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Alert | Private Wealth Services

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Estate Planning Under the Tax Cuts and Jobs Act

Introduction

On Dec. 22, 2017, the Tax Cuts and Jobs Act (the Act) was signed into law. It is the most sweeping federal tax legislation in decades and significantly changes the landscape of individual, corporate, partnership, international, and trust and estate taxation. In general, the changes made by the Act take effect as of Jan. 1, 2018, with most of the provisions affecting individual taxpayers being scheduled to sunset at the end of 2025. The implications of the Act are far-reaching. Residents of states that impose a state income tax and/or a state estate tax will face greater planning challenges in order to mitigate their tax burden.

As with all significant tax law changes, it will be important for clients to review the effects of the Act on their personal planning with their advisors. The changes bring significant opportunities to engage in beneficial estate planning. Many of those opportunities are scheduled to expire at the end 2025, and could expire sooner by future legislative action.

Estate, Gift, and Generation Skipping Transfer Tax Provisions

Increase in Transfer Tax Exemption Amounts

Pursuant to the Act, the cumulative amount of transfers exempt from both federal gift and estate taxes (the federal exemption amount) is doubled from $5 million per person to $10 million per person, indexed for inflation beginning after 2010. While the transfer tax exemptions continue to be indexed for inflation, the indexing is by a different measure (the chained CPI) that results in a smaller inflation adjustment than under prior law. For 2018, the exemption available to each individual under the new indexing is $11,180,000, allowing a married couple to transfer up to $22,360,000 free of the federal gift and estate tax.

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As was the case under prior law, to the extent an individual uses his or her federal gift tax exemption during life, it will reduce the exemption available for federal estate tax purposes. The amount exempt from the federal generation-skipping transfer (GST) tax in 2018 also is $11,180,000, and will also be indexed for inflation in subsequent years. The federal estate, gift, and GST tax rate remains at 40 percent. The increased exemption amounts sunset at the end of 2025, reverting back to $5 million, indexed for inflation.

Making gifts of property in trust continues to provide a significant opportunity to reduce estate and GST taxes as well as provide asset protection for the trust's beneficiaries. For donors domiciled in a state with a state estate tax but no state gift tax, making taxable gifts also can dramatically reduce the combined federal and state transfer taxes payable. In addition, the computation of federal gift tax is "tax exclusive" meaning that a donor pays gift tax only on the gifted property. The estate tax imposed at death is on the decedent's entire wealth at death, including the portion used to pay estate taxes.

Notwithstanding the seeming benefits of lifetime transfers made in 2018 through 2025, there are countervailing factors that potential donors need to consider. One issue to consider when making lifetime gifts with the increased gift tax exemption amount is the potential of a "clawback" of the increased federal exemption amount upon a death occurring after 2025. The Act directs the Treasury Department to prescribe such regulations as may be necessary or appropriate to carry out the purposes of the law with respect to differences between the exemption amounts in effect (1) at the time of death and (2) at the time of any gifts made by the decedent. Presumably these regulations will clarify that a "clawback" of the increased federal exemption amount is not intended, but there will be some uncertainty until these regulations are issued. Nonetheless, it will make sense for many wealthy individuals to make gifts that take advantage of the available increased exemption despite the current uncertainty about a potential clawback so as to remove any post-gift appreciation of and income generated by the gifted property from the donor's estate and to create transfers that are exempt from GST tax without incurring gift tax. The loss of any potential step-up in basis of the assets to be transferred, however, will need to be considered, although the use of grantor trusts to swap low basis assets for high basis assets may mitigate any adverse effects.

Step-up in Basis

The Act did not change the rules relating to a "step-up" in basis for appreciated assets included in an individual's estate on death. Accordingly, such assets will continue to be entitled to a new basis equal to their fair market values at the individual's death, even if no estate tax is imposed on those assets. Thus, the step-up in basis eliminates the taxable gain inherent in appreciated assets that existed at the time of death.

As a result, individuals need to consider the pros and cons of either retaining or gifting property, taking into account both the increased federal exemption amounts and the scheduled sunset of the increased federal exemption amounts. Individuals now below the exemption threshold who have made lifetime transfers of appreciated assets so as to remove them from their estates might consider strategies that would cause any such appreciated property to be includible in their gross estates and thereby obtain a step-up in basis in the property. In light of the scheduled sunset of the increased federal exemption amounts, however, any such planning must be carefully weighed against the risk that the current exemption will have reverted to a lower amount at death by reason of either sunsetting or subsequent legislative action. For those individuals who currently face no estate tax, if their assets are likely to appreciate, it is important for them to take into account the possibility that they might face one in the future, even with only modest rates of compounding.

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Applicability to Residents of States with Estate Tax

Thirteen states and the District of Columbia impose an estate tax.[1] Of those jurisdictions, only Washington, D.C., Hawaii, and Maine provide for an upward adjustment that aligns their exemptions with the increased federal exemption under the Act. The New York estate tax exemption is $5,250,000 for decedents dying on or after April 1, 2017 and before Jan. 1, 2019.[2] The Maryland estate tax exemption is $4,000,000 for 2018 and will match the federal exemption amount as of Jan. 1, 2019. Although the New Jersey estate tax was repealed effective Jan. 1, 2018, there have been discussions about reinstating it, and the New Jersey inheritance tax remains in effect.[3] For residents of those jurisdictions with a separate state estate tax, that tax must be taken into account when doing estate planning.

Wealthy residents of those states are incentivized to make gifts of up to the federal exemption amount and thereby remove the transferred assets from their state taxable estates.[4] Residents of those states whose potential estates exceed the federal exemption amount may be inclined to make gifts even though a federal gift tax would be incurred thereon if it would avoid a state transfer tax on such property. Such planning can be done without losing access to the assets.

Planning Possibilities

Gifting Strategies

The increased federal exemption amounts provide a significant opportunity to transfer wealth outright to or in trust for the benefit of lower generations. In light of the perhaps temporary existence of the increased federal exemption amounts, wealthy individuals who can afford to do so should consider engaging in lifetime planning. In addition, an individual with a high net worth can leverage the combination of the increased gift tax exemption and the current low interest rate environment with transactions similar to those engaged in under prior law, such as selling assets to a tax advantaged trust for the benefit of family members in exchange for a promissory note bearing a low rate of interest. Such transfers can result in significant transfer tax savings upon the donor's subsequent death. In addition, the allocation of GST exemption to the purchasing trust can leverage the transfer tax savings for future generations. It is even possible to allocate the increased GST exemption to an existing trust that is not presently GST-exempt.

A primary consideration in all lifetime planning strategies is whether the donor is willing, and can afford, to relinquish control of the gifted property. A married couple might consider using trusts created for the other spouse as a way to retain indirect access to the assets. In addition, the estate planning benefit of removing the gifted property and the appreciation thereof from the donor's estate has to be weighed against the loss of a step-up in basis for any such appreciated property, although subsequent planning can

[1] Connecticut, Delaware, Hawaii, Illinois, Maine, Maryland, Massachusetts, Minnesota, New York, Oregon, Rhode Island, Vermont, and Washington.

[2] After Jan. 1, 2019, the credit amount is scheduled to be $5 million, indexed for inflation beginning in 2010. If, however, a New York taxable estate exceeds the exemption amount by 5 percent, the entire taxable estate will be subject to the New York estate tax (commonly referred to as the cliff).

[3] The New Jersey inheritance tax is based upon the relationship of the recipient to the decedent. Notably, the inheritance tax exempts transfers to spouses, children, and lineal descendants in any amount. While certain relatives receive preferential tax rates, the inheritance tax rate on all others is 15-16 percent and is imposed on amounts starting at just $500. (The New Jersey estate tax, when in effect, did not exempt transfers to children and lineal descendants). Iowa, Kentucky, Maryland, Nebraska, and Pennsylvania also impose an inheritance tax.

[4] The only state that imposes a gift tax is Connecticut. New York does not levy a gift tax. It does, however, require estates to add back to the total value of the estate the value of gifts (other than gifts of real property and tangible personal property located outside of New York) made while the decedent was a New York resident and within three years of death, if the gift was made between April 1, 2014 and Jan. 1, 2019.

mitigate those effects.[5] As under prior law, consideration also should be given to the non-tax benefits of planning, such as creditor protection, protection in the event of divorce, and the financial acumen of beneficiaries.

Formula Clauses and Other Considerations

Individuals who have formula clauses in their wills or revocable trusts, providing for the maximum amount exempt from the estate or GST tax to pass to certain beneficiaries, may want to review their plans to ensure that it is still in accord with their intent. If, for example, an individual provided for the maximum amount that can pass free of the federal estate tax to pass to children with the balance passing to a spouse, the financial impact of a significantly larger exemption amount passing to the individual's children, and the negative impact on the spouse, should be evaluated. Alternatively, individuals now below the current exemption thresholds may want to reconsider and simplify their estate plans by providing for a greater portion, if not all, to go to a surviving spouse.

Non-Grantor Trust Planning

Given the loss of the state and local income tax deduction, the tax cost of living in a high income tax state, such as California, New Jersey, or New York, has increased. Historically, for clients considering gifting strategies, grantor trusts have been effective to leverage the value of the gifted property. A grantor trust is treated the same as the taxpayer for income tax purposes, and the donor would pay the tax on trust income, allowing the trust to grow income tax free. The payment of the income tax on the trust assets effectively allows the donor to make additional tax free transfers to the trust.

Individuals now may wish to consider making gifts to trusts that are not grantor trusts for income tax purposes. If the trust income is not taxable to the grantor, it may be possible to structure a trust so that the income is not taxable in the state of the grantor's residence, thereby permitting the trust to grow without the imposition of state income tax.

Under current law in both New York and New Jersey, for example, a trust is a resident taxpayer (a Resident Trust) if it is funded by a settlor who was a resident of the state at the time of funding. A Resident Trust, however, is not subject to New Jersey or New York income tax if all three of the following conditions are met: (i) all of the trustees are domiciled outside of the state of residence; (ii) all tangible real and personal trust property is located outside of the state of residence; and (iii) all trust income and gain is derived from sources outside of the state of residence. The trust would remain a Resident Trust but assuming no taxable income was distributed to beneficiaries in the resident state, neither the settlor, the beneficiaries, nor the trust, would be subject to New York or New Jersey state income tax on the trust assets. Under New York law, if the accumulated income of a trust is distributed to a New York beneficiary of a Resident Trust that is not subject to tax under these rules, the income would be taxable to the beneficiary. To the extent no distributions are made or the beneficiaries are located outside of New York, this may permit a settlor to shift the income to a state without an income tax or defer the state income taxes until assets are distributed to beneficiaries.

Alternative or Additional Planning Possibilities

Reverse Planning: Given the increased federal exemption amounts and the continued availability of a step-up in basis for appreciated assets, individuals who are below the estate tax threshold may consider

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[5] There may be various techniques available to enable the donor's estate to take advantage of the step-up in basis, notwithstanding the lifetime transfers, but such techniques are beyond the scope of this alert.

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making gifts to older generation family members to obtain a step-up in basis on their likely earlier deaths. In addition, individuals who are below the exemption thresholds may consider methods of bringing assets into their own taxable estates in order to obtain a step-up in basis. To achieve a stepped-up basis for irrevocable trusts, there are certain strategies that can be utilized for assets presently excluded from an individual's estate. In light of the scheduled sunset of the increased federal exemption amounts, however, any such planning should take into account and be weighed against the possibility that the exemption will have reverted to a lower amount at the time of death.

Change of Domicile: With the increased cost of state income taxes, individuals may hasten the process of moving to a low income tax jurisdiction. Any such planning should be done in consultation with advisors and care must be given to effectuate properly any such move for tax purposes.

Marital Agreement Planning

In addition to the transfer tax provisions mentioned above, a change affecting prenuptial agreements and divorce agreements should be noted. Alimony will no longer be deductible for income tax purposes by the payor spouse or taxable to the recipient spouse with respect to any divorce or separation instrument executed after Dec. 31, 2018, or any divorce or separation instrument executed on or before Dec. 31, 2018 and modified after that date, if the modification expressly provides that the amendments made by the Act apply to such modification. Note that these grandfathering rules do not cover preexisting prenuptial or postnuptial agreements that provide for alimony based on the then applicable tax treatment thereof. Therefore, such agreements may need to be renegotiated if they contain maintenance and support provisions based on the deductibility of alimony payments.

Conclusion

Planning should continue for individuals with estates expected to exceed the increased federal exemption amounts. The increased federal exemption amounts are temporary, and are scheduled to revert to the prior law in 2025, thus creating a substantial current estate planning opportunity for many. Importantly, none of the available transfer tax reduction techniques will be adversely affected by the Act. Valuation discounts remain intact, as do many of the popular wealth transfer techniques, such as GRATs, QPRTs, and installment sales. Therefore, techniques that will shift post-transfer appreciation outside of the transferor's taxable estate will continue to be effective, and are in fact facilitated by the increased federal exemption amounts, permitting large transfers to be made without the application of any transfer tax.

Individuals should also review their current estate planning documents in light of the changes made by the Act to determine if any changes are appropriate. In addition, individuals should review their estate planning from time to time to determine if changes are appropriate for important non-tax reasons, such as business succession, planning for disability, changes in wealth, asset protection and changes in family and life circumstances.

About Greenberg Traurig's Private Wealth Services Practice

Greenberg Traurig's Private Wealth Services Practice is primarily responsible for assisting individual clients and families in attaining their wealth transfer and estate planning objectives. The team offers integrated income and transfer tax advice that takes into account current and projected changes in the tax and state laws affecting client estate planning.

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