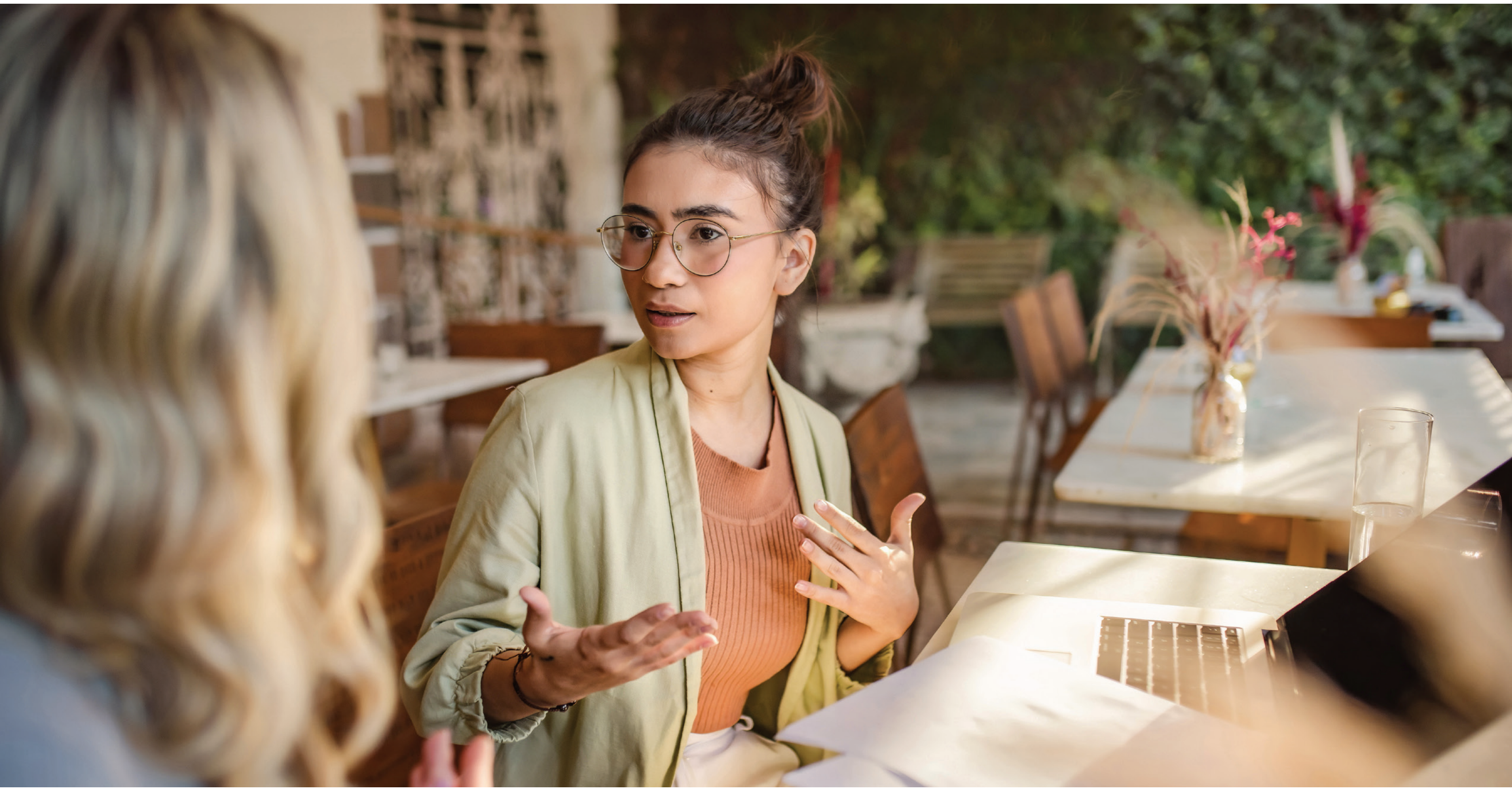
An Overview of Wealth Transfer Tax Planning



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Wealth transfer tax planning involves consideration of various taxes. At the federal level, there are three wealth transfer taxes:
– Gift tax
– Estate tax
– Generation-skipping transfer (GST) tax

In 2025, an individual's lifetime exemption (i.e., gift and estate tax exemption) is $13.99 million.[1] This amount adjusts annually for inflation and currently includes a temporary increase.[2] Unless tax laws change, this increase expires after 2025, at which time the lifetime exemption will be cut roughly in half.[3] To the extent an individual didn't use their lifetime exemption during life, they can use it upon their death. To the extent an individual makes taxable gifts in excess of their lifetime exemption, the excess is generally subject to a 40% gift tax. Similarly, to the extent that, upon an individual's death, their estate for estate tax purposes exceeds their unused lifetime exemption, the excess is generally subject to a 40% estate tax.

In 2025, an individual's GST tax exemption is $13.99 million.[4] This amount adjusts annually for inflation and currently includes a temporary increase.[5] Broadly speaking, the GST tax is a 40% tax on transfers to individuals who are two or more generations younger than the transferor. The GST tax applies in addition to the gift or estate tax, although it also can apply in situations in which neither tax applies. For a more in-depth discussion of the GST tax, see Rebecca Sterling, *Generation Skipping Transfer Tax* (a publication of the UBS Advanced Planning Group).

Many states also impose wealth transfer taxes. More than one-third of the states impose estate or other death taxes (i.e., estate taxes, inheritance taxes, and similar taxes).[6] One state imposes a gift tax, some states impose death taxes on gifts (usually only gifts made within a certain time before death), and one state imposes a GST tax.[7]

For a discussion of state death taxes, see Carrie J. Larson, *State Death Taxes* (a publication of the UBS Advanced Planning Group). In this whitepaper, we'll focus on federal wealth transfer taxes.

In addition to wealth transfer taxes, planning often has income tax implications. For example, an individual might transfer assets to an irrevocable trust that's designed to be outside of the individual's estate for estate tax purposes. When the individual dies, the assets shouldn't be includable in the individual's estate for estate tax purposes (so long as the trust was properly designed and administered), but the assets also typically wouldn't qualify for stepped-up basis (or, more precisely, basis adjustment). In contrast, if the individual retains the assets rather than transfer them to an irrevocable trust, the assets are includable in their estate for estate tax purposes, but those assets generally receive a stepped-up basis equal to the fair market value of the assets as of that individual's date of death. Thus, there's a trade-off between potential estate tax savings and potential income tax savings. For a discussion of some of the income tax aspects of wealth transfer planning, see Rebecca Sterling, *Income Tax Basis Considerations in Estate Planning* (a publication of the UBS Advanced Planning Group).

With this backdrop, let's explore some common ways individuals look to reduce their exposure to wealth transfer taxes.

Making non-taxable gifts

An individual who wishes to reduce their estate for estate tax purposes might consider making non-taxable gifts to family members and others. A non-taxable gift transfers wealth out of an individual's estate without using any of the individual's lifetime exemption or causing the individual to be subject to any gift tax. Non-taxable gifts include:
– Annual exclusion gifts
– Tuition exclusion gifts
– Medical expense exclusion gifts

[1] IRC §§ 2010(c) and 2502(a). See Rev. Proc. 2024-40. This assumes the individual is a US person for gift and estate tax purposes.
[2] IRC §§ 2010(c)(3)(B) and (C).
[3] IRC § 2010(c)(3)(C).
[4] IRC § 2631(c). See IRC § 2010(c) and Rev. Proc. 2024-40.
[5] IRC § 2010(c)(3)(B).
[6] "State Death Tax Chart," American College of Trust and Estate Counsel, April 7, 2024, https://www.actec.org/resources/state-death-tax-chart/.
[7] Id.

Annual exclusion gifts

Under the annual exclusion, the first $19,000 of gifts made by an individual to a donee during 2025 are non-taxable.[8] This amount adjusts annually for inflation.[9] In addition to removing the money or other property from the individual's estate for estate tax purposes, the gift removes any future appreciation with respect to that money or property from the individual's estate. To the extent a gift is non-taxable, it doesn't consume any of the individual's lifetime exemption (i.e., gift and estate tax exemption).

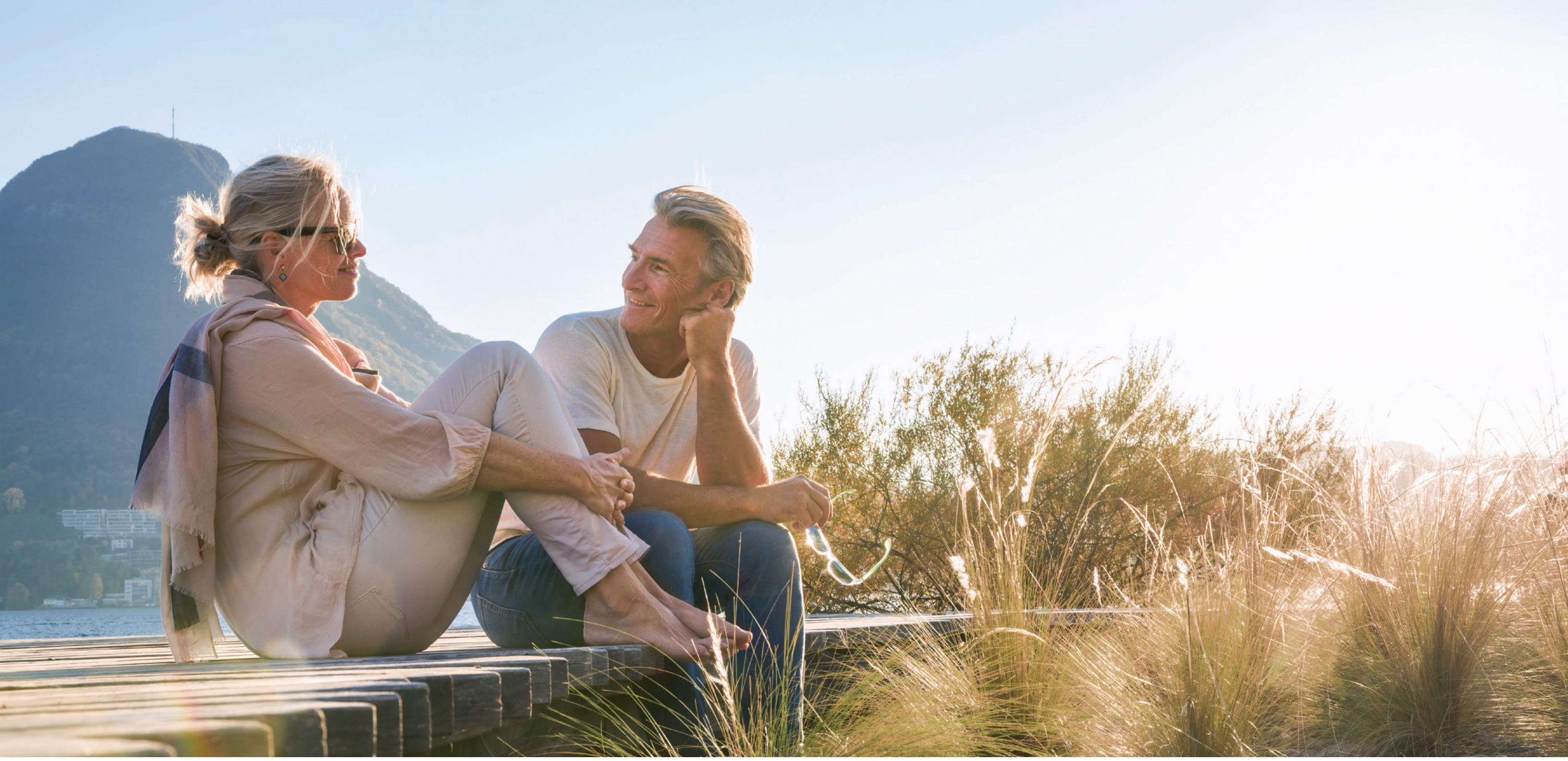
An outright gift to an individual can potentially qualify as an annual exclusion gift. A gift to a Uniform Gifts to Minors Act (UGMA) account, a Uniform Transfers to Minors Act (UTMA), or a 529 account is a gift to the beneficiary of the account and can potentially qualify as an annual exclusion gift. In some cases, a gift in trust can qualify as an annual exclusion gift. For example, an individual might create an *irrevocable life insurance trust*, which is an irrevocable trust designed to hold an insurance policy on the life of the settlor (or the settlor and the settlor's spouse). Under the terms of the trust, the beneficiaries may have withdrawal powers (sometimes called *Crummey powers*), so that some or all of the settlor's gifts to the trust can qualify for the gift tax annual exclusion.

For more information about UGMA and UTMA accounts, see Carrie J. Larson, *Avoiding UTMA Regret* (a publication of the UBS Advanced Planning Group). For more information about 529 plans, see Jessica Mazzaro Friedhoff, *Funding Education: 529 Accounts and Annual Giving Trusts* (a publication of the UBS Advanced Planning Group). For a more in-depth discussion of irrevocable life insurance trusts, see *Life Insurance* (a publication of the UBS Advanced Planning Group).

Tuition exclusion

Under the tuition exclusion, the payment of another individual's tuition is non-taxable if it's made directly to the school or other educational provider.[10] This exclusion applies only to the payment of tuition and doesn't apply to the payment of room, board, books, or other educational expenses.[11] To the extent the exclusion applies, the payment of the medical expenses is a non-taxable gift and doesn't consume any of the individual's annual exclusion or lifetime exemption.[12] Under state law, a parent may have a legal obligation to pay a minor child's tuition (and sometimes an adult child's tuition), in which case the payment of the child's tuition isn't a gift and the tuition exclusion is irrelevant.

[8] IRC § 2503(b)(1) and Rev. Proc. 2024-40.
[9] IRC § 2503(b)(2).
[10] IRC § 2503(e)(2)(A).
[11] Treas. Reg. § 25.2503-6(b)(2).
[12] IRC § 2503(e)(1).



Medical expense exclusion

Under the medical expense exclusion, the payment of another individual's medical expenses is non-taxable if it's made directly to the healthcare service provider.[13] Premiums for healthcare insurance generally are treated as a medical expense.[14]

To the extent the exclusion applies, the payment of the medical expenses is a non-taxable gift and doesn't consume any of the individual's annual exclusion or lifetime exemption.[15]

Under state law, a parent ordinarily has a legal obligation to pay a minor child's medical expenses, in which case the payment of the child's medical expenses isn't a gift and the medical expense exclusion is irrelevant.

Using the lifetime exemption

An individual who wishes to reduce their estate for estate tax purposes might consider making gifts that use their lifetime exemption. These are gifts that don't qualify for the gift tax annual exclusion, tuition exclusion, medical expense exclusion, marital deduction, or charitable deduction.

In tax parlance, these are called taxable gifts, even though an individual doesn't pay any gift tax on them until the total amount of taxable gifts that an individual makes during their life exceeds their lifetime exemption.[16]

By making gifts that use their lifetime exemption, the individual potentially removes from the individual's estate any future appreciation with respect to the money or property that the individual gives away. In addition, by making gifts before the lifetime exemption potentially decreases after 2025, the individual can take advantage of the higher exemption.[17]

Let's assume that an individual has made $12 million of taxable gifts by the end of 2025 and, as a result of the scheduled decrease, the lifetime exemption is $7 million in 2026.

The individual generally won't be subject to gift or estate taxes on the $5 million of taxable gifts that they made before 2026 while the higher exemption was in effect.[18]

[13] IRC § 2503(e)(2)(B).
[14] Treas. Reg. § 25.2503-6(b)(3).
[15] IRC § 2503(e)(1).
[16] Treas. Reg. § 25.2505-1(a).
[17] Treas. Regs. §§ 20.2010-1(c)(1) and (c)(2).
[18] Id.

When making gifts that use their lifetime exemption, an individual might make gifts into an irrevocable trust, such as a descendant's trust, a spousal lifetime access trust, or a self-settled spendthrift trust.[19] Using a trust may offer important advantages. A trust can potentially insulate trust property from the claims of a beneficiary's creditors (including a spouse or former spouse), and it can potentially keep the trust property out of a beneficiary's estate for estate tax purposes. A trust, however, requires proper administration, which involves some time and expense. For a more in-depth discussion of trust administration, see Casey Verst, *Duties of a Trustee* (a publication of the UBS Advanced Planning Group).

Descendants' trusts

A descendants' trust is an irrevocable trust of which the settlor's descendants are beneficiaries (and neither the settlor nor the settlor's spouse is a beneficiary).

Spousal lifetime access trusts

A spousal lifetime access trust (sometimes called a *SLAT*) is an irrevocable trust of which the settlor's spouse is a beneficiary (and contributions to which don't qualify for the marital deduction). Other beneficiaries may include the settlor's descendants. While a spousal lifetime access trust can be appealing because the beneficiary-spouse can potentially receive distributions from the trust, it's best to gift to the trust only amounts that the settlor and the settlor's spouse don't expect ever to need to touch. If both spouses create spousal lifetime access trusts, the trusts must be sufficiently different, otherwise they may not achieve their wealth transfer tax planning objectives. For a more in-depth discussion of spousal lifetime access trusts, see Catherine McDermott, *Spousal Lifetime Access Trusts* (a publication of the UBS Advanced Planning Group).

Self-settled spendthrift trusts

A self-settled spendthrift trust is an irrevocable trust of which the settlor is a beneficiary. Other beneficiaries may include the settlor's spouse, descendants, and other family members. The trust must be created in a state that recognizes self-settled spendthrift trusts. Not all states do. While the settlor can potentially receive distributions from a self-settled spendthrift trust, it's best to gift to the trust only amounts that the settlor doesn't expect ever to need to touch. For a more in-depth discussion of self-settled spendthrift trusts, see Todd D. Mayo, *Self-Settled Spendthrift Trusts* (a publication of the UBS Advanced Planning Group).

Shifting future appreciation out of the estate

An individual who has used as much of their lifetime exemption as they can or are comfortable using but isn't looking to accumulate more wealth might consider implementing one or more strategies that freeze the value of their estate (or a portion of it) for estate tax purposes. These strategies effectively shift future appreciation out of an individual's estate without using any of the individual's lifetime exemption or causing the individual to incur any gift or estate taxes.

Selling assets to a grantor trust

If an individual hasn't previously created a grantor trust, then the individual would make a gift to an irrevocable trust that's designed to be a grantor trust with respect to that individual.[20] This gift may be a seed gift—possibly, about 10 percent or 11 percent of the value of the assets that the individual intends to sell to the trust—or it may be more substantial.[21] The individual subsequently would sell assets to the trust in exchange for a promissory note. Since the trust is a grantor trust with respect to the individual, the sale is ignored for income tax purposes.[22] Thus, the individual doesn't recognize any gain upon the sale. The transaction, however, is respected for gift and estate tax purposes.[23]

[19] Treas. Reg. § 25.2503-2(a) (a gift in trust is generally treated as a gift to the beneficiaries of the trust).

[20] A grantor trust is generally disregarded for income tax purposes, and the settlor (or, in some cases, the beneficiary) reports the trust's income, deductions, and credits on their personal income tax return. IRC §§ 671 to 679.

[21] The purpose of this seed gift is to provide the trust with sufficient financial capacity so that the trust isn't financing the entire purchase price, which would not usually occur in an arm's length transaction. The gift also provides the trust with some liquidity so that it has funds to service the interest payments on the promissory note.

[22] Rev. Rul. 85-13.

[23] See IRC § 2511(a).

The promissory note may be designed so that the trust pays only interest until maturity and a lump-sum (balloon) payment at maturity, or it may be designed so that it's amortized. For purposes of avoiding potential gift tax issues, the interest must not be less than the applicable federal rate. To the extent that, over the term of the promissory note, the transferred property appreciates more than the interest rate on the promissory note, the sale to the grantor trust potentially would shift wealth to the trust and out of the individual's estate without any gift or estate tax costs.

For a more in-depth discussion of sales to grantor trusts, see Casey C. Verst, *Sales to Grantor Trusts* (a publication of the UBS Advanced Planning Group).

Grantor retained annuity trusts

A grantor retained annuity trust (GRAT) is an irrevocable trust that distributes an annuity to the settlor for a term of years, after which the remaining assets are distributed to one or more individuals (typically, the settlor's children) or a trust for their benefit. A zeroed-out GRAT is a GRAT that's designed so there isn't any taxable gift upon its creation and, to the extent its assets appreciate at a rate that exceeds the 7520 rate in effect when the trust was funded, the excess appreciation passes to the remainder beneficiaries without incurring any gift or estate taxes. The section 7520 rate, which is the interest assumption that's used for valuing certain interests for gift and estate tax purposes, acts like a hurdle rate.[24] The IRS publishes the section 7520 rate monthly.[25]

For a more in-depth discussion of GRATs, see *Grantor Retained Annuity Trusts* (a publication of the UBS Advanced Planning Group).

[24] More specifically, the 7520 rate is 120% of the federal midterm rate (subject to rounding). IRC § 7520(a)(2). The federal midterm rate is based on the average market yield on outstanding marketable obligations of the United States with a remaining maturity period of more than three years and not more than nine years. IRC § 1274(d)(1)(C)(ii).

[25] Treas. Reg. § 1.7520-1(b)(1)(i).

Charitable lead annuity trusts

An individual who is charitably inclined and wishes to potentially shift wealth on a gift and estate tax free basis to children (or others) might consider creating a charitable lead annuity trust. A charitable lead annuity trust pays an annuity to one or more charities (possibly the individual's donor advised fund or private foundation) for a term of years, after which the remaining property is distributed (either outright or in trust) to one or more non-charitable beneficiaries (typically, the donor's children). The trust often is designed so that there isn't any taxable gift upon its creation and, to the extent its assets appreciate at a rate that exceeds the 7520 rate that applied when the trust was funded, the excess appreciation passes to the non-charitable beneficiaries without incurring any gift or estate taxes.[26] In addition, the donor potentially may be entitled to an income tax charitable deduction upon funding the trust.

For a more in-depth discussion of charitable lead annuity trusts, see *Charitable Lead Annuity Trusts* (a publication of the UBS Advanced Planning Group).

Qualified personal residence trusts

A qualified personal residence trust (sometimes called a *QPRT*) is an irrevocable trust to which the settlor contributes their personal residence while retaining the right to use the residence for a term of years.[27] Upon the expiration of that term, the residence usually remains in trust for the benefit of one or more individuals (typically, the settlor's children). If the settlor wishes to continue using the residence, they must pay fair market rent to the trust.[28] The settlor makes a taxable gift when they contribute the residence to the trust. Since the settlor retains the right to use the personal residence for a term of years, the amount of the gift is a fraction of the total value of the property contributed to the trust.[29]

With an important caveat, a qualified personal residence trust can be an effective way of shifting future appreciation out of the settlor's gross estate. The settlor must survive the initial term to achieve the estate tax benefits; if the settlor dies during the initial term, their gross estate includes the trust property.[30] To the extent the settlor has other assets that are more likely to appreciate faster than their personal residence, however, other wealth transfer planning strategies may be more tax-efficient. A qualified personal residence trust isn't as flexible as other types of grantor trusts. For example, the settlor can't retain the power to swap (substitute) property for trust property.[31] Also, the rules governing qualified personal residence trust can be restrictive and sometimes annoying to follow.

A qualified personal residence trust might not currently be a viable planning strategy. Under proposed regulations issued by the IRS in 2022, there may be adverse tax consequences if a settlor creates a qualified personal residence before 2026 (i.e., before the scheduled decrease in the lifetime exemption) and dies after 2025 but before the initial term expires. For a more in-depth discussion of this issue, see Todd D. Mayo, *Proposed Regulations Cast a Shadow on Qualified Personal Residence Trusts* (a publication of the UBS Advanced Planning Group).

Discount planning

For gift and estate tax purposes, the amount of a gift or other transfer usually is the fair market value of the property that's gifted or otherwise transferred. Fair market value reflects any appropriate discounts. For example, the fair market value of a 50% interest as a tenant-in-common in a woodlot would typically reflect a fractional interest discount. Similarly, the fair market value of 1% of the outstanding shares of a privately held corporation's nonvoting common stock would typically reflect a lack of control discount and a lack of marketability discount. Being thoughtful about how assets are valued and the conditions under which an asset's value properly reflects discounts can enable an individual to more tax-efficiently transfer wealth.

[26] Id.

[27] Treas. Reg. § 25.2702-5(c)(1). More broadly, a settlor might create either a personal residence trust or a qualified personal residence trust, but a qualified personal residence trust generally is more favorable, because it's more flexible. See Treas. Reg. § 25.2702-5(b)(1). Compare Treas. Reg. § 25.2702-5(c)(1).

[28] If the settlor doesn't pay fair market rent, the settlor's gross estate potentially would include the trust property. See IRC § 2036(a)(1).

[29] Treas. Reg. § 25.2512-5(d)(2)(iii).

[30] IRC § 2036(a)(1).

[31] Treas. Reg. § 25.2702-5(c)(9).

In some cases, family members create a limited partnership or a limited liability company that's classified as a partnership for federal tax purposes for purposes of managing business or other assets, facilitating gifting, and achieving other objectives. This type of arrangement is sometimes called a *family limited partnership*. Because the value of a partnership interest would potentially reflect a lack of control discount and a lack of marketability discount, it may be less than the corresponding proportional value of the partnership's assets. For example, the fair market value of a 10% limited partnership interest in a partnership that has $10 million of assets (and no liabilities) would potentially be less than $1 million, because of the applicable discounts.

The design and operation of a family limited partnership requires care and attention to detail. If an individual retains too much control over the partnership or fails to respect the formalities of the partnership (e.g., treating the partnership like a personal bank account), the partnership's property may be includable in the individual's estate for estate tax purposes. In such a case, the valuation of the partnership interest is immaterial.

For a more in-depth discussion of family limited partnerships and similar entities, see Casey Verst, *Family Business Entities* (a publication of the UBS Advanced Planning Group). For a discussion of a case involving a family limited partnership, see Andrea Sanft, *Recent Tax Court Case on FLPs Cast a Shadow on Valuation Discount Planning* (a publication of the UBS Advanced Planning Group).

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The Advanced Planning Group provides comprehensive planning and sophisticated advice and education to ultra high net worth (UHNW) clients of the firm. The Advanced Planning Group also serves as a think tank for the firm, providing thought leadership and creating a robust intellectual capital library on estate planning, tax and related topics of interest to UHNW families.

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