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How these multimillionaires are avoiding a 40% tax hit

PUBLISHED TUE, DEC 3 20192:36 PM EST

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KEY POINTS

- The Tax Cuts and Jobs Act roughly doubled the amount of assets you can transfer without being subject to the 40% federal gift and estate tax.
- In 2020, an individual can transfer up to $11.58 million without the tax hit. This is known as the gift and estate tax exclusion.
- The exclusion will revert to about $5 million after 2025, but those who transfer assets prior to that date won't have their gift clawed back into their estate.

If you're sitting on a few million dollars and you want to save on taxes, consider giving some of it away.

The Tax Cuts and Jobs Act roughly doubled the amount an individual can transfer to others without being subject to the 40% gift and estate tax.

In 2019, this so-called gift and estate exemption is $11.4 million per individual. This amount will tick up to $11.58 million in 2020.

Prior to the tax overhaul, individuals were able to transfer only $5.49 million in lifetime gifts or through bequests at death without being subject to the tax.

Now might be the time to think about making those gifts if you're hoping to save on estate taxes. The exemption is going to fall back to about $5 million per person at the end of 2025.

"Earlier is better versus waiting until the end of 2025," said Ronald Finkelstein, CPA and national co-partner in charge of the trusts and estates practice group at Marcum LLP.

After the tax overhaul, accountants were concerned that transfers exceeding $5 million would be clawed back into people's estates and subject to the 40% tax after the gift and estate exemption decreases in 2026.

"There was this concern that if I give away $11.4 million today, what happens when the exemption drops? Will I be taxed on the amount I gave, or will my estate be taxed?" asked John Voltaggio, CPA and managing director at Northern Trust in New York.

A final rule issued by the IRS in late November permits taxpayers who were planning on making those large gifts between now and 2025 to do so without fear of having the money they've given away be pulled back into their estates.

"These regulations are telling us that you're grandfathered and safe; they won't try to claw back the additional amount that you've gifted," said Voltaggio.

"This means a lot to those clients; they have more certainty to take action before 2026 – before the exemption falls," he said.

Another reason for thinking about how to move forward: 2020 is an election year. Both Sen. Elizabeth Warren and Sen. Bernie Sanders — challengers vying for the presidency — have proposed a slew of wealth taxes.

Sanders has also pitched an estate tax with a rate as high as 77% on estates exceeding $1 billion.

"Many Democratic proposals call to reduce the estate tax exemption," said Finkelstein. "If that happens, the higher exemption won't last until 2025. It can expire earlier."

The benefit of making large gifts in your lifetime is that you're moving assets and their appreciation out of your estate, which reduces the amount that's subject to estate tax once you die.

But this move doesn't work for everyone.

For instance, if your estate is under $5 million and thus likely to escape the estate tax, you might be better off holding onto the assets until death. This way, your beneficiary gets a so-called step-up in basis.

That means when you die, your heir gets the asset valued as of the date of death. If your beneficiary sells the asset right away, he or she won't pay any capital gains taxes.

Gifted assets don't get a step-up in basis.

Proceed deliberately and work closely with your estate planning attorney, your CPA and your financial advisor to decide what's best for your circumstances.