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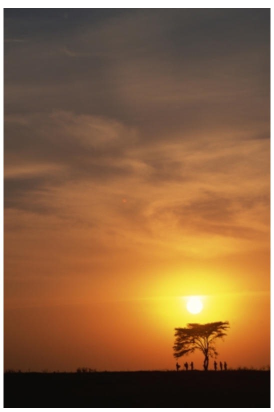
The New Estate Tax Rules and Your Estate Plan



Looking ahead

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The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (the 2010 Tax Act) included new gift, estate, and generation-skipping transfer (GST) tax provisions. The 2010 Tax Act provided that in 2011 and 2012, the gift and estate tax basic exclusion amount was $5 million (indexed for inflation in 2012), the GST tax exemption was also $5 million (indexed for inflation in 2012), and the maximum rate for both taxes was 35%. New to estate tax law was gift and estate tax applicable exclusion portability: generally, any gift and estate tax basic exclusion left unused by a deceased spouse could be transferred to the surviving spouse in 2011 and 2012. The GST tax exemption, however, is not portable. Starting in 2013, the American Taxpayer Relief Act of 2012 (the 2012 Tax Act) permanently extended the $5 million (as indexed for inflation) basic exclusion amount and GST tax exemption and portability of the gift and estate tax applicable exclusion amount, but also increased the top gift, estate, and GST tax rate to 40%. The Tax Cuts and Jobs Act doubled the basic exclusion amount to about $11.2 million in 2018 (indexed annually for inflation). After 2025, the exclusion is scheduled to revert to its level prior to 2018 and be cut by about one-half. You should understand how these new rules may affect your estate plan.

Exclusion portability

Under prior law, the gift and estate tax exclusion was effectively "use it or lose it." In order to fully utilize their respective exclusions, married couples often implemented a bypass plan: they divided assets between a marital trust and a credit shelter, or bypass, trust (this is often referred to as an A/B trust plan). Under the recent Tax Acts, the estate of a deceased spouse can transfer to the surviving spouse any portion of the basic exclusion amount it does not use (this portion is referred to as the deceased spousal unused exclusion amount, or DSUEA). The surviving spouse's applicable exclusion amount, then, is increased by the DSUEA, which the surviving spouse can use for lifetime gifts or transfers at death.

Example: *At the time of Henry's death in 2011, he had made $1 million in taxable gifts and had an estate of $2 million. The DSUEA available to his surviving spouse, Linda, is $2 million ($5 million - ($1 million + $2 million)). This $2 million can be added to Linda's own exclusion for a total of $13,200,000 ($11,200,000 + $2 million), assuming Linda dies in 2018.*

The portability of the exclusion coupled with an increase in the basic exclusion amount to $11,200,000 per taxpayer allows a married couple to pass on up to $22,400,000 gift and estate tax free in 2018. Though this seems to negate the usefulness of A/B trust planning, there are still many reasons to consider using A/B trusts.

- The assets of the surviving spouse, including those inherited from the deceased spouse, may appreciate in value at a rate greater than the rate at which the basic exclusion amount increases. This may cause assets in the surviving spouse's estate to exceed that spouse's available applicable exclusion amount. On the other hand, appreciation of assets placed in a credit shelter trust will avoid estate tax at the death of the surviving spouse.
- The distribution of assets placed in the credit shelter trust can be controlled. Since the trust is irrevocable, your plan of distribution to particular beneficiaries cannot be altered by your surviving spouse. Leaving your entire estate directly to your surviving spouse would leave the ultimate distribution of those assets to his or her discretion.
- A credit shelter trust may also protect trust assets from the claims of any creditors of your surviving spouse and the trust beneficiaries. You can also include a spendthrift provision to limit your surviving spouse's access to trust assets, thus preserving their value for the trust beneficiaries.

A/B trust plans with formula clauses

If you currently have an A/B trust plan, it may no longer carry out your intended wishes because of the increased exclusion amount. Many of these plans use a formula clause that transfers to the credit shelter

Gifts

The large exclusion may make it easier than ever to make large gifts, but they may also reduce the need to make large gifts in order to reduce the gross estate for estate tax purposes.

trust an amount equal to the most that can pass free from estate tax, with the remainder passing to the marital trust for the benefit of the spouse. For example, say a spouse died in 2003 with an estate worth $11,200,000 and an estate tax exclusion of $1 million. The full exclusion amount, or $1 million, would have been transferred to the credit shelter trust and $10,200,000 would have passed to the marital trust. Under the same facts in 2018, since the exclusion has increased, the entire $11,200,000 estate will transfer to the credit shelter trust, to which the surviving spouse may have little or no access. Review your estate plan carefully with an estate planning professional to be sure your intentions will be carried out under the new laws.

Wealth transfer strategies through gifting

Because of the larger exclusion and lower tax rates, there may be unprecedented opportunities for gifting.

By making gifts up to the exclusion amount, you can significantly reduce the value of your estate without incurring gift tax. In addition, any future appreciation on the gifted assets will escape taxation. Assets with the most potential to increase in value, such as real estate (e.g., a vacation home), expensive art, furniture, jewelry, and closely held business interests, offer the best tax savings opportunity.

Gifting may be done in several different forms. These include direct gifts to individuals, gifts made in trust (e.g., grantor retained annuity trusts and qualified personal residence trusts), and intra-family loans. Currently, you can also employ techniques that leverage the high exclusion to potentially provide an even greater tax benefit (for example, creating a family limited partnership may also provide valuation discounts for tax purposes).

For high-net-worth married couples, gifting to an irrevocable life insurance trust (ILIT) designed as a dynasty trust can reduce estate size while providing a substantial gift for multiple generations (depending on how long a trust can last under the laws of your particular state). The value of the gift may be increased (leveraged) by the purchase of second-to-die life insurance within the trust. Further, the larger exclusion enables you to increase, gift tax free, the premiums paid for life insurance policies that are owned by the ILIT or other family members. Premium payments on such policies are taxable gifts, so these premium payments are often limited to avoid incurring gift tax. This in turn restricts the amount of life insurance that can be purchased. But the increased exclusion provides the opportunity to make significantly greater gifts of premium payments, which can be used to buy a larger life insurance policy.

Before implementing a gifting plan, however, there are a few issues you should consider.

- Can you afford to make the gift in the first place (you may need those assets and the related cash flow in the future)?
- Do you anticipate that your estate will be subject to estate taxes at your death?
- Is minimizing estate taxes more important to you than retaining control over the asset?
- Do you have concerns about gifting large amounts to your heirs (i.e., is the recipient competent to manage the asset)?
- Does the transfer tax savings outweigh the potential capital gains tax the recipient may incur if the asset is later sold? The recipient of the gift gets a carryover basis (i.e., your tax basis) for income tax purposes. On the other hand, property left to an individual as a result of death will generally receive a step-up in cost basis to fair market value at date of death, resulting in potentially less income tax to pay when such an asset is ultimately sold.

Caution: *The amount of gift tax exclusion you used in the past will reduce the $11,200,000 available to you in 2018. For example, a person who used $1 million of his or her exclusion in 2012, will be able to make additional gifts totaling $10,200,000 during 2018 free from gift tax.*

Tip: *In addition to this opportunity to transfer a significant amount of wealth tax free, it's important to remember that you can still take advantage of the $15,000 (in 2018, $14,000 in 2017) per person per year annual gift tax exclusion. Also, gifts of tuition payments and payment of medical expenses (if paid directly to the institutions) are still tax free and can be made at any time.*