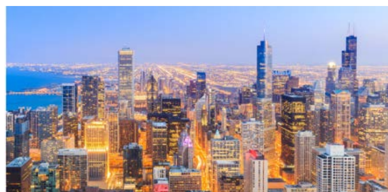

SPECIAL TAX NEWSLETTER

Estate and Gift Tax Changes Create Major Opportunities

What Should You Do Now?

January 31, 2018

When the 2017 Tax Cut and Jobs Act became law, you may have shouted "Hurrah" or you may have sighed "Oh no." Either way, we hope the next thing you said was, "I had better consult with my tax advisors at SFGH." In this newsletter we will attempt to guide you through some of the Estate Planning opportunities and complexities created by the new Act.

Increased Estate Tax Exemptions: Most significantly, the Federal estate, gift and GST tax exemption for an individual has doubled from $5,490,000 to $11,180,000 (indexed for inflation, it is now about $11,200,000). A married couple can thus transfer about $22,400,000 estate tax-free.

Changes Are Not Permanent: None of the changes made by the Act to the estate and income tax systems is permanent. They are all scheduled to expire at the end of 2025. The Act creates great opportunities, but as they may be temporary we advise caution in taking advantage of them.

Simple Change - Big Impact: No changes were made directly impacting estate planning, other than the exemption increase, although other changes in the Act will incidentally impact estate planning.

(We will discuss this in future newsletters.) The maximum estate tax rate remains 40%. In recent years limitations were proposed on many commonly used estate tax reduction strategies, but none of those limitations was implemented in the Act. Property transferred at death continues to receive an adjustment to income tax basis (commonly a basis "step-up"). Exemption unused by the first spouse to die remains portable and usable by the surviving spouse. FLPs, QPRTs, CLTs, SLATs, GRATs, and other planning structures remain valuable.[1] All of these strategies, however, need to be re-examined in light of the increased exemptions and changes in the income tax.

WHAT SHOULD YOU DO NOW?

Examine All Existing Documents: Due to the increase in the exemption amount from $5,490,000 to $11,200,000 per person, most existing estate plans should be re-examined. Your documents very likely provide for creation of one trust (a "credit shelter trust") intended to use your entire unused exemption amount and exempt that trust from estate tax. If your spouse is intended to be the beneficiary of that trust, it is probably designed to not be included in his or her taxable estate either. Last year this trust could have been no greater than $5,490,000. The remaining assets in your estate would go to a separate marital trust for your spouse. Now, with the increased exemption amount, the credit shelter trust that would be created by your document could be funded with the full $11,200,000, and no funds might remain to fund the marital trust for your surviving spouse. This will be a special problem for clients in second marriages who intended to give the $5,490,000 exemption amount (which passes tax-free) to children by their first marriage, and the remainder to their surviving spouse. The increased exemption amount, if your document is not altered, might result in your surviving spouse receiving much less than you intended. The estate tax in Illinois, as in many other States, is not coordinated with the Federal tax, and the Federal exemption amount is not applicable for Illinois purposes. The Illinois estate tax continues to apply to estates over $4,000,000. It is now essential to examine how your State's taxes interact with the Federal exemption to avoid an unintended Illinois estate tax burden.

Consider Gifts: The increased estate and gift tax exemptions create important opportunities for gifting. Individuals, including those who have already used all or part of their $5,490,000 exemption, may conclude that the opportunity to make additional tax-free gifts should not be passed over, particularly since the opportunity is scheduled to lapse in eight years. The increased exemption might, for example, be used now to fund a

[1] Family Limited Partnerships, Qualified Personal Residence Trusts, Charitable Lead Trusts, Spousal Lifetime Access Trusts, Grantor Retained Annuity Trusts.

multi-generational trust for grandchildren and descendants.

Using the increased exemption to make gifts to a multi-generational trust for children, grandchildren, and younger generations (a generation-skipping trust) is particularly attractive. The tax code allows an amount equal to the individual estate tax exemption to be exempted from the generation-skipping tax (GST). That tax would otherwise be imposed at the highest estate tax rate when the trust distributes to grandchildren. A trust to which generation-skipping tax exemption has been allocated should thus escape estate tax forever. The GST exemption is not portable and thus must be used separately by husband and wife, but like the estate tax exemption, the GST exemption has been doubled to $11,200,000. Allocating GST exemption to a multi-generational trust may avoid unnecessary taxes.

Take Advantage of Basis Step-Up: Assets transferred by gift during life retain, in the donee's hands, the donor's income tax basis. The donee may therefore incur a capital gains tax liability when the asset is sold. On the other hand, assets transferred at death receive a step-up (or step-down) in income tax basis to their fair market value at that time. The beneficiary recipient could sell them immediately without incurring any capital gains tax liability. This remains true, even for an estate that pays no tax, such as the $22,400,000 estate of a married couple. This is tremendously powerful. Although for estates under the exemption amount, estate taxes may no longer be a concern, such estates still call for careful planning to make the best use of the basis step-up. That planning can be complicated.

When making gifts to take advantage of the increased gift tax exemption, donors must consider which assets should be gifted, to what individual or entity, the age of the individual donee, and the tax character of the entity. Most importantly, there may be ways of making a gift with low basis property while assuring that the gifted property is nonetheless treated as part of the decedent's estate to obtain a basis step-up at death. Existing planning intended to shelter assets from estate tax should be re-examined to determine if it is or will be possible to get assets back into an estate where their basis might be stepped up.

Consider the opportunities for basis step-up not only for new trusts, but also for many if not all trusts already created, such as existing credit shelter trusts and irrevocable trusts holding interests in family limited partnerships. A credit shelter trust that was created at the death of one spouse to keep assets out of the survivor's taxable estate might, under the new Act, yield a better result if it were included in the survivor's estate and the basis of its assets were stepped up.

Consider Basis When Making Gifts: Usually, trusts to which gifts are made would be designed to keep the gifted assets

out of the donor's taxable estate. Now, however, a trust to which gifts are to be made should be designed, if possible, to enable inclusion in the grantor's taxable estate of those gifted assets that will benefit from a basis step-up. A grantor trust (one treated for income tax purposes as still owned by the grantor) may be useful for that purpose but may for other reasons be undesired.

An elderly client should probably be advised to retain low basis assets and make gifts of cash or high basis assets. Usually gifts are made from older to younger generations, but now you may consider gifts "upstream" to elderly family members to obtain a basis step-up in the elders' estates. If the older family member's estate is under the $11,200,000 exemption, the added property won't incur an estate tax but should obtain a basis step-up. The benefit of transactions like this must be carefully analyzed and calculated, because the upstream gift will use the exemption of the younger donors; and the older family member must not be terminally ill.

Consider Three Different Estates: To understand various aspects of the Act it will help to consider three different estates: (1) an estate that was not taxable under the law in 2017; (2) an estate that would have been taxable last year, but is not taxable now under the new law; and (3) an estate that would have been taxable and will continue to be subject to estate tax.

(1) Not Subject to Tax Last Year: If your estate would not have been subject last year to estate tax because it was under $5,490,000 or $11,180,000 for a couple, you now need to examine your documents to see if the increased exemption amount would undesirably change the disposition of your estate, perhaps reducing a spouse's share or increasing someone else's share. If so, the language in your documents may need to be amended.

(2) Taxable Last Year but Not Now: If your estate would have been taxable last year, but would not be under the new Act because your estate will be less than the exemption ($22,400,000 for a married couple), new opportunities are available to you. Consider making gifts now, not to reduce estate tax, but to shift income of gifted property to younger generations. Such gifts will incur no current gift tax and the gifted property may remain exempt from estate tax in the future even if the exemption amount reverts to its 2017 level in eight years.[2] The techniques you implemented in the past to reduce your estate tax exposure remain useful and effective. There is no immediate reason to unwind them. FLPs and GRATs may continue to shift income to family members who pay income tax at lower rates. They will remain useful even if the exemption

[2] If the exemption reverts in eight years to the 2017 level, it is possible that the IRS might seek to "claw back" that gifted amount and include it in the calculation of the taxable estate. There is no guidance on this issue, but the Act directs the IRS to issue such guidance in the future.

reverts in 2025 to its 2017 levels. An important part now of your planning for your estate may be to use the increased exemption to secure a basis step-up for as many of your assets as possible, regardless of who dies first – you or your spouse.

(3) If Your Estate is Still Taxable: If your estate remains taxable because it is over the $11,200,000 exemption ($22,400,000 for a married couple), all the known and familiar estate planning techniques continue to work. Family Limited Partnerships (FLPs) enable consolidated control of family assets and are likely to reduce the value for estate tax purposes of the partnership assets. Well-designed FLPs can still reduce or freeze estate tax values. Grantor Retained Annuity Trusts (GRATs) are trusts designed to return value to the creator of the trust property equal to the value of the property contributed. Consequently, there is no taxable gift on funding of the trust. But any growth in value of the trust assets stays in the trust, thus shifting the growth to the trust beneficiaries (younger generations) with no gift tax or estate tax cost. Current low interest rates make GRATs particularly attractive. The low rates also mean intra-family loans are effective for both shifting growth and for freezing estate tax values. In recent years there were efforts to curtail some of these strategies, but the new Act leaves them all untouched.

Those strategies you've implemented in the past should now be re-examined to consider how the opportunities of the increased exemption affect them: Should you give more to existing irrevocable trusts? Should you add partners to the FLP? Should you increase the funding of the GRATs?

Use 529 Plans to Fund Education: The Act creates a new opportunity for tax favored funding of education. Since at least 2001 State administered college expense savings plans authorized by Section 529 of the Income Tax Code have been an attractive way for families to save funds for the education of children and grandchildren. Funds invested in such plans grow tax-free, and are not subject to income tax when they are used to pay for college expenses. These plans previously were limited to funding higher education (college and graduate school). Now, under the new Act, they may be used to also pay for expenses of elementary and high schooling of the beneficiary. Withdrawals from a 529 plan to pay for elementary and high school expenses are limited to $10,000 per year. That may not fully pay tuition at a private elementary or high school, but it helps. Distributions to pay for higher education are not so limited.

Gifts to fund a 529 Plan of up to the $15,000 annual gift tax exclusion incur no gift tax. Plans can be funded in advance with up to five years at once of annual exclusion gifts – thus $150,000 for a couple ($15,000 x 2 x 5). Given the increased estate and gift tax exemptions, a gift greater than the annual gift tax exclusion may have no negative tax impact if your estate will be under the

estate tax exemption. A 529 plan funded today with $200,000 for a newborn should be able to provide $10,000 a year through high school and then approximately $60,000 a year for four years of college tuition. The extra $50,000 of funding will use part of the married donors' exemptions, but that may not matter if their estates are under $22,400,000.

Section 529 plans may be more attractive than a conventional trust for funding education, because funds in a 529 plan grow tax-free and are not subject to income tax when paid out, whereas, trust income is always subject to income tax. The income tax deductions available to trusts have been severely curtailed and trust net income over $12,500 will be taxed at the highest income tax bracket.

Defend State and Local Tax Deductions: The new $10,000 limit on the deductibility of State and local income taxes applies to trusts as well as to individuals. Trusts subject to high State and local taxes will suffer. Grantors, trustees, and advisors may consider reforming or decanting a trust to change its tax situs to a low tax State. It may be possible to split a trust into several smaller trusts, so that each may use its own $10,000 deduction. Changing the situs of the trust from a State that taxes trust income (like Illinois) to one that does not (like Delaware) may reduce the trust's expenses (even after considering the fees of the trustee in the new State).

Conclusion: The increased Federal gift, estate and generation-skipping tax exemptions create singular opportunities for estate-planning. The opportunities must however be approached with caution. Many parts of the Act are ambiguous. It may be years before we have clarifying regulations, and because the changes introduced by the Act are scheduled to lapse in 8 years, dealing creatively with such uncertainty will require judgment and skill.

The Act also made major changes in the income tax. Those changes will impact trusts and estates and should be considered in designing or altering estate plans. We will address those changes in a future newsletter.

Your tax advisors at SFGH are ready now to advise you about prudent and effective ways of taking advantage of the new opportunities.

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