ESTATE PLANNING IN A HIGH EXEMPTION ENVIRONMENT

By: Geoffrey N. Taylor, Esq.

I. INTRODUCTION

A. One of the many, major changes made by the Tax Cuts and Jobs Act ("TCJA") has significant implications for estate planning. Under the TCJA, the combined gift and estate tax exemption jumped from $5,000,000 as adjusted for inflation to $10,000,000 as adjusted for inflation. The amount for 2018 with the inflation adjustment is $11,180,000 per person. Thus, a husband and wife have a combined estate tax exemption of $22,360,000.

B. In some ways this increase is not as significant as it might seem, given the exemption has been at a robust $5,000,000 since 2010, and hasn't been less than $1,000,000 for almost 20 years.

C. However viewed, the reality is the estate tax in its current form applies to very few individuals and families.

1. How does this impact planning for clients?

2. How should existing plans be modified?

3. What if existing plans cannot (apparently) be modified?

II. HOW DOES THIS IMPACT PLANNING FOR CLIENTS?

A. Clients may feel they don't need an estate plan because of the high exemption. After all, estate planning is only for the rich, right? The answer to that question is a resounding "no."

B. Generally, the purpose of an estate plan is to provide for your family, and the TCJA does not change that. Many nontax reasons for estate planning remain, including:

1. To avoid probate at death and minimize the expense of administering an estate upon death. A Will alone does not avoid probate. Other options include joint ownership, beneficiary designations, and transfer/payable on death designations.

2. To make certain assets actually pass to the people they wish to benefit upon death in the manner they determine. Without a Will, a person is said to have died "intestate" and the State of Michigan's plan for who receives their assets will apply which may, but often won't, accomplish the client's estate planning goals.

3. To utilize trusts as a vehicle through which young and other beneficiaries with unique needs to receive their inheritance.

4. To designate who will make financial and medical decisions in the event of a disability and to avoid the costs/hassles of a guardianship or conservatorship.

5. To protect assets (and their child's inheritance) from lawsuits, creditors, or the claims of a spouse upon divorce.

6. To avoid issues upon death in second marriages and blended families.

C. The permanency of estate tax exemption "portability" (where any unused estate tax exemption of the first spouse to die can be carried over to and used by the surviving spouse) and the larger exemption mean most married couples do not need tax-oriented estate planning.

This has caused a shift away from having separate trusts for a husband and wife and using a single, joint trust instead. Many issues can arise when considering using a joint trust.

1. The psychology of keeping assets together rather than dividing them between separate trusts appeals to many clients.

2. Joint trusts can be administratively easier when the first spouse dies, because the surviving spouse does not need to file separate tax returns or provide accountings to remainder beneficiaries.

3. Typically, each surviving spouse can remove all assets of the joint trust. Therefore, a joint trust might not be the best approach if the marriage is troubled.

4. For couples in a second marriage and with one or more separate children, it is generally not a good planning option because of the flexibility and control granted to the surviving spouse on the first death. For example, the surviving spouse may disinherit a child from a previous marriage or relationship.

5. If a spouse has or may receive significant separate, non-marital property, using a joint trust may result in the conversion of the property from separate to marital. In this case a preferred approach may be to have separate trusts for separate property and a joint trust for the marital property.

6. Generation Skipping Transfer Tax. A joint trust is not an appropriate vehicle in (rare) instances where both spouses need or want to use all or substantially all of their exemptions from generation skipping transfer tax because portability does not apply to generation skipping transfer tax.

D. Planners are now focusing far more on income tax issues in place of gift and estate tax issues.

1. Changing Marital Trust/Family Trust funding formulas (discussed below) should be considered.

E. The sunset looms, albeit on the distant horizon. The increased exemption amount is scheduled to end as of January 1, 2026, at which time the exemption will revert to the $5,000,000 amount (plus inflation). Of course, Congress may make further changes (perhaps good or bad) to the estate and gift tax laws in the coming years.

1. For wealthier clients, this sunset may make it very worthwhile to make large gifts (e.g., in excess of $5,000,000) over the next few years.

2. The gifting will take the appreciation in the gifted assets out of the client's estate without incurring gift tax and, depending on the size of the gift, may use exemption that will be lost in the future.

3. One downside is that assets gifted during life will lose the benefit of the step-up in basis at death.

4. Another downside is a potential problem relating to "clawback," where a taxpayer makes a gift that was exempt from tax at the time of the gift but is in excess of the estate tax exemption when the donor dies. It is believed, but not certain, that gifts made under the current high exemption amounts will not result in taxation later if the exemptions are reduced.

5. Clawback may also be an issue where an estate elects portability and the exemption subsequently decreases at the death of the second spouse. The IRS may attempt to reduce

the unused exemption amount of the first-to-die spouse upon the passing of the second-to-die spouse. However, if a bypass trust is used, the assets funded into the bypass trust never become a part of the estate of the second-to-die, and thus, should not be clawed back into the estate of the second-to-die.

III. HOW SHOULD EXISTING PLANS BE MODIFIED?

A. The new exemption amount may result in some unintended consequences in the operation of an estate plan, particularly for married couples.

B. If a married couple has separate trusts, one issue is whether two trusts are still needed, or whether a joint trust is preferable.

1. Even where a switch from separate trusts to a joint trust makes sense, some clients are hesitant to go through the process of retitling assets.

2. If one spouse's trust has significantly more assets, one possible way to reduce this downside is to amend and restate that spouse's trust as a joint trust and transfer the assets of the other's spouse's trust to the (new) joint trust.

C. If separate trusts will be retained, the dispositive provisions of the trusts, particularly those provisions that apply during the surviving spouse's lifetime, need to be carefully examined.

1. Most estate plans for a married couple contain an allocation formula that divides assets between a Marital Trust and a Family Trust (also known as a credit shelter trust) when the creator of the Trust dies. In order to reduce estate taxes prior to portability, assets are allocated first to the Family Trust in an amount equal to the deceased spouse's remaining estate tax

exemption, with the balance of the assets allocated to the Marital Trust, which qualifies for a marital deduction and defers estate taxes until the death of the surviving spouse. This formula resulted in no estate tax upon the death of the first spouse, no matter how large the estate.

2. In order to avoid the assets in the Family Trust from being included in the estate of the second spouse, the Family Trust has some restrictions on the distributions and the surviving spouse does not have unfettered control of the Family Trust assets. For example, where the spouse is the sole trustee, distributions to the surviving spouse may only be made for the health, education, maintenance and support of the surviving spouse in order to prevent the Family Trust assets from being included in the surviving spouse's estate. On the other hand, the surviving spouse is very often given complete access to and control over the assets in the Marital Trust.

3. When the estate tax exemption was lower, this was not much of an issue. However, the surviving spouse may not be happy with all of the trust assets being allocated to the Family Trust and no assets allocated to the Marital Trust.

4. Allocations to the Family Trust also limit the ability of this Trust to receive a step-up in basis upon the death of the surviving spouse (while we refer to this as a "step-up", it is actually a new basis at the time of death, which could also be a reduction in basis if the value of the asset has declined since it was purchased). Assets in the Family Trust do not receive a new basis upon the death of the surviving spouse since the assets in the Family Trust are not included in the estate of the surviving spouse. However, assets in the Marital Trust will

receive a new basis. If there is an increased basis, capital gains tax on a later sale assets may be reduced or eliminated.

5. For example, under the old law, if the deceased spouse had an estate of $7,000,000, approximately $5,000,000 would be allocated to the Family Trust and $2,000,000 allocated to the Marital Trust. Under the new law with the increased exemption, the full $7,000,000 is allocated to the Family Trust and nothing to the Marital Trust.

D. If separate trusts will be retained, the clients should be advised regarding the advantages and disadvantages of changing the Marital Trust/Family Trust funding formula.

1. A common approach is to allocate all assets to the Marital Trust. This ensures a step up in basis of all of the couple's assets upon the passing of the surviving spouse.

2. For second marriages and other blended families, a Marital Trust that gives the surviving spouse full access to the assets may not be appropriate. Instead, the traditional QTIP trust could be used to provide for a full step up without allowing the surviving spouse to change the ultimate disposition of the assets (e.g., away from the children of the predeceasing spouse).

3. If the surviving spouse has (or may have) creditor issues and full control over the assets, the spouse's creditors can also reach the assets. Again, the QTIP trust may be preferable.

E. If the plan involves significant bequests to grandchildren or "dynasty" planning, great care must be taken to ensure generation skipping transfer taxes are minimized because portability does not apply to the generation skipping transfer tax exemption.

IV. WHAT IF EXISTING PLANS CANNOT (APPARENTLY) BE MODIFIED?

A. Although the estate tax now applies to so few clients, many clients have irrevocable trusts that were created and funded to reduce estate taxes. If there is no longer a need for those irrevocable trusts, what can be done?

B. The client may want the assets back.

1. The income tax savings to the client's beneficiaries as a result of the step up in basis can be huge (e.g., commercial real estate with a 754 election).

2. However, if the assets are returned to the client and the exemption sunsets back to $5,000,000, will the client now have a taxable estate?

C. Even if the client does not necessarily want the assets back, often times the trust provisions become no longer appropriate as a result of changed circumstances.

1. The client may want to remove a beneficiary, such as a former spouse or an estranged child.

2. The client may want to add a beneficiary, such as a new child or grandchild.

3. The client may want to change asset allocations or distribution provisions (e.g., "pop out" ages).

4. The client may want to change trustees.

D. What can be done?

1. Read the trust agreement, read the trust agreement, and read the trust agreement (and then read it again).

a. Is anyone, such as a spouse, granted a power of appointment? These powers are often limited in terms of permitted appointees (only the client's children or charities). If a beneficiary holds the power, the beneficiary has to be careful about the potential tax consequences of a lifetime appointment.

b. Is there a "trustee appointer" who can remove and replace trustees? These powers are often limited in terms of permitted appointees (only someone who is not related or subordinate to the client).

c. Is there a "trust protector" who can amend the trust agreement?

2. What if the trust agreement doesn't provide any help?

a. Can the parties enter into a nonjudicial settlement agreement under MCL 700.7111? This avoids court involvement and can be used to (i) interpret the terms of the trust, (ii) approve a trustee's accounting, and (iii) fill a trustee vacancy. It cannot be used to (i) violate a material purpose of the trust, (i) modify the trust, or (iii) terminate the trust. Its application is therefore fairly limited.

b. Can the parties pursue a judicial modification under MCL 700.7411? This requires petitioning the court. Will the court "rubber stamp" a modification if the grantor, trustee, and all trust beneficiaries agree? What if less than all beneficiaries agree? Note that the statute requires the court to conclude that the modification is consistent with the material purposes of the trust.

c. Can the trustee "decant" the assets of the trust into another trust under MCL 700.7820a? The trust agreement must include a "discretionary trust provision" as defined MCL 700.7103 (it usually does). However, the terms of the second trust cannot "materially change the beneficial interests of the beneficiaries of the first trust." See also MCL 556.115a.