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The Impact of Tax Cuts and Jobs Act of 2017 on Estate Planning

The Tax Cuts and Jobs Act of 2017 (the act), which was signed into law on Dec. 22, 2017, made substantial changes to the Internal Revenue Code, most of which went into effect on Jan. 1. One significant result of the passage of the act is the doubling of the exemption amount for the federal estate, gift and generation-skipping transfer taxes.

By Amy Neifeld Shkedy and Rebecca Rosenberger Smolen | January 09, 2018

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The Tax Cuts and Jobs Act of 2017 (the act), which was signed into law on Dec. 22, 2017, made substantial changes to the Internal Revenue Code, most of which went into effect on Jan. 1. One significant result of the passage of the act is the doubling of the exemption amount for the federal estate, gift and generation-skipping transfer taxes.

Beginning in 2018, the exemption for federal estate, gift and generation-skipping taxes, for tax years 2018 through 2025, increases from a $5 million base, set in 2011, to a new $10 million base. As was previously the case, the $10 million base is to be annually adjusted for inflation. Thus, after taking into account the inflation index, in 2018, the

exemption will be approximately $11.2 million (or $22.4 million for a married couple, when taking into account portability). Before the passage of the act, such exemptions were set to be $5.6 million (or $11.2 million for a married couple) in 2018. By doubling the exemption, each person has been given the opportunity to give away (during life or at death) a cumulative total of $11.2 million without incurring any federal gift or estate tax. This means a married couple may together give away, gift and estate tax free, a total of $22.4 million. To the extent that assets are gifted (or remain at death) in excess of these exemption amounts, there would be a federal gift (or estate) tax imposed at the rate of 40 percent (the rate of tax is unchanged by the act).

As was the case under the prior tax acts where the exemption was scheduled to increase from $1 million to higher amounts, this increase is designed to only last for a set number of years. After 2025, under the terms of the act, the exemption would revert to the $5 million base (indexed for inflation). In light of the potential reduction in the exemption amount in the future, whether due to the sunset provision taking effect after 2025 or due to an earlier change in legislation (perhaps as early as the next presidential election), there are estate planning opportunities to consider, particularly for those couples with assets in excess of $11 million. To illustrate the effect of the sunset provision, for an individual with a taxable estate of $11 million, the scheduled sunset provisions could mean a federal estate tax bill of over $2 million after 2025, compared with a zero federal estate tax under current law.

Based on the exemptions that will be available beginning in 2018, individuals and couples who have accumulated sufficient wealth should consider whether to make gifts, in one form or another, before the sunset provisions take effect after 2025 (or perhaps even earlier, depending on the next presidential election results) in order to reduce their taxable estates significantly. This may be a “use it or lose it” scenario. It is important to understand that in order to benefit from the current high exemption, the gift made must be greater than what the estate tax exemption is reduced to in the future. Although the law, as currently written, is set to decrease the estate tax exemption to approximately $5.6 million (indexed for inflation) after 2025, this could certainly change.

Making gifts now not only locks in the current estate and gift tax exemptions, but also provides the following advantages: removes future appreciation from the taxable estate, allowing the transferred assets to grow in the hands of the gift recipient; potentially avoids state estate or inheritance tax; and for instances where gift tax may be paid, avoids the tax inclusive nature of a later estate tax since the gift tax (unlike the estate tax) is tax exclusive, meaning that there is no tax on the funds used to pay the tax (if the donor lives for three years after making the gift). Although making gifts certainly comes with a potential tax savings opportunity, that opportunity must be weighed against the lost possibility for a step-up in basis (for capital gains tax purposes) with respect to the gifted assets that would have been available if the assets had been retained until death pursuant to Section 1014 of the Internal Revenue Code. For that reason, it is best to gift higher basis assets and retain lower basis assets to pass at death.

Gifts can range from simple outright gifts or forgiveness of outstanding loans to family members to more complicated gifts into irrevocable trusts, including generation-skipping trusts. For gifts to irrevocable trusts, the type of trust varies depending on the desires and circumstances of each particular client, so a careful analysis should be done to find the right fit (there is no one size fits all). A client may consider making a gift to a dynasty trust (i.e., a trust lasting in perpetuity for the benefit of children, grandchildren and more remote descendants) in order to remove those assets from his or her taxable estate now and also remove those assets from the taxable estates of future generations, while protecting the assets from creditors. On the other hand, if a married couple wishes to make use of their gift tax exemptions, but are concerned about relinquishing access to their property and providing for themselves, each can create a Spousal Lifetime Access Trust (SLAT) for the mutual benefit of each other. SLATs were popular estate planning tools in the year 2012 when individuals tried to lock in their $5 million exemptions which were set to decrease to $1 million under former sunset provisions (which decrease was averted at the very last minute).

In addition to the possibility of making large gifts to lock in the use of the historically high federal estate, gift and generation-skipping transfer tax exemptions, clients should not forget about the use of their annual gift tax exclusion gifts, which continues to be a good estate planning tool, regardless of the passage of the act. Each individual can make a cumulative annual gift tax exclusion gift of $15,000 per donee during 2018 ($30,000 for a married couple), without using any portion of the federal estate and gift tax exemption (note that this is an increase from the $14,000 annual gift tax exclusion amount which had been in effect since 2013). Annual exclusion gifts can be made outright to, or for the benefit of, individuals and can also be made in trust for beneficiaries.

One common use of the annual exclusion gifting is to fund 529 plans (contributions to which can be front-loaded for up to five years at one time). The act has made gifts to these plans more appealing. In addition to paying for higher education expenses, 529 plan distributions can now also be used tax-free for elementary and secondary school expenses (but limited to $10,000 in distributions per student each year).

Many of our colleagues outside of our practice area question whether there remains enough "sophisticated" estate planning work to keep us busy as the number of clients subject to the federal gift and estate tax diminishes as the exemption increases. It is certainly true that there is a smaller volume of clients engaged in active estate planning geared at reducing the estate tax hit than was the case in prior decades. However, we have found that there remains plenty of important work to be addressed that requires fine-tuned understanding of design options for estate plans and trusts to protect inherited assets from creditors and spouses, as well as to avoid fostering "affluenza" among descendants who can too easily be more harmed than helped by unfettered access to a significant inheritance. Not to mention the complex procedural, state inheritance tax and income tax issues for decedents' estates which contain many traps for the unwary.

When trying to digest the sweeping changes in the federal gift and estate tax exemption, it is important to understand the historical context. It was only 20 years ago, back in 1997, that the exemption was $600,000 and the top rate (starting at $3 million) was 55 percent. So, the exemption has increased about 1,800 percent over the last 20 years (or about 90 percent per year). This is compared with the first increase of $25,000 from $600,000 back in 1998—a mere 4.1 percent increase. The biggest jump during that period was from $675,000 to $1 million in 2002, a 48 percent increase (but only a 66.6 percent increase over the five-year period, or 13.32 percent per year compared to the 90 percent per year over the last 20 years). Although there is no historical precedent for the exemption decreasing, we must be mindful that the pendulum has swung to an extreme point with our federal government, and in theory, it could swing to an extreme point in the other direction before this "estate planning game" is over for many of our clients. So, we believe it remains advisable to make an effort to be braced for a potential move in the opposite direction as part of the estate planning process. Stay tuned!

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