A Closer Look

Why You Need to Review Your Estate Plan Today

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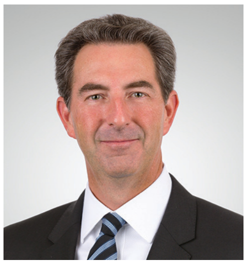

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In Brief

- **With the new tax act now in effect, estate tax planning has become more complicated.**
- **Some parts of the tax code related to estate planning have remained the same, others have changed, creating issues that need to be addressed and opportunities to be pursued.**
- **To ensure you are on track to meet your goals and taking advantage of any new planning opportunities, it is imperative to review your estate plan with your advisors as soon as possible.**

The New Tax Law Brings Meaningful Challenges and Opportunities

The most significant overhaul to the U.S. tax code in 30 years was signed into law by the president on December 22, 2017.

While the new law certainly represents substantial change, many of the provisions are temporary. With expiration dates starting after 2025, many of the changes will only impact eight tax years. The extent of the changes and their temporary nature, as well as the possibility of legislative changes to the tax code by future Congresses, have major planning implications.

The new tax law presents significant transfer tax planning opportunities, but it also raises the possibility of unintended negative consequences that could result from previous planning. As a result, a thorough review — and possibly revision — of your current plan is critical to making sure it will achieve your estate planning goals.

What Changes? What Remains the Same?

Despite early proposals for repeal, the entire estate, gift, and generation skipping transfer (GST) tax system remains in place. Indeed, most of the transfer tax provisions are retained, but a few major changes were made:

- **Basic exclusion amounts.** The tax act doubles the gift, estate, and GST tax exemption by raising the basic exclusion amount from $5 million to $10 million, adjusted annually for inflation.

  The exclusion amount does not apply to each exemption equally. The GST tax exclusion is $10 million, inflation adjusted, while the *combined* gift and estate tax exclusion is $10 million, inflation adjusted. In industry parlance, the gift and estate tax exemptions are said to be "unified." The exclusion amount for 2018 is $11,180,000.

- **Transfer tax.** The transfer tax rate (gift, estate, and GST) is retained at 40%. The federal gift tax annual exclusion is retained. Under indexing rules, it increased to $15,000 versus $14,000 in 2017. The annual gift tax exclusions for non-citizen spouses is retained at $152,000. As before, annual exclusion amounts are considered separately from the basic exclusion amounts.

- **Basis step up/down.** The rules regarding step up (or down) in cost basis at death remain unchanged, meaning heirs will receive estate assets with a new basis for capital gains tax equal to fair market value at the time of a decedent's death.

- **Portability.** The opportunity for a surviving spouse to use the deceased spouse's unused estate and gift tax exemption has been retained — and it still does not apply to the GST exemption.

- **Clawback.** There is uncertainty about whether a gift that was covered by the gift tax exemption at the time it was made will result in an estate tax if the estate tax exemption has decreased by the time of the donor's death. This is known as clawback.

  For example, a gift of $10 million made today would be exempt from estate taxes under current law; however, if the donor dies after the exemption amount reverts back to $5 million, the estate could be liable for taxes on the difference between the gifted amount and the then-lower exemption ($10 million–$5 million).

  It's not certain that clawback will happen, and the tax act requires the Treasury Department to issue regulations clarifying whether it would apply. Until then, however, it is a possibility that needs to be considered when planning.

Estate Planning Considerations

The tax act changes — and their temporary nature — impact estate tax planning in a number of important ways:

Review your estate plan's formula clauses.
The doubling of the exemptions, while a welcome development, makes it extremely important to examine the flow of your estate plan — as soon as possible — to ensure it will still achieve your goals.

For example, one popular approach to estate planning involves creating a family trust to benefit children and grandchildren (known as a credit shelter, or bypass, trust) and a marital trust for the benefit of the surviving spouse. Usually, when the first of two spouses dies, the plan separates their assets into two buckets — an amount equal to the estate tax exemption goes into the family trust bucket, and the remaining assets go into the marital trust bucket. A family trust may be drafted to exclude the surviving spouse. If so, combined with the doubling of the estate tax exemption, it is no exaggeration to say that this strategy could be disastrous (see Enhanced Exemptions and the Potential for Unintended Consequences).

Even if you're not subject to an estate tax, incorrect formula clauses could have adverse income tax implications — such as the loss of a second step up in basis for assets transferred to a surviving spouse. If you have a significant amount of low-basis assets, your planning must be especially sensitive to the step up in basis rules and their interplay with estate tax planning.

As a result, it is critically important to review — and revise as necessary — formula clauses with your estate planning professional to ensure that the flow of assets still works as intended. Since no one can predict the future, the sooner you do this the better.

Enhanced Exemptions and the Potential for Unintended Consequences

Bob and Sarah, a married couple, have a taxable estate of $10 million; they have substantially more assets, but sophisticated planning — using various trusts and other strategies for their children and others — has organized their wealth in this way.

Scenario A: When Bob dies in 2017, the couple's estate plan directs an amount equal to the full estate tax exemption (their planning, in 2013, assumed the then-prevailing exemption of $5 million, indexed to $5.49 million in 2017) into the family trust with the remaining assets ($4.51 million) going in the marital trust. Bob has taken advantage of his full exemption, and Sarah receives the assets as planned. The estate plan works as intended.

Scenario B: When Bob dies in 2018, however, the estate plan directs an amount equal to the full estate tax exemption ($10 million, since the exemption has doubled to $11.18 million) with the remaining assets ($0) for the marital trust.

	Scenario A	Scenario B
Taxable Estate	$10 Million	$10 Million
Estate Tax Exemption	$5.49 million	$11.18 million
Family Trust Receives	$5.49 million	$10 Million
Marital Trust Receives	$4.51 million	$0

Sarah ends up with nothing from the marital trust and, as is frequently the case, she has no access to the family trust's assets. The estate plan has failed — in spectacular fashion — to accomplish its goals.

When it comes to the GST, the rules have never been as generous as they are right now, and we know they are scheduled to change.

The generation skipping tax (GST) exemption represents an enormous — if temporary — opportunity. For high-net-worth families, the temporarily enhanced GST exemption creates unusually attractive opportunities to shelter more wealth through the use of long-term trusts — or more assets in such trusts — to which the GST exemption can now be allocated.

This could be particularly powerful for succeeding generations by virtue of compounding, and especially so if the exemption is later reduced to a level lower than your family's net worth with no clawback (see How the GST Works).

Further planning can be implemented by using general powers of appointment and embedding other forms of flexibility into documents designed to create methods to tap into exemptions that otherwise would go unused. For example, granting a general power of appointment to a "poor" parent who then exercises the power into a trust over which he or she allocates their GST exemption (that otherwise would have been wasted) creates long-term estate tax protection as well as a basis step up — plus the benefits of a trust structure.

The key here is that this opportunity is temporary. For eight years, there is a doubled exemption amount. Assuming clawback doesn't become an issue, the sooner you take advantage of this exemption the better. Why? With a gift, as soon as you give it, you're moving the future appreciation on those assets out of your estate. Second, no one can forecast the political winds; a new Congress could always change the exemption sooner than eight years. Finally, the proposed IRS regulations that would have severely limited (or eliminated) the ability to use valuation discounts have been set aside, allowing for potentially powerful ways of taking advantage of your exemption. But these proposals could come back.

When it comes to the GST, the rules have never been as generous as they are right now, and we know they are scheduled to change. And unlike the estate tax exemption, the GST exemption is not portable, meaning you either use it or you lose it, and it makes good sense to use it, preferably as soon as possible.

How the GST Works

Through much of the last century, when very wealthy parents passed away, their assets would typically go to their children and be subject to estate tax. When those children eventually died, any remaining assets would pass to their children — and be subject to a second estate tax.

Families seeking to avoid this second estate tax would take money that their children wouldn't need and give it instead to their grandchildren, leaving only one estate tax to be paid.

In 1976, however, Congress created a new tax — the generation skipping tax, or GST — which applied in cases where grandparents "skipped" a living generation and gave money to their grandchildren (or to an unrelated person more than 37.5 years younger). The GST was designed to be equal to the estate tax that would have been collected had the grandparents transferred their money in the traditional way. Congress revamped this law in 1986 to tax assets at the highest marginal estate tax rate and added a GST exemption.

The new tax law doubles the previous GST exemption from $5 million to $10 million, adjusted for inflation. For 2018, the amount is $11.18 million.

This year, grandparents can each put $11.18 million into a trust, and as long as those assets remain in that trust, they will not be subject to additional estate tax. Depending upon the location of the trust, this could conceivably be for hundreds of years — up to 360 years in Florida. These long-term, multigenerational trusts are often referred to as dynasty trusts.

The potential tax benefit from the passing of wealth from grandparent to grandchild is powerful, but it becomes magnified with every generation thereafter.

Imagine the ever-widening gap between assets passing from generation to generation free of estate taxes and assets being reduced by the current estate tax rate of 40% at each generational transfer.

Gifting Just Became More Complicated

If you give an asset worth, say, $1 million (with zero cost basis), and it then grows to $2 million in value, you avoid the estate tax on the $1 million appreciation. That's $400,000 in estate tax savings.

However, you've created income of $2 million that will be subject to a 23.8% capital gains tax when sold. That's a tax hit of $476,000.

To balance out savings and taxes, that $1 million gift would have to grow 247% to $2.49 million.

Use the (temporarily) enhanced gift tax exemption, but do so wisely. The new tax law does not change the fact that traditional holistic planning can still be impactful with the proactive use of gift exemptions. It just gives us a larger exemption to use. While this is a positive development, it can actually complicate planning, particularly when it comes to basis carryover.

In other words, if you were to make a gift of an asset with zero cost basis, since there's no step up in basis when you make a lifetime gift, how much would that asset have to appreciate in value for the estate tax savings on the growth to overcome the loss of a basis step up? Clearly, with a greater exemption, the amount of appreciation needed is greater as well (see Gifting Just Became More Complicated).

There are strategies that can help address this issue (securities portfolios, for example, tend to experience creeping growth in their cost basis, since there is generally buying and selling of securities over time). It's important to take advantage of your gift tax exemption before it sunsets, but to do so by thoughtfully structuring a plan and selecting which assets to give away so that the loss of basis step up won't hurt you.

Split-interest planning requires close analysis. One of the ways to benefit charities is with split-interest planning. This involves splitting a gift between a taxable person and a charity using one of several types of qualifying trusts. Charitable remainder trusts, for instance, are a frequent choice because they offer a number of benefits — they remove assets from your estate and also provide you with income and a current income tax deduction.

With the new tax law, that deduction may not be worth today what it was worth last year because of the inability to deduct other previously deductible items, forcing more of the charitable deduction to offset the now increased standard deduction.

Further, there may no longer be a need to use a qualified trust to avoid estate tax. So, the traditional approach can still work, depending upon your personal situation, but it demands a careful review of the numbers, as well as forecasting future income and income tax laws.

Review your life insurance policies. In many cases, when life insurance is used as part of an estate plan, it's used to provide liquidity to pay some (or all) of the estate taxes. Given the possible changes to what your estate tax liability is likely to be as a result of the new tax law, and to the extent that your life insurance is intended to be a tool for estate taxes, now is a good time to review your policy, to evaluate whether it's still the right tool for that job, or whether modifications could make sense. Maybe the death benefit can be reduced, which would allow the value of the policy to last even longer.

Reconsider the usefulness of IRAs to fund individuals. Historically, individuals who inherit traditional IRAs have been able to claim a deduction on their income tax returns equal to the pro rata amount of estate tax paid (IRAs are taxable in estates). Basically, this worked to reduce the double taxation — for the estate and also for the IRA recipient — that would have occurred without the deduction. The new tax law preserves this deduction; however, with the doubling of the estate tax exemption, fewer IRAs will trigger an estate tax, so the deduction will benefit far fewer beneficiaries.

Moreover, given the income tax changes in the tax act, the deduction's relative usefulness is diminished even further. When these issues are combined with several other changes related to IRAs that impact certain planning strategies, you may want to speak with your advisor about whether using traditional and Roth IRAs to benefit taxable individuals is useful in your particular situation.

Review Your Estate Plan as Soon as Possible

Originally, the tax act was intended to simplify the tax code, but that aspiration was dropped by the legislators as it wound its way through the political system. The process resulted in some very complex provisions and some new complexities with regard to estate tax planning. We've touched upon a few of the major planning considerations, but there are others, and they all need to be considered in the context of your existing plan and estate planning goals. To ensure peace of mind and an effective estate plan, a complete review of your current plan is essential.

If you would like to discuss the implications of the new tax law for your estate plan, Bessemer's estate planning and life insurance advisory professionals are available to assist you.

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