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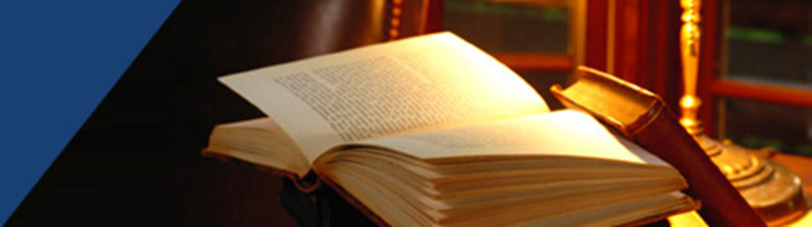
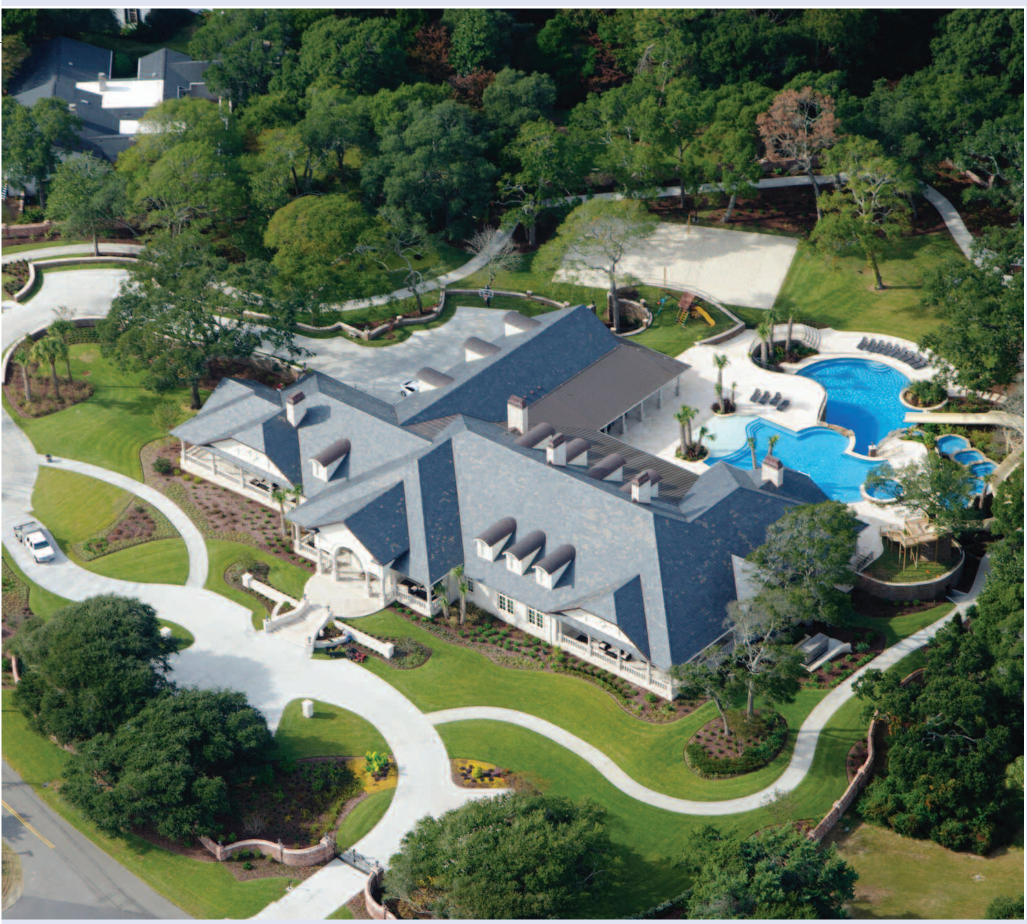


How the Tax Cuts and Jobs Act Might Change Estate Planning

By Martin M. Shenkman

The Tax Cut and Jobs Act (TCJA) was signed into law by President Trump on December 22, 2017 and is the most comprehensive tax law change in decades. Far from the advertised simplicity, however, the TCJA introduces tremendous changes, and for many individuals it introduces considerable complexity. With all this uncertainty, CPAs will need to react quickly, given the massive changes in the law. While the planning suggestions below will hopefully be helpful and practical, they should be read in consideration of what the final passed legislation contains.



Estate Tax Non-Repeal and Exemptions

The final legislation does not include a full repeal of the estate tax; however, it does temporarily double the exemption. This will transform estate planning, as many individuals will presume that, based on the higher exemptions, estate planning is no longer required. CPAs will have to educate clients that the high exemptions might merely prove to be a window of planning opportunity before a future administration changes the estate tax rules yet again. Regardless, the full array of non–estate tax planning, such as business succession planning, later life planning, and asset protection, will remain vital for all clients. Advisors will have to explain these needs to individuals and motivate them to take important steps when they, associating estate planning with only tax planning, no longer perceive a need to plan as a result of high exemptions. Even moderate-wealth individuals should use the high exemptions while they can.

This suggestion might immediately invoke concerns regarding the many individuals who felt buyer's remorse after funding significant wealth transfers in 2012, fearing (unfoundedly, as it turned out) that the exemption might decrease from \$5 million to \$1 million in 2013. But most of the 2012 buyer's remorse was based on planning that did not provide individuals with adequate access to the funds transferred. The answer to that issue is ensuring that transfers exploiting the new doubled gift tax and GST exemptions are made into trusts, specifically trusts that provide the grantor access to the assets transferred. Married individuals can use spousal lifetime access trusts (SLAT), with which the grantor spouse can benefit from the trust assets, and the individual might indirectly benefit.

Another technique is the use of self-settled domestic asset protection trusts (DAPT); the individual herself could be a beneficiary of such a trust. While this could be a great plan for a single individual, there are risks in a state that does not permit such trusts (e.g., New York). While some support the theory that a New York resident can set up a DAPT in a state that permits them (e.g., Alaska), others disagree. A variant of this planning is to set up an "almost-DAPT," wherein the individual/settlor is not a beneficiary of at inception, but descendants of his grandparents could be added by a nonfiduciary; that would provide a safety valve to add the individual back as a beneficiary. While these techniques will likely become part of every planner's tool kit, and although the new law seems to suggest that use of the new exemption will not be recaptured after the sunset, there remains the possibility that a future tax law change that rolls back exemption amounts could be accompanied by the clawback of prior gifts.

SALT

One of the major changes that will have a dramatic impact for advisors in high-tax states, such as New York, New Jersey, and Connecticut, is the restriction of the state and local tax (SALT) deductions for income taxes and property taxes with a $10,000 cap. Some taxpayers may endeavor to shift property taxes to business entities where the restrictions do not apply, and other might consider claiming home office deductions to obtain more deductions.

Domicile

Individuals have always evaluated the benefits of changing their domicile to low-tax jurisdictions, such as Florida, to avoid the estate tax in, for example, New York. The loss of the SALT deduction might accelerate this trend, as the net income tax cost of remaining in a high-tax state will be more significant every year. CPAs will likely have more individuals requesting guidance on tax and related planning to change domicile. In addition to the traditional steps necessary to sever the old domicile and establish a new one, moving expenses may no longer be deductible (although many of the individuals making such a move may not have qualified for a moving expense deduction under prior law). While a proposal to change the qualification period to obtain the home sale exclusion from two out of five years to five out of eight years was not enacted, eliminating moving expense deductions, capping mortgage interest, and limiting property tax deductions may make the cost of selling the old home more significant. Finally, new estate planning documents that are signed in the new state of domicile and recite the individual's residency in that state should be obtained.

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Nongrantor Trust Variations

The doubled estate tax exemption and the reduced SALT deduction may also drive advisors to thread a new trust tax needle. Most trust planning results, with one major exception, in the creation of grantor trusts. The taxation of trust income to the grantor is an effective tool to burn or reduce the individual/grantor's estate and facilitate further tax oriented planning (e.g., swaps of trust assets for personal cash to obtain a basis step up on highly appreciated trust assets). Some high-earning individuals use incomplete nongrantor (ING) trusts to shift income out of the reach of state tax authorities; these trusts are funded with incomplete gift transfers and structured to avoid grantor trust status. Thus, income, such as a large capital gain on the sale of stock might be earned inside the ING and avoid high state taxation. This technique has become so successful that New York has enacted legislation to treat such trusts as grantor trusts subject to New York taxation.

For wealthy individuals, the above planning may continue. For many individuals with more moderate wealth (e.g., $10–$40 million) who reside in high-tax states, however, a different variation of the above planning might be preferable if feasible. While these individuals may be so wealthy that estate tax planning should continue, they may not be wealthy enough to afford to give up access to their trusts. Furthermore, with the restriction of the SALT deduction, it may be prudent to shift investment income to a different low/no tax jurisdiction if feasible. Could these individuals structure completed-gift, nongrantor trusts to achieve both goals? Would it be feasible to have a spouse as a named beneficiary, or the grantor only receive distributions with the consent of an adverse party in order to avoid grantor trust status? Could such trusts be planned around New York's anti-ING legislation and avoid grantor trust status for New York purposes? The IRS might argue that such consent constitutes a gift—but how might the value of that gift be measured? In addition, with the new higher exemptions, the risk for most will be academic.

A trust may distribute income to the individual/settlor's spouse, or hold or accumulate it for future distribution to the settlor's spouse, all subject to the required consent of an adverse party, and not be characterized as a grantor trust [Internal Revenue Code section 672(a)]. An adverse party is a person having a substantial beneficial interest in the trust who would be adversely affected by the exercise or nonexercise of the power; this might include trust beneficiaries, such as an adult child. A variation of the Beneficiary Defective Irrevocable Trust (BDIT) might also qualify in the above context. A BDIT is an irrevocable trust that is grantor, for trust taxation purposes, to the beneficiary and not the settlor. For example, a parent may set up a trust for a child crafted to avoid all incidence of grantor trust status to the parent/settlor, but include an annual demand or *Crummey* power making the trust grantor to the child/beneficiary. If the parent lives in a high-tax state, like New York, and the child in a no-tax state, like Florida, this shift of business opportunity might save on state taxes.

For individuals residing in low-tax states, more traditional grantor trust planning, as described above, may be preferable.

Pass-through Entities Held in Trusts

Although the Senate bill specifically excluded trusts and estates owning pass-through entity interests from the favorable 20% deduction for business income, the TCJA does not include that restriction. The complexity of these rules, as well as the dramatic change to the corporate tax rates, will require an analysis of the new rules, the entity format of individual business interests, the implications of trust ownership, and much more. These new wrinkles will add complexity to the planning issues noted above.

No Easy Task for Planners

While simplification and reform of the tax system, and repeal of the estate tax, were the stated goals of this legislative effort, it appears that the sausage-making process has yet again morphed into more complexity, myriad questions, and planning opportunities and traps CPAs must decipher. Non-tax planning, in particular asset protection planning, should receive new attention. Planners should guide clients to new types of estate transfers to secure the new higher exemptions before they sunset or are modified. All existing planning needs to be revisited. The more things change, the more they stay the same. ❑

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