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2018 Year-End Estate Planning: Double the Tax Benefits, but with an Expiration Date

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The beginning of 2018 saw new major tax legislation, commonly known as the Tax Cuts and Jobs Act (TCJA), which has had a significant effect on estate planning for many individuals. Over the past year, the opportunity provided by TCJA to transfer an unprecedented amount of wealth free of any federal gift, estate and generation-skipping transfer (GST) taxes has been brought into sharper focus. Given that most TCJA provisions related to estate planning "sunset" on January 1, 2026, now is an ideal time to revisit estate plans to ensure they make full use of this opportunity.

Summary of New Exemption Levels

Effective January 1, 2018, the federal gift, estate and GST exemptions (i.e., the amount an individual can transfer free of any of these taxes) were doubled to $11,180,000 for single individuals and $22,360,000 for married couples. These amounts also contain annual inflationary increases and are projected to rise to $11,400,000 for single individuals and $22,800,000 for married couples in 2019.

However, on January 1, 2026, the TCJA provisions related to federal gift, estate and GST exemptions sunset and revert to 2017 levels (with inflationary increases). Both federal and Illinois estate tax laws allow for a marital deduction for assets passing outright to a spouse or to qualifying trusts for the benefit of a surviving spouse. Illinois allows this deduction to be claimed even if a marital deduction is not elected for federal purposes. Thereafter, the federal estate tax rate is 40 percent. Illinois imposes a state estate tax based on a $4,000,000 threshold, which is not adjusted for inflation, at effective rates ranging from 8 percent to approximately 29 percent. (The Illinois estate tax paid is allowable as a deduction for federal estate tax purposes.)

While the estate tax laws may undergo additional changes between now and January 1, 2026, currently, the only way to take advantage of the increased federal exemptions is to utilize planning strategies in advance of the sunset date. The following are planning opportunities and pitfalls as a result of TCJA, as well as other year-end planning tactics.

Annual Exclusion Gifts

Making use of annual exclusion gifts remains one of the most powerful — and simplest — estate planning techniques. The "annual exclusion amount" is the amount that any individual may give to any other individual in a year without gift tax consequences. This amount, indexed for inflation, is currently $15,000 and is expected to remain at that level for 2019. However, an individual cannot carry over unused annual exclusions, so if such exclusions are not utilized by the end of the year, the balance is lost.

Married couples can combine their annual exclusion amounts when making gifts to adult children, meaning that a married couple can give $30,000 per year to an adult child without using any transfer tax exemption (although filing a gift tax return may be required in some circumstances). When the spouses of adult children are included in the annual exclusion gifting, the amount that can be gifted is doubled again, meaning that a married couple can give a total of $60,000 per year to an adult child and the child's spouse without using any transfer tax exemption. It is also possible to make annual exclusion gifts to minors using Uniform Transfers to Minors Accounts, 529 Plans or properly structured trusts.

Annual exclusion gifts can result in substantial transfer tax savings over time as they allow the donor to remove the gift amount and any income and growth thereon from the donor's estate, without paying any gift tax or using any transfer tax exemption. Annual exclusion gifts also reduce a family's overall income tax burden when income-producing property is transferred to family members who are in lower income tax brackets and not subject to the "kiddie tax" or the 3.8 percent net investment income tax.

Tuition and Medical Gifts

Individuals can make unlimited gifts on behalf of others by paying tuition costs directly to the recipient’s school or paying their medical expenses directly to a health care provider (including the payment of health insurance premiums).

Lifetime Utilization of Transfer Tax Exemption (And Doing So Soon!)

The most obvious planning opportunity under TCJA involves early and full use of the new exemptions. Lifetime gifts utilizing the exemption amounts will almost always result in overall transfer tax savings, unless the assets that have been transferred decline in value. As with any gifting strategy, all income and future appreciation attributable to the gifted assets escapes future gift and estate taxation. Therefore, assuming that assets are appreciating, the sooner a planning strategy is implemented, the greater the estate tax savings will be. Because the exemptions are now at historically high levels, rapidly appreciating assets will have an exponential impact on any gifting strategy.

Valuation Discounts in the Family Context and Leveraging Strategies

"Minority interest," "lack of marketability," "lack of control" and "fractional interest" discounts can still be applied under current law to the valuation of interests in family-controlled entities, real estate and other assets that are transferred to family members. Such discounting provides for estate and gift tax savings by reducing the value of the transferred interests. Leveraging strategies (e.g., family partnerships, sales to grantor trusts and grantor retained annuity trusts) also can be utilized to advantageously pass tremendous amounts of wealth for the benefit of many generations free of federal and Illinois transfer taxes.

Use Trusts When Gifting

As with any gifting strategy, assets may be gifted outright so that the recipient directly controls the assets, thereby exposing the assets to the claims of the beneficiary's creditors. Alternatively, assets may be gifted in trust, which 1) protect the gifted assets from the beneficiary's creditors, including the spouses of beneficiaries in the event of divorce, 2) determine the future use and control of the gifted assets and 3) shelter the gifted assets from future gift, estate and GST taxes through the allocation of the GST exemption.

When planning with trusts, donors have great flexibility in determining who will be responsible for the payment of income taxes that are attributable to the assets in a trust. As an enhanced planning technique, trusts can be structured as "grantor trusts," in which the trust is a disregarded income tax entity, and the donor — not the trust or the beneficiaries — would be responsible for paying tax on the trust's income. In essence, by structuring a trust as a grantor trust, a donor can make tax-free gifts by paying the tax attributable to the trust's income. This technique promotes appreciation of the trust assets while simultaneously decreasing the size of the donor's estate, which produces additional estate tax savings.

Gift Some Assets, Sell Even More Assets to Grantor Trusts

Additional estate tax benefits can be obtained by combining gifts to grantor trusts with sales to grantor trusts. Because the grantor is treated as the owner of the trust for income tax purposes, no capital gains tax is imposed on the sale of assets to a grantor trust. The trust can finance the sale with a promissory note payable to the grantor, which provides the grantor with cash flow from the trust. The growth on the assets that are sold would then escape estate taxation at the grantor's death.

Make Gifts to Spousal Lifetime Access Trusts

Most people would consider $11,180,000 to be a very large gift and either cannot, or do not want to, give away this much money, as they may need or want it for themselves. A gift to a properly structured "spousal lifetime access trust" lets an individual make a completed gift now, utilizing the temporarily increased transfer exemptions, but allows the individual's spouse to be a beneficiary of the trust and have access to trust assets if needed. If the spousal lifetime access trust is implemented properly, the assets of trust (and the growth thereon) will not be subject to estate tax at the death of the grantor or at the death of the grantor's spouse.

Account for the State of Illinois

As discussed above, Illinois continues to tax estates in excess of $4,000,000, which is not adjusted for inflation and not allowed to be "ported" to a surviving spouse. Given the disparity between the $11,180,000 federal estate tax exemption and the $4,000,000 Illinois estate tax exemption, married couples domiciled in Illinois should make certain that their estate plans are structured to take advantage of the Illinois QTIP marital deduction. Otherwise, an estate plan that is designed to fully utilize the federal exemption can inadvertently cause an Illinois estate tax of approximately $1,080,000 upon the death of the first spouse.

The obvious and most direct strategy to address the Illinois estate tax is to simply move to a state that does not impose an estate tax (e.g., Florida). In the event that a change of domicile is not possible or is not desired, all of the traditional planning techniques described in this article (in addition to others) are available to address this state liability. Because Illinois does not impose a gift tax, enacting gifting strategies will reduce future Illinois estate taxes.

Plan for Income Tax Basis Changes

TCJA made no changes to the tax laws providing an income tax basis adjustment for assets received from a decedent upon his or her death (commonly known as the "step-up in basis"). With the increase in the federal gift, estate and GST exemptions, and even with Illinois' $4,000,000 exemption, transfer taxes are no longer a concern in many circumstances, and there is increased emphasis on income tax planning (specifically, planning with the goal of obtaining an income tax basis step-up at death). For many clients, it may be advisable to reverse prior estate planning techniques, including trusts that were established on the death of a first spouse to die.

Review Estate Plans

As discussed above, this is an excellent time to review existing estate plans, many of which contain terms and formulas that are tied to federal estate tax laws that have changed. Because of the highly expanded exemption levels under TCJA, many of these plans may now be outdated or may produce unintended consequences. Similarly, now is a good time to review titles to assets and beneficiary designations.

Don't Forego Traditional Estate Planning

There is no time like the present to make certain that estate planning documents accurately reflect current wishes and make beneficial use of the federal and state transfer tax exemptions (to the extent not utilized during lifetime), federal and/or state marital deductions, and federal GST exemptions. Revisions may also be needed if family circumstances have changed (e.g., births, deaths, marriages and divorces) since documents were originally executed.

Even individuals who are unaffected by the new exemption levels under TCJA need to address their estate plans from time to time. Everyone has different estate planning goals. Many people no longer have taxable estates for federal estate tax purposes and may be able to adjust their estate plans accordingly, while others have existing plans that automatically adjust to the increased exemptions and do not desire more aggressive planning. Still others may want to take prompt action to aggressively utilize the new exemptions.

The above summary is not intended to list all of the issues raised by TCJA or to enumerate all of the available estate planning techniques. Non-tax reasons to review and implement estate plans include:

- Planning for probate avoidance
- Planning for individuals with special needs (or otherwise require specialized planning)
- Implementing advance health care directives (such as living wills and health care powers of attorney)
- Planning for incapacity
- Business succession planning

- Planning for minor children and designating guardians
- Charitable planning

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