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Issues Representing Family Businesses

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I. Overview of Current Transfer Tax System

Over the past year, a maelstrom of political discourse engulfed the Federal Transfer Tax system. Although historically a lightning rod, the current economic conditions, as well as the widening political divide between left and right, garnered significant focus on the transfer tax system. Currently, the basic exclusion amount under the estate, gift and generation skipping transfer taxes sit at their highest levels ever - $12.06M per U.S. person.[1] Illustrative of this point is the exponential increase in exemption amounts over the preceding 20-year period. Over the 20-year period from January 1, 2002, to January 1, 2020, the federal estate tax exemption increased more than twelve-fold or at annualized rate of growth of nearly 12.5%[2]. The basic exclusion amount may be applied for lifetime gifts subject to federal gift tax and/or testamentary transfers at death subject to federal estate tax. In this regard, as discussed further below, the basic exclusion amount supports the unified transfer tax system under which the federal gift tax and the federal estate tax, although separate taxes, are irrevocably linked.

On December 22, 2017, President Donald Trump signed into the law the Tax Cuts and Jobs Act of 2017 (the "TCJA"). This sweeping tax law amended Internal Revenue Code §2010(c)(3)(C) to double the basic exclusion amount. Under the existing law, the basic exclusion amount was set at $5,000,000 subject to an annual inflation adjustment, or $5,490,000 for 2017. However, under the amended §2010(c)(3)(C), the higher basic exclusion amount sunsets on December 31, 2025, after which time the basic exclusion amount reduces to pre-2017 levels (subject to inflation adjustment).

The temporary increase of the basic exclusion amount presented a practical question for those taxpayers making large gifts with an increased exemption. Under existing law, prior taxable gifts are a component of the calculation to determine the amount of a taxpayer's estate subject to estate tax. Prior gifts are included in determining a taxpayer's taxable base. These prior gifts are offset by the taxpayer's unified credit. However, the current law did not consider the possibility the basic exclusion amount could decline during the intervening period between taxable gifts being made and the taxpayer's death. This potential for the imposition of an estate tax on previously tax-free gifts is often referred to as "clawback." TCJA directed the Treasury to issue regulations that address the potential clawback. In 2019, the Treasury issued Treas. Reg. § 20.2010-1(c) effectively eliminating this risk. After the issuance of this Treas. Reg., the potential for a massive reduction in the basic exclusion amount when the increase sunsets at the end of 2025 provided an impetus for a previously unparalleled level of estate

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[1] "U.S. persons" are citizens and permanent resident aliens.

[2] In 2002 the federal estate and gift tax exemption was set at $1,000,000.00.

tax planning during the intervening years. Many taxpayers and their advisors viewed this increased basic exclusion amount as providing a "use it or lose it" opportunity for wealth taxpayers. In nearly all cases, this increased activity focused on senior generation clients making large gifts to utilize the new larger exemption. Most, if not a large majority, of such gifts involved the transfer of closely held business interests to trusts, particularly grantor trusts, for the benefit of family members.

The TCJA's increased exclusion amounts drew criticism from those on the political left for providing too much benefit and "relief" for a miniscule portion of the American population already in control of a vastly disproportionate amount of wealth. Prior to the doubling effect of the TCJA, only an estimated 0.2% of estates were subject to federal estate tax with a basic exclusion amount of $5,000,000.00[3]. Based on current research, the increased basic exclusion amount of the TCJA exempted all but less than 0.1% of estates from the federal estate tax. In response to this perceived favorable treatment for the wealthiest Americans, several proposals were considered by President Biden and Congressional Democrats. Among many other changes, the proposed action items included reducing the basic exclusion amount to its pre-TCJA level or less, reducing or eliminating the step-up in basis, and including in the estates of taxpayers certain transfers to grantor trusts. While none of the proposals became law, the proposals gained enough traction to obtain coverage by the financial media and added proverbial gas to the fire for clients that had not already completed their planning. Many commentators believe the same or similar proposals will be reconsidered prior to the 2025 sunset of the TCJA.

II. Ethical Considerations

When undertaking representation regarding the formation, transfer or restructuring of family entities, attorneys should closely monitor the situation for potential conflicts that could arise among the family members. Family members, including those of multiple generations, may view the attorney as "their attorney" for the purpose of considering each person's best interests. This fundamental misunderstanding often plants the seeds that later grow to weeds in the form of ethical conflicts or even malpractice concerns. This concern notwithstanding, it may be very difficult for the attorney to only represent the entity and not represent, at a minimum, the senior generation that is driving the planning. When undertaking representation for a family entity, the attorney should (a) perform a conflicts analysis; (b) prepare proper engagement letter(s) and conflict waivers; and (c) monitor the engagement for conflicts arising after the representation has begun.

[3] Joint Committee on Taxation, "History, Present Law, and Analysis of the Federal Wealth Transfer Tax System," March 16, 2015.

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