

Top 10 Effects of the Tax Reform Act on Estate Planning

The Tax Reform Act,[1] signed three days before Christmas 2017, gave a big present to clients concerned about estate taxes. The estate and gift exemption[2] (adjusted annually for inflation) increases from $5.49 million per person in 2017 to $11.18 million in 2018,[3] and from $10.98 million per married couple in 2017 to $22.36 million in 2018.[4]

This month, the Tennessee Bar Journal welcomes Dan Holbrook back as our columnist. Holbrook wrote "Where There's a Will" from 2001 to 2012.

The Journal also thanks Knoxville lawyer Eddy Smith who brought insights and great writing to the column for six years. Thank you, Ed!

However, the increased exemption sunsets in 2026, reverting to the 2017 level (still adjusted for inflation).[5] Clearly, the number of Americans potentially affected by estate tax has dropped from measly to minuscule, for at least about eight years.

Surprisingly, many of the most important gift and estate tax features remain unchanged, including the 40 percent gift and estate tax rate; portability of the estate tax exemption between spouses; the GST exemption equaling the estate tax exemption; the annual gift tax exclusion, inflation-adjusted to $15,000 in 2018; and importantly, the step-up in income tax basis upon death.

Here are the Top 10 things estate planners should be considering in 2018 and beyond:

1 Ignore Estate Tax. Almost all estate planning can safely ignore the federal estate tax, and Tennessee has repealed its inheritance tax. Large gifts can be made freely, ignoring gift tax consequences (except the nuisance of filing gift tax returns). Keeping assets out of a person's gross estate for estate tax purposes, once the primary planning paradigm, is largely irrelevant. Consider dropping any insurance policies held only for estate tax purposes. Consider eliminating the power to make gifts from durable powers of attorney. For most clients, we can focus on the traditional estate planning objectives of preserving wealth, protecting beneficiaries from creditors, predators or spendthrift tendencies, and caring for family, business and community.

2 Focus on Income Tax. With a step-up in income tax basis on assets includible in a decedent's gross estate,[6] planners need to focus on ways to include, rather than exclude, assets in gross estates whenever feasible. Existing irrevocable trusts might be modified to add general powers of appointments so that there is estate inclusion and basis step-up at the death of each beneficiary. Even non-beneficiaries can be given a general power of appointment. For example, a client could fund a trust with appreciated assets, then give his parents a general power of appointment over the trust, causing inclusion in the parents' estates when they die, giving the client a "free" step-up in basis on his own assets. Conversely, practitioners might advise transferring assets with built-in losses to entities or trusts to preserve the built-in loss at a client's death, or else selling the assets to recognize the loss before client's death. Portability between spouses remains the easiest way to have the double estate tax exemption cake and eat the income tax step-up too. A Tennessee community property trust may allow married taxpayers to obtain a full step-up in basis for jointly owned assets in the trust on the death of the first spouse to die, rather than only a one-half step-

up in basis if the property were owned jointly as non-community property.[7] Clients in states with high state and local taxes (SALT) whose deductions for such taxes have been limited to $10,000 under the Tax Reform Act should consider creating trusts with fractionalized property interests, each trust obtaining its own $10,000 deduction.

3 Re-think Charitable Giving. If the estate tax is no threat, there may be less reason to be bound by structures such as qualified charitable remainder trusts and the like that may no longer need to be designed to meet complex estate tax requirements. Consider "charitable conduit bequests," leaving bequests to trustworthy individuals with non-binding precatory requests that they give to charity. There is no estate tax cost upon death, and the beneficiary gains an income tax deduction for the charitable gift.

4 Continue to Avoid Estate Tax for High-Net-Worth Clients. All the tried-and-true techniques for reducing or avoiding estate tax remain in effect for clients whose exposure to the estate and gift tax remains. Single clients may want to focus on domestic asset protection trusts (Tennessee Investment Services Trusts[8] in Tennessee), while married couples may focus on non-reciprocal, dynastic, grantor, GST-exempt, spousal lifetime access trusts (SLATs), perhaps with a power to loan to provide the client access to assets. Other common techniques include insurance trusts, family limited partnerships, "freeze" devices, and zeroed-out GRATs (perhaps ending not later than 2025 before exemptions drop, so if the grantor dies before the term ends the trust is includible in the estate allowing a step-up in basis). The number of estate planners experienced in these techniques will decline as the number of clients decline, but for the experienced, business may increase, not decrease.

5 Encourage High-Net-Worth Clients to Make Large Gifts. To the extent clients can afford to do so, they should take advantage of the doubled exemption while it's clearly the law, since it may not last. In addition to locking in the current doubled gift tax exemption, gifts will remove all future appreciation from estate tax exposure. However, be cautious about making gifts of low-basis assets unless the estate tax savings are likely to outweigh the loss of income tax step-up in basis on the death of the donor.

6 Create Flexibility in the Event the Exemption Drops in (or before) 2026. Estate planners need to keep the changing exemption amount in mind for every client with significant assets. An estate plan that makes sense today might be inappropriate whenever any significant change occurs in the tax laws. Since we know that the exemptions are scheduled to be reset in 2026, and Congress could change it even before that, practitioners should not lock their clients into structure that would be inappropriate if the exemptions reset. Practitioners should also add disclaimers in their client letters that explain the upcoming changes in the exemption and suggest a new consultation to address any changes in the tax laws.

7 Create Flexibility in the Event of Death Before 2026. Post-mortem options at the death of the first spouse can be increased significantly with the use of a QTIP-able trust, "Clayton" alternatives, disclaimers, Trust Protectors or various general or limited powers of appointment. The surviving spouse, with the help of advisors, can analyze all relevant factors, such as tax rates, the surviving spouse's health and life expectancy, and the desirability of utilizing the GST tax exemption of the first spouse to die, and effectively allocate the estate of the first spouse to die among a range of alternatives, including distributions outright or in trust for the benefit of the spouse, descendants, charities or others.

8 Review All Formula Clauses. Formula clauses are widely used, and should continue to be where appropriate, since they can optimize tax planning with a direct reference to an exemption. However, formula clauses implemented before the recent increases in the exemptions can create wild distortions in clients' plans. This might occur, for example, if a client has $10 million of assets and her prior documents were completed when the exclusion amount was $5 million. If the documents left all that could pass tax-free to her children, and the remainder to her husband, then the changes in the law might completely cut out the husband. Estates in second or third marriages could be especially susceptible to problems with inappropriate formula clauses. Formulas may also cause charities that are named as remainder beneficiaries, based on formulas that save estate tax, to receive little or nothing if the estate is no longer taxable.

9 Remember to Allocate the Generation-Skipping (GST) Tax Exemption. A gift in trust may be good planning, but even with modest and normally non-taxable estates, failure to allocate the GST exemption can cause GST tax to become payable if a skip person dies unexpectedly. All may still be well if the trust is includible in the decedent beneficiary's taxable estate,

continued on page 30

continued from page 29

since estate tax inclusion trumps GST tax, but many if not most trusts do not cause such inclusion. Similarly, all may be well if the gift in trust met the requirements for automatic allocation of the GST exemption, but not all trusts that may become subject to GST tax qualify for automatic allocation.

10 Stay Vigilant. Congress always needs (or at least demands) more revenues, and the pressure to increase taxes in light of future deficits requires planners to stay tuned for future developments. Forthcoming regulations and potential legislative changes are inevitable.

In the meantime, the higher estate tax exemption gives us far greater leeway to draft estate planning documents based solely on our clients' needs and desires, without the restrictions and complexity of the estate tax.

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Notes

1. We refer herein to the act as the "Tax Reform Act" or simply "the Act." Senate rules required the title of the bill to be changed from the "Tax Cuts and Jobs Acts" to "An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018," for which no useful acronym was possible.

2. This is technically the "applicable exclusion amount" under Code §2010(c), but is referred to as an "exemption" for ease of reference.

3. Rev. Proc. 2018-18. The exact amount of each year's exemption may not be known quickly. The Act amended Code §1(f) so that the method of calculating the inflation adjustment is changed to the "Chained" Consumer Price Index (CCPI), which assumes that as prices rise, people will switch to cheaper substitutes, thus slowing the overall rise in prices. Unlike the Consumer Price Index (CPI), the final CCPI for a given year is initially estimated for the period from September to August preceding that year, and then continually recalculated based on updated information, and may not be definitely finalized until many months after the preceding August.

4. Because of the nearly doubled exemption, the Joint Committee on Taxation anticipates that filings of the Estate Tax Return Form 706 in the entire country will decrease from about 5,000 in 2017 to only about 1,800 in 2018. https://www.forbes.com/sites/ashleaebeling/2017/12/21/final-tax-bill-includes-huge-estate-tax-win-for-the-rich-the-22-4-million-exemption/#2bb9ce791d54 (discussing memo from Joint Committee on Taxation).

5. Fortunately, amended Code §2001(g)(2), renumbered from §2001(g), retains an "anti-clawback" provision to prevent gifts made using the higher exemption from being subject to estate tax if and when the exemption drops again, as scheduled in 2026.

6. Code §1014(a)(1) and (b)(9).

7. See Holbrook, "Community Property Trusts," *Tennessee Bar Journal* (December 2010), and Roberts, "Community Property Trusts: A Cautionary Tale," *Tennessee Bar Journal* (July 2011).

8. See Holbrook, "The TIST Test: Tennessee Competes for Trust Dollars," *Tennessee Bar Journal* (August 2007), and Holbrook, "When to TIST? Here's a List," *Tennessee Bar Journal* (November 2007).

Learn More from These TBA Webcasts

- **How New Tax Laws Impact Lawyers**

Column co-author Bradley C. Sagraves contributed to this webcast with J. Leigh Griffith of Waller in Nashville.

Description: The Tax Cuts and Jobs Act contained multiple tax cuts, particularly for corporate and pass-through entities, which may benefit lawyers. This presentation will review the impact of the new tax laws on lawyers who operate as a sole practitioner, partnership, limited liability company or corporation. For some, a change in organizational structure may be the best way to take advantage of the new legislation.
https://cle.tba.org/catalog/course/4428

- **Overview of New Tax Cuts and Jobs Act**

Description: This presentation will give a high-level overview of the main provisions contained in the new act, including the new corporate rates and the new section on pass through entity taxation.
Speakers/Producers are Cullen Boggus, Holton & Mayberry PC, Nashville; Michael Goode, Stites & Harbison PLLC, Nashville; and Hannah Smith, Sherrard, Roe, Voight & Harbison, Nashville.
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