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2018 Ushers In New Estate Planning Opportunities and Pitfalls

January 18, 2018

On December 22, 2017, President Trump signed into law the most sweeping tax reform bill in over 30 years (the "2017 Tax Act" or the "Act"). ***For clients and their advisors, this client alert focuses on the estate planning implications of the new law.***

I. Estate, Gift, and GST Changes

The Act increases the estate tax "basic exclusion amount" from $5 million to $10 million. The basic exclusion amount has been indexed since 2011 and would have been $5.6 million in 2018. Under the 2017 Tax Act, it is estimated that the basic exclusion amount for 2018 will be $11.18 million ($22.36 million for a married couple). This will also be the exclusion amount for gift tax and generation-skipping transfer ("GST") tax. The increase put in place by the Act is effective from 2018 through 2025. Absent further action by Congress, in 2026 the basic exclusion amount will revert to $5 million indexed from 2011. Starting this year, indexing of the exclusion amount (as well as other amounts indexed in the tax code) will be based on the "chained CPI-U" which is a slower-to-grow measure of inflation than used in prior years.

The estate tax exclusion remains portable (it can be transferred to a surviving spouse at death), while the GST exemption remains not portable. The tax rate remains at 40%.

The 2017 Tax Act did not change the basis rules for property received by gift or bequest. Thus, appreciated property transferred by gift still keeps the transferor's basis (adjusted for any gift tax paid with respect to the appreciation). Appreciated property transferred at death generally gets a new basis equal to the fair market value of the property on the date of death (typically referred to as a step-up in basis).

While these changes seem simple, their impact on any particular client will be complex. Planning opportunities are highly dependent on individual facts and circumstances. Please contact us if you would like assistance in analyzing the impact of the Act on your situation.

II. Planning Considerations: Questions & Answers

Since the estate tax changes are only temporary, what is likely to happen to the exclusion amount in the future? As enacted, the increase in the basic exclusion amount will expire on December 31, 2025. Historically, it is very unusual for the exclusion to decrease. However, these are unusual times, and this exclusion amount is unusually high. (It leaves only about 0.1% of estates subject to the estate tax.) We see three possibilities:

1. a new Congress could undo this increase earlier than 2026;
2. the increase could be allowed to expire at the end of 2025; or
3. the increase could be extended either temporarily or permanently.

As a result, we expect that most clients who can afford to do so will prefer to use their newly-increased exclusion to make lifetime gifts in the next few years.

Should I be making large gifts in the next few years? The answer depends on a balancing of estate tax and income tax considerations. If the increased exclusion is used to gift appreciated assets, those assets will retain the donor's basis in the hands of the recipient. On the other hand, if the appreciated assets were retained until the donor's death and then transferred, they would generally get a new stepped-up basis. Thus, it is important to consider basis before deciding whether and which assets to gift using the increased exclusion amount. Making gifts to an irrevocable grantor trust can mitigate these concerns. Whether gifts will be advantageous depends on the evaluation of a number of factors, including the amount of unrealized appreciation in the assets, the wealth of the donor, whether the donor's state of residence has an estate or inheritance tax, state and federal capital gains tax rates, anticipated future appreciation of the assets, the age of the donor, and marital status.

Could the benefit of the increased exclusion be "clawed-back" later? As we read the law, there is a clear intent that exclusion used during the 2018 to 2025 period not be "clawed back." For example, in 2018, Claudia makes a gift of $8 million to a trust for her children and grandchildren. She uses her basic exclusion to avoid paying gift tax and allocates $8 million of GST exemption to the transfer. In 2026, the basic exclusion amount reverts to $6 million (indexed from $5 million) and Claudia dies. Since Claudia used more than $6 million of her exclusion, she has no exclusion left to use against the assets owned at her death. Her trust, which had GST exemption allocated to it in 2018, remains exempt from the GST. Had Claudia made a gift of $5 million rather than $8 million in 2016, she would have $1 million of basic exclusion amount remaining at her death in 2026. (Note that the only ways to use the entire increased exclusion amount prior to 2026 are to die or to make gifts of the entire amount.) This analysis is based on the language in the Act and the conference report. Congress probably has the power to alter this result, although we believe it unlikely that Congress would do so.

I have an old Will that is drafted using formulas for dividing my assets among my spouse, children, and grandchildren. Should I revisit those decisions? Formula bequests may not produce the results anticipated when they were drafted, so it is best to review estate plans that use formula bequests. For example, an estate plan that leaves the amount exempt from tax to children and the remainder to a surviving spouse may – with the increase in exclusion – leave an insufficient amount to the surviving spouse. Likewise, a formula bequest that leaves the amount that is exempt from GST tax to a trust for grandchildren may now leave too much to grandchildren as compared to the amount left to children. In light of the frequent changes to these exclusion and exemption amounts, we now recommend drafting estate plans with more flexible disposition provisions.

Should I get rid of old trusts that were set up when the exclusion was lower? Some trusts funded when the exclusion was much lower, such as old credit shelter (or "bypass") trusts funded at the death of a first spouse, should be re-examined to see whether it would be more beneficial to have those assets included in the estate of the surviving spouse, if that can be accomplished. There are some techniques for liquidating old trusts if that is advantageous.

How are valuation discounts impacted by this legislation? For several decades, taxpayers and the IRS have battled over the use of valuation discounts in the transfer of interests in family-owned entities. Litigation of this issue has resulted in victories and losses on both sides, largely depending on the facts and circumstances of the particular case. In 2016, the IRS issued regulations under Section 2704 that would have drastically reduced the circumstances in which valuation discounts were available, but in January 2017, the Treasury withdrew the proposed regulations. For clients who will no longer be subject to estate tax due to the increased exclusion of the 2017 Act, however, discounts may no longer be advantageous. If the estate will not be subject to estate tax, discounts will serve only to reduce the basis in the assets in the hands of heirs. In those circumstances, clients may wish to re-examine their planning to see whether the provisions or circumstances that produce discounts can be eliminated.

Do I still need to worry about estate planning if my assets are less than the new exclusion level? There are many other considerations in estate planning, including appropriate distribution of your assets, protecting your heirs from potential creditors, and providing for asset management in the event of incompetency. In addition, some states still have estate or inheritance taxes that apply at lower thresholds than the federal taxes. Finally, there is always a risk that the exclusion could revert to previous levels in 2026 or sooner, if Congress enacts new legislation. It is best to keep your estate plan up-to-date and flexible to accommodate changes in law.

Are there changes that impact estate planning for non-resident aliens? In general, there were few changes that impact estate planning for non-resident aliens. The exclusion amount for a non-resident alien remains at $60,000, unindexed. Neither rates nor the definition of U.S. situs property were altered by the Act. However, we are concerned about one provision of the Act that impacts the use of foreign "blocker" corporations to insulate U.S. situs assets from estate tax at the death of a non-resident alien. A change to the definition of a controlled foreign corporation will make it impossible for U.S. citizens or residents who inherit assets held through a foreign blocker corporation to avoid treatment as a controlled foreign corporation. Thus any planning utilizing foreign blocker corporations should be reviewed by an experienced estate planning attorney.

III. Income Tax Provisions of Interest

While there is only one section of the Act devoted to estate, gift, and GST taxes, many provisions in the legislation affect the income taxation of high-net-worth individuals. Some of the relevant provisions include:

- The top marginal income tax rate is reduced from 39.6% to 37%; the net investment income tax remains unchanged at 3.8% and the tax on capital gains and qualified dividends remains at 20% for high income individuals. Children subject to the "Kiddie Tax" will be taxed on the trusts and estates rate schedule rather than at their parent's marginal tax rate.
- Typical itemized deductions for individuals are eliminated except the deduction for state and local taxes (limited to $10,000 per year for most taxpayers), the home mortgage interest deduction (limited to interest on a mortgage of $750,000), and the charitable contribution deduction.
- The deduction for estate tax paid on "income in respect of a decedent" (items such as retirement accounts or salary not paid before death) remains in effect.
- The AGI limitation on the deductibility of cash charitable contributions to public charities is increased from 50% to 60%.

- The standard deduction is increased and Pease (the phase out of itemized deductions for higher income taxpayers) is repealed.
- The individual AMT remains in effect, but the exemption and phase out points are increased.
- Up to $10,000 per year of 529 account money can be used to pay elementary or high school tuition for a student.
- Roth IRA conversions are still allowed, but re-conversions to traditional IRAs before the tax filing date are forbidden.
- Some passthrough entities are allowed a 20% deduction.
- Trusts and estates generally are subject to the same restrictions as individuals on itemized deductions; however, trusts retain their deductions for the personal exemption and distributions to beneficiaries, as well as trust deductions that were never subject to the 2% floor.

Caplin & Drysdale's Private Client team is ready to assist you and your family in analyzing the impact of the 2017 Tax Act. Please contact one of the team members below if you have questions.

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