RECENT DEVELOPMENTS IN TRANSFER TAX STATUTES: 2018 ESTATE PLANNING OPPORTUNITIES

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Introduction

The Tax Cuts and Jobs Act of 2017 ("TCJA"), signed into law on December 22, 2017 by President Donald Trump, drastically increased the federal gift, estate and generation-skipping transfer tax exemption from its former level of $5.49 Million per individual. This outline provides a brief overview of tax planning opportunities in light of the pending changes to the tax laws.

I. Delaware Estate Tax

Governor Carney signed an estate tax repeal bill on July 2, 2017, repealing the Delaware estate tax effective January 1, 2018.

II. Federal Estate, Gift and Generation-Skipping Tax Rates and Exemptions

In 2018, the top federal estate, gift and GST tax rates are 40%. The rates are now being viewed, in effect, as a flat tax rate. Technically, the tax code contains different tax rates that apply to different sizes of estates, and the highest marginal tax rates begin at about $1 Million. However, because the estate tax exemption is well over $1 Million, the top tax rate applies to all taxable estates.

The basic exclusion amount was doubled by the TCJA for decedents dying or gifts made after December 2017 and before January 1, 2026, and that amount is indexed for inflation occurring after 2011. In 2018 the estate, gift and GST tax exemption is $11,180,000 per individual. The annual exclusion for gifts is $15,000.

The exclusion amount has not increased for non-resident alien individuals. The exclusion remains at $60,000 for nonresident alients.

The increased exclusion amount means that estate and gift taxes are irrelevant for most people. The Joint Committee staff estimates that only about 1800 of 2018 decedents will have to pay estate tax, down from 5,000 in 2017.

Portability (the ability for a surviving spouse to use a deceased spouse's unused exclusion amount) is still in place following the enactment of the TCJA.

III. "Clawback"

Since the new larger exclusion amount is set to sunset at the end of 2025, what will happen if a taxpayer makes a gift of $11 Million now but dies when the estate tax exemption reverts back to $5.5 Million? Will Internal Revenue Code Section 2001(b)(1) offset for taxes payable use the estate and gift tax exemption amount applicable at the time of the gift or at the time of the client's death? There is potential for the IRS to "clawback" nearly half of the gift into a decedent's taxable estate.

Internal Revenue Section 2001(g)(2), together with the accompanying Conference Committee Report, indicates that the Secretary is to issue regulations addressing the potential disparity between the estate tax exemption in effect at the death of the decedent and the lifetime gift exemption in effect at the time the gifts are made by the decedent, to carry out the purposes of IRC Section 2001. Fortunately, the IRS has recently issued proposed regulations that provide that individuals taking advantage of the increased gift and estate tax exclusion amounts in effect from 2018 through 2015, as provided for by the TCJA, will not be adversely impacted after 2025 when the exclusion amount is scheduled to drop to pre-2018 levels.

Note: Even in a worst case scenario where there is a clawback put into effect, all post-gift appreciation attributable to the excess gift amount would still be removed from the decedent's estate. Plus, there could be additional benefit for those individuals residing in states that impose an estate or inheritance tax but not a tax on lifetime transfers.

If the sunset does occur in 2026, there could be a huge advantage to making lifetime gifts in excess of $5.5 Million before January 1, 2026.

IV. Gift and Estate Tax Planning Issues and Opportunities

- Review Formula Clauses in Existing Revocable Trusts
    - Many estate plans are written with formula clauses that are intended to fund a "credit shelter" trust with the decedent's estate tax exemption amount. If the plan was put in place when the exemption amount was much smaller, does the plan still reflect the client's wishes?
    - Was the surviving spouse intended to only be a beneficiary of a marital trust that will no longer be funded because of the new exemption amount? If the credit shelter trust goes only to the kids, the spouse could be left with nothing.
    - Some formulas may generate state estate taxes at the first spouse's death.
- Portability Elections
    - If the first spouse dies before 2026 while the estate tax exclusion amount is still $10 Million (indexed), consider filing a return and electing portability. This should leave the surviving spouse with more flexibility in his or her planning, particularly if the exclusion amount later decreases.
    - A tax advantage of relying on portability rather than creating a credit shelter trust after the first spouse's death is the basis step-up that is achieved at the surviving spouse's death.
- Add to existing dynasty trusts or create a large dynasty trust and use up GST exemption
    - If GST exemption is applied to the trust, no estate, gift or GST tax would ever be incurred so long as the property remains in trust. A so-called dynasty trust which

permits property to pass from one generation to the next in perpetuity could preserve current tax benefits for future generations. Delaware has generally abolished the rule against perpetuities (except with respect to real property), allowing dynasty trusts to be established in Delaware.

  - Real estate can only be held in a Delaware trust for 110 years. If real estate will be transferred to the trustee, contribute it instead to a limited liability company and then transfer the LLC membership interests to the trustee to be held as an intangible asset.

- Make a gift to a Spousal Lifetime Access Trust

  - Another possibility is for each spouse to create a trust of $11.2 Million for the other spouse and descendants. To avoid application of the reciprocal trust doctrine and estate inclusion in the respective estates of the spouses, the trusts should not have identical terms. Each spouse may have access to the trust for his or her benefit, provided that access is not identical or reciprocal to the other spouse's trust. If each spouse will create a trust, it is best not to fund the trusts with the same assets and not to create the trusts at the same time. A spouse may also serve as his or her own trustee or co-trustee if distributions to the spouse are limited by an ascertainable standard, and may have significant rights and powers with respect to the trust created for his or her benefit. This is one gifting strategy whereby each spouse has continued access to trust funds, if needed.

  - Consider making the trusts non-grantor trusts for additional income tax savings possibilities (multiple SALT deductions, Section 199A deductions, etc.).

  - Note that Internal Revenue Code Section 672(e) treats a grantor as holding any interest in a trust that is held by an individual who was the grantor's spouse at the time the interest was created. Many SLATs are grantor trusts because the grantor's spouse is a beneficiary. 672(e) appears to continue grantor trust status even after divorce if the grantor's ex-spouse continues to hold the beneficial interest that caused grantor trust treatment. You may want to address whether or not the spouse will continue as a beneficiary following a divorce, otherwise the grantor may be left paying all of the income taxes associated with the SLAT even following the end of the marriage.

- Make a Gift to an Asset Protection Trust

  - Delaware is a jurisdiction that has legislation permitting a grantor of an irrevocable trust to be a beneficiary of the trust, while not generally subjecting the assets of the trust to the reach of the grantor's creditors. Such a trust may be designed for federal tax purposes as a grantor trust that is not includible in the grantor's estate for estate tax purposes, transfers to which are completed gifts for federal gift tax purposes. The grantor may contribute up to $11,200,000 to the trust, or double that amount if the grantor is married, without incurring gift tax, and may apply GST exemption of that same amount. The grantor and the grantor's spouse may be beneficiaries of the trust eligible to receive distributions during the respective lifetimes, and the trust may continue perpetually for the benefit of their descendants. This is another planning strategy that will use up gift tax exemption while assuring that the grantor and the grantor's spouse have continued access to the trust funds.

  - Consider making the APT a non-grantor trust for additional income tax savings possibilities (multiple SALT deductions, Section 199A deductions, etc.).

- Apply GST Exemption to a Marital Trust

  - In the event that an individual is unable or does not desire to use his or her gift tax exemption, he or she may still use up his or her GST exemption by creating a lifetime marital trust for a spouse and allocating GST exemption to it. During the spouse's lifetime, all of the net income of the trust must be distributed to the spouse, which would supplement other income during retirement. Following the spouse's death, the trust assets could be held in further trust for the grantor's descendants. All of the trust property, including the appreciation of the assets, remains exempt from GST tax so long as the property is held in the trust.

V. Planning Opportunities Using Powers of Appointment

- Grant a formula general power of appointment

  - A general power of appointment can be granted to cause estate inclusion in order to use up GST tax and estate tax exemption that would otherwise be lost.

    - Portions of non-exempt trusts could become GST exempt with the allocation of new GST tax exemption.

    - Assets can receive a step-up in basis at the power holder's death resulting in income tax savings.

  - A settlor can grant a formula power of appointment in a newly created trust to cause that portion of a trust to be included in a beneficiary's estate to the extent of the unused exemption. (Note: Draft the power to pull in the low basis assets first). Note: The settlor could make upstream gifts in trust for the benefit of individuals who are expected to have no taxable estate.

  - For existing trusts:

    - Is there an independent trustee or trust protector that has a power to grant a general power of appointment?

    - Can a formula general power of appointment be added by a decanting?

      - If the trustee has a discretionary principal distribution power that is not limited by an ascertainable standard, the trust could be decanted to add formula general powers of appointment. If there is an ascertainable standard, the ability to do this is questionable.

- If the settlor is living, a trust modification or nonjudicial settlement agreement could also be considered for purposes of adding such a power.

- Consider adding powers for aging relatives who are expected to have unused exemption.

- Is it preferred that the power not actually be exercised? How can this be addressed?

  - Limit the class of appointees to the creditors of the power holder's estate

  - Require the consent of a non-adverse party

  - Grant the power to a person who is not competent

- Trigger the Delaware tax trap if a beneficiary has a limited power of appointment

  - This could be valuable in cases where there is an old dynasty trust that has very low basis assets. If a beneficiary has a limited power of appointment but not enough of a taxable estate to use up his or her estate tax exemption, the beneficiary could trigger the Delaware tax trap to cause estate inclusion with the exercise of his or her limited power.

  - As a matter of Delaware law, the validity of an exercise of a power of appointment is governed by Delaware law if the situs of the trust is in Delaware at the time the power is exercised. *See Wilmington Trust v. Wilmington Trust*, 24 A.2d 309 (Del. 1942).

  - Under Delaware law, a person can exercise a limited power of appointment in favor of a further trust which contains another power of appointment (which can be a limited power) that can be exercised so as to postpone the vesting of the trust property for a period determined without regard to the date of the creation of the original power. Under Section 2041(a)(3) of the Internal Revenue Code, if someone exercises a power of appointment that creates a second power of appointment that can start a new perpetuities period running, the exercise will cause all of the assets subject to the exercised power of appointment to be included in the estate of the power-holder for federal estate tax purposes.

  - If the trust is GST exempt, in order to trigger the trap the power holder must explicitly opt-in to Section 501(a) of Title 25, which begins a new perpetuities period running under Delaware law when a power of appointment is exercised.

VI. Additional Basis Planning Opportunities

- Basis Step-Up at Surviving Spouse's Death
  - Elect portability instead of using a credit shelter trust to get basis step up at a later time.
  - QTIP all or part of the credit shelter trust to push the assets to the surviving spouse's estate for a later basis step up. The credit shelter trust would have to be drafted to meet the QTIP trust requirements.
  - A formula general power of appointment could be included in a credit shelter trust so that if the surviving spouse passes with available exemption, assets can be stepped up again to the extent of the available exemption.
- The grantor might purchase assets from a grantor trust or consider exercising a substitution power in a grantor trust to re-acquire low basis assets to get a step up in basis in his or her estate.
- Make trust distributions to a beneficiary for basis step up planning purposes.