Pitfalls and Opportunities Under the New Federal Tax Law

Part 3: Estate Planning Opportunities

By temporarily increasing the federal exemption from $5.5 million to $11.4 million for the gift, estate and generation-skipping taxes, the Tax Cuts and Jobs Act of 2017 (the "Act") has created estate tax and income tax planning opportunities as well as traps for the unwary. In this multipart series, we explore all of these in depth. In Part 1, we looked at potential tax pitfalls in the new law. In Part 2, we looked at new income tax planning opportunities, which are available regardless of one's net worth.

In this final Part 3 we look at potential estate planning opportunities. Each strategy involves making gifts to family members, either outright or in trust, but those can often raise concerns for the donor. For example, the combination of rising health care costs and longer life expectancies leads some to worry about needing the assets themselves someday. Others may be concerned about creating unmotivated "trust funders" who do not lead productive lives.

Below we discuss a number of strategies in a Q & A format that allow a donor to take advantage of the doubled tax exemption in ways that address these concerns and that may benefit taxpayers regardless of their net worth.

Q: What if I might someday need the assets I have gifted away?

A: For married couples, consider a Spousal Lifetime Access Trust ("SLAT")

A spousal lifetime access trust (SLAT) is a trust for married couples which addresses the concern that you might someday need the assets you have given to family members. Under this strategy, one spouse creates the SLAT and names the other spouse and their descendants as beneficiaries. Naming a spouse as a beneficiary creates a safety net of sorts that can enable the couple to reclaim trust assets if necessary. Of course, distributing trust assets to the spouse means that they will be included in the spouse's taxable estate at death. For that reason, most couples typically only access SLAT assets if they have drawn down all other available resources.

Funding a SLAT requires the selection of an independent trustee. If the donor spouse is deemed to exert an outsized influence over the trustee (e.g. because of a familial or employment relationship), the assets could be included in the donor spouse's estate at death.

Although SLATs can be a great solution in the right situation, they also carry some risks. If the beneficiary spouse dies, only the children and grandchildren remain as beneficiaries and the donor loses the primary avenue for indirectly benefiting from the trust. The same result may occur if a couple divorces after creating a SLAT.

Finally, because one spouse is a beneficiary of a SLAT, the couple can only use the exemption of the donor spouse. Therefore, to make full use of both spouses' exemptions, each spouse must create their own SLAT naming the other as beneficiary. In doing that, care must be taken to avoid triggering the "reciprocal trusts" rule, which disregards trusts that are essentially mirror images of each other (thereby nullifying the tax benefits).

Q: I don't want my children or grandchildren to become "trust funders." What can I do?

A: Consider using a Quiet Trust

A quiet trust can address the concern that large gifts into trusts may have a negative effect on the development of a young person's work ethic and their sense of personal, financial and social responsibility. There may also be a concern that the beneficiary will be taken advantage of by creditors, friends or even other family members if word gets out that they are a "trust funder."

A quiet trust can take different forms, but essentially it directs the trustee not to communicate with the beneficiary about certain aspects of the trust, such as its value or the circumstances in which distributions are to be made. It can even prohibit the trustee from informing the beneficiary about the existence of the trust.

The ability to set up a quiet trust can vary from state to state. Our clients have typically set up quiet trusts under New Hampshire law, which has thoroughly modernized its trust laws and become one of the best states in the nation in which to establish a trust. Most clients have provided that the beneficiary be made aware of the trust's existence upon reaching a certain age, at which point they hope he or she will have developed enough maturity to handle that knowledge responsibly. Of course, the donor is free to let the beneficiary know about the trust at any time, but the trustee must wait until authorized under the trust terms.

Q: I'm worth a lot on paper but gifting makes me concerned about my cash flow and liquidity. What should I consider?

A: Consider gifting illiquid assets such as real estate

Gifting illiquid assets can accomplish a number of different goals: (i) it is less likely to affect your cash flow, (ii) the gift recipients typically cannot go on a spending spree; and (iii) discounting the value of the gift when reporting it on a tax return is typically allowed, which means it uses less exemption than gifting the same amount of liquid assets. Illiquid assets can include privately-held companies, real estate, artwork and other collectibles, limited liability company ("LLC") interests, alternative investments such as hedge funds, private equity and venture capital funds, and others.

Perhaps the most common illiquid asset used for gifting is real estate. A property owner can give real estate to an irrevocable trust of which children are the beneficiaries or to an LLC owned by children, in both cases using exemption on the gift without affecting the donor's cash flow. If the donor wants to continue using the property, he or she would rent it back. Although paying rent affects the donor's cash flow, the donor would no longer have to pay for ownership expenses such as property tax and insurance. Instead, the children can use rental income to pay those expenses. Having said that, the donor must be very careful to formalize the landlord/tenant relationship with lease agreements that charge fair market value rent (updated regularly) and must always act as if a true business relationship exists with the children. Failure to do so will risk an IRS claim that the donor retained the right to use and enjoy the property, which could result in the real estate being included in the donor's estate at death.

Q: I'm too young to consider doing this, or I'm not wealthy enough to give away $11 million. Is there any anything else I should consider?

A: Possibly. Consider making "upstream gifts" to eliminate capital gains tax

As discussed in Part 2 of this series, the temporarily-doubled tax exemption may create an opportunity for some to make gifts "upstream" to a parent or grandparent. The tax advantage of this would be to reduce or eliminate the capital gains tax upon sale of the gifted asset. Under this strategy, an adult child makes a gift of appreciated property, either outright or in trust, to an elderly family member whose net worth is well below the tax exemption level.

When the elderly family member dies, there is no estate tax due because their estate's value is below the exemption level, but it receives a "step-up" in cost basis because the gifted asset is included in their taxable estate, so that the cost basis equals the asset's fair market value.

Because capital gains are calculated by subtracting the cost basis from the sale price, stepping up cost basis so that it equals the asset's fair market value will eliminate the capital gain tax if the asset is sold before its value increases again. If the asset appreciates further prior to a later sale, the capital gains tax will only apply to the appreciation that occurred following the elderly family member's death.

Upstream gifts can be risky. If the elderly family member dies within a year of receiving the gift and under their estate plan the asset passes back to the adult child or that child's spouse, the asset will not receive a step-up in cost basis—so the strategy would have failed. Moreover, the adult child would not be able to recoup the exemption they used on the gift.

Another risk can arise if the property is gifted outright: the elderly family member may choose to leave it to whomever he or she chooses, which might not match how the adult child wants the gifted asset to pass. And if the elderly family member lives in a state that imposes an estate tax (like Massachusetts) with an exemption level lower than the federal exemption, the gift may cause unintended estate tax at the state level. Finally, if the elderly

family member is living when the federal tax exemption is reduced by close to 50% in 2026, the value of their estate might exceed the exemption, which could result in tax due.

Conclusion

The current exemption provides individuals an unprecedented opportunity to engage in proactive planning that could result in profound tax savings. With the window of opportunity currently open until January 1, 2026, one might not feel a sense of urgency to focus on gifts. However, identifying the appropriate assets, amounts, and recipient vehicles can be an extensive process. Often people who explore these options take time to digest the information and possibly discuss things with family members. There is also a chance that the 2026 change could be accelerated or that new legislation could reduce the exemption to levels lower than $5.5 million. Budgeting enough time to consider possible approaches will ensure that you avoid hasty decision-making and achieve the best result for your family.

Additional Resources

This multipart series, explores estate tax and income tax planning opportunities and pitfalls created by the Tax Cuts and Jobs Act of 2017.

- Part 1 explored pitfalls under the Act.
- Part 2 looked at new income tax planning opportunities which are available regardless of one's net worth.

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