Trusts and Estates

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Estate Planning Opportunity Under New Tax Act

President Donald J. Trump today signed into law the largest federal tax overhaul in more than three decades. H.R. 1, *"An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018"* has a major impact on estate planning: doubling the federal exemption for estate tax, gift tax and the tax on generation-skipping transfers (GST). Starting January 1, 2018, the lifetime exemption for each of these taxes will be $11.2 million per taxpayer. Married couples can pool their exemptions, doubling them to $22.4 million. The exemptions, which are subject to reduction through prior use during life, are indexed for future inflation. (The gift tax annual exclusion amount is currently $14,000 and will increase to $15,000 in 2018. In addition, unlimited payments of medical expenses or tuition on behalf of any individual directly to the provider will continue to be exempt from gift and GST tax. The increased exemptions under the Act do not affect these exclusions from the gift tax.)

The increased gift, estate and GST tax exemptions should be viewed as a temporary opportunity. Even if there is no change in the control of the White House or Congress, the law is scheduled to revert in 2026 to the current-law exemption amounts ($5.6 million plus inflation after 2018). While it may make sense for some clients to take advantage of this opportunity to engage in additional estate planning, there is also a potential risk that the new exemptions will unintentionally alter existing estate plans, requiring important immediate changes.

Unanticipated Impact on Existing Documents

The increased exemptions may significantly skew clients' existing estate plans, so it is important for clients to review their estate planning documents to make sure they continue to reflect their intentions. Many estate plans for married couples use a formula to divide assets at the first death between a "marital" portion passing to or held in a trust for the surviving spouse (not taxable until the second death) and a "bypass" portion intended to bypass the estate of the surviving spouse (sheltered from estate tax in either estate). The bypass portion may be allocated to a trust for the surviving spouse and/or descendants. It may also be allocated directly to descendants, skipping the surviving spouse entirely. Similarly, at the second death, the estate plan may have a formula dividing assets, based on the GST exemption, between children and grandchildren.

Depending on the exact language of the document (and local law provisions), this division may be vastly different now because of the much larger exemptions. For some clients, the new division will be acceptable. For others, it will be important to update the language of their estate planning documents to avoid a sharp reduction in what the surviving spouse receives (at the first death) and what the children receive (at the second death).

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Planning Opportunity Using the Increased Exemptions

Clients may also want to take advantage of the potential opportunity to pass large portions of their wealth to younger family members with as little tax as possible.

Benefits of a Lifetime Gift

As under the current law, making a lifetime gift using some or all of the exemption is more tax-efficient than merely waiting to use the same exemption at death, for several reasons.

Assets that have been gifted by a client to an individual or a trust are removed from the client's estate, so they are no longer includible in the client's estate and subject to estate tax. As the gifted assets grow in value and generate income, the income generated, as well as those increases in value, also escape estate tax because they are no longer in the client's estate. Furthermore, for those living in a state with its own estate tax (including New York and Illinois, for example, but not California or Florida), a lifetime gift may escape such state estate tax.

If the gift is to a "grantor" trust (a completed gift, but the donor still pays the income tax on the assets in the trust), then the advantage of the trust and its beneficiaries receiving the income and growth is leveraged even further because the client is reducing the size of his or her estate by the amount of the tax paid, and the trust's net worth is increased – which is the economic equivalent of a gift – without any gift tax. A grantor trust has even more benefits, including that the grantor may substitute equivalent assets into the trust and may sell assets to the trust without recognizing capital gain.

Another benefit of the lifetime gift using the larger exemptions is that the amount of estate tax exemption available at death in a future year may be much lower than the new gift tax exemption (either because the increased exemptions have expired or because the law may be changed in the future). This benefit is not certain because, in this case, under current law, the mechanics of the estate tax calculation might "claw back" the increased exemption and require the lower exemption in place at the time of death to apply. (The Act directs the Treasury Department to issue regulations to eliminate claw-back, but there is some concern that regulations may not be able to cure this entirely and that a technical correction to the legislation would be needed instead.)

In all cases, however, there is no claw-back for a transfer to which the increased GST exemption is applied.

For example, if a couple has previously made lifetime GST-exempt gifts that used up all the pre-Act gift and GST tax exemptions, such as by funding a "dynasty" trust intended for the long-term benefit of their descendants, together they would be able to give away $11.2 million of additional GST-protected gifts to the dynasty trust in January 2018. An unmarried individual in the same situation could give $5.6 million to a dynasty trust. There would be no future gift, estate or GST tax imposed on the dynasty trust and wealth accumulated in it (subject to the claw-back issue described above). As mentioned above, if the dynasty trust is structured as a grantor trust, the benefits can be even further magnified.

Issues to Consider in Making Lifetime Gifts

Although a lifetime gift makes sense for some clients, making a large lifetime gift may not be an appropriate strategy for every client. Some clients may wish to retain their wealth for their own use during their lifetimes, passing it to future generations only at death. From a family dynamic perspective, clients may feel that their children and grandchildren are already wealthy enough, or that whatever their children and grandchildren will inherit at the clients' death will be sufficient. Clients who are leaving their estates to charity may not be impacted by the change in the estate tax exemption because of the estate tax charitable deduction.

For clients who are concerned with the estate tax, one important consideration is the loss of step-up in basis for any asset that has been given away during life. Under current law (and preserved by the Act), with limited exceptions, assets that pass at death receive a new income tax basis equal to their fair market value at the date of death (known as a "step-up in basis"). In contrast, the recipients of assets that have been gifted during life have the donor's cost basis. Thus, for extremely low-basis assets, the potential for capital gains tax upon a sale by the recipient after the donor's death needs to be taken into account. Whatever potential estate tax savings may be effected by the gift may be partly or wholly offset by the loss of the step-up in basis for such gifted assets.

If the asset under consideration is not likely to be sold even after death, or in the case of assets with a high basis, such as cash or recently acquired property, then the estate and GST tax benefits should prevail, and the gift makes sense. On the other hand, if there is a reasonable prospect of sale after death, then it will be important to consider how the likely income tax on the sale (including both federal and any state income tax) compares with the estate tax savings.

An additional factor here will be the length of time expected before the future tax is imposed – whether it is the estate tax or the capital gains tax on sale. Not only does the time value of money come into play (the present value of a future savings is diminished if the savings won't be realized for a long time), but the more distant the expected tax event, the more opportunity there will be in the intervening years for all the tax rules to change.

Next Action Steps

As noted, the estate, gift and GST provisions of the Act present substantial new planning opportunities. They also have a potentially significant impact on existing estate plans. Clearly, clients need to review their existing documents to determine the impact of the Act, if any. Furthermore, each client's circumstances must be considered in detail before deciding whether a large gift, such as to a dynasty trust, makes sense. Our trusts and estates lawyers are ready to help you with all aspects of this analysis and to advise you on the various available alternatives.

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