Estate Taxation: Greater Certainty for a While

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ABSTRACT

With the passage of the Tax Cuts and Jobs Act of 2017, estate planners now have greater certainty as to the future of federal estate, gift, and generation-skipping taxation—at least, for a while. We look at several techniques that can be used if or when the estate tax resumes in 2025.

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With the passage of the Revenue Reconciliation Act of 2017 (also known as the Tax Cuts and Jobs Act of 2017) (2017 act), estate planners now have greater certainty as to the future of federal estate, gift, and generation-skipping taxation—at least, greater certainty than existed through 2016, when it seemed possible, if not probable, that the estate tax might be repealed.[1] If we pause for a moment and take the long view of estate taxation into account, we quickly realize that certainty is elusive. Certainty, like permanence, is great while it lasts, until it becomes upended by time and events.

A Little History: Is the Past a Prologue?

In an oft-quoted phrase, Justice Oliver Wendell Holmes stated that "a page of history is worth a volume of logic."[2] Let's look at a page of estate tax law history. First, the estate tax exemption has not decreased since 1935, when it decreased from $50,000 to $40,000. That statement ignores two other facts that might refute it upon closer scrutiny. First, an obvious one: The estate tax went away altogether in 2010, when it was repealed for a year (with the loss of a step-up in basis for those estates whose executors chose to avoid estate taxation). A more subtle form of effective reduction was when the estate tax exemption remained unchanged for years at a time even though asset values grew because of inflation, notably from 1942 through 1976 when it was $60,000 and from 1987 through 1997 when it was $600,000. After its sabbatical in 2010, the estate tax

returned in 2011 with a $5 million exemption and indexing, which annually increased it according to the cost of living until it reached $5.49 million in 2017. Without the new tax law, it would have increased to $5.6 million this year. However, the 2017 act doubled the exemption so that it is now about $11.2 million. [More precisely, it is $11.18 million in 2018 because the method of calculating inflation adjustments in 2018 and later years is now based on a chained Consumer Price Index (CPI) instead of the former method of calculating CPI, which will lead to smaller increases in the CPI than had formerly been the case.]

Who Is Affected by Estate Tax Changes?

At first blush, the pool of possible clients concerned about federal estate taxation will decrease as the exemption reaches $11.18 million. It is estimated that about 11,300 federal estate tax returns were filed in 2017, of which about 5,500 are taxable. In 2018, it is estimated that about 4,000 returns will be filed, and perhaps 1,800 might result in the payment of estate tax.

However, the changes to the estate tax law, along with many other changes introduced by the 2017 act, are in effect only through December 31, 2025, so we have this back-to-the-future effect in our laps. After a period of relative certainty when the exemption reached $5 million and seemed to be permanently in place (other than indexing changes), we now have a planning horizon that is scheduled to cut the exemption in half after 8 years. In 2001, the estate tax exemption increased from $675,000, in increments, until it reached $3.5 million in 2009. That development called for wholesale changes to be made to estate tax planning strategies, with an increased emphasis on maintaining flexibility in those strategies.

How to Approach Estate Tax Planning Now

We all know that to be effective, an estate plan must function effectively if premature death occurs—clients die much sooner than expected for whatever reason. At the same time, the plan usually incorporates various elements of projection as to life expectancy, growth, or depletion of estate values, and not least, likely developments in the tax law. With the doubling of the estate tax exemption, it is now all too easy for clients and their advisors to be lulled into a fool's paradise of shrugging off planning measures. Perhaps a review of the estate tax law with an affluent client should begin with considering the probability that the client(s) will live for 8 years. It's worth pointing out that, until age 81 (males) or age 83 (females), the odds are better than even that a person will live more than 8 years. In 2026, the exemption will revert to half its then-indexed amount. Unless, of course, the tax law changes sooner, and who knows how likely that is and in which direction will it change.

Flexible Strategies

When future visibility is unclear, greater flexibility is paramount. A disclaimer trust can be an effective strategy for many clients who may not be subject to estate taxation with the current exemption but may nonetheless be taxed upon death if the exemption is reduced according to its schedule. Married spouses may leave all assets to each other, with a disclaimer trust in place as a fallback measure if the surviving spouse is concerned about avoiding estate taxation. So, all assets of one spouse pass to the other upon the first death, and, if the prospect of future estate taxation seems unlikely to the survivor, the story can end there. On the other hand, if ownership and beneficiary designations are properly structured in advance to pass an asset to the disclaimer trust if the surviving spouse disclaims, the disclaimed asset can pass to the trust. In that case, if all requirements of IRC Section 2518 governing disclaimers are satisfied, no gift is made by the spouse, and the value of the disclaimer trust is excluded from the spouse's estate for federal estate tax purposes. The terms of the disclaimer trust are generally identical to a typical nonmarital trust, and it should be administered by a trustee other than the spouse who disclaims.

Another method of deferring the estate tax planning decision until the second death of a spouse is to have a single trust established by each spouse. The

single trust has a dual identity: Its terms permit it to function as either a typical nonmarital trust or as a marital trust if a qualified terminable interest property (QTIP) election is made, or it can be divided to serve both purposes. All income must be paid to the surviving spouse, and the spouse is the sole beneficiary of the trust during his or her lifetime. The trustee may also distribute principal to the spouse according to the terms of an ascertainable standard—i.e., for the spouse's health, education, support, or maintenance. Upon the surviving spouse's death, the trust assets pass as directed by the spouse who dies first.

After the first death, the trust could function as a nonmarital trust that would be funded with assets of the decedent that are equal to or less than the decedent's estate tax exemption. Let's assume that the spouse and another person are co-executors. After considering the prospect of estate taxation at the surviving spouse's subsequent death, based upon the spouse's age, health, projected asset values, and the exemption, the trust may be left as a nonmarital trust. Or a portion of the trust may be left as is, and the nonspouse executor may make a QTIP election for the balance of its value.

For example, suppose that husband leaves $15 million to a trust for wife that could qualify as a QTIP trust and/or a nonmarital trust. If a QTIP election is filed for $6 million, that amount would be administered as a QTIP trust. The remaining $9 million would absorb that much of the husband's estate tax exemption and would comprise a nonmarital trust. If the estate tax exemption then available is $11.2 million, by filing the federal estate tax return for her husband's estate, the wife can earmark the remaining $2.2 million as the deceased spouse's unused exemption (DSUE). At the wife's subsequent death, her estate should be able to utilize the $2.2 million DSUE amount plus whatever exemption she would then have available ("should" be able to without the effect of a clawback if the exemption decreases as scheduled, as discussed below with regard to larger gifts).

The net effect of using a single trust puts the surviving spouse in a similar position to where she would have been if the all-to-spouse/disclaimer trust approach had been utilized instead. In both cases, the surviving spouse has great flexibility, but the plan needs an additional action after the first death to secure its outcome: a disclaimer or a QTIP election. Both actions must occur within 9 months after the first death, although the QTIP election could be extended to 15 months if the estate tax return filing due date is extended for 6 months. One last point that should not be overlooked: If the surviving spouse prefers to have greater control over the ultimate distribution of assets, the direct ownership of assets offers greater control than if a QTIP election is made.

Should a Large Gift Be Made While the Gift Tax Exemption Is So Great?

Wealthy clients who can easily afford to take advantage of the double-sized gift tax exemption may want to do so while it lasts. There is no assurance that a clawback of the benefit from the larger exemption may not occur after the exemption reverts to half its size after 2025. In the conference committee reports to the 2017 act, the Senate amendment states that, in the computation of the estate tax, the secretary of the Treasury shall prescribe regulations "as may be necessary or appropriate" to carry out the purposes of IRC Section 2010(g), as to differences between the exemption in effect at the time of the decedent's death and at the time of any gifts made by the decedent.[3] In other words, stay tuned for further guidance from the IRS as to what will happen if, for example, an individual makes an $11 million gift this year and dies 10 years from now when the estate tax exemption is, say, $6.5 million. If that individual is financially comfortable making a large gift, it might as well be done while the increased exemption is available. However guidance from the IRS may resolve the issue, if a large gift is made, appreciation in value of the transferred asset can be removed from the donor's estate for estate tax purposes, whether or not a clawback occurs in the calculation of the tax if the exemption decreases. Careful attention should be given to which assets are most suitable, taking into account not only the prospect of

future appreciation but also income tax consequences of the transfer and whether a discount may apply, as for a gift of closely held stock or a limited partnership interest. Perhaps an asset sale, such as to an irrevocable grantor trust or a spousal limited access trust might also be made, or a combination of a sale and a gift.

The discussion above deals with possible strategies in forming a new estate plan that works currently and far as the eye can see, or possibly, for 8 years. In the September issue, I will also address how existing trusts or other entities might be reconsidered as the 2017 act is processed by clients and their advisors. ■

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(1) Revenue Reconciliation Act of 2017, PL 115–97 (2017).
(2) *New York Trust Co. v. Eisner,* 256 U.S. 345 (1921).
(3) "Senate Amendment," *Conference Report to Accompany H.R. 1—Tax Cuts and Jobs Act,* December 20, 2017; accessed at: https://www.gpo.gov/fdsys/pkg/BILLS-115hr1eas2/pdf/BILLS-115hr1eas2.pdf.