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THE NEW TAX ACT WILL CHANGE HOW CLIENTS PLAN THEIR ESTATES

The new ***Tax Act*** (the *Tax Act* was originally known as the õ*Tax Cuts and Jobs Act*ö but for technical reasons the new *Tax Act* dropped this name) doubled the federal estate tax and gift tax exemption amount and the generation-skipping transfer tax exemption amount, effective January 1, 2018. The following summarizes the new estate planning opportunities and strategies under the new *Tax Act*.

1. ***The Tax Act Increased the Unified Estate and Gift Tax Exemption Amount.***

Beginning January 1, 2018 the federal estate and gift tax exemption amount (which can be utilized by lifetime gifts or at death) increases to $11,200,000 per person after inflation adjustments (or $22,400,000 combined for a married couple). Thus, in 2018 two spouses will be able to jointly gift or leave at death $22,400,000 in assets estate and gift tax-free. This exemption amount will further increase in future years for inflation adjustments.

In 2026 this exemption amount is scheduled to revert to the lower exemption amount before the *Tax Act* was enacted (which is $5,600,000 per person in 2018, <u>plus</u> inflation adjustments after 2018). There is concern that if this exemption amount is reduced in 2026, clients who previously utilized the higher $11,200,000 exemption amount for lifetime gifts may be required at their death to give back (or õclawed backö) a portion of their previously used exemption amount. The legislative history of the *Tax Act* suggests that such a õclaw backö is not the intent of the *Tax Act*. This legislative history instructs the IRS to issue Treasury Regulations to confirm that gifts using the higher increased exemption amount will not later be subject to a tax if this high exemption amount is later reduced.

This new increased exemption amount can be maximized by either using a Bypass Trust (sometimes known as a õDecedentøs Trustö). Alternatively, the surviving spouse (upon the death of the first-to-die spouse), can rely upon the õportabilityö provisions which allow the surviving spouse to utilize the deceased spouseøs estate tax exemption amount (along with the surviving spouseøs exemption amount). To utilize õportabilityö, an estate tax return must be filed for the first-to-die spouse even if no estate tax is due. If the surviving spouse remarries, then this õportabilityö provision ceases to apply to the first-to-die spouseøs exemption.

2. ***The Annual Gift Tax Exclusion Amount Remains Unchanged Under the New Tax Act.***

In addition to the increased lifetime exemption amount, in 2018 the annual gift tax exclusion amount increased to $15,000 per donee (or $30,000 per donee each year for both spouses combined). Additionally, unlimited amounts can be paid by a parent or grandparent gift tax-free for their childøs or grandchildøs qualified medical and tuition payments. This $15,000 annual exclusion amount increases in the future based upon inflation adjustments. The new *Tax Act* does not affect this gift tax annual exclusion amount.

3. ***What is the New Generation-Skipping Tax Exemption Amount Under the New Tax Act?***

The generation-skipping tax exemption amount increased to $11,200,000 on January 1, 2018 (or $22,400,000 combined for a married couple). Thus, a married couple can structure their estate plan to gift or leave at death up to a combined $22,400,000 of assets to their grandchildren free of generation-skipping taxes. The generation-skipping tax exemption amount is not portable. Therefore, each spouse should plan in their trust document to use their own generation-skipping tax exemption.

A generation-skipping transfer tax at the forty percent (40%) rate, applies to gifts made at death or during lifetime to a person two or more generations below the transferor. The generation-skipping transfer tax is in addition to the federal estate and gift tax. Thus, the generation-skipping tax applies to gifts to grandchildren or any other person who is more than thirty-seven and one-half (37.5) years younger than the transferor.

A major tax planning opportunity is now available to clients who elect to use this increased generation-skipping tax exemption. Since the new *Tax Act* does not impose any limitation on the duration of a generation-skipping trust, trusts can now be designed to continue for multiple generations without having a transfer tax imposed as each generation should die.

4. ***Federal Estate and Gift Tax Rates Remain the Same Under the New Tax Act.***

The maximum federal estate and gift tax rate remains at forty percent (40%) for the top tax bracket under the new *Tax Act*.

5. ***The New Tax Act Still Preserves the Step-Up in Income Tax Basis at Death.***

The *Tax Act* preserves the tax rule that assetsø income tax bases are adjusted to those assetsø fair market value at the clientøs death (and for community property assets upon the death of either spouse). The increased estate tax exemption amount ($11,200,000 per person in 2018)

offers clients the opportunity to receive a step-up in their assetsø income tax basis at death without any estate tax cost for the value of those assets covered by this exemption amount.

Clients need to consider whether gifting assets to other family members during the clientøs lifetime will risk losing this step-up in those assetsø income tax basis that the clientøs heirs would otherwise receive had the client retained those assets until death. For example, clients with community owned property may wish to retain assets until the death of the first-to-die spouse before gifting those assets. Other clients may wish to consider retaining assets in their estates in order to fully utilize the estate tax exemption amount and receive the benefit of the step-up in those assetsø income tax basis.

If the client makes lifetime gifts of assets to their children then the client should choose for gifting those assets that are not likely to be immediately sold by their children (such as the stock of a closely held business that the children work in).

6. ***Valuation Discounts are Still Permitted for Lifetime Gifts and Death Time Transfers.***

The new *Tax Act* does not affect the current valuation discount rules. The Treasury Department during 2017 withdrew Proposed Treasury Regulations which would have disallowed certain valuation discounts. Thus, clients can utilize valuation discounts (such as for a minority interest or for lack of marketability) to transfer gift and estate tax-free to their family, real estate, businesses, stock and bond portfolios, partnership and limited liability company interests and other assets. Valuation discounts remain an important tax planning tool enabling clients to transfer large amounts of their wealth to their children and grandchildren at reduced or no estate and gift tax cost.

7. ***New Tax Act May Cause Unintended Results From Existing Estate Plan Formula Clauses.***

Clients need to now review their estate planning documents to verify that the changing tax laws do not cause unintended results to their estate plans. Unintended large amounts of assets may be left by existing formula clauses to beneficiaries because of the new higher estate tax exemption amount. Tax formula clauses could result in a client unwittingly leaving more assets to some beneficiaries than that client otherwise intends. Thus, Will and trust formula clauses should be reviewed in light of the current new higher estate and gift tax exemption amount. Similarly, the increased generation-skipping tax exemption amount may result in the clientøs documents unintentionally leaving more assets to grandchildren or other lower generation persons than that client otherwise intends.

8. ***<u>Should a Client Now Use their High Exemption Amount to Make Lifetime Gifts? Or Will that Client Risk Losing in the Future their High Exemption Amount?</u>***

The increased gift tax exemption amount offers clients the planning opportunity to gift tax-free large portions of their estates to their children and grandchildren. If this exemption amount is in fact reduced in future years (such as this higher exemption amount being reduced in 2026) then the clientøs current gifts will have been tax advantageous because of the current high exemption amount ($22,400,000 combined in 2018 for a husband and wife). Gifting assets currently to family members also removes from a clientøs taxable estate the income from those gifted assets as well as those gifted assetsø future appreciation.

Similarly, the increased generation-skipping tax exemption amount makes it tax advantageous to make large gifts to grandchildren and other lower generation persons in order to avoid a potential future generation-skipping tax.

However, weighing against the client making lifetime gifts is the clientøs loss of the step-up in the gifted assetsø income tax basis at the clientøs death. Clients instead of gifting assets to a beneficiary during the clientøs lifetime could instead leave those same assets to that beneficiary at the clientøs death and have those assets receive a step-up in the assetsø income tax basis.

9. ***<u>Clients Can Now Fund Dynasty Trusts Tax-Free With Substantial Wealth.</u>***

Since the gift and estate tax exemption amount has been increased (a combined $22,400,000 for both spouses in 2018) with the same increased exemption amount applied to generation-skipping transfers, clients can now use dynasty trusts to transfer their assets tax-free to multiple generations. This increased exemption amount is scheduled to expire in 2026. Thus, wealthy clients for the next eight years have an opportunity now to establish a dynasty trust for multiple generations of their family.

> **EXAMPLE:** A married couple establishes a dynasty trust which provides for the trustøs holding assets for the benefit of the clientsø children, grandchildren, great-grandchildren and further lower generations. The clients fund this dynasty trust during their lifetimes by gifting in 2018 $22,400,000 of assets into the trust. The gifting is accomplished by using the full gift tax and generation-skipping tax exemption amounts. The clients in order to transfer more assets to this dynasty trust first use valuation discounts by funding a family limited liability company (õLLCö), and transfers the LLC membership interests into sub-trusts within the dynasty trust document, a twenty-five percent (25%) interest to each of their four (4) childrenøs separate subtrusts. The assets

which fund the LLC consists of the familyøs closely held business which has an undiscounted value of $32 million. With a 30% valuation discount for minority and lack of marketability interests the LLC membership interests have a gift tax value of $22.4 million in the four subtrusts. Thus, the married couple clients first transfer this business to the LLC and then the LLC membership interests are transferred to the clientsø dynasty trust (split into four separate children subtrusts) tax-free. The business (or the sales proceeds if that business is sold) continues in the LLC and the separate dynasty trusts, which LLC membership interests then pass tax-free to multiple generation levels, with no future estate, gift or generation-skipping taxes. Furthermore, any future appreciation in the family business also passes free of any estate, gift or generation-skipping taxes. Under this above example, instead of using a closely held business in the LLC, real estate assets or other investment assets could be utilized to fund the family LLC and dynasty trust.

10. ***Clients Need to Consider Non-Tax Reasons on Why They Wish to Gift (or Wish Not to Gift) Assets to Family Members.***

Clients will consider nontax issues in deciding whether to make substantial lifetime tax-free gifts to their children and grandchildren. For example, clients may not wish to gift significant amounts of their wealth during the clientøs lifetime to their children and grandchildren because of concerns that large gifts might be a disincentive to those family members working or obtaining an education. Clients might also be concerned that substantial gifts of wealth could cause certain family members to become dilettantes without a career.

Clients may desire to retain their wealth because of the clients need to have sufficient assets for their own use and comfort. Furthermore, many clients have strong charitable desires and those clients might rather leave a substantial amount of their estates to charities, to a private charitable foundation or to charitable trusts in order to support that clientøs charitable causes and goals.

11. ***Income Tax Changes Affecting Estate Planning.***

The new Tax Act reduces the top marginal income tax bracket for estates and trusts to 37%, and also allows trusts to receive the tax advantage of the new 20% deduction where there is specified qualified business income.

The new income tax limitations on deducting state and local income taxes will apply to estates and trusts. State and local income taxes for trust owned businesses and income producing real estate will remain deductible. This new limitation on deducting state and local taxes

encourages clients with existing trusts subject to high state income taxes (such as trusts subject to California or New York state income taxes) to make those trusts subject to lower state income tax jurisdictions.

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