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How to Use Irrevocable Gift Trusts to Take Advantage of Your Estate and Gift Tax Exemptions

Before the presidential election, many wealthy taxpayers were worried that a "blue wave" would mean a reduction of their $11.58 million estate, gift, and generation-skipping transfer tax exemption. That's because the Democrats were expected to propose lowering those exemptions back down to the $3.5 million to $5 million range they were before President Trump signed the 2017 Tax Cut and Jobs Act.

Even though that blue wave was more like a blue ripple, it's still possible that the Democrats could gain control of the Senate. Right now, the Senate is split 50-48 between the GOP and Democrats, and we won't know who won the final two seats until the run-off elections in Georgia on January 5. If both Democratic candidates prevail, a 50-50 Senate will tilt to the Democrats because the vice president casts the deciding vote in the event of a tie. In the face of this uncertainty, it could make sense to move some assets out of your estate now to ensure you reap the benefits of the higher exemptions.

One of the best ways to do that is to put the assets into an irrevocable gift trust, which enables you to make large gifts without giving up control and enjoyment of those assets.

For example, let's say you and your spouse have a net worth of $60 million, which consists of both marketable and private investments, as well as your primary residence, vacation home, and personal assets such as cars and dogs. Also, assume that you still have $20 million of your joint $23.16 million estate, gift, and generation-skipping transfer tax exemption left.

Although you may not want to give that $20 million to your children now, if a new tax law reduces the current exemptions, you and your spouse would each end up paying an additional $2 million to $3 million in gift and estate taxes. By putting that $20 million into an irrevocable gift trust, you essentially move those assets from one pocket to the other in a way that shields them from the 40% estate and gift tax.

How Irrevocable Gift Trusts Work

When properly structured, an irrevocable trust enables you to avoid additional estate and gift taxes while preserving the hallmarks of asset ownership: control and enjoyment. Control means you have the power to decide how to invest those assets, such as whether to buy, sell, or hold shares of stock, or to give them to someone else. Enjoyment is the ability to use the income or other proceeds from the assets as you see fit.

An irrevocable gift trust allows you to retain control of the trust assets through your choice of trustee. You can name your spouse, sibling, friend, or trusted advisor as the trustee, enabling you to retain indirect control of the assets by influencing their decisions. In some circumstances, you can make yourself the trustee, which gives you sole discretion over what happens to the assets, including decisions about distributions to the beneficiaries.

In terms of enjoyment, trust beneficiaries are entitled to enjoy trust assets, typically through cash or in-kind distributions or other benefits such as living in a house owned by the trust. However, the trustee determines the extent to which the beneficiaries enjoy the trust assets in accordance with the trust terms.

As the grantor, your retention of the enjoyment of trust assets must be indirect, except in a rare circumstance related to asset protection trusts. Indirect enjoyment is easiest if you are married. By making your spouse one of the beneficiaries, you can indirectly benefit from trust distributions made to him or her because those distributions can be used to pay joint living expenses or joint tax liability, depending on the terms of the trust.

If you are not married, get divorced, or your spouse predeceases you, the trustee (even if you are the trustee) can make loans to you from the trust assets. A caveat is that you will need to have a net worth high enough to justify a loan from the trust, so you shouldn’t give all of your assets to an irrevocable gift trust. The value of your non-marketable assets, such as personal real estate, cars, collectibles, and business interests, is typically enough to establish a net worth that justifies a loan from an irrevocable gift trust.

The Role of Flexibility

Irrevocable gift trusts are typically structured to continue for generations and even in perpetuity. Over such long periods, circumstances can change, so building flexibility into these trusts is critical. Although a grantor can’t directly amend an irrevocable gift trust, you can modify it using the following three mechanisms

1. Gift trusts can include a “trust protector” who has extraordinary powers such as the ability to amend or revoke the trust. Usually, the trust protector is a trusted friend, business partner, or advisor.
2. Under the law in most states, an irrevocable trust can be amended with the mutual consent of the grantor, trustee, and current beneficiaries. If the grantor has died, the trustee and beneficiaries can usually amend the trust with court approval.
3. Most states have recently passed laws allowing irrevocable trusts to be “decanted” into a new trust with modified terms.

Putting It All Together

So, in the example of you and your spouse having a net worth of $60 million, you might start by establishing an irrevocable gift trust naming you and your spouse as the trustees and your children as the beneficiaries. You could make your lawyer the trust protector, which gives him or her the power to amend the trust and add beneficiaries, including your spouse.

Then you gift $20 million to the trust, and you and your spouse file gift tax returns that split the gift, so half is attributed to you and half to your spouse. This gift to the trust is also subject to the GST tax exemption, which allows it to pass to future generations without estate tax for as long as the trust lasts. In some states, that can be forever.

The benefit of this planning is not only protecting that $20 million from additional estate taxes but also the fact that any growth on those assets will be free from estate tax upon your deaths and for future generations. In the meantime, you can access the assets by having your trust protector add your spouse as a beneficiary and then making distributions to him or her. An alternative to distributions is for the trustee to make loans from the trust to you or your spouse, allowing you to use the trust assets without reducing the trust's value or adding assets back into your estates.

Another bonus of this strategy is that a gift trust is considered a "grantor trust" for income tax purposes, which means you pay tax on the trust's income. This is a significant benefit to the trust because it allows the assets to grow tax-free due to you, as the trust creator, paying the income taxes on the interest, dividends, and gains realized inside the trust. You can also structure the trust so it can be changed to a non-grantor trust whenever you want, so the trust pays its own taxes at a time you choose.

Finally, because trust and tax laws are complicated, it's critical to consult a qualified lawyer to advise you on the irrevocable gift trust structure and strategy that works best for you. This article is only intended to introduce the types of measures that can give you estate-planning peace of mind no matter how big or small the size of future political waves.