additional $860,000 of gifts in 2023 without incurring any gift taxes. The $12.92 million exemption will revert to 2011's original $5 million base amount (adjusted for inflation) on January 1, 2026, unless Congress takes action.

There are a number of different planning strategies that individuals may want to consider with this increased gifting ability. A benefit to using the exemption during lifetime is that any appreciation of the asset given away is also outside of the individual's estate for estate tax purposes at death. For example, if an individual gives away stock currently worth $5 million and it grows to $8 million at the individual's death, that additional $3 million in appreciation passes free of gift and estate tax. The gift can be made outright to another individual, or more commonly, made in trust.

1 Rev. Proc. 2022-38.
2 Id. Typically most relevant when a gift is made in trust, there are certain requirements that must be met in order for that gift to qualify for the gift tax annual exclusion.

One type of trust individuals commonly utilize to make use of their exemption is commonly referred to as a spousal lifetime access trust (also known as a "SLAT") for the benefit of their spouse and descendants. A SLAT is a popular trust for married individuals as it allows the grantor (the person who contributes money or other property to a trust) to retain an indirect benefit from the irrevocable trust since their spouse is a beneficiary and assets may be distributed from the trust to support the couple's lifestyle. Another benefit to making a gift to a SLAT is that a SLAT is generally structured as a grantor trust. A grantor trust is one where the grantor is responsible for reporting all items of income, credit, and deduction on their own personal return, rather than treating the trust as a separate taxpayer. While this may not initially seem beneficial to continue paying income taxes on assets the grantor has given away, by paying the income taxes on behalf of the trust, it allows the trust to grow undiminished by income taxes.[3]

Other clients may choose to make gifts to a number of other types of trusts created for their descendants or other beneficiaries to make full use of the additional exemption. A descendants trust is an irrevocable trust generally set up for the benefit of the grantor's children, and often grandchildren as well. Unlike a SLAT, the grantor's spouse is not a beneficiary. A descendants trust can be structured as a grantor trust or a nongrantor trust, where the trust is responsible for the payment of its own income taxes. The trust assets may be used for the intended beneficiaries for any purpose specified in the trust agreement. These types of trusts are very flexible and can be tailored to the grantor's wishes, which makes them a very popular gifting vehicle.

One other option that an individual may consider with the increased exemption available in 2023 is life insurance. Many individuals utilize life insurance to offset state or federal estate taxes that may be due upon their death. The federal estate tax is 40% of the value of the decedent's assets in excess of their remaining exemption and any marital, charitable, and other deductions,[4] so it may be a significant financial burden. If structured properly through the use of an irrevocable life insurance trust (often referred to as an "ILIT"), the proceeds of the life insurance policy are not be includable in the decedent's estate for estate tax purposes and can provide the liquidity needed to pay the estate tax when due nine months after the decedent's death. Many married couples utilize a second-to-die policy since many estate plans rely on the marital deduction to defer estate taxes until the death of the surviving spouse.[5] Second-to-die policies are also typically less expensive than a policy on a single life because the premiums are based on the joint life expectancies of both insured individuals. The increased exemption may provide the ability to purchase a paid-in-full policy to offset potential estate taxes, if that is a concern.

There are a number of options to consider with the increased exemption from gift and estate tax in 2023. These may be existing trusts or newly created ones and may be structured as grantor trusts or as nongrantor trusts, as discussed above. Whatever the estate planning goal, individuals should consider taking advantage of the increased gift tax annual exclusion and lifetime exemption to the extent they are comfortable doing so.

[3] For more information about SLATs, see Catherine McDermott, *Spousal Lifetime Access Trusts* (a Publication of the UBS Advanced Planning Group).
[4] More precisely, the top marginal federal estate tax rate is 40%. The federal estate tax is graduated but reaches the top marginal rate once the taxable estate exceeds $1 million.
[5] The marital deduction is unlimited between spouses who are both U.S. citizens. For more information about estate planning for non-US citizens, see Carrie J. Larson, *Planning for Non-US Citizens* (a Publication of the UBS Advanced Planning Group).

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