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What Goes Up Must Come Down: Estate Planning With The Current Exclusion, While We Still Have It

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Public Law 115-97, commonly referred to as the Tax Cuts and Jobs Act (the “Act”), was signed into law on Dec. 22, 2017.¹ The Act significantly altered many provisions of the Internal Revenue Code, resulting in substantial changes to the calculation of personal and entity-level income taxes and the further reduction to the pool of individuals to whom the estate, gift and generation skipping transfer taxes will apply. Although less than .02 percent of taxpayers are affected by the federal wealth transfer tax, depending on an individual’s age and life expectancy, taxpayers who would not be subject to an estate tax under the current exemption levels may still find opportunities for making lifetime gifts.² By incorporating flexibility in the structure and mechanics of a client’s estate plan, practitioners can assure a client who is uncertain about the future “opportunity cost” of his/her gift that his/her plans can adapt with changing family and legal circumstances. Even for those individuals who are not likely to be affected by the federal estate or gift tax, several constants remain which should continue to drive estate planning, including state estate tax reduction or avoidance, asset protection or using the larger exemption to cushion smaller gifts of hard-to-value assets from the risks of an audit.

Changes to the Wealth Transfer Tax System

After several weeks of partisan negotiations, on November 2, 2017, House of Representative Republicans presented their first iteration of the proposed tax bill. Anticipating the probability of a Democratic filibuster if a permanent bill with a 60 vote-requirement by the Senate was proffered, Republicans incorporated a “sunset” provision, requiring only a simple majority but restricting the law’s applicability to eight years. Although the bill presented to the House of Representatives included the repeal of the estate and generation skipping transfer (GST) taxes, the Senate’s version of the bill proposed a doubling of the estate, gift and GST tax exemptions. The Conference Committee ultimately adopted the Senate’s version, which became law with the passage of the Act.

The Act nearly doubled the wealth that individuals can transfer without incurring a wealth transfer tax from an already historically high \$5,490,000 to \$11,180,000 (technically the “Basic Exclusion Amount,” but often simply referred to as the “exemption,” and, as was the case under prior law, will be indexed for a cost of living inflation adjustment. The exemption levels will return to \$5 million (indexed for inflation) on Jan. 1, 2026, when many provisions of the Act expire, or perhaps even sooner if a newly elected administration legislates preemptively.³ Taxpayers were confronted with a similar

scenario in 2011 and 2012, when the \$5 million exemption was slated to return to \$1 million at the expiration of the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, Public Law 111-312 (“the 2010 Tax Act”) on Dec. 31, 2012.⁴ Anticipating the possible 80 percent reduction in the exemption, a large number of potentially affected taxpayers were presented with the opportunity to remove wealth from their taxable estates. For example, had the exemption reverted to previous levels, many individuals owning life insurance policies would have likely had gross estates in excess of a \$1 million exemption. Therefore, the onus driving individuals to make gifts during 2011 and 2012 was largely the concern that the increased gift tax exemption might lapse.

Despite the gifting opportunities of 2011 and 2012, practitioners cautiously advised clients of the possibility that large transfers could be “clawed back” and subject to estate tax if the taxpayer died in a year in which the estate tax exemption failed to exceed the gift tax exemption used for an earlier gift. The American Taxpayer Relief Act of 2012 (ATRA), passed on Jan. 1, 2013, extended the \$5 million estate tax exemption amount, so this issue never surfaced. Lessons learned from the possibility of ATRA’s sunset at the end of 2012 indicate that it is unlikely that the Internal Revenue Service (IRS) would apply

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a clawback. Section 2001(g)(2) of the Act, originally sourced from the 2010 Tax Act, authorizes the Treasury Department to issue regulations to address the potential for a clawback. The legislative history seems to indicate that the intended purpose of the request for regulations stems from the technicality of drafting regulations sufficient to prevent gifts exempt from gift tax from being clawed back. Nevertheless, until regulations are issued, practitioners should continue to advise clients of the possibility of a clawback.

Planning for Changes in the Tax Law

Some individuals who made, or contemplated making, gifts in 2011 or 2012 may be hesitant to make current lifetime gifts out of skepticism that the wealth transfer tax exemption levels will actually decrease. This “wait and see” approach may result in a missed opportunity that practitioners should challenge under the appropriate circumstances. By dispelling two common misconceptions – first, that gifting necessitates the relinquishment of all access and control of the transferred funds, and second, that gifting precludes a future step-up in income tax basis for the appreciated or appreciating assets, practitioners can provide added value to clients who would benefit from lifetime gifting. As such, gifts made through the use of flexible trust structures can accomplish these goals through periods of unforeseen and changing circumstances.

One such structure, known as a Spousal Lifetime Access Trust (SLAT), is a trust whereby married individuals, siblings, or a pair of individuals, can utilize the increased estate tax exemptions without relinquishing permanent access to the funds.⁵ Most commonly used between spouses, SLATs are structured so that each spouse creates and funds a reciprocal trust for the discretionary lifetime benefit of the other and their issue. Each spouse is able to serve as the trustee of the trust created by the other for his or her benefit, provided that he or she is limited to making distributions to himself or herself pursuant to an “ascertainable standard” for the purposes of health, education, maintenance, or support.⁶ An independent co-trustee should also be appointed with authority to make distributions for any purpose, in such co-trustee’s sole and absolute discretion.⁷ Further, if each spouse creates a SLAT for the other, the trusts must be drafted with material differences in order to avoid the re-inclusion of the transferred assets in each spouse’s estate pursuant to the “reciprocal trust doctrine.”⁸ Negating the intended utility of the structure, the trusts will be uncrossed if, after funding each trust, the spouses have left themselves “in approximately the same economic position as they would have been in had they created trusts naming themselves as life beneficiaries.”⁹

Each spouse’s transfer to the SLAT is treated as a completed gift with the objective of utilizing lifetime gift tax exemption and removing assets and commensurate future appreciation from estate and gift taxation, and, if structured to be GST exempt, even for future generations.¹⁰ During their joint

lifetimes, each spouse has access to the trust created for his or her benefit, and, assuming the spouses maintain a happy marriage, each spouse also retains beneficial enjoyment of the trust that he or she created as a result of the beneficiary spouse receiving distributions from the trust. Although it is not necessary for both spouses to each create such a trust, doing so enables the couple to effectively double the amount of transferred wealth while minimizing the risk of losing indirect access to the assets upon the first spouse’s death. Ideally, the couple will never require distributions from their trusts, allowing the unreduced trust funds to grow for the benefit of future generations. Nevertheless, if the spouses lack sufficient individual assets to maintain their desired lifestyles without receiving distributions from the trusts, accessing the funds in each of the SLATs is still possible.

In a majority (albeit gradually decreasing number) of states, a grantor cannot be the beneficiary of a trust that he/she has created without the trust assets being includible in his/her estate upon his/her death.¹¹ Therefore, the trust will terminate at the beneficiary spouse’s death and the balance of the trust principal will continue to be held in further trust for the benefit of the couple’s children and grandchildren. Consequently, at such time, the grantor spouse will lose indirect access to the beneficiary spouse’s trust that he/she enjoyed during his/her lifetime. Moderately wealthy clients who were motivated to plan primarily for asset protection, state estate tax savings, or reasons other than federal estate tax savings, may, however, require access the trust funds of both trusts. Often by naming a corporate or individual trustee with a presence in a self-settled domestic asset protection trust (DAPT) jurisdiction, the trust can authorize an independent party to add the grantor as a permissible trust beneficiary should he/she require access to the trust funds after the death of the donee spouse.¹² If the trust is not initially sited in a self-settled DAPT jurisdiction, the trustees should ensure that the situs of the trust is moved to such a jurisdiction prior to adding the grantor as a permissible beneficiary.¹³

Historical estate planning convention generally prioritized avoiding the estate tax over the income tax consequences to beneficiaries inheriting assets. This philosophy developed primarily due to a significant disparity between the estate and gift tax rates and the capital gains rates. For example, from 2001 through 2008, the estate and gift tax exemptions ranged from approximately \$675,000 to \$2,000,000 with tax rates ranging from 45 percent to 55 percent, whereas the long-term capital gains rates generally ranged around 15 percent to 20 percent during the same period. Income tax planning has become an increasingly vital component of a comprehensive estate plan as the federal estate tax has applicability to fewer individuals.

Despite this paradigm shift, determining at the time of planning whether to gift an asset to utilize the high gift tax

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exemption or retain it in order to obtain a step-up in basis is made a near-impossible task by a series of variables relating not only to the grantor, but also to the ultimate beneficiaries.¹⁴ For example, estate tax exemptions and rates and the income tax brackets and rates that will likely be in effect in the grantor's or beneficiary's state of residency, the life expectancy of the grantor, as well the nature of the inherited asset and the likelihood that it will be sold or retained by the beneficiary, are all circumstances that cannot be determined with any reasonable degree of certainty. If, at the time of the grantor's death, the estate tax exemption remains at historically high levels or the beneficiary has a large portion of unused estate tax exemption available, it may be advantageous to cause a portion or all of the trust assets to be included in the taxable estate of a beneficiary or another third party.

Therefore, although SLATs are initially structured to avoid estate inclusion, the current estate planning environment dictates the use of flexible mechanisms that, if engaged, will selectively trigger a step-up in income tax basis. Estate inclusion can be accomplished by granting a disinterested trustee the discretion to later confer a general power of appointment (GPOA) to the grantor, a trust beneficiary or independent third party. The value of the property subject to the exercise of the GPOA is includible in the estate of the powerholder and any appreciated assets subject to the power will receive a step-up in basis at the powerholder's death, regardless of the whether the power is actually exercised.¹⁵ Authorizing a trustee to confer a GPOA eliminates some of the uncertainties present at the time of the trust's creation by allowing the trustee to determine the appropriate time, individual, and assets over which to trigger estate inclusion.

Furthermore, a trustee may confer a GPOA upon an elderly relative of the grantor with a modest estate to achieve a step-up in basis at the time of the relative's death.¹⁶ Choosing an individual whose estate would not exceed any state or federal estate tax exemptions in place at the time of his or her death would achieve a step-up in basis without any estate tax consequence. To mitigate any risk that the GPOA would be exercised by a third party donee, the grantor may mandate that the exercise requires the consent of a non-adverse party, or, alternatively, the donee can be given a limited power of appointment restricted to its exercise among the grantor's issue or other family members that could later be converted into a GPOA by another individual.¹⁷

If the grantor has available exemption, other techniques

may be used to cause estate inclusion that would not require reliance on a third party. For example, if the grantor is not concerned with her own potential creditors, the trustees can simply distribute the trust assets to the grantor. Furthermore, the trustee may choose to confer a GPOA upon an ailing grantor, if doing so would result in the imposition of an estate tax at the time of the Grantor's death.¹⁸ It is also common for trusts to include a power of substitution, also called a "swap power," which enables the grantor to reacquire the trust principal by substituting it with other property of equivalent value. If the grantor possesses minimally appreciated assets, he/she may exercise this discretion to replace appreciated trust property that would benefit from a basis step-up with such lesser appreciated assets.¹⁹ Exercising a swap power is likely to be more advantageous than a direct distribution, as it enables the grantor to retain the creditor protection of assets held in trust assets while also maintaining estate tax and GST tax efficiencies of the trust.

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Practitioners often also incorporate the swap power into their trust agreements as a practical means of triggering "grantor trust" status. The grantor's payment of the trust income serves to further reduce his/her estate, allowing for the tax-free growth of trust assets, permits the grantor to engage in sale transactions with the trust without triggering gain, and, may result in a lower income tax burden, as undistributed trust income will be taxed at the highest rate bracket at only \$12,500 of income.²⁰ Although triggering grantor trust status has traditionally been an important, if not automatic, estate planning device, practitioners should rethink whether doing so will best suit taxpayers given the changes instituted by the Act.

The Act capped the federal itemized deduction for state and local income, sales, and property taxes paid (SALT) to \$10,000 and increased the standard deduction to \$12,000 for unmarried tax filers and \$24,000 for joint filers. Taken together, many taxpayers in high tax states such as New York and New Jersey who likely have SALT deductions in excess of \$10,000, will have an increase in income tax liability either from itemizing with fewer deductions or because they will be limited to the standard deduction. As a result, although federal taxation of the non-grantor trust income would be imposed at significantly compressed income tax brackets, the grantor could avoid state income tax in the grantor's state of residency and have the opportunity to reduce the grantor's state and federal income taxes by shifting investment income to beneficiaries pursuant to Sections 661 and 662.²¹

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By default, a SLAT is automatically taxed as a grantor trust pursuant to Section 677(a), because the trust income and principal may be distributed to the spouse in the discretion of the trustee.²² Grantor trust status may be avoided, however, if all distributions to the spouse are subject to the consent of an adverse party.²³ Furthermore, some powers that trigger grantor trust status, such as a swap power, may still be desirable in order to obtain a basis step-up for appreciated trust assets. In such a circumstance, the swap power may also be made subject to the consent of an adverse party, which would prevent it from causing grantor trust status, but would still provide basis planning flexibility.²⁴

For residents of high income tax states creating completed gift SLATs or hybrid DAPTs in self-settled asset protection trust jurisdictions, many of which do not impose a state income tax, creating SLATs taxed as non-grantor trusts or later “toggling off” grantor trust status can provide the additional benefit of avoiding state income tax on the trust income. The decision to create a non-grantor trust will depend largely on the expected income generated by the trust’s investments as well as whether, to whom and to what extent, the trustees anticipate making distributions that will carry out income to one or more beneficiaries. If either of the grantors anticipate that they will require a significant portion of the trust income during their lifetimes, then structuring the SLATs as non-grantor trusts will likely offer little income tax benefit. However, avoiding grantor trust status may result in a total net income tax savings if income is not required or if distributions will be made to the grantor’s children, who may be taxed at lower tax brackets or who may reside in states without an income tax. For grantors living in states without an income tax, traditional grantor trust planning is more likely the favorable option. If grantor trust status would again become desirable under a future change in state or federal tax laws or a grantor moves to a low income tax state, the SLAT can be modified accordingly to re-engage grantor trust-triggering powers.

Conclusion

The decision to part with the control of one’s wealth is not always an easy one for an individual to make. In contrast to previous years, when taxpayers faced a narrow gifting window before exemption levels were slated to sunset, taxpayers now have several years to make their decision. Given the unprecedented opportunity for wealth transfer, however, even those who would not be subject to a federal gift or estate tax at current exemption levels, should consider making lifetime gifts. The decision to part with assets may be made easier for many individuals through the use of flexible trust structures, given the benefits of reacquiring use of the trust assets and adjusting income, estate, and/or GST tax consequences as circumstances change.



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Endnotes

- 1 Tax Cuts and Jobs Act, Pub. L. No. 115-97, 12/22/17.
- 2 With a Basic Exclusion Amount of \$5,430,000, 99.8 percent of taxpayers would not be subject to the estate tax. Joint Committee on Taxation, History, Present Law, and Analysis of the Federal Wealth Transfer Tax System, March 16, 2015, JCX 52-15.
- 3 The Act utilizes the Chained Consumer Price Index for All Urban Consumers (“C-CPI-U”) instead of the Consumer Price Index for All Urban Consumers (“CPI-U”) as a measure of inflation, which will slow the typical increase in the annual inflation adjustment in future years. I.R.C. § 2010(c)(3)(C).
- 4 The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, Public Law 111-312 (“the 2010 Tax Act”) established an estate tax exemption of \$5 million, effective Jan. 1, 2010 through Dec. 31, 2012. I.R.C. §§302(a), 101(a).
- 5 See *Estate of Levy*, T.C. Memo. 1983-453 (1983); *Lehman v. Commissioner*, 109 F.2d 99 (2nd Cir. 1940), cert. denied, 310 U.S. 637 (1940); *Estate of Bischoff*, 69 TC 32 (1977).
- 6 Treas. Reg. § 25.2511-1(g).
- 7 A beneficiary who has the power to distribute assets to himself that is not limited by an ascertainable standard, will have a GPOA and will be required to include the assets in his gross estate for estate tax purposes pursuant to Section 2041. Section 2041 includes an ascertainable standard exception for a power that is limited to the health, education, support, or maintenance of the decedent.
- 8 A discussion of the particulars of drafting non-reciprocal trusts is beyond the scope of this article.
- 9 *United States v. Estate of Grace*, 395 U.S. 316, 324 (1969).
- 10 Contributions to the trust are completed gifts for gift tax purposes because the trust does not satisfy the requirements of qualified terminable interest property under I.R.C. § 2523(f)(2).
- 11 Due to the lack of creditor protections to self-settled trusts in non-DAPT states, the grantor cannot retain a beneficial interest in trusts sited such jurisdictions without causing the transfer to be an incomplete gift or included in the grantor’s estate. See Rev. Rul. 76-103; Rev. Rul. 77-378; and *Paolozzi v. Commissioner*, 23, T.C. 102 (1954); I.R.C. §§ 2036(a)(1), 2036(a)(2), 2038.
- 12 Seventeen states have adopted self-settled trust legislation. See *Eleventh Annual ACTEC Comparison of the Domestic Asset Protection Trust Statutes, updated through August 2017*, Edited by David G. Shaftel, Nine other states have adopted some more limited version of a self-settled trust legislation. www.actec.org/assets/.../Shaftel-Comparison-of-the-Domestic-Asset-Protection-Trust. There is a risk that creating a self-settled trust in a jurisdiction that the grantor does not reside in will cause the trust to be subject to such spouse’s creditor claims. As such, it may be prudent to provide that the independent person, preferably acting in a non-fiduciary capacity, can add any individual in the class of persons consisting of the descendants of the grantor’s parents rather than specifying that the grantor may be added specifically. Such a trust is often referred to as a “hybrid” domestic asset protection trust. Steven J. Oshins, *The Hybrid Domestic Asset Protection Trust*, LEIMBERG ASSET PROTECTION PLANNING NEWSLETTER #200 (May 10, 2012).
- 13 *Supra* note 11.
- 14 If an individual at her death owned assets that have appreciated in value since the date of the acquisition, the beneficiary inheriting the asset will receive a step-up in income tax basis to the fair market value of the asset at the date of the decedent’s death. I.R.C. § 1014.

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