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The Tax Cuts and Jobs Act: Gift, Estate and Generation-Skipping Transfer Tax Reform

The Tax Cuts and Jobs Act (Act), passed at the end of 2017 by Congress and signed into law by President Trump on December 22, 2017, provides far-reaching changes to the federal tax landscape. Much has been written regarding the domestic corporate and individual income tax implications of the Act. This advisory will address the federal gift, estate and generation-skipping transfer (GST) tax impacts of the Act, as well as notable fiduciary income tax and international tax implications. On the transfer tax front, while federal gift, estate and GST taxes remain in place, the related exemption amounts have doubled until December 31, 2025. It is important to review existing estate plans, consider future planning to take advantage of the increased exemption amounts, and maintain flexibility given the current environment to avoid any missed opportunities for strategic planning.

Gift, Estate and GST Exemptions, Rates and Stepped-Up Basis

The Act retained the federal estate, gift and GST tax rates at a top rate of 40 percent, as well as the stepped-up income tax basis for assets includible in a decedent's taxable estate at death.

While the federal gift, estate and GST taxes were not repealed by the Act, fewer taxpayers will be subject to these transfer taxes due to the Act's increase of the related exemption amounts. Under the Act, the base federal gift, estate and GST tax exemptions have doubled from $5 million per person to $10 million per person, indexed for inflation. The relevant exemption amount for 2018 is expected to be $11.18 million per person, resulting in a married couple's ability to pass $22.36 million worth of assets free of federal estate, gift and GST taxes. These amounts will increase each year until the end of 2025, with inflation adjustments to be determined by the chained Consumer Price Index (CPI) (which will lead to smaller increases in the relevant exemption amounts in future years than would have resulted from the previously used traditional CPI). Without further legislative action, the increased exemption amounts will sunset, and the prior exemption amounts (indexed for inflation, using the chained CPI figure) will be restored, beginning in 2026.

While the federal estate tax exemption amount has risen, it is important to keep in mind that multiple US states impose a state estate tax. The estate tax exemption amount in some of these states matches, or will match, the increased federal estate tax exemption amount. However, in other states, such as Illinois and New York, the state estate tax exemption amount will not increase with the federal estate tax exemption amount, absent a change in relevant state law. Additionally, states may have their own laws that impact planning in that state. For example, in New York, gifts made until 2019 will be included in the base amount for calculation of state estate tax.

It should also be noted that the federal estate tax exemption that applies to non-resident aliens was not increased under the Act. Under current law, the exemption for non-resident aliens remains at $60,000 (absent the application of an estate tax treaty).

There is uncertainty about whether future legislation will address the sunset, either by extending the new exemption amounts beyond 2025 or changing the exemption amounts further. While the IRS has not yet definitely addressed how, or if, additional gift and/or estate taxes may be due on planning that takes advantage of the increased exemption (often referred to as a clawback), most view clawback as unlikely. Regardless, the potential of clawback should be addressed with advisors as taxpayers entertain prospects of planning to take advantage of the increased federal exemptions.

Given the changes implemented by the Act, taxpayers should review their existing estate plans and consult with their tax advisors about how to best take advantage of the higher exemption amounts while they are available. The following is a summary of several items which should be considered.

Review Formula Bequests

Many estate plans utilize "formula clauses" that divide assets upon the death of the first spouse between a "credit shelter trust," which utilizes the client's remaining federal estate tax exemption amount, and a "marital trust," which qualifies for the federal estate tax marital deduction and postpones the payment of federal estate taxes on the assets held in the marital trust until the death of the surviving spouse. While the surviving spouse is the only permissible beneficiary of the marital trust, the credit shelter trust may have a different class of beneficiaries, such as children from a prior marriage. With the Act's increase in the exemption amounts, an existing formula clause could potentially fund the credit shelter trust with up to the full federal exemption amount of $11.18 million. This formula could potentially result in a smaller bequest for the benefit of the surviving spouse to the marital trust than was intended, or even no bequest for the surviving spouse at all. There are many other examples of plans that leave the exemption amount and the balance of the assets to different beneficiaries. Taxpayers should review any existing formula clauses in their current estate plans to ensure they are still appropriate given the increase in the federal exemption amounts and the implications of the potential sunset of these exemption amounts. In addition, taxpayers should consider alternative drafting strategies, such as disclaimers, to maintain flexibility in drafting.

Income Tax Basis Planning

Taxpayers should consider the potential tradeoffs of utilizing the increased exemption amounts during their lifetimes to gift assets to others, as opposed to retaining appreciated assets until their death, so that those assets receive a stepped-up income tax basis. Taxpayers may want to consider retaining low basis assets, which would then be included in their taxable estates and receive a step-up in income tax basis, while prioritizing high-income tax basis assets for potential lifetime gift transactions. In addition, if a trust beneficiary has unused federal estate tax exemption, consideration should be given to strategies that would lead to low-income tax basis assets currently held in trust, and otherwise not includable in a beneficiary's taxable estate, being included in the beneficiary's taxable estate (e.g., granting the beneficiary a general power of appointment over the trust assets, utilizing the trust's distribution provisions to distribute assets directly to the beneficiary, or converting a beneficiary's limited power of appointment into a general power of appointment by a technique commonly known as "tripping the Delaware tax trap"). Consequently, the assets included in the beneficiary's estate would receive a step up in income tax basis at the beneficiary's death and would take advantage of the beneficiary's unused federal estate tax exemption amount. These techniques can be implemented in an estate plan and should be discussed with advisors.

529 Plan Changes

The Act expanded the benefits of 529 plans for federal income tax purposes. Historically, withdrawals from 529 plans have been free from federal income tax, if the funds were used towards qualified higher education expenses. Under the Act, qualified withdrawals of up to $10,000 can now also be made from 529 plans for tuition in K-12 schools. As a result, the owner of the 529 plan can withdraw up to $10,000 per beneficiary each year to use towards K-12 education. The earnings on these withdrawals will be exempt from federal income tax under the Act. However, it should be noted that each state has its own specific laws addressing 529 plan withdrawals, and not all states provide that withdrawals for K-12 tuition will be exempt from state income taxes. Taxpayers should consult with their advisors to confirm the rules in their respective states.

Planning To Utilize Increased Federal Exemptions

Given that the increased federal exemption amounts are currently set to sunset at the end of 2025, it may be prudent to make use of these increased amounts before they disappear (with a caveat that the law may, of course, change). While there are a vast number of strategies that can be used to take advantage of the increased exemptions, below is a summary of several widely applicable recommendations:

- Gifts to Trusts. Taxpayers should consider gifting assets to existing or newly created trusts in order to use some or all of their increased federal exemption amounts. For instance, a taxpayer could create a trust for the benefit of the taxpayer's spouse (a "spousal lifetime access trust" or SLAT) and gift assets to the SLAT utilizing the taxpayer's increased federal exemption amounts. The gifted assets held in the SLAT should not be includible in the taxpayer's or spouse's respective taxable estates, and distributions could be made to the spouse from the SLAT to provide the spouse with access to the gifted funds, if needed, in the future. Additionally, gifts could be made by a taxpayer to dynasty trusts (to which GST exemption is allocated), which would allow the trust property to benefit future generations without the imposition of estate or GST tax.
- Sales to Trusts. Taxpayers should also consider utilizing the increased federal exemption amounts with respect to sale transactions to grantor trusts. The increased federal exemption may provide a cushion against any asset valuation risk attendant with such sales. Taxpayers who enter into such sale transactions should consider taking advantage of the adequate disclosure rules to start the three-year statute of limitations running.
- Loan Forgiveness. If taxpayers are holding promissory notes from prior estate planning transactions, from loans to family members or others, they should consider utilizing some or all of the increased federal exemption amounts to forgive these notes.
- Allocation of GST Exemption to GST Non-Exempt Trusts. If a taxpayer's existing estate plan utilizes trusts that are subject to GST tax (GST non-exempt trusts), consideration should be given to allocating some or all of the taxpayer's increased GST exemption amount to such trusts.
- Balancing Spouses' Estates. For married taxpayers, if the value of the assets owned by one spouse is greater than the increased federal exemption amounts and greater than the value of the assets owned by the other spouse, consideration should be given to transferring assets to the less-propertied spouse. Such a transfer would provide the less-propertied spouse with more assets to take advantage of the increased federal exemption amounts, especially the increased GST exemption, which is not portable to the surviving spouse upon the first spouse's death. Taxpayers should be mindful, however, that transfers to non-US citizen spouses are not eligible for the unlimited marital deduction for federal gift tax purposes, and such transfers should stay within the annual exclusion for such gifts ($152,000 in 2018) to avoid federal gift tax. Note that the annual exclusion for gifts (to donees other than a spouse) is $15,000 in 2018.
- Life Insurance. Taxpayers may wish to review or re-evaluate their life insurance coverage and needs with their insurance advisors.
- Other Planning Options. Taxpayers should also consider other means for utilizing the increased federal exemption amounts, such as triggering a transfer under Section 2519 of the Internal Revenue Code (Code) of a surviving spouse's qualified terminal interest property in a marital trust or the formation and funding of an entity that purposely violates Code Section 2701, in each case utilizing the increased federal gift tax exemption amount.
- Unwinding Prior Planning. While consideration should be given to the above recommendations for new planning, taxpayers should also consider whether certain prior planning is now unnecessary in light of the higher exemptions and should be unwound, such as certain qualified personal residence trusts (QPRTs), family limited partnerships (FLPs) and split-dollar arrangements.

Income Taxation of Trusts and Estates

The Act added new Code Section 67(g), which applies to trusts and estates, as well as individuals, and provides that no miscellaneous itemized deductions (all deductions other than those specifically listed in Code Section 67(b)) are available until the Act sunsets after December 31, 2025. While the Act doubled the standard deduction for individuals, taxpayers that are trusts and estates are not provided a standard deduction. Under the Act, trust investment management fees (as well as executor and trustee fees related thereto) will no longer be deductible. There is uncertainty about the deductibility of fees directly related to the administration of a trust or estate (e.g., fiduciary compensation, legal fees, appraisals, accountings, etc.). Historically, these fees have been deductible under Code Section 67(e) and without regard to whether they were miscellaneous itemzied deductions or not. It is not clear at this time whether new Code Section 67(g) eliminates these deductions.

New Code Section 67(g) will also impact a beneficiary's ability to deduct excess deductions or losses of an estate or trust upon termination. Prior to the Act, it was common tax planning to carry out unused deductions of a trust or estate to the beneficiary upon termination, so the deductions could be used on the beneficiary's personal income tax return. Under new Code Section 67(g), these deductions are miscellaneous itemized deductions, and are no longer deductible by the beneficiary. It will be important to engage in planning to utilize (to the extent permissible) these deductions at the trust or estate level.

Finally, the Act made a number of taxpayer-friendly changes to the taxation of electing small business trusts (ESBTs). Non-resident aliens are now permissible potential beneficiaries of ESBTs. Also, the charitable deduction rules for ESBTs are now governed by Code Section 170 instead of Code Section 642(c), which means that several restrictions imposed by Code Section 642(c) (e.g., that the charitable donation be paid out of income and pursuant to the terms of the trust) no longer apply. Additionally, an ESBT's excess charitable deductions can now be carried forward five years, but the percentage limitations and substantiation requirements will now apply.

Additional Implications of the Act Relevant to International Tax Planning

Under the Act, there were major implications for international tax planning. Specifically, with respect to US individuals who own interests in foreign corporations, those foreign corporations may be classified as controlled foreign corporations or "CFCs" pursuant to a new definition of CFC. A foreign corporation will be classified as a CFC if more than 50 percent by vote or value is owned by US "shareholders." US "shareholders" are now defined as US persons owning 10 percent or more by vote or value of the foreign corporation. The prior definition of "shareholder" was 10 percent or more by vote only of the foreign corporation. In addition, previously, an individual was only taxed on problematic "Subpart F" income of a CFC, if he or she owned the stock of the CFC for 30 days or more. The 30-day period has now been eliminated by the Act. This change may alter, for example, post-mortem planning for US beneficiaries of foreign grantor trusts with foreign holding companies upon the death of the foreign grantor. The categorization of a foreign company as a CFC is also more likely as the definition of a CFC has been expanded to allow constructive "downward" attribution to US entities from their foreign partners, owners and beneficiaries beginning in 2017.

The Act also imposed a repatriation tax on US shareholders of "Specified Foreign Corporations". Specified Foreign Corporations include CFCs and foreign corporations in which at least one domestic corporation is a US shareholder. The repatriation tax is on the US shareholder's pro rata share of any accumulated post-1986 deferred foreign income in 2017. This repatriation tax may impact unsuspecting US individuals who did not own an interest in a CFC, but owned at least a 10 percent interest in a foreign corporation in which a US corporation also was a US shareholder.

In addition, a new tax on all shareholders of CFCs called "Global Intangible Low-Taxed Income" (not so subtly, the acronym for which is GILTI) will disproportionately impact individual shareholders of CFCs. For US corporate shareholders of CFCs, there will be a deduction against GILTI that will apparently not be available to US individual shareholders of CFCs. Exceptions to GILTI and deferred payments of the repatriation tax allow for planning opportunities for affected clients, who should reach out to tax advisors as soon as possible.

Finally, due to the fact that the US corporate tax rate has been permanently reduced to 21 percent, foreign families purchasing US real estate interests may choose to protect themselves from US estate tax exposure through two-tiered corporate rather than partnership structures. Also, foreign clients with US corporations should check with home-country advisors to see if the US corporations may be re-characterized as CFCs under their local law rule.

We Can Help

The Act contains many significant changes on the income and transfer tax fronts. Taxpayers should review their existing estate plans, consult with their tax advisors, and consider any potential changes or additional planning that should be undertaken in light of the changes to the law.

As always, the Trusts and Estates practice at Katten Muchin Rosenman LLP stands ready and able to assist with these matters at any time.

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