The Tax Cuts and Jobs Act:

The Implications for Estate Planning

With the changes brought about by the recently enacted Tax Cuts and Jobs Act (TCJA), and even after the temporary increase reverts to the prior rules, most people will not be subject to federal estate taxes because their estates will be less than the exemption equivalent amount (the "federal exemption" or "the estate tax exemption").

This white paper will focus on the implications from a federal estate tax standpoint only. Currently, 17 states and Washington, D.C. impose a state estate and/or inheritance tax at a much lower level of wealth than the federal exemption. Planning for individuals subject to a state estate tax will differ from individuals who are only subject to the federal estate tax.

For purposes of analyzing the implications on estate planning and looking at different strategies to consider, we will divide the population into different groupings based upon tax exposure and estate size. The strategies mentioned below are not exclusive to a single group. Some strategies may be appropriate for multiple groups, whereas some strategies may only be more advantageous for a particular group that it is listed under.

GROUP 1:

Those that are not subject to federal estate taxes

How planning will change

Over the last several years, since the increase in the federal exemption went from $1 million to more than $5 million and now, more than $11 million, the focus has shifted from giving away appreciated property prior to death, which results in no estate tax savings and creates capital gains tax for heirs when they eventually sell the property. Ultimately, taxpayers are shifting their planning approach in order to take advantage of the step-up in basis available for assets held at death. In short, planning has moved away from saving estate taxes to become more income tax driven.

One important issue these individuals or couples should address is the revision of old estate planning documents. Many estate plans were drafted in such a way that would pass the portion of the estate that is not subject to estate tax by reason of the estate tax credit (which is where the exemption equivalent comes from) to children with the rest of the estate that might have been subject to estate tax to the spouse—using the unlimited marital deduction. Such estate plans would have produced the desired result when the estate tax exemption was $1 million, but with an $11,180,000 million estate tax exemption, the result may have unintended consequences.

If an estate were $11,180,000 million or less at the testator's death, such a plan would leave the entire estate to the children and nothing to the surviving spouse, as the entire estate would be sheltered by the estate tax exemption. Fortunately, these unintended consequences can be addressed by simply updating an outdated will and/or trust agreement.

You may also have an old estate plan where life insurance was purchased in order to pay for future estate taxes. This purpose for life insurance has become less relevant. Plan to meet with your insurance advisors to consider repurposing such policies.

GROUP 1:

Those that are not subject to federal estate taxes

Strategies to Consider

- **Basis planning has become more important.**
  It might be advisable for you to retain certain assets or have them included in the estate at death so that they will be eligible for a basis step-up. One tool to accomplish this is by use of a power of appointment. Any assets over which you hold a "general power of appointment" will be included in your taxable estate and therefore receive a step-up in basis at your death. Individuals may also want to consider the use of an Optimal Basis Increase Trust to qualify appropriate assets for this step-up in basis. By using this trust, the taxpayer may still obtain the needed step-up in basis, but may also avoid a step-down in basis for "loss" property; resulting in lower capital gain taxes on the current loss property.

- **Another way to obtain step-up in basis is to make gifts to parents who have non-taxable estates so that those assets will receive a stepped-up in basis at the parent's death.**
  Just remember that if you reacquire previously gifted appreciated property within one year of the transfer, you will not receive a step-up in basis.

- **The use of valuation discounts may not be as valuable as in the past.**
  If you are not projected to owe an estate tax, then applying the discount could be disadvantageous. You would want the asset to be valued at the stepped-up cost basis rather than the discounted cost basis.

- **Instead of making charitable bequests through your will, for which you will not be able to benefit from the charitable estate tax deduction, consider accelerating the gift during lifetime and obtaining a charitable income tax deduction.**
  Be aware however, that with the new tax law passed at the end of 2017, deductions may be less valuable now.

GROUP 2:

Those projected to have potentially taxable estates when they die

How planning will change

For those under the $22,360,000 effective combined federal exemption for a married couple given portability, or $11,180,000 exemption (if single), you have to consider their future wealth. Do not discount the effects of good investment returns and compounding. A current net worth of $5 million could be worth more than $10 million in 2026 (the exemption is set to sunset after 2025 and return to the inflation-adjusted exemption under prior tax law). For someone who is 70 years old and worth $1 million today, it may not be a future concern. However, remember the "rule" that your invested resources double in 10 years. For current estates that are more than $3 or $4 million and with either spouse having a remaining lifespan of more than 20 years, then you could exceed the exemption then available at the time of your death.

For this group, you may want to consider using gifting techniques to reduce the size of your potential estate. However, there is the fear that if you give up access to assets. What if you will need them later in life? Perhaps circumstances change and assets you previously thought you would not need are now needed for long-term care.

The strategies outlined below allow you to utilize your increased exemption, but still retain some level of access to assets.

GROUP 2 (Continued):

Those projected to have potentially taxable estates when they die

Strategies to Consider

- **Use the available increased exemption now.**
  You either use it or lose it. This is similar to much of the planning that was done when the exemption increased after 2013.

- **Basis planning has become more important.**
  It might be advisable for you to retain certain assets or have them included in your estate at death so that it will be eligible for a basis step-up as discussed above for those unlikely to face an estate tax.

- **In order to obtain grantor trust status, add a power to permit the settlor to swap assets from his or her personal trust in exchange for assets of equivalent value.**
  This could be used to pull highly appreciated assets, with a low basis, out of an irrevocable trust so that they are included in your estate upon death and can achieve a step-up in basis. The result is that the basis on which capital gains tax is calculated is reset to fair market value, thus reducing the capital gains tax on a future sale.

- **Making use of what is often referred to as an Intentionally Defective Grantor Trust (IDGT) may also help.**
  This special grantor trust can be seeded with cash and buy assets from the grantors so as to increase basis in those assets.

- **Forgive loans to children.**
  You may have taken advantage of the low interest rate environment and made an arms-length loan to your child. With the increased exemption, now would be a good time to forgive that loan.

- **Remember that for portability of a spouse's unused federal estate exemption, a federal estate tax return has to be filed upon the death of the first spouse.**
  With the increased exemption amount, there may be a push to secure portability now so that if the surviving spouse dies after 2025, there will still be use of the previous spouse's potentially larger unused exemption amount still available. If the federal exemption returns to its current level in the future, the loss of portability from failure to file an estate tax return at the death of the first spouse can create a greater estate tax upon the death of the survivor.

- **Consider forming non-reciprocal, spousal lifetime access trusts (SLATs).**
  In order to retain access to assets if circumstances change, you could give your spouse a limited power of appointment to appoint assets back to yourself, or you could add powers to take loans, or incorporate life insurance proceeds that could be used to provide that needed liquidity.

- **Single individuals may consider self-settled domestic asset protection trusts (DAPTs).**
  Assets can be removed outside of your estate but you can nonetheless remain a beneficiary.

- **The use of annual exclusion gifts may no longer be worthwhile.**
  The amount has become immaterial to the increased exemptions. For many individuals the cost and bother of annual gifts and Crummey Powers when made through trusts may no longer be worthwhile.

GROUP 3:

Those with larger estates subject to federal estate taxes

How planning will change

For this particular group, it will be planning as usual and augmenting existing plans.

There have also been significant discussions around utilizing trusts in order to maximize some changes introduced in the new tax law. Those that fall into this group usually incorporate dynastic planning and utilize generation-skipping tax planning. Some strategies are related to the use of the increased available generation-skipping tax exemption.

Some of these strategies being mentioned by other practitioners are highlighted below. However, guidance has not yet been issued in this area, and any of these strategies should proceed with caution.

Strategies to Consider

- **For larger estates, the increased exemption should be used, likely in combination with a leveraged transaction to maximize the wealth transfer from the increased exemption.**
- **Valuation discounts can and should be leveraged now that the IRC Section 2704 Regulations have been withdrawn.**
- **If you have a previous note sale transaction, consider making additional seed gifts to the purchasing trusts to strengthen the economics of the transaction.**
  You may also evaluate whether previous guarantees in lieu of seed money for the trust are still warranted.
- **If you previously used a rolling Grantor Retained Annuity Trust (GRAT) strategy, the larger exemption will permit a one-time transfer to an irrevocable trust as a completed gift in order to remove assets from your estate.**
- **Grantor trusts are still useful to reduce the grantor's estate without making additional gifts.**
  These trusts also allow trust assets to grow income tax-free.
- **With the introduction of the new Section 199A pass-through entity qualified business income deduction, consider utilizing non-grantor trusts and transferring ownership interests from a business to those trusts.**
  Each trust could potentially shield 20% of the pass-through income. This area of the new law still needs some guidance to be issued.
- **Consider using non-grantor trusts to multiply property tax deductions in high-tax states in order to minimize the state and local tax (SALT) limitation impact.**
  For example, real estate (house and/or vacation home) would be owned by an LLC (for protection purposes) and interests in the LLC, along with other marketable securities (or other income producing assets) would be used to fund non-grantor trusts. The trust must own an intangible asset (LLC interest) not the actual real estate, or you will taint the trust. The LLC would elect out of partnership status, so that the property tax is not reported on a partnership tax return, but instead on the returns of the separate trusts (it changes the tax reporting). Effectively, this could allow the full deduction for the annual property taxes. Remember that the trust must have enough income to offset the property tax. If there is any question about the potential loss of the Code Section 121 home sale exclusion because the home is owned by a non-grantor trust, you could convert back to grantor trust status if you plan to sell the house in the future so that you can meet the ownership rules (2 of 5 year rule).

Strategies to Consider (continued)

- **If you will not need to preserve the Generation-Skipping Transfer (GST) exemption, consider allocating the increased GST exemption to previously created non-GST exempt trusts so that those trusts will be GST exempt no matter if the GST exemption rolls back down.**

- **The increased GST exemption may be an opportunity to address existing irrevocable trusts.** If you have created any irrevocable trusts that have inclusion ratios greater than zero and assets may ultimately pass to skip persons (either by design or due to changed facts), consider making a late allocation of GST exemption where appropriate to cause such trusts to have inclusion ratios of zero.

Non-estate tax related considerations

Regardless of which group you may fall into, estate planning is not just for tax-related benefits. Estate planning has several non-tax related benefits, including asset protection, divorce protection, and management structure for potential future disability.

With the tax laws subject to change, depending on the agenda of the current administration, the best advice is to incorporate flexibility into plans. Flexibility is the key. You should use trusts that are flexible. This can be accomplished through the use of trust protectors. A trust protector is generally an independent person (not a beneficiary or a trustee) who acts in a fiduciary capacity and is given the power to remove and replace the trustee, change situs and governing law of the trust and other powers.

Conclusion

These strategies all depend on your wealth level and the state in which you live. If your estate is currently below the federal estate tax exemption and there is very little chance that you will exceed that amount, then you should focus on the following items:

- Capital gains tax basis planning
- Ensuring your current estate planning documents match your intent
- Reviewing if any life insurance policies, previously purchased for estate planning reasons, are still warranted.

If your taxable estate is currently below the federal estate tax exemption, but could potentially grow and exceed the available exemption at the time of your death, then you should consider gifting techniques to reduce the size of your estate in ways that allow you to retain access to assets in the future, should your circumstances change.

If you have a larger taxable estate and will most likely always be subject to federal estate tax, then planning should occur as usual and you should augment your existing estate plan to take advantage of the increased federal estate exemption. Utilizing multiple non-grantor trusts could help you maximize some of the new income tax changes in the tax law, such as taking advantage of the qualified business income deduction or state and local income tax limitation. And finally, if assets will ultimately pass to skip persons, you should take advantage of the increased generation-skipping tax exemption available now.

For more information, please contact your Key Private Bank Advisor.

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