ESTATE PLANNING ALERT
NOVEMBER 2018

Many of our clients have asked whether they need to review or revise their estate plans as a result of the enactment of the Tax Cuts and Jobs Act (the "Tax Act"). Now that we have had an opportunity to digest this critical change in the law and see how it is playing out in practice, we want to highlight a few issues for you to consider in light of the new law.

Under the Tax Act, the estate, gift and generation-skipping transfer ("GST") tax exemptions increased to **$11.18 million** for a single person and **$22.36 million** for a married couple in 2018, and **$11.4 million** for a single person and **$22.8 million** for a married couple in 2019 (subject to inflation-based increases in future years). At the same time, the Tax Act made no changes to the rules that cause the income tax basis (cost) of an asset owned by a person to be "stepped-up" to the asset's fair market value upon that person's death.

IMPORTANT PLANNING NOTE: **The increased exemptions will expire at the end of 2025**. Starting January 1, 2026, the exemptions will revert to at least $5.49 million for a single person and $10.98 million for a married couple (subject to inflation-based increases). Subject to further changes in the law before 2026, listed below are the issues we are focusing on when creating current estate plans for our clients.

1. **Simplification**: The increased exemptions may enable you to simplify your estate plan by leaving assets outright to your children upon your death, rather than retaining those assets in trust for them.

> ***Example***: *Assume that your revocable living trust that you created in 2009 establishes lifetime trusts for each of your two adult children upon your death. Those trusts were designed to avoid any estate taxes when each of your children dies. Assume further that your total estate is $3 million, so that each child's trust would receive $1.5 million upon your death. Finally, assume that your children do not have large estates of their own, and are unlikely to have estates that exceed the estate tax exemption when each of them passes away.*
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> *In this case, given the amount of the current estate tax exemption, and the likely increase in the exemption when each of your children passes away, the larger estate tax exemption likely will exceed everything the child owns, including whatever was held in the trust for the child. Therefore, if everything was left directly to the child, no estate taxes would be due upon the child's death. While there are certainly reasons to still consider lifetime trusts, such as protection against creditors and divorcing spouses, if saving estate taxes was the primary reason to establish lifetime trusts for your children, the larger estate tax exemption may enable you to make things a lot simpler by leaving everything directly to them.*

2. **Specific Bequests Tied to Estate Tax Exemption**: If your current plan contains any bequests that are equal to the amount of the estate tax exemption and/or the Generation-

Skipping Transfer Tax exemption (the "GST exemption"), you will definitely want to review those provisions to make sure they still conform with your wishes.

> ***Example****: Assume that you wanted to leave your grandchild an amount equal to the GST exemption in the year that you died. When you created your trust in 2009, the GST exemption was $3.5 million. In 2018, the GST exemption increased to $11.18 million. If your trust didn't cap the amount going to the grandchild, the major increase in the GST exemption would result in your grandchild receiving a much larger gift ($11.18 million) than you intended, to the detriment of your other beneficiaries.*

3. **<u>Planning to Reduce Future Capital Gains Taxes</u>**: Your current plan may be deficient in minimizing future capital gains taxes for your intended beneficiaries. With proper planning, future capital gains tax liability can be reduced or even eliminated. For any estate plan that establishes continuing trusts for the lifetime of a spouse, children and/or grandchildren, we strongly urge you to have your trust reviewed to make sure that certain safeguards have been incorporated into the trust to help minimize future capital gains taxes.

> ***Example****: Assume the following: Mom's revocable living trust provides that a lifetime trust will be established for the benefit of Daughter upon Mom's death. When Mom later passes, Daughter's trust receives Mom's residence, which has a value and an income tax basis of $3 million. The trust will remain in effect for Daughter's entire lifetime. Upon Daughter's death, the residence will pass equally to Daughter's children without any estate tax or GST tax. Assume that the residence appreciates in value to $8 million between Mom's death and Daughter's death. Finally, assume that Daughter has $2 million of her own assets when she dies and that the estate tax exemption upon Daughter's death is $12 million.*
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> *Since Daughter's trust will not be included in her estate for estate tax purposes, the grandchildren will receive the house with a $3 million basis. If they sell the house for $8 million, they will incur a $5 million capital gain, which could result in a $1.6 million capital gains tax liability. This capital gains tax could have been eliminated if Daughter's trust gave an independent "special trustee" the power to cause the value of the trust assets to be included in Daughter's estate. If the special trustee exercised this power:*
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> *(a) There still would be no estate tax due upon Daughter's death, since the $8 million home, plus Daughter's personal assets of $2 million, is still less than the $12 million estate tax exemption in effect when Daughter dies; and*
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> *(b) The residence would receive a new income tax basis of $8 million upon Daughter's death. Thus, when the residence is sold, the capital gains taxes would be eliminated, saving the grandchildren approximately* ***$1.6 million****.*

4. **Use Increased Gift Tax Exemption Prior to 2026**: If your estate is significantly larger than the current $11.18 million exemption, we encourage you to consider gifting strategies that will take advantage of that exemption prior to 2026, when it reverts to $5.49 million (with inflation adjustments). The failure to use your gift tax exemption could be very costly. At a 40% estate tax rate, your heirs could pay as much as $2,276,000 in unnecessary estate taxes ($4,552,000 for a married couple).

5. **Property Tax Planning**: Any of the planning resulting from the Tax Act also must factor in California property tax considerations. While your estate plan may be completely free from estate taxes, and properly planned to minimize future capital gains taxes, it may not be appropriately structured to deal with California property taxes.

> ***Example****: If you leave your primary residence to a trust for the benefit of your children* AND *grandchildren, the residence will be reassessed upon your death. If the residence's current assessed value is $500,000 and its fair market value is $3 million, the annual property taxes could increase by at least $25,000. However, if you modified your estate plan to leave the residence directly to your children (or in trust for the exclusive benefit of your children) the assessed value of the residence would remain at $500,000 upon its transfer to your children, saving your children at least $25,000 in property taxes each year.*
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> *The reason: the transfer of your primary residence to your children (or to a trust for the exclusive benefit of your children) qualifies for an exclusion from reassessment for property tax purposes. If you leave your primary residence to a trust which currently benefits children* AND *grandchildren, the exclusion is lost. This is just one simple example of how proper property tax planning can save thousands of dollars in unnecessary property taxes. There are many more ways that we can plan an estate to minimize property tax increases, especially if you own a large real estate portfolio in California.*

We hope the above descriptions and scenarios give you a better idea of how the Tax Act might affect you. We strongly recommend that you contact us to make sure that your current estate plan accomplishes all of your objectives while taking advantage of current tax-saving opportunities.

Sincerely,

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