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Memorandum

TO: LeBlanc & Young Clients

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SUBJECT: Primer on Transfer Taxes

I. Overview of Federal Transfer Tax System

The federal government imposes a tax on certain transfers made during life (gift tax) or at death (estate tax); and it assesses an **additional** tax on certain transfers made to or for the benefit of persons two or more generations below that of the transferor (generation-skipping transfer tax). There are common elements in these three tax regimes which we will summarize here. More specific information about each tax will be provided in the following three sections. The common elements are:

a. **Marital Deduction**.[1] No transfer tax is imposed on transfers to your spouse. Transfers qualifying for the marital deduction can be made directly to your spouse or to a qualifying trust for his or her benefit. A qualifying trust must distribute all of its net ordinary income to the spouse at least annually; and the trust must be prohibited from making any distribution to any beneficiary other than the spouse during his or her lifetime. You may (but need not) give your spouse a power of appointment to direct in his or her Will where the balance of the trust is to be distributed following your spouse's death. Many clients opt to provide their spouse with such a power, which can be restricted to benefiting descendants only, or some other defined group of permitted beneficiaries, including charities.

b. **Charitable Deduction**. No transfer tax is imposed on transfers to qualifying charities, i.e. charities recognized as tax-exempt by the IRS. This includes direct transfers to such charitable organizations, including charitable foundations and donor-advised funds at public foundations like the Maine Community Foundation. It also includes the "charitable portion" of certain trusts or other arrangements which involve both charitable and non-charitable beneficiaries, such as charitable remainder trusts, charitable lead trusts, and charitable gift annuities.

c. **Exemptions from Tax**. Transfers which do not qualify for a marital deduction or charitable deduction may be subject to a federal transfer tax, but only when the aggregate amount of such transfers exceeds an applicable exemption. The exemptions available with regard to the gift tax, estate tax and generation-skipping transfer tax are all the same. The Tax Cuts and Jobs Act of 2017 (TCJA) doubled the taxable threshold, which is now set statutorily at $10 million but indexed for inflation. The exemption is currently $13.61 million (for 2024). Specific information about these various exemptions is set forth in the next three sections of this memorandum. The changes enacted in 2017 were not

[1] The provisions described in this section assume your spouse is a US citizen. If that is not the case, then different and more restrictive rules will apply. See Section 5 below.

permanent; because of budgetary issues, the changes are set to "sunset" or revert back to previous levels in 2026. It is unclear whether future legislation will seek to make the changes permanent. Consequently clients with very large estates may want to do planning to take advantage of the higher exemptions while they are available. Only people who would be inclined to make substantial gifts approximating the full exemption would benefit from such planning.

II. <u>Federal Gift Tax</u>

Some transfers are not treated as gifts for federal transfer tax purposes, and others are treated as gifts but do not have to be reported. The first category consists of tuition payments made directly to a school, and medical expenses paid directly to a provider, for the benefit of another person. The second category includes so-called "annual exclusion gifts." These are present-interest gifts made to individuals (or to certain trusts[2]) which have a value equal to or less than the annual exclusion amount in the year of the gift. Gifts not covered by the annual exclusion amount are called "taxable gifts" and are offset by the transferor's lifetime gift tax exemption on a cumulative basis over the years. Once your entire lifetime exemption has been so utilized, all taxable gifts thereafter will result in a gift tax. More details on these various concepts are set forth below.

a. **<u>Annual Exclusion and Gift Splitting</u>**. For many years the gift tax annual exclusion was fixed at $10,000. Now that it is being adjusted from time to time for inflation, the current annual exclusion amount for gifts made in 2024 is $18,000 per recipient. In other words, you can transfer property worth up to $18,000 per year per recipient and not have to report those gifts to the IRS. If your spouse signs an appropriate consent, you can also use your spouse's annual exclusion and therefore give up to $36,000 per recipient without making a taxable gift; however, this **does** require your filing a gift tax return with the IRS, because that is the form on which your spouse would be confirming his or her consent. This is called "gift splitting" and, if it is done, it must apply to all gifts you are making to persons other than your spouse during the year in question. If all gifts are made independently by each spouse (that is, $18,000 directly from each) then no gift splitting is needed.

An example may be helpful. If John gives his daughter property worth $233,000 in 2024, the first $18,000 is covered by his annual exclusion and the remaining $215,000 is a taxable gift reportable on a gift tax return. That taxable gift will reduce John's lifetime exemption (see Section b below) by $215,000; but no gift tax will be due unless John's remaining exemption going into 2024 was less than $215,000. If John's wife agrees to gift splitting and signs the consent portion of his gift tax return, then she will be treated as having made half of the gift even though the entire gift came from John. Accordingly, $36,000 of the total gift would be sheltered by their respective annual exclusions, the remaining $197,000 would be treated as a taxable gift of $98,500 made by each of them, and their respective lifetime exemptions would each be reduced by that $98,500 amount. A gift tax return that consents to gift splitting must split all gifts reported and the Donor/Spouse cannot choose which gifts to split.

[2] Only "present interest" gifts qualify for the annual exclusion. These are gifts made directly to a recipient and over which he has immediate control. Accordingly, most gifts to trusts do not qualify for the annual exclusion. There are limited exceptions, however, for certain trusts which have special tax-sensitive provisions, including so-called Crummey trusts.

b. **<u>Lifetime Exemption and Tax Rate</u>**. The lifetime gift exemption is the same as the estate tax exemption of $13.61 million (for 2024). Each taxpayer's gift tax exemption is "used up" on a cumulative basis over his lifetime to shelter "taxable gifts" from any gift tax liability. Once the exemption has been fully utilized, all further taxable gifts will generate a gift tax at a flat rate of 40%. One last point about the gift tax exemption: whenever a taxpayer makes a "taxable gift" and uses up some of his lifetime gift tax exemption, he is also in effect reducing his estate tax exemption by the same amount. In other words, John's $98,500 taxable gift to his daughter in 2024 will reduce **both** his gift tax exemption and his estate tax exemption by $98,500. This is because the estate and gift tax is considered a "unified transfer tax" that can be used either during an individual's lifetime or at death. As the exemption increases with indexing, clients may be able to make taxable gifts that top off earlier gifts that fully utilized previous exemptions.

III. <u>Federal Estate Tax</u>

Transfers at death that do not qualify for the marital deduction or charitable deduction are subject to a federal estate tax on the aggregate amount that exceeds the exemption available in the year of death. The estate tax exemption for 2024 after indexing is $13.61 million per decedent and the federal estate tax rate on the amount over that exemption is 40%. Assets other than IRAs, pensions and similar assets (with a special income tax categorization) that are included in a decedent's estate for tax purposes, wherever they are intended to pass, receive a "step up" in cost basis to the date of death value of the asset. For low basis holdings, this can be a tremendous benefit and allow diversification of a portfolio, neutralization of risk and rebalancing assets.

The federal estate tax (but not the Maine estate tax) now includes the concept of "portability," which allows the estate of a surviving spouse to utilize the unused estate tax exemption of his or her last predeceased spouse to shelter additional assets over the exemption amount from estate taxation at the second death, provided an estate tax return was filed signifying that the deceased spouse's unused exemption will be "ported" to the surviving spouse. If a federal estate tax return is filed for the estate of the first spouse to die, electing to pass his or her unused exemption to the surviving spouse, the surviving spouse may use the exemption and essentially "add" it to his or her own exemption. This allows the assets inherited by the surviving spouse in qualified form to receive a second step up in cost basis on his or her subsequent death, which can be a tremendous benefit. There are a few complex rules that pertain to portability, and if the surviving spouse turns out to have different beneficiaries from the first spouse to die, the surviving spouse's estate might use the exemption of the first to die to "cover" his or her own assets that pass to his or her own beneficiaries and thus the beneficiaries of the first to die could, in certain circumstances, pay tax that would otherwise have been avoided if the first to die had used his or her own exemption with a traditional trust plan. Further, if the surviving spouse remarries, the portability is only available on his or her death if he or she predeceases the subsequent spouse (it is the unused exemption of the last <u>deceased</u> spouse).Thus, portability, while offering a simple solution for some plans, does not fit all circumstances and must be used intentionally and with caution. This portability provision does **not** apply to the generation-skipping transfer tax **or to the Maine estate tax**, so it may have limited utility for some couples who are Maine residents who have very large estates, and are worried about the Maine estate tax but are not inclined to make a large gift after the death of the first spouse.

Before recent tax law changes increased the federal exemptions and made permanent the concept of portability, a very common estate planning problem involved married couples whose total combined estate value exceeded the amount of a single available estate tax exemption. This meant that each spouse would have to separately own enough property so each could use a Family Trust to hold assets with a total value equal to his or her available estate tax exemption to avoid or at least reduce the estate tax liability on the overall estate. The concept of portability neutralized those Family Trusts for federal estate tax purposes for many clients whose combined estates would not exceed the aggregate of the exemptions, although the use of trusts still have substantial appeal for clients who are concerned about Maine or other state estate tax issues, or who wish to do generation skipping planning. Further, for married clients of substantial wealth whose estates approach or exceed the combined exemption, they can be useful to shelter appreciation that might push the estate of the survivor over the combined exemption. A trust can provide the Donor with certainty that the assets will ultimately pass to his or her intended beneficiaries upon the death of the income beneficiary. Trusts can also protect the assets from a beneficiary's creditors, including matrimonial claims in many circumstances. Thus the use of Family Trusts is still powerful, but they are no longer the cornerstone of federal estate tax planning for many clients.

IV. <u>Generation-Skipping Transfer Tax</u>

The Generation-Skipping Transfer Tax (GSTT) was enacted by Congress in 1976, and substantially revised in 1986, to eliminate a perceived loophole in the federal transfer tax system: the ability of very wealthy families to avoid estate taxes by utilizing multi-generational dynasty trusts. These generation-skipping trusts would typically provide for the transferor's children as the primary beneficiaries initially, but would also provide for subsequent generations of descendants before terminating pursuant to applicable state law under the so-called Rule Against Perpetuities. This meant that estate taxes could be avoided at each child's death, and each grandchild's death, etc., because those later decedents would not be owners of any portion of the continuing trust.

The GSTT is essentially a surtax assessed on generation-skipping transfers in addition to any gift tax or estate tax payable by a transferor or his estate on account of a given transfer. The rate of this tax is equal to the highest estate tax rate then in effect. Thus, after subtracting a 40% gift or estate tax from the value of the transferred property, the balance is taxed again at a 40% rate when the generation skipping transfer occurs. The 2024 exemption applicable to the GSTT is $13.61 million, the same as for both gift taxes and estate taxes.

Given the draconian nature of the GSTT, most generation-skipping tax planning involves the utilization of each transferor's full GSTT exemption to fund one or more generation-skipping trusts and limit such arrangements to the exemption amount so that no GSTT will have to be paid. Under current law, this allows a married couple to set aside up to $27.22 million in generation-skipping arrangements without incurring any GSTT. The specific elements of the GSTT are extremely complicated and require very careful planning to avoid the imposition of this surtax when generation-skipping arrangements are desired.

V. <u>Special Rules for Non-Citizen Spouses</u>

The unlimited marital deduction discussed at the beginning of this memorandum does not apply to transfers made to a non-citizen spouse. Transfers to such a spouse, whether made during one's lifetime or at death, are subject to the following special rules:

a. **<u>Gift Tax</u>**. Gifts totaling up to $185,000 per year can be made to a non-citizen spouse in 2024 under a limited marital deduction provision. Gifts to such a spouse in excess of that amount will be "taxable gifts" which can be offset by the transferor's lifetime gift tax exemption. This threshold amount is also indexed and changes annually and enables an additional gift each year.

b. **<u>Estate Tax</u>**. Death-time transfers to a non-citizen spouse (including life insurance and qualified plan/IRA benefits) can qualify for an unlimited marital deduction **only** to the extent such transfers are made to a Qualified Domestic Trust (QDOT) which satisfies various requirements set forth in the Internal Revenue Code. Transfers made directly to the non-citizen spouse (including joint property passing by survivorship), or to a trust which does not qualify as a QDOT, are subject to estate taxation but can be offset by the transferor's federal estate tax exemption.

c. **<u>QDOT Impact</u>**. One key feature of a QDOT which can create estate tax problems for a couple is that all principal distributions made from such a trust during the remaining lifetime of the surviving spouse (other than certain defined hardship distributions) are treated as transfers from the original transferor's estate and are subject to estate tax payable by the QDOT. Upon the later death of the surviving spouse, when the trust assets are distributed to other beneficiaries, such distributions are treated as having been made from the estate of the original transferor and, again, are subject to an estate tax payable by the QDOT. In other words, no part of the estate tax exemption available to the non-citizen surviving spouse can be used to shelter the principal in a QDOT from an estate tax assessed in connection with the estate of the U.S. citizen transferor.

A surviving spouse who is not a U.S. citizen on the date of death of his or her spouse may avoid the need for a QDOT, and may qualify for an unlimited marital deduction as a U.S. citizen, if he or she becomes a citizen by the time the deceased spouse's estate tax return is **timely filed**. Since every estate is entitled to an automatic 6-month extension beyond the 9-month due date for filing estate tax returns, this gives the surviving spouse up to 15 months to become a U.S. citizen.

VI. <u>No Maine Gift Tax, but . . . .</u>

Maine does not have a gift tax. This means that, for the most part, gifts made during one's lifetime will escape the Maine estate tax at death. However, Maine includes taxable gifts (i.e. those not covered by one's annual exclusions) made within 12 months of death in the transferor's estate for Maine estate tax purposes.

The absence of a state-level gift tax in Maine can tip the scales in favor of making lifetime taxable gifts, notwithstanding the potential income tax cost down the road of doing so. The major "downside" of making such gifts is that the recipient of the gift succeeds to the transferor's cost basis in the gifted property. Any capital gain realized on the later sale of that property will generate an income tax liability. Conversely, assets **inherited** from a decedent receive a cost basis adjustment at death. The new cost basis is the fair market value of the property as of the decedent's date of death. As a result, the sale of inherited property shortly after a decedent's death should generate little if any capital gain. This significant difference in the treatment of basis for property received by inheritance rather than by gift is an important factor to be weighed in determining whether or not to make "taxable gifts" particularly by persons whose estates are not likely to be subject to the federal estate tax. But for persons seeking to reduce or even eliminate a Maine estate tax liability, the making of such taxable gifts may be advisable, so long as there is a strong likelihood the transferor will outlive such gifts by more than a year.

VII. <u>Maine Estate Tax</u>

The Maine estate tax system has undergone a series of fairly significant changes over the past decade, culminating in a complete overhaul which became effective on January 1, 2016. Maine does not recognize portability, and thus couples with large estates may well require trust tax planning, but couples with estates comfortably under the Maine and federal exemption amounts may now have simplified estate plans without the need for tax motivated trusts.

Beginning in 2016, Maine's estate tax statute includes a true exemption and new tax rates, with the exemption level increasing from $2 million to a current exemption of $6.8 million per decedent. The tax rates for decedents who die in 2024 are as follows: 8% for estates with assets over $6.8 million and up to $9.8 million; 10% for additional assets between $9.8 million and $12.8 million; and 12% on amounts in excess of $12.8 million. In addition, although gifts made within one year of death are still added back to the estate of decedents, completed gifts made earlier than one year before death are no longer included in the taxable estate.

It is important for nonresidents who own Maine property to understand that Maine has a special rule when real estate or tangible personal property is held in a pass-through entity which is run as an active business for profit. In such situations, the pass-through entity will be recognized and taxed as an intangible asset by the state of the nonresident's domicile (and not by Maine). When Maine property is held in a pass-through entity that is **not** run as an active business for profit (ownership of a vacation home, for instance), Maine will disregard the entity and impose an estate tax on the nonresident's estate based on the proportion that the value of the Maine property comprises of the decedent's entire estate. The critical distinction for nonresidents is between personal use property (taxable) and business property (not taxable) held in a pass-through entity.

The Maine estate tax structure also applies to nonresident estates. Once the initial tax is calculated under the new system, the initial tax is multiplied by the Maine property fraction to arrive at a final tax liability for nonresident estates.