The New Estate Tax Law – Here Today, Gone Tomorrow

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Increase in Exemption from Estate, Gift and Generation-Skipping Transfer Taxes

On December 22, 2017, the Tax Cuts and Jobs Act (the "Act") was signed into law. The Act implements a variety of significant tax reforms. Pertinent to estate, gift and generation-skipping transfer ("GST") taxes, the Act effectively doubles the exemption amount that an individual can give away or die owning without incurring gift or estate tax (the "unified credit") or GST tax. In 2017, an individual could give away during their lifetime, or die owning, $5.49 million of assets without incurring any gift, estate or GST tax. In 2018, it was scheduled to rise to $5,600,000. The Act instead almost doubles that exemption to $11,180,000 or $22,360,000 for a married couple. The unified credit and GST tax exemption will continue to increase each year based on an inflationary index. Upon an individual's death, assets owned by the deceased individual will still receive a "step-up" in basis, meaning that such assets will be deemed to have a new income tax basis equal to their fair market value at the time of the owner's death.

However, this "doubling" of the unified credit amount and generation-skipping tax exemption is not permanent. The Act provides that such amounts will revert back to pre-2018 numbers after December 31, 2025. This means that there is a limited period of time when clients can take advantage of the increased amounts that can pass free of estate, gift and generation-skipping tax.

Testamentary Dispositions: Use of Unified Credit Amount Definitions and How It Affects Your Proskauer Documents

Proskauer-drafted Wills and revocable trusts frequently include references to the unified credit amount which is an amount equal to the maximum amount that can pass free of federal estate tax. We typically direct that this amount should be distributed to a "bypass trust." Under a typical Proskauer plan for a husband and wife, a bypass trust is often held for the benefit of the surviving spouse and the couple's then living descendants. The remaining assets often are held in marital trusts for the benefit of the surviving spouse and, after the surviving spouse's death, in trust for the couple's children. Below is a chart showing the funding of a bypass trust in 2017 versus 2018 for a married couple where the first spouse to die had $25 million and his or her full exemption from gift and estate tax available.

Married Couple upon First Spouse's Death with $25,000,000 in Deceased Spouse's Estate

	2017	2018
Bypass trust for spouse and issue	$5,490,000	$11,180,000
Marital residuary trusts	$19,510,000	$13,820,000

In some cases, the doubling of the unified credit may dramatically change the effect of your estate plan. For instance, if your estate plan provides for your current spouse and a child from a previous marriage, you may be funding a trust for one's benefit with an amount equal to the unified credit and providing that the remainder of your estate be held in trust for the benefit of the other beneficiary. You also may be making outright gifts to children or grandchildren in a total amount equal to the unified credit (or an amount that can pass free of both estate tax and GST tax). In both cases, it is important for you to review your estate plan and evaluate whether, given the larger unified credit amount and exemption from GST tax, your property is still being distributed in the proportions you desire. The increased unified credit and GST tax exemption may result in you giving more or less than you expected to certain beneficiaries.

If you have any questions, please communicate with your Proskauer attorney who can review your documents with you and advise you on how the increased unified credit and generation-skipping tax exemption may affect your existing estate plan.

Lifetime Giving: Increased Opportunity to Reduce or Eliminate Transfer Tax at Death

The increased exemption from gift, estate, and generation-skipping tax creates an opportunity for a limited period to make larger lifetime gifts and "lock-in" this increased exemption before it sunsets at the end of 2025. This can be accomplished through a variety of means, including:

1. Forgiveness of Outstanding Loans. You may have loaned money to family, friends, trusts or entities. Sometimes clients have previously made loans, rather than gifts, to avoid incurring gift tax. To the extent you would have preferred to have given this loaned money to the borrower outright rather than lend it, there is an opportunity now with the increased unified credit amount to forgive outstanding loans. This is an easy way to use the additional exemption now and simplify your current estate plan.

2. Larger Gifts to Trusts, including SLATs and other Grantor Trusts. The increased exemption from estate and gift tax, as well as GST tax, means you can make larger gifts to irrevocable trusts, which can be administered for the benefit of friends and family. Additionally, if you would like to take advantage of the temporary increase in unified credit prior to 2025 but are concerned about giving away too much, you should consider creating a spousal lifetime access trust (a "SLAT") for your spouse. A SLAT is a trust created by an individual (the "donor") for the lifetime benefit of the donor's spouse and, if desired, the donor's descendants. During the spouse's lifetime, assets held by the trust may be distributed to the spouse as beneficiary of the trust. Upon the spouse's death, assets are usually held in trust for the couple's descendants or other family or friends. The SLAT essentially enables the donor to give away assets but, if necessary, regain access to those assets at a later date via the trustees distributing trust assets to the donor's spouse (provided the spouse is still living and married to the donor).

   The benefits of gifting assets to an irrevocable trust are amplified when a trust is an "intentionally defective grantor trust," meaning that for income tax purposes (but not estate and gift tax purposes) the grantor is taxed as if he or she still owned such gifted assets. This allows assets held by the trust to grow more quickly, since the grantor, and not the trust, will be responsible for the income tax. By paying such tax, you also are, in essence, making additional tax-free gifts to the trust of the amount of the tax that the trust otherwise would pay. As a result, SLATs and other grantor trusts can be very powerful tools in transferring assets to your friends and family free of transfer tax.

3. Increased Life Insurance Planning. If you have substantial illiquid assets (such as art, real estate or an operating business) or other issues that require substantial life insurance, you may wish to reevaluate your current life insurance policies and consider increased life insurance planning. Because of the increase in exemption, you can now make larger gifts free of tax to an irrevocable life insurance trust (an "ILIT"), which can then be used by the trustees of the ILIT to pay insurance premiums.

4. Allocation of Increased GST Tax Exemption. You may have one or more irrevocable trusts that are not fully exempt from GST tax. If a trust is only partially exempt from GST tax, this means that some portion of the trust will be subject at a later date to a 40% GST tax (most commonly when property passes to a grandchild). You also may have created one or more grantor retained annuity trusts ("GRATs") that resulted in a successful transfer of asset appreciation, free of gift tax, to an irrevocable trust. If so, it is likely that GST exemption has not been allocated to the trust that received such assets. You now have a substantial amount of additional GST exemption that you can allocate to trusts that are either partially GST-exempt or not GST-exempt at all. Allocating GST exemption to make a trust fully exempt from GST tax will result in substantial tax savings to the extent such trust is or will be held for the benefit of grandchildren or later generations.

5. Increased Sales of Assets to Intentionally Defective Grantor Trusts. A sale to an intentionally defective grantor trust is used to "freeze," for estate tax purposes, the value of the assets you sell to the trust by exchanging them for a promissory note with a stated interest rate and principal amount. Any and all appreciation on the assets after the sale to the trust is not included in your estate, and if the asset is an interest in a limited partnership, limited liability company or a closely held corporation, a discount should apply to the sales price. Most practitioners believe that, in order for the sale transaction to be respected by the IRS, the grantor trust should be funded, before the sale takes place, with at least 10% of the value of the assets the grantor trust is purchasing (the "seed money"). One way to satisfy this requirement is by a gift to the grantor trust of the seed money prior to the sale. With the increase in exemption, you now can make a significant tax-free gift to a grantor trust to enable it to purchase significant additional assets from you, the appreciation on which will escape future estate taxation.

6. Gifts to Noncitizen Spouses. Unlike gifts to U.S. citizen spouses, gifts and bequests to non-U.S. citizen spouses (even if the spouse lives in the U.S. and is a U.S. green card holder) do not qualify for the unlimited marital deduction. Instead, for lifetime gifts, there is an increased annual exclusion amount (expected to be $152,000 in 2018). For bequests at death to a noncitizen spouse, assets in excess of the unified credit amount must be held in a so-called "qualified domestic trust," or "QDOT," to qualify for the marital deduction. One of the major limitations of a QDOT is that tax-free distributions of principal can be made to the surviving spouse only for hardship. Therefore, it may be worth using some of the increased unified

credit amount to make lifetime gifts to a noncitizen spouse in excess of the annual exclusion amount, so that the noncitizen spouse has additional assets in his or her own name. It also is especially important to revisit the formula for the funding of the bypass trust in any existing estate planning documents, because the increased exemption makes it possible for more assets to be held in a bypass trust for the benefit of the surviving noncitizen spouse without being subject to the QDOT restrictions.

Income Tax Considerations: Increased Importance of Income Tax Planning

Gifting assets during life will reduce the size of your taxable estate at death and, correspondingly, reduce your estate tax liability. But with each lifetime transfer, now more than ever before, the income tax consequences should be weighed against estate tax savings. Because of the narrowed gap between income tax rates (which vary among the states) and estate tax rates and the increased unified credit amount, in some situations the income tax costs can reduce the overall tax savings significantly.

However, there are ways for clients who want to take advantage of lifetime gifting techniques to still simultaneously reduce future income tax liability. For instance, many trusts include a swapping power permitting the creator of the trust (also known as the "settlor" or the "grantor") to reacquire trust property by substituting other property of equal value. The trustees of the trust are obligated to ensure the incoming property is equal in value to the outgoing property. Provided this is the case, the creator of the trust can swap out assets owned by the trust that have a low income tax basis and replace such assets with those that have a high income tax basis. When an individual dies, each asset included in his or her estate gets a "step-up" in basis. This means the basis of an asset becomes its fair market value as of the individual's date of death. If instead an irrevocable trust held low basis assets, such assets would not be part of the creator's estate at death and would escape estate taxation, but those assets would also not receive a "step-up" in basis at the creator's death. Therefore, a "swap" is most effective when (i) an individual has gifted low basis assets to an irrevocable trust, (ii) owns in his or her own name high basis assets, (iii) is comfortable holding onto and not selling the swapped out low basis assets until his or her death.

Similarly, instead of swapping assets, the trustees of a trust could distribute low basis assets to a beneficiary who will likely hold onto and not sell such assets until his or her death so that such assets receive a "step-up" in basis at the beneficiary's death.

Reconsidering Estate Plans in a Second Marriage

In addition to the considerations discussed above, it is important for individuals who previously have entered into a prenuptial or postnuptial agreement (a "Marital Agreement") and/or are on their second (or third or fourth) marriage to revisit their Marital Agreements and estate plans to determine whether any changes may be necessary as a result of the new tax law. This is especially important for an individual whose spouse is significantly younger and/or who has children from a prior marriage.

In a first marriage, both spouses generally share the same estate planning goals – provide for the surviving spouse for as long as they live, and then, upon the surviving spouse's death, transfer everything to the descendants of the marriage. This often is not the case in a second marriage where one or both spouses may have children from a prior marriage and/or children of the current marriage.

In these situations, each spouse may want to provide for their children (both from a prior marriage and the current marriage) upon their death rather than leaving everything to the surviving spouse. This is especially true in situations where the second spouse is much younger (sometimes the same age as children from a prior marriage), as leaving everything in trust for the spouse could result in the children not receiving any assets until very late in life (or maybe not at all if they predecease the spouse).

Rather than leaving everything (in trust) to the surviving spouse in a second marriage, it may be desirable to provide the surviving spouse with the minimum amount necessary to live comfortably for the remainder of his or her life. However, these desires may conflict with the surviving spouse's entitlements under state law (e.g., right to an elective share and homestead). Marital Agreements often are implemented in second-marriage situations to "override" state law entitlements and set forth the obligations of the parties regarding their respective assets during life, upon divorce and most importantly (from an estate planning perspective) at death.

The most relevant changes to the tax law affecting second marriages are the increase in gift, estate and generation-skipping transfer ("GST") tax exemptions (doubling the exemptions available in 2017) to $11.18 million and changes to the alimony rules, which result in alimony no longer being deductible by the payor or treated as income to the payee. In light of these changes, the carefully thought out estate plans and negotiated Marital Agreements may no longer make sense and may need to be readdressed. What follows is a summary of some of the situations that may need to be reconsidered.

- Formula Bequests
    - If bequests were made based on a formula (for instance, a trust equal to the maximum amount that can pass free of federal estate tax), the increased exemption may result in the assets passing in an unintended manner. For example, for smaller estates, it is possible that the parties entered into a Marital Agreement and both parties waived all of their respective rights in the other's property in exchange for receiving assets of the other spouse in excess of the estate tax exemption amount (essentially each utilizing the surviving spouse to defer estate tax until the second death). When the exemption was $5.49 million, this may have resulted in substantial assets passing to the surviving spouse. For example, if the deceased spouse died owning $10 million of assets, this formula bequest would leave nearly one-half of the decedent's assets to the surviving spouse. With the increased estate tax exemption, the surviving spouse would receive nothing. Similarly, it may have been the intent to provide the children of a prior marriage with a certain amount of assets and then leave everything else to the surviving spouse in trust. In these situations, if the amount passing to children was based on a formula keyed to the estate tax exemption, the increased exemption may result in too much passing to children now.
- Lifetime Marital Trusts, also known as Inter Vivos QTIP Trusts
    - An Inter Vivos QTIP Trust is a planning technique utilized in situations where one spouse does not own in his or her individual name sufficient assets to utilize all of his or her estate and GST tax exemptions. Although it is possible to make a portability election to transfer a deceased spouse's unused estate tax exemption to a surviving spouse, the same cannot be done with respect to the deceased spouse's unused GST tax exemption.

    - Inter Vivos QTIP Trusts are preferable to transferring assets directly from one spouse to the other in order to "equalize" their estates, because an Inter Vivos QTIP Trust allows the spouse having more assets to retain the ability to direct disposition of the assets upon the surviving spouse's death (i.e., if assets are equalized by transferring assets outright to the spouse with fewer assets, he or she can then dispose of those assets as he or she sees fit).

    - The wealthier spouse generally will fund an Inter Vivos QTIP Trust with assets having a value equal to the lesser of his or her spouse's estate tax exemption and GST tax exemption (less the value of any assets such spouse owns in his or her individual name).

    - The trust will be structured to qualify as a QTIP Trust so that the wealthier spouse is entitled to a marital deduction upon funding of the trust (i.e., the beneficiary spouse will be entitled to all income from the trust for life and may (but is not required) to receive distributions of principal). Thus, this transfer is not considered a taxable gift. Upon the death of the beneficiary spouse, all of the assets of the Inter Vivos QTIP Trust will be included in his or her gross estate, which will result in the beneficiary spouse being treated as the transferor for GST tax purposes. This will allow the beneficiary spouse to allocate his or her GST tax exemption to the trust.

    - With the significant increase in estate and GST tax exemptions, clients with existing Inter Vivos QTIP Trusts should consider contributing additional assets to such trusts to maximize the use of the beneficiary spouse's exemption amounts. Additionally, a client who has a spouse (or who is engaged to be married to an individual) who does not own assets having a value in excess of $11.18 million should consider creating an Inter Vivos QTIP Trust to prevent such spouse's unused GST tax exemption from going to waste.

- Marital Agreements

    - Inter Vivos QTIP Trusts – Provisions regarding funding inter vivos QTIP Trusts should be reviewed.

    - Alimony – Many Marital Agreements include provisions regarding the payment of alimony in the event of divorce. These provisions may have been negotiated on the assumption that the alimony payments would be income to the recipient and deductible by the payor. Now that alimony is no longer deductible or included in income, the negotiated alimony amounts may result in a windfall to the recipient spouse.

    - Gift Splitting – Many Marital Agreements require the spouse with fewer assets to consent to gift splitting whenever requested to do so by the spouse with more assets. In light of the increased gift tax exemption amount, consideration may need to be given to placing a cap on the amount of gifts with respect to which consent must be given.

    - Portability – When reviewing Marital Agreements, consideration should be given to adding a provision requiring the first to die spouse to file an estate tax return to make a portability election to "port" his or her remaining estate tax exemption to the surviving spouse. This is of increased importance as a result of the increase in the estate tax exemption.

National Law Review, Volume VIII, Number 52