THE ESTATE PLANNER

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Estate Planning Red Flag

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Now's the time to review your GST tax exposure

Absent congressional action this year, the federal gift and estate exemption and the generation-skipping transfer (GST) tax exemption (currently $13.99 million) are scheduled to return in 2026 to their pre-2018 levels of $5 million (around $7 million adjusted for inflation). So, it's a good idea to consider strategies for taking advantage of higher exemptions this year using gifts or trusts.

Now is also the time to review your estate plan for potential GST tax exposure. The GST tax is complex and potentially harsh. Plus, unlike gift and estate taxes, it's possible to have a substantial GST tax liability regardless of how much exemption you have left.

GST tax in a nutshell

Designed to ensure wealth is taxed at each generational level, the GST tax is a flat 40% tax (in addition to gift and estate taxes) on transfers that skip a generation. This includes transfers to "skip persons" — such as grandchildren or other relatives more than one generation below you — and to nonfamily members more than 37½ years younger than you. Note: if your child predeceases you *before* you make a transfer, then his or her children move up a generation and are no longer treated as skip persons.

The GST tax may apply to outright gifts or certain distributions to a skip person. Here's why the GST tax can be dangerous: Transfers subject to gift or estate tax are automatically protected by your gift and estate tax exemption amount. However, the GST tax requires proactive allocation of your GST tax exemption to shield such transfers from the tax. Failure to allocate can lead to unintended tax liability.

To prevent costly mistakes, the tax code automatically allocates your GST tax exemption to certain transfers that may result in GST tax, such as outright gifts to skip persons or transfers to "GST trusts" that may benefit skip persons in the future. Unfortunately, these provisions don't always have the desired result.

Avoiding the pitfalls

Here are a few examples of GST tax pitfalls and how they can be avoided.

Wasted allocation of exemption to GST trusts. As noted, the tax code automatically allocates your GST tax exemption

What's a trust's inclusion ratio?

A trust's inclusion ratio refers to the portion of a trust's assets that will be subject to generation-skipping transfer (GST) tax if a taxable event occurs. If you haven't allocated any of your exemption to a trust, its inclusion ratio is 1.0. If the exemption protects a trust's assets, its inclusion ratio is 0.0.

How do you end up with a blended trust (one with an inclusion ratio between 0.0 and 1.0)? Here's one way: Suppose in 2008, you transferred $4 million to a trust to benefit your children and grandchildren. At the time, the GST tax exemption was $2 million. Because the exemption only covered half of your gift, its inclusion ratio is 0.5, so 50% of any distributions to your grandchildren are subject to GST tax.

to GST trusts. However, if the possibility is remote that a trust will benefit skip persons, your exemption may be wasted. To avoid this result — and preserve your exemption for transfers that are more likely to trigger GST taxes — elect to opt out of automatic allocation on a timely filed gift tax return. If you neglect to opt out, obtaining relief from the IRS may be possible. Doing so allows you to make a late election so long as you can demonstrate that you acted reasonably and in good faith.

Premature death of a trust beneficiary. Suppose Jane establishes a trust for her daughter, Ella, that calls for the assets to be distributed to her when she reaches age 35. Although Ella's children (Jane's grandchildren) are contingent beneficiaries, the possibility they'll receive the trust's assets is remote, so Jane doesn't allocate any of her GST tax exemption to the trust.

However, if Ella dies at age 33, the trust will be subject to GST tax on the assets that go to Jane's grandchildren, even though Jane hasn't tapped her GST tax exemption. Fortunately, she can retroactively allocate her exemption to the trust by filing a timely gift tax return for the year of Ella's death.

"Blended" trusts. You may end up with a trust partially protected by the GST tax exemption for various reasons. For example, suppose Dick established a trust for the benefit of his children and grandchildren. The trust has an "inclusion ratio" of 0.5, meaning 50% of any distributions to his grandchildren will be subject to GST tax. (See "What's a trust's inclusion ratio?" above.)

The GST tax may apply to outright gifts or certain distributions to a skip person.

To avoid this result, Dick could split the trust into two trusts (if permitted by the trust document and applicable law). Trust A would have an inclusion ratio of 1.0, and Trust B would have an inclusion ratio of 0.0. If Dick uses Trust A to make distributions to his children and Trust B to make distributions to his grandchildren, he'll avoid GST tax.

A dangerous tax

Unlike gift and estate tax, you can be liable for GST tax even if you haven't used your exemption. So, reviewing your estate plan and taking steps to avoid or minimize this dangerous tax is critical. Contact your estate planning advisor for help.

What's my collection worth?

Proper estate planning is important when accounting for works of art

If you possess paintings, sculptures or other art pieces, they may represent a significant portion of your estate. Thus, these assets must be properly accounted for in your estate plan.

In your planning, you'll want to preserve the value of your collection and avoid unnecessary taxes, but also be sure to spell out how your collection will be managed and displayed after you're gone.

Appraising your art collection

It's important to have your collection appraised periodically by a professional. The frequency depends partly on the type of art you collect, but generally, obtaining an appraisal at least every three years is advisable, if not annually.

Regular appraisals give you an idea of how the collection grows in value and help you anticipate tax consequences. Also, most art donations, gifts or bequests require a "qualified appraisal" by a "qualified appraiser" for tax purposes.

In addition, catalog and photograph your collection and gather all appraisals, bills of sale, insurance policies and other provenance documents. These items will be necessary for the recipient or recipients of your collection to carry out your wishes.

3 options to consider

Generally, there are three options for handling your art collection in your estate plan: 1) sell it, 2) bequest it to your loved ones, or 3) donate it to a museum or charity.

If you opt to sell, remember that capital gains on artwork and other "collectibles" are taxed at a top rate of 28%, compared to 20% for different types of assets. Rather than selling the collection during your lifetime, including it in your estate may be

preferable to take advantage of the stepped-up basis. This allows your heirs to reduce or even eliminate the 28% tax. For example, you might leave the collection to a trust and instruct the trustee to sell it and invest or distribute the proceeds for the benefit of your loved ones.

You may leave your collection to your heirs if you prefer to keep it in the family. You could make specific bequests of individual artworks to various family members, but there are no guarantees that the recipients will keep the pieces and treat them properly. A better approach may be to leave the collection to a trust, LLC or other entity — with detailed instructions on its care and handling — and appoint a qualified trustee or manager to oversee the maintenance and display of the collection and make sale and purchasing decisions.

Finally, you can donate your collection to avoid capital gains and estate taxes and to ensure that your collection becomes part of your legacy. It also entitles you or your estate to claim a charitable tax deduction. To achieve these goals, however, the process must be handled carefully. For example, to maximize the charitable deduction, the artwork

must be donated to a *public* charity — such as a museum or university with that status — rather than a private foundation.

And the recipient's use of the artwork must be related to its tax-exempt purpose. In other words, the recipient would have to exhibit or use it for art education, for example, rather than sell it. Also, if you wish to place any conditions on the donation — such as specifying where the collection can or can't be displayed or including your name on signage accompanying the artworks — you'll need to negotiate the terms with the recipient before you deliver the items.

Seek professional help

Because the estate planning issues surrounding an art collection are unique, it pays to work with an advisor with the proper expertise in dealing with this asset type. Indeed, qualified valuation and estate planning advisors can help design the right strategy for your circumstances.

Revisit your buy-sell agreement in light of U.S. Supreme Court decision

Buy-sell agreements are essential estate and succession planning tools for many family businesses and other closely held companies. These agreements, among other things, ensure that the business stays within the family or other ownership group.

Typically, this is accomplished by providing that if an owner dies or leaves the business, the company or the remaining owners are permitted or required to purchase his or her interest. Life insurance is often used to fund the buyout.

Most buy-sell agreements include a mechanism for setting the buyout price. If certain conditions are met, that price can establish the value of a departing owner's interest for estate tax purposes.

In June 2024, the U.S. Supreme Court ruled on *Connelly v. United States*, a case involving corporate-owned life insurance proceeds. The proceeds, used to fund a buyout under a buy-sell agreement, had to be included in the corporation's value for estate tax purposes. In addition, the proceeds weren't offset by the corporation's obligation to redeem a deceased shareholder's stock.

What happened in *Connelly*?

In the *Connelly* decision, two brothers owned a building supply corporation. They signed a buy-sell agreement providing that if one brother died, the survivor could purchase his shares; otherwise, the corporation would be required to redeem the shares. The corporation obtained $3.5 million life insurance policies on each brother to fund such a redemption.

> ***Most buy-sell agreements include a mechanism for setting the buyout price.***

One of the brothers died in 2013. At the time, he owned 77.18% of the corporation's outstanding shares, and the surviving brother owned the

remaining 22.82%. The survivor declined to purchase the shares, triggering the corporation's obligation to redeem them.

Although the buy-sell agreement set forth procedures for establishing the price for the corporation's shares, the brothers had never followed them. Instead, in this case, the surviving brother and the deceased brother's son agreed on a purchase price of $3 million. This was the value reported on the deceased brother's estate tax return. The IRS claimed the shares should have been valued at $5.3 million and assessed almost $900,000 in additional estate taxes.

In connection with this dispute, the estate's valuation professional valued the company at $3.86 million, meaning the deceased brother's 77.18% interest was worth about $3 million. In valuing the company, the professional excluded the $3 million in insurance proceeds used to fund the buyout, reasoning that they were offset by the obligation to redeem the stock. The IRS disagreed and asserted that the $3 million in insurance proceeds should be added to the corporation's value, bringing the total to $6.86 million. Under the IRS's argument, the deceased brother's shares were worth 77.18% of $6.86 million, or approximately $5.3 million.

The U.S. Supreme Court sided with the IRS, holding that the life insurance proceeds were a corporate asset that increased the company's value and wasn't offset by the company's obligation to redeem the shares.

What's next?

The *Connelly* decision leaves many questions unanswered. For instance, would the result have been different if the brothers had followed the valuation procedures outlined in their buy-sell agreement? The Court also limited its ruling to the case's specific facts, suggesting that there could be situations in which a corporation's obligation to redeem shares under a buy-sell agreement would reduce its value.

Nevertheless, in light of this decision and its potential tax implications, family and closely held

business owners should review their buy-sell agreements with their tax and estate planning advisors and consider alternate structures if appropriate. For example, some companies may want to consider cross-purchase arrangements, under which the surviving shareholders, rather than the corporation, purchase a departing shareholder's stock, and the shareholders use life insurance policies on each other's lives to fund such a buyout.

ESTATE PLANNING RED FLAG

You don't understand the rules when splitting gifts

Here's a quick estate planning tip: one of the easiest ways to reduce the size of your taxable estate is to take advantage of your gift tax exclusion. For 2025, you can transfer up to $19,000 per recipient gift-tax-free. And you can double the exclusion to $38,000 per beneficiary if you split the gifts with your spouse.

However, it's critical to understand the rules of gift-splitting to avoid unintended — and potentially costly — mistakes. Pitfalls to avoid include:

Failing to make the election. To elect to split gifts, the donor must file a gift tax return, and the nondonor must consent by checking a box on the return and signing it or, if a gift exceeds $30,000, filing his or her gift tax return. Once you make the election, you must split *all* gifts to third parties for the year.

Splitting gifts with a noncitizen. To be eligible for gift-splitting, one spouse must be a U.S. citizen.

Divorcing and remarrying. You must be married at the time of the gift to be eligible for gift-splitting. You're ineligible if you divorce and either spouse remarries during the calendar year in which the gift was made.

Gifting a future interest. Gift-splitting can be used only for present interests. So, a gift in trust qualifies only if the beneficiary receives a present interest — for example, by providing the beneficiary with so-called Crummey withdrawal rights.

Benefiting your spouse. Gift-splitting is ineffective if you give the gift to your spouse rather than a third party. The same is true if you give your spouse a general power of appointment over the gifted property, or if your spouse is a potential beneficiary of the gift. For example, suppose you make a gift to a trust of which your spouse is a beneficiary. In that case, gift-splitting is prohibited unless the chances your spouse will benefit are incredibly remote.

Also, when splitting gifts, know that if you die within three years of splitting a gift, some of the tax benefits may be lost.

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