Estate & Charitable Planning After the Tax Cuts & Jobs Act of 2017

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The Tax Cuts and Jobs Act, signed into law on December 22, 2017, by President Trump (the "Act"), nearly doubled the federal estate and gift tax exemptions for individuals, increasing the exemption from $5.49 million per individual in 2017 to $11.18 million in 2018, to be indexed for inflation each year. While this is a dramatic increase, even before the Act only a very few estates were required to file estate tax returns and even fewer were actually paying any estate tax[1]. Our clients can now either gift during their lifetimes or leave to a non-spouse at their death $11.18 million in assets, and for our married clients, they can structure their estate plan to leave $22.36 million with no imposition of gift or estate taxes. The past decade has seen dramatic changes to the estate and gift tax landscape, with exemptions as low as $2 million in 2008, increasing to $5 million in 2010 and 2011 and increasing each year thereafter by an inflation adjustment.

Because the Act sunsets these estate and gift tax changes at the end of 2025, and because we cannot predict whether or not a client's death will occur within this window, most estate planning considerations are still being made with the assumption that the exemptions will revert back to $5 million per person (indexed for inflation) beginning January 1, 2026. This window of time provides some very unique lifetime gifting opportunities for wealthier clients, some of which can and should incorporate charitable giving. For our clients who are wealthy but who will likely not have a taxable estate even after reversion back to lower exemptions, we can still recommend some strategic planning that can incorporate charitable giving.

When estate exemptions were much lower we would include projections of a client's estate tax liability as part of the planning discussion. Although this practice is becoming increasingly rare, the same concepts still apply to a client's overall estate plan, meaning, the less estate taxes they will owe results in more money they can leave to family members and/or charity. Many commentators have projected that, since the higher exemptions will result in fewer taxable estates, testamentary bequests to charity will decrease because there will be no need for the estate to claim the unlimited charitable deduction. Let's start with an example that I hope illustrates why a charitable deduction for estate tax purposes (in and of itself) would not motivate a taxpayer to leave assets to charity:

George is a widow (his wife Louise having predeceased many years ago) and has one adult child, Lionel, and an estate valued at $10 million. If George died in 2017

[1] According to the Tax Policy Center, for decedents who died in 2017 there is estimated to be only 11,300 estate tax returns filed with only 5,500 of those being taxable.

leaving everything to Lionel, his estate tax liability would generally look like the following:

Gross Estate	$10,000.000
Federal Exemption	- 5,490,000
Taxable Estate	$ 4,510,000
x 40% tax rate[2]	-1,804,000
Balance after Taxes	$ 8,196,000

What would George's estate tax liability look like if he had made testamentary charitable bequests? George would have been able to reduce his tax liability by $1.00 per each $2.50 bequest that he made to charity in his Will or other testamentary instrument. In this example, in order to eliminate his tax burden entirely, George would have to leave $4,510,000 to charity, which would mean that Lionel would be left with the balance of $5,490,000.00 versus $8,196,000.00 in the scenario where no taxes were paid and no charitable contributions were made.

If George instead dies in 2018, his single federal exemption of $11.18 million now exceeds his gross estate, meaning he now has $10 million to distribute however he desires without any adverse tax consequences. Assume also that George had made plans years before when he was expecting to have a taxable estate and purchased $2 million in life insurance through an irrevocable life insurance trust (ILIT) to cover his expected tax liability. Because the life insurance proceeds are not included as part of George's gross estate with a properly structured ILIT, he now has $12 million available to distribute estate tax free.

In my experience, clients are much more inclined to make charitable donations when they have an abundance of assets, and particularly where they feel they will end up with more assets than they were previously expecting. For those clients of ours who already have created and funded ILITs, we do not recommend termination of those trusts and can now encourage that these funds be used to replenish their estates if they desire to make charitable contributions at their deaths or even during their lifetimes where they can take advantage of the increased allowable charitable income tax deductions implemented by the Act. With less of their estates going to the IRS, clients should be even more motivated to donate to charities from any such excess. For those clients who are not inclined to make charitable donations, more is now able to pass estate tax free to their children and/or grandchildren who are all potential donors.

LARGER EXEMPTIONS HAVE SHIFTED OUR FOCUS: FROM ESTATE TAX SAVINGS TO INCOME TAX SAVINGS

Although the new very large exemptions will not impact most people, estate and financial planners have to assume for now that the 2025 sunset will happen and that most of our clients will still be facing the $5 million individual estate and gift tax

[2] Simplified for illustrative purposes. The federal estate tax rate is actually progressive, however, the maximum rate is reached at $1,000,001.00 in taxable assets.

exemptions. These high exemption levels when combined with the "portability" election will lead many individuals to believe they no longer have any tax planning to worry about, however, this is absolutely not the case. The portability election was made permanent by the American Taxpayer Relief Act signed by President Obama on January 2, 2013. In general, portability is a rule allowing the surviving spouse of a decedent to utilize the deceased spouse's unused exemption for making future lifetime transfers and/or for the use at the death of the surviving spouse. Portability, when combined with the larger exemptions we have seen this decade, has been a game changer in the estate planning world because we can recommend to fewer clients that they have to separate assets in order to fund credit shelter trusts[3]. For most married couples we can now recommend wills that leave everything outright to the surviving spouse with an option for the survivor to disclaim to a marital or credit shelter trust in the event there is an unexpected estate tax issue or other non-tax reason to fund a trust, such as for creditor protection.

In the past, we would create provisions in wills that would fund testamentary credit shelter trusts, whether mandatory or subject to a disclaimer. Now, however, for couples who have combined estates of less than the combined federal exemption (and who desire that assets pass in trust for their spouse rather than outright) we would likely want to fund a marital trust at the second death. Every client's situation will vary of course, but for those who will most likely not have a taxable estate we want to ensure that their children will not have to pay capital gains taxes on what they inherit once they turn around and sell those assets. To the extent that assets can pass outright to a surviving spouse or fund a marital trust for which a QTIP election can be made to take advantage of the unlimited marital deduction[4], those assets will all be included in the survivor's estate and so will receive a step up in basis at the surviving spouse's death. Because of the available portability election, the surviving spouse will now have use of their deceased spouse's exemption as well as their own exemption at the survivor's death. For those couples safely below $10 million in assets (remembering we have to assume that the sunset will occur in 2025), our focus has now entirely shifted to minimizing income taxes for future generations when they later sell the assets they inherit.

What do we do about those credit shelter trusts created many years ago where we still have a surviving spouse who is living? These families have options to consider that would involve transferring low basis assets from the trusts to the surviving spouse during such spouse's lifetime so that they will be owned by such spouse at their death and thus would receive a step up in basis. It is possible such a distribution/termination

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[3] Credit shelter trusts have been used in the past to absorb the separate assets of a decedent up to the amount of their remaining available exemption from estate taxes. Before portability if a decedent did not own separate assets at their death and those assets passed to their surviving spouse, the deceased spouse's exemption would be forever lost and the couple's combined assets would all be included in the survivor's estate with only the survivor's exemption amount available.

[4] The QTIP election allows a properly structured trust created for a spouse to be treated as "qualified terminable interest property" under IRC §2056 so that the marital deduction can be claimed for the assets transferred to such trust.

will create gift tax issues in some situations, however with the current $11.18 million exemption for both estate and gift taxes, it is the perfect time to take advantage of transferring those assets out of the trust even if it means there may be a gift to the children as the remainder trust beneficiaries after the surviving spouse's death. This is not the right solution for every lingering credit shelter trust out there, even if the numbers work out. Many times these trusts are created with the knowledge of possible adverse tax consequences in the future, most of the time where the testator desired to include their children as beneficiaries during the surviving spouse's lifetime and/or to control the ultimate disposition of the assets, such as in a blended family situation. Estate and financial planners must ask the right questions and where there are opportunities to "undo" these credit shelter trusts and save our clients or their descendants from having to pay unnecessary capital gains taxes we need to educate them of the opportunities available, because for some they may not be available after 2025.

THE ACT HAS CREATED UNPRECEDENTED OPPORTUNITIES FOR VERY WEALTHY CLIENTS

The Act creates this window of time where individuals who would have a taxable estate under the 2017 levels, but not under the current levels, to make current gifts to take advantage of this excess. If George from our prior example would like to ensure that he does not have a taxable estate in the event he dies after 2025 and the exemption returns to $5 million, he has the opportunity to gift $5 million now to his child and/or grandchildren. The current $11.18 million is an exemption from not only estate, but also gift and generation skipping transfer taxes, so George can spread this gift out over several generations and absorb not only this additional estate tax exemption but also his generation skipping transfer tax exemption. If George makes this gift to a trust for his child and his grandchildren and allocates his GST exemption, then so long as these assets remain in trust they will never be included in a lower generation's estate for estate tax purposes.

If George wants to take advantage of this gifting opportunity and also incorporate charitable giving, he can consider one of several charitable trust options that would allow him to still provide for his child and grandchildren, give to charity and in some cases take advantage of a charitable deduction for income tax purposes.

CHARITABLE SPLIT INTEREST TRUSTS

We have advised our clients for many years of their two main options for giving through split interest charitable trusts, meaning a trust that benefits both charitable and non-charitable beneficiaries. Those options take the form of either a charitable lead trust (CLT) or a charitable remainder trust (CRT). CLTs provide income payments to at least one qualified charitable organization for a period measured either by a term of years, the lifetime of one or more individuals or based on the lifetime of an individual followed by a term of years and at the end of the trust term, the remainder is paid to one or more non-charitable beneficiaries, usually the donor's children and/or grandchildren.

CLTs are normally structured as non-grantor trusts, meaning that the donor does not receive a charitable donation deduction for income tax purposes, however, the income generated within the trust during the trust term is not taxable to the donor. A particular type of CLT (a charitable lead annuity trust or CLAT) is exceedingly more popular in low interest rate environments because the goal over the trust term is for the trust investments to outperform the low interest rate fixed as of the trust's inception so that ultimately more is left to the donor's children gift and estate tax free.

CRTs are the reverse of CLTs and provide payments to one or more non-charitable beneficiaries during the trust term and upon the termination of the trust term pay out to a charitable beneficiary. Most CRTs are structured to provide the donor with with a charitable contribution deduction upon creation of the trust, which deduction will equal the present value of the remainder interest passing to the charity. CRTs are more popular in higher interest rate environments because the higher the interest rate the higher the present value of the remainder interest and thus the greater the charitable income tax deduction. With interest rates projected to increase this year and to continue to increase for the foreseeable future, discussions of CRTs will become more popular.

Regardless of which type of trust we use, we still have to calculate the present value of the term (in the case of a CRT) and remainder (in the case of a CLT) interest in order to determine the amount of the taxable transfer to the donor's family members. Once this is determined the donor must reduce their estate/gift tax exemption by that amount. Now that most taxpayers (even very wealthy ones) have an abundance of exemption available (at least until 2025), we can recommend the use of CLTs now before the upcoming projected interest rate increases and we can encourage that they use up this excess available exemption. Once it disappears it is likely gone for good and there should be no clawback of any amounts gifted during this time period[5].

CONCLUSION

The recent changes to the estate and gift tax laws are dramatic and provide some unique opportunities for our clients. As financial and estate planners we must inquire not only as to a client's current plan but also to past planning for them and the generation or two above them, as the new larger exemptions provide opportunities to correct older techniques that have already been put into action. Overall, clients should feel optimistic that most can now focus entirely on how they want to direct their assets at their death without any concern of an estate tax. For those clients who still have the concern of a taxable estate, we must insure that they are informed of the narrow window of time available to make some aggressive gifts and the potential consequences if they do not act. For our clients who are charitably inclined, we can provide them with many split gifting techniques that will be more attractive to them now that most can freely make gifts to children and/or grandchildren without any fear of adverse estate and/or gift tax consequences.

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[5] Planners are still awaiting clarification on IRC §2001 that the IRS will not clawback any lifetime transfers if and when the exemption levels revert back for those decedents dying after such reversion.