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2017 New Tax Law: Estate Planning

This client alert is part of a special series on the Tax Cuts and Jobs Act and related changes to the tax code, where Blank Rome's lawyers share their analysis of different provisions in the Act and how they may affect you and your business, along with specific action items. To see the full list of client alerts in this series, please click [here](#).

On December 22, 2017, the president signed into law the Tax Cuts and Jobs Act of 2017 (the "Act"), which represents one of the most extensive modifications to the U.S. tax code in recent history, significantly modifying U.S. taxation for individuals and business. This client alert will address significant changes to the federal estate, gift, and generation skipping transfer tax (each a "Transfer Tax" and collectively the "Transfer Taxes") system, which impacts virtually all estate plans regardless of the level of net worth.

TRANSFER TAXES BEFORE THE ACT

Prior to January 1, 2018, the federal government imposed Transfer Taxes on all transfers of assets during lifetime or at death. Each individual had an exemption from the estate and gift tax equal to \$5,000,000, indexed annually for inflation (also known as the "Applicable Exclusion Amount"). For 2017, the inflation adjusted amount was \$5,490,000. Thus, under prior law, a married couple would be subject to estate tax only if their combined estate exceeded \$10,980,000 in 2017. The exemption amount was scheduled to increase to \$5,600,000 (or \$11,200,000 for a married couple) in 2018.

The gift tax exemption is applied against taxable gifts made during lifetime. Generally, taxable gifts are those gifts that exceed the annual exclusion, are not subject to the marital or charitable deduction and those not made to pay qualified tuition or medical expenses. The annual exclusion excludes from the gift tax outright gifts to any number of individuals (or gifts to certain trusts). The amount of the annual exclusion in 2017 was \$14,000, which is indexed for inflation annually and is \$15,000 for 2018. The Act did not change the amount or application of the annual exclusion.

Taxable gifts up to the gift tax exemption amount are not subject to gift tax. Once an individual's gift tax exemption is consumed, taxable gifts would be subject to a gift tax equal to 40 percent of their fair market value. The estate tax exemption available to an individual at death is reduced by the amount of gift tax exemption applied to offset taxable gifts made by that individual during his or her lifetime. For example, in 2017, if a person had made taxable gifts of \$2,000,000, such person's available estate tax exemption would have been reduced to \$3,490,000, and if his or her estate exceeded such amount upon death, the excess would be taxed at a 40 percent rate.

The GST tax is a separate tax that applies to transfers to, or in trust for the ultimate benefit of, individuals two or more generations below the transferor (generally, grandchildren and more remote descendants). There is a separate exemption from the GST tax. Although the amount of the exemption from the GST tax is the same as the federal gift and estate tax exemption, \$5,490,000 in 2017, scheduled to increase to \$5,600,000 in 2018, it is applied differently. To the extent a transfer is subject to the GST tax and is not sheltered by a current or previous allocation of GST exemption, the GST tax is imposed at a rate of 40 percent. It is possible for both a gift or estate tax and a GST tax to apply to the same transfer, in which case the effective tax rate would be as high as 64 percent.

For married individuals, any estate tax exemption of the first spouse to die that is not used following such spouse's death (for example, because the deceased spouse's taxable estate is not sufficiently large) is "portable" to the surviving spouse for his or her use during lifetime or at death, subject to certain requirements. (This is known colloquially as "Portability"). It is important to note that the GST tax exemption is not portable, and titling of assets is critical when a married couple's estate plan is designed to utilize their GST exemption.

A final important related note is the interplay between the estate tax and federal income tax. When an individual dies, generally, the assets that are included in his or her gross estate (with certain important exceptions, such as retirement plans and IRA accounts) receive an income tax basis equal to their date of death value. If the assets have increased in value from their acquisition the basis will increase (a "Step-Up"). Of course, if the assets have decreased in value, the basis will decrease (a "Step-Down"). Generally, basis is used to determine gain or loss on an asset's subsequent sale or disposition. The simplest way to think of basis is the purchase price for an asset. If, for

example, a stock was purchased at \$10, and then sold for \$100, the basis would be \$10 and the gain would be \$90. If, rather than selling the asset, an individual dies still owning the asset, his or her beneficiaries would receive the asset with a Step-Up in basis of \$100, eliminating the \$90 gain and the capital gains tax thereon.

TRANSFER TAXES UNDER THE ACT

Annual Exclusion. The application of the annual exclusion remains unchanged and continues to be adjusted annually for inflation. The annual exclusion is expected to increase to \$15,000 per recipient in 2018.¹

Gift, Estate, and GST Tax Exemptions. Effective January 1, 2018, the Act *temporarily* doubles the gift and estate tax exemption amount to \$10,000,000, indexed annually for inflation. The Act also *temporarily* doubles the GST Tax exemption amount to \$10,000,000, indexed annually for inflation. The inflation adjusted exemption amount is expected to be approximately \$11,200,000. However, as mentioned above, the actual amount will depend upon how inflation is calculated under the Act. It is important to note that the increased exemption amounts sunset on December 31, 2025, at which time the exemption amounts will revert back to the \$5,000,000, indexed for inflation to 2026.

Portability. The Act did not change the concept of portability. Again, it is important to note that only gift/estate tax exemption amounts are portable, and the GST tax exemption is not.

Step-Up. The Act did not change the Step-Up for income tax purposes for assets included in a decedent's gross estate to date of death values. This is a boon for millions of families, particularly for individuals with estates below the increased exemption amount who will not be subject to Transfer Tax but will nonetheless receive a significant income tax savings as a result of Step-Up.

1. The annual inflation adjustment calculation for many tax provisions is modified under the Act from a traditional Consumer Price Index ("CPI") adjustment to a "chained" CPI adjustment. The inflation adjustments under the Act have not been finalized, but the annual exclusion amount is still anticipated to be \$15,000 in 2018

EVERY CLIENT SHOULD REVIEW HIS OR HER ESTATE PLAN

The Act impacts each individual plan differently, and each plan should at least be reviewed and, perhaps, revised in light of the changes made by the Act. Below is a summary of some key factors that may be applicable both to single individuals and married couples at varying levels of overall net worth. Nevertheless, this summary should only be used as a guide, as each person and his or her estate plan is different and should be reviewed to determine what changes, if any, are appropriate.²

ACTION ITEMS: MARRIED COUPLES WITH A NET WORTH BELOW \$11,200,000³

These clients do not have a current Transfer Tax liability under the Act, but may very well be exposed to tax when the exemption amounts revert to their prior levels in 2026. While federal Transfer Tax planning may not be critical to the structure of their estate plan, there are significant other reasons to review and update their estate plans:

- 1. Inheritances for Spouses.** Many clients prefer the simplicity of leaving their entire estates outright to their surviving spouse so that the surviving spouse has full control of the family's entire wealth. In many instances, however, it may continue to make sense to divide assets during lifetime so that some portion of the combined assets are held in trust for the benefit of the surviving spouse. A trust for the surviving spouse provides potential asset protection benefits, and also ensures that upon the surviving spouse's subsequent death, the assets pass to beneficiaries and in the manner designated by the first spouse.
- 2. Inheritances for Children.** Clients should revisit how their children will inherit their remaining wealth to make sure they are giving their children the best opportunity to financially succeed. Often times, it makes sense to hold assets in trust for the benefit of a child for an extended period of time. Trusts provide

several benefits, including asset protection, spendthrift protection and structured financial oversight.

The assets in properly structured and administered trusts can be protected from the spouses of children in the event of a divorce. The benefits of trust planning can be extended to grandchildren and more remote generations through the allocation of GST exemption to trusts that continue beyond their children's lifetimes for their grandchildren and perhaps for future, more remote descendants. This type of multi-generational planning can protect a family's wealth long into the future while "locking-in" the higher exemption amounts should a future Congress lower the estate and GST tax exemptions.⁴

- 3. Annual Exclusion Gifting.** Clients comfortable with their current cash flow needs should consider starting, or continuing to make, annual exclusion gifts up to the increased amount of approximately \$15,000 per recipient in 2018 (\$30,000 jointly from a married couple). Consider making these gifts should in trust for younger beneficiaries or beneficiaries who do not have an immediate need for the gifted amount.
- 4. 529 Plan Gifting.** The Act includes for the first time elementary and secondary educational expenses up to \$10,000 annually as qualified expenses from 529 Plans. Clients may consider increasing annual gifting to 529 Plans for current and/or future descendants.
- 5. Income Tax Planning.** Clients should also be aware of the major changes to the federal income taxation of individuals and businesses, discussed in our previous and future client alerts on the Tax Cuts and Jobs Act. See: [Overview of Provisions](#) and [Accelerate Deductible Expenses before Year End](#).

2. It should be noted that although the following concepts have been divided at certain dollar break points, this division is for organizational purposes only, the concepts outlined below are cumulative, and as net worth increases, may overlap.

3. And Individuals with Net Worth below \$5,600,000. These amounts are approximate and designed to mirror the exemption amounts under previous and current law, which, as stated above, is still being finalized under the new chain CPI calculation.

4. Note that it is unclear whether Congress would provide for a claw back of tax of tax on transfers made during the period of high exemption amounts.

In addition, clients who are current beneficiaries of irrevocable trusts (such as Credit Trusts created by deceased spouses or trusts created by parents or other family members) should review the unrealized gains in the trusts and determine if it is possible and prudent to take steps to include those assets in the client's estate, thereby removing the potential income tax liability on the trust's assets through a Step-Up in basis.

- 6. State Death Taxes.** Based on an individual's domicile or the location of certain assets, his or her estate could be subject to state estate and/or inheritance taxes. Planning should be considered for these taxes. It is possible that these taxes can be reduced through gifting or ownership restructuring.
- 7. Asset Ownership.** Asset titling is a critical part of any estate plan. In some states assets can be titled to protect them from creditors' claims. In addition, the title to an asset may also dictate to whom the asset is transferred at death.
- 8. Fiduciary Appointments.** The appointment of Personal Representatives and Trustees under the estate plan should be reviewed. Clients often select family members or advisors who are contemporaries in the role of Trustees. As the duration of trusts increase, clients should consider younger individuals as successors and/or review the mechanisms for how successors are appointed under their plans. For longer duration trusts, this may result in the appointment of a corporate fiduciary, which may also require a review of the provisions of the document to ensure that the corporate fiduciary will accept its appointment.
- 9. Incapacity Planning.** Individuals are living longer, and the chances of an individual losing capacity during his or her lifetime is therefore also increasing. Plans should be reviewed to ensure that Powers of Attorney and Health Care Directives are current, and the individuals appointed thereunder are appropriate. Individuals may also want to consider incorporating a Revocable Trust into their estate plan in order to provide a smoother transition of control in the event of incapacity.

ACTION ITEMS: MARRIED COUPLES WITH A NET WORTH BETWEEN \$11,200,000 AND \$22,400,000⁵

The good news for clients in this category is that they no longer have current exposure to Transfer Taxes under the Act. These clients most likely incorporated some Transfer Tax planning into their current estate plan, and have potentially made some irrevocable lifetime transfers. However, proper planning for such clients is still critical because of future exposure to Transfer Taxes after the sunset in 2026, and existing planning should not be unwound without careful consideration of the consequences:

- 1. Existing Formula Plans.** Many estate plans divide an estate between a so called credit shelter trust and the surviving spouse using a formula based on the estate tax exemption amount. The Act, having doubled the estate tax exemption amount, may cause assets to be divided differently than desired. This may result in the overfunding certain trusts at the expense of other beneficiaries. For example, assume a client with a \$15,000,000 estate, whose Will provides a the funding of trust for the client's children up to the estate tax exemption amount with the balance passing outright to the surviving spouse. In 2017, that Will would result in a trust for the children of \$5,490,000 and an outright gift to the spouse of \$9,510,000. In 2018, that same Will would result in a trust for the children funded with \$11,200,000 and only \$3,800,000 passing outright to the surviving spouse. In those instances where the surviving spouse is a beneficiary of the credit shelter trust, the surviving spouse's interest may be discretionary or the surviving spouse may not be the only beneficiary of the trust. Therefore, existing plans that incorporate formula clauses should be reviewed to confirm not only the amounts funding each portion under the formula, but also that the terms of each such portion, continue to make sense given the dramatic change in the estate tax exemption amount.

5. **And Individuals with a Net Worth between \$5,600,000 and \$11,200,000.**

- 2. Irrevocable Trusts.** Clients may create irrevocable trusts during lifetime to remove assets from their taxable estates. Assets that could be held in such a trust might include life insurance policies, business interests, or other assets. Clients with cash flow concerns or who are new to having a liquid portfolio (for example, after the sale of a business) may be hesitant to irrevocably transfer assets away from their own use. A possible solution to this concern for some clients is through indirect access utilizing a trust in which a spouse is a beneficiary (also known as a “Spousal Lifetime Access Trust” or “SLAT”). Flexibility is the key for any new irrevocable trust. Plans with existing irrevocable trusts should be reviewed from both a cost and need perspective. Nevertheless, it may not be prudent at this time to cancel any insurance policies, at least without careful consideration. In other situations, changes to a trust may be warranted. There may, however, be situations where changes to existing trusts may be desirable and may be possible despite the fact that the trust is irrevocable. For example, while assets that are transferred to appropriately structured irrevocable trusts are generally not included in the transferor’s taxable estate, the assets transferred do not receive a basis Step-Up at the transferor’s death. Therefore, if there is minimal concern for estate tax exposure, it may be possible to modify or unwind an existing trust, “decant” the trust’s assets into another trust, or obtain a judicial amendment to the trust in order to achieve a Step-Up at the transferor’s death or to reflect the updated goals and objectives for the clients and the beneficiaries. Also, if a client has created a trust that is not fully exempt from the GST tax, during this time of increased GST exemptions, it is appropriate to examine whether additional GST exemption can be allocated to the trust to make it fully exempt from the GST tax.
- 3. Income Tax Planning.** Clients who are likely to die before 2026, while the increased exemptions under the Act are in force (thereby reducing or eliminating estate tax exposure) should consider maximizing their ability to obtain Step-Up for assets for income tax purposes.
- This could be done through exercising “swap” powers in grantor trusts to return low basis assets appreciated assets to the estate of the trust’s grantor (causing those assets to be subject to estate tax and receive a Step-Up), or through more complex income tax planning structures.
- 4. Charitable Planning.** As a result of the increase in the standard deduction for individuals, many individuals will lose the income tax benefit of making charitable gifts. Charitable planning (outright gifts, Donor Advised Funds, Private Foundations, Charitable Remainder Trusts and Charitable Lead Trusts) should be reviewed to make sure the tax and non-tax impact still align with the client’s philanthropic intent. The Act does increase the deductibility limitation for cash contributions to public charities from 50 percent of Adjusted Gross Income (“AGI”) to 60 percent of AGI.
- 5. Estate Freezes.** Clients wealthy enough to forgo any further appreciation of their estates and which may be subject to estate and GST taxes after the increased exemptions amounts sunset in 2026 can still benefit from techniques that freeze the value of their estates at current values in excess of a small interest factor. These clients should still be considering estate planning techniques such as Grantor Retained Annuity Trusts (“GRATs”) and sales of assets to existing funded Irrevocable Grantor Trusts. These techniques can transfer future appreciation on trust assets to the client’s heirs with minimal or no gift tax cost while allowing the client to maintain some cash flow from the assets, such as an annuity payment from a GRAT or a note repayment from a sale to an Irrevocable Grantor Trust. If a sale to an Irrevocable Grantor Trust has already been completed, during this time of increased gift tax exemptions, making a gift to the trust could shore up an underperforming note or allow for the note’s repayment (reducing the possibility IRS could try to include the value of the trust in the client’s estate for estate tax purposes).

6. Additional Lifetime Gifting. Clients should consider taking advantage of the new ability under the Act to transfer up to an additional \$5,600,000 (as discussed above this amount is estimated), indexed for inflation. This is especially important for clients that do not anticipate needing the gifted assets during their lifetimes. Note, however, that assets gifted away during life will not receive a basis Step-Up on death.

ACTION ITEMS: MARRIED CLIENTS WITH A NET WORTH GREATER THAN \$22,400,000⁶

These clients continue to have federal taxable estates and should continue to actively plan to limit exposure to Transfer Taxes. Clients whose wealth exceed the higher exemption amounts continue to have a many planning opportunities to increase the legacies they leave for their families and/or favorite charities. In addition to the planning opportunities discussed above, these clients should consider the following:

- 1. Review Allocation Provisions.** Clients with significant net worth often view their estate plans as dollar amounts being allocated among family/individual beneficiaries, charities and taxes. The increased gift, estate and GST tax exemption amounts may impact how this allocation is made.
- 2. Additional Lifetime Gifting.** Clients who have utilized all or a portion of their previous gift tax exemption amount now have the opportunity to make significant additional gifts given the doubling of the gift tax exemption. Further, the increased GST exemption amount will present many clients with the opportunity to create or enhance long-term (and in many states, perpetual) trusts, the appreciation on which will benefit future generations without the imposition of estate tax in future generations. The primary benefits of making these additional lifetime transfers early are twofold: (1) earlier transfers removes all future appreciation from the Transfer Tax system, and (2) early transfers mitigate the risk that Congress may allow the exemption amounts to sunset as scheduled under the Act or reduce the exemption amounts without enough time to react. Following are some gifting techniques that are still available to wealthy families:

a. Gifting Closely Held Assets. As discussed throughout this client alert, gifting assets today can lock in the increased exemption amount and remove all appreciation on those assets from the donor's estate. Although not part of the Act, the Treasury Department recently withdrew proposed regulations that would have impacted the ability to utilize valuation discounts for closely held entities in a family setting. Leveraging gifts through valuation discounts by gifting minority interests in closely held entities continues to be an effective way to get the most from a donor's gift tax exemption.

b. Estate Freezing. Estate freezing techniques, such as GRATs and sales to Irrevocable Grantor Trusts, have been discussed in other sections of this client alert and are particularly appropriate for families with significant wealth. When contemplating a sale of assets to an Irrevocable Grantor Trust, the increased gift tax exemption can allow for increased amounts of property to be sold to the trust. If one follows the "rule of thumb" that for every one dollar of trust principal, \$10 of assets can be sold to the trust, a gift of an additional \$5,000,000 to the Irrevocable Grantor Trust could allow \$50,000,000 of additional assets to be sold to the trust.

c. Life Insurance. Life insurance remains a tax efficient way to offset the bite of Transfer Taxes. When held in a properly structured and administered life insurance trust the death benefit generally pays out estate tax and income tax free. The increased exemption may provide an opportunity to support policies that have been under funded or for which internal performance has been poor. This can be done by using the increased exemption to add cash to a life insurance trust, which can be used to purchase a new policy or be added to an existing policy to bolster its internal value. This technique can be especially useful with underfunded current assumption universal or variable universal life policies. Additionally, the increased exemption may provide an opportunity to purchase additional life insurance if appropriate.

6. **And Individuals with a Net Worth Greater Than \$11,200,000.**

d. Long-Term Trusts. The increased exemption amount for families with significant wealth offers the opportunity to create trusts that (at least under current law) need not be subject to Transfer Taxes for multiple generations. Historically, trusts were required to terminate after a certain amount of time and their assets distributed to their beneficiaries (known as the “rule against perpetuities”). Many states in the United States have repealed this rule, or replaced the old time limit with one that is so long as to effectively be “perpetual.” If one can afford to part with assets, such person can create a trust in a state without a rule against perpetuities, and through application of the exemption from the gift tax and GST tax, for so long as assets remain in the trust, they will never again be subject to Transfer Tax. This allows the assets in the trust to appreciate without reduction by a Transfer Tax as each generation dies. A transfer to such a trust can be further leveraged by utilizing other techniques mentioned in this client alert, such as transfers of interests in closely held entities at a discounted valuation or through an initial gift to the trust followed by a sale of assets to the trust.

While this client alert focuses on estate, gift, and GST taxes, there are significant changes to individual income taxes and corporate taxes that will influence estate planning.

Clients who would like more information about their specific circumstances should contact a member of Blank Rome’s [Tax, Benefits, and Private Client](#) practice group.

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