Estate Planning After Tax Reform

Opportunities and Hidden Hazards

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The Tax Cuts and Jobs Act (Public Law No. 115 — 97, the "Act") was signed into law on December 22, 2017, and makes significant changes to U.S. tax law. With respect to the federal transfer tax regime (i.e., the gift, estate, and generation-skipping transfer (GST) taxes), many estate planners predicted tax reform would include a repeal of the estate tax. Early drafts of the Act were consistent with these predictions, but the final Act does not repeal the estate tax. Instead, the Act dramatically increases estate, gift, and GST tax-exemption amounts through December 31, 2025. Due to these increased exemption amounts and currently low (albeit increasing) interest rates, our clients now enjoy the most favorable estate planning period in recent history.

INCREASED EXEMPTION AMOUNTS

The Act increases the basic exclusion amount for gift and estate taxes from $5 million to $10 million (indexed for inflation). As a result, for 2018, the basic exclusion amount will increase to $11.18 million. This means that prior to January 1, 2026, an individual can transfer up to $11.18 million (indexed for inflation) as gifts during life and/or bequests upon death, without incurring gift or estate tax, even before engaging in planning to utilize other deductions and credits that may be available to him or her. In addition, married couples can continue to pool their exemptions (for a total of $22.36 million) by splitting gifts, utilizing portability, and/or engaging in sophisticated estate planning.

The GST tax exemption also doubles from $5 million to $10 million (indexed for inflation). The Act does not expressly increase the GST tax exemption, but such increase is built into Internal Revenue Code Section 2631(c), which provides that the GST exemption is equal to the basic exclusion amount.

Other transfer tax exemption amounts remain the same but continue to be indexed for inflation. For example, for 2018, the gift tax annual exclusion amount will be $15,000, and the annual gift tax exclusion amount for noncitizen spouses will be $152,000.

WINDOW OF OPPORTUNITY THROUGH 2025

The increase in the basic exclusion amount and GST exemption amount is not permanent. Under the Act, the amounts will "sunset" back to approximately $5 million (indexed for inflation) on January 1, 2026. Of course, further changes in law could cause this eight-year window of opportunity to close prematurely. For example, on March 7, 2018, Senator Chuck Schumer introduced a $1 trillion infrastructure proposal that would be financed by, among other revenue raisers, an elimination of the Act's increased basic exclusion amount. Moreover, if political winds were to shift with the 2018 and 2020 elections, we could see the return of proposals from the 2016 election to reduce the basic exclusion amount to $3.5 million and increase the top gift, estate, and GST tax rates.

RISK OF "CLAWBACK"

The Act instructs the Treasury to issue regulations regarding "clawback." "Clawback" refers to the possibility that an individual could make a nontaxable gift during this window of opportunity, but upon the individual's later death, the value of the gift could still be subject to estate tax, if the basic exclusion amount decreases by the time of the individual's death. The same issue was a concern in 2012 when it appeared that the basic exclusion amount would drop from $5 million to $1 million. At that time, there were indications that clawback was never intended, and now most analysts believe that the Treasury regulations to be issued under the Act will eliminate the possibility of clawback with respect to gifts made during or after 2018.

ESTATE PLANNING OPPORTUNITIES

High-net-worth individuals and families should take advantage of the favorable estate planning environment to transfer wealth to members of lower generations (or others) with as little tax as possible. The increased exemptions magnify the benefits of estate planning techniques by creating more exemption to leverage. For example:

- **Gifts to dynastic trusts** – A gift to a dynastic trust for future generations can be sheltered from gift tax (using increased basic exclusion amounts) and GST tax (using increased GST tax exemption amounts). Moreover, if properly designed, a dynastic trust's assets will not be included in the estate of future generations either.
- **Gifts to grantor trusts** – A gift to an intentionally defective grantor trust can be sheltered by the increased exemption amounts while also allowing the grantor to pay the trust's income taxes, which tax payments are like additional tax-free gifts.
- **Leveraged gifts to trusts** – Gifts to trusts can be designed to leverage the use of the increased exemption amounts by using loan and/or sale techniques, thereby potentially passing additional value to the trust beneficiaries while soaking up less of an individual's available exemptions.
- **Gifts to endow life insurance trusts** – Life insurance planning for the benefit of later generations is sometimes limited when an individual's annual policy premiums would exceed that individual's annual gift tax exclusion amount (currently $15,000). The increased exemption amounts can be used to make a large gift to an irrevocable life insurance trust (ILIT), which endowment could fund premium payments in excess of the annual gift tax exclusion amount.
- **Gifts to trusts for spouses** – A spousal lifetime access trust (SLAT) can be created by an individual for the benefit of his or her spouse.
- **Equalizing gifts** – Often earlier-born children and grandchildren have benefited from years of appreciation on assets given to them (or to a trust for their benefit). The increased exemption amounts can be used to make additional gifts to equalize later-born children or grandchildren who did not benefit from the same appreciation.
- **Upstream gifting** – In limited circumstances, gifts to parents can be an efficient tax planning technique. If both a child and his or her parents are very unlikely to have taxable estates (perhaps due to the increase in exemption amounts), a gift of low-basis property can be made from the child to the parent. If the parent later dies with that property in his or her estate, the property will receive a step-up in tax basis and the child will receive the property with that higher basis.

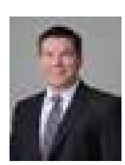
HIDDEN HAZARDS

Moderately wealthy and high-net-worth individuals and families must be mindful of the impact of the Act on their estate plans. Under- or overreacting to the impact of the Act can reveal hidden hazards. For example:

- **False sense of securit**y – The increase in the exemption amounts may lead some to feel that they no longer need sophisticated estate planning because they no longer have taxable estates. To the contrary, these individuals may need more thoughtful advice because they are in uncertain territory. They may die under current law and have no taxable estate; they may die after current law sunsets and have a taxable estate; or they may die at a time when there is an entirely new law in place. Under such circumstances, they need to be thoughtful about their estate planning goals and build sufficient flexibility into their plans to account for all scenarios. Moreover, all the other traditional reasons for estate planning still exist: control over the disposition of assets, business succession planning, probate avoidance, creditor protection, planning for disability, etc.
- **Overreliance on portability election** – Portability generally allows spouses to transfer their remaining basic exclusion amount to the surviving spouse. With the increase in the basic exclusion amount for gift and estate taxes, spouses may be tempted to rely on portability to shelter their combined assets if their estates have a combined value less than $22.36 million. However, overreliance on portability can lead to bad results if assets appreciate, the basic exclusion amount decreases, and/or GST tax planning is appropriate (notably, GST tax exemption is not portable).
- **Over-gifting** – The dramatic increase in exemption amounts may also lead some to focus too narrowly on utilizing increased exemption amounts before they sunset. Before making large gifts, one should carefully review his or her finances to be certain that enough assets will remain to fund his or her lifestyle for the remainder of his or her life.
- **Formula clauses** – Formula funding clauses should be reviewed to avoid unintended dispositive consequences. For example, a common estate planning technique is to fund a credit shelter trust with a descendant's remaining basic exclusion amount. With the dramatic increase in exemption amounts, this may result in the entire estate flowing into the credit shelter trust and nothing going to other beneficiaries, which may be contrary to the grantor's wishes and/or may trigger substantial state estate and inheritance taxes.
- **Loss of step-up in basis** – The basis of gifted property and its potential for appreciation should be carefully considered. Gift and estate tax savings can be offset by the loss of a basis step-up when an individual dies no longer owning gifted property (e.g., if at the time of death such individual is no longer subject to estate taxes because his or her assets have been depleted or the exemption amounts have increased).

CONCLUSION

The Act has not reduced the need for sophisticated estate planning. The fact remains that good estate planning requires thoughtful analysis of an individual's personal, financial, dispositive, charitable and other goals, all while being mindful of fluid federal and state transfer tax laws. At present, we are enjoying an era of historically favorable interest rates and transfer tax laws, and those individuals in a position to engage in planning now have the potential to benefit greatly.



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