After Tax Reform: Practical Planning for the 99%

By Nicholas A. Reister

History has shown a steady increase in the federal estate tax exemption. It has not been smooth sailing, but a long-term view of the federal estate tax reveals a trend toward estate taxes only impacting a very small fraction of the population. While we all know that past performance may not be a guarantee of future results, odds are high that the vast majority of our clients no longer need to be concerned about their estates being impacted by estate taxes. This article seeks to explain strategies by which you may deliver value to your clients by improving their existing plans while creating flexibility to adapt in the future.

Summary of TCJA

In the waning days of 2017, Congress passed P.L. 115-97, commonly known as the Tax Cuts and Jobs Act of 2017 ("TCJA"). Effective January 1, 2018, the TCJA embodied the most comprehensive changes to federal tax law in decades. Among the many changes to the U.S. Tax Code brought about by the TCJA, the doubled basic exclusion amount of $11.18 million per individual forces estate planners to adjust their strategies and the advice they give to clients. Although there was a significant amount of ink spilled hypothecating about the anticipated elimination of the step-up in income tax basis upon the death of the low-basis asset's owner, IRC 1014 survived, presenting a powerful tool for estate planners seeking to deliver value to their clients by way of tax savings. While decreased estate taxes and income tax savings give clients reasons to celebrate, as Chaucer pointed out, all good things must come to an end. In this case, the good things are scheduled to come to an end as the result of a sunset provision at the end of 2025.

Scope

As a result of the increased exemption amount, fewer than 99% of clients[1] need to worry about the impact of estate taxes on their estates. Conversely, most individuals are subject to income taxes, opening the door wide for income tax considerations in estate planning. This article seeks to highlight practical considerations and techniques for planning for the vast majority of our clients who are not expected to be subject to estate taxes.

Income Tax Planning

IRC 1014 generally provides for an adjustment ("step-up") in basis to date-of-death values of assets received from a decedent. In simple terms, if a decedent dies owning an asset which has appreciated significantly in value during the decedent's lifetime, whoever receives the asset from the decedent's estate (or revocable trust) does so without concern for capital gains taxes on the appreciation experienced during the decedent's lifetime. With long-term (assets held longer than 366 consecutive days) capital gains taxed at up to 20% and short-term (assets held for fewer than 366 consecutive days) capital gains taxed at an individual's ordinary income tax rate, a thoughtful practitioner may be able to save his or her client a significant amount of money by learning how to use a few tools in our toolbox.

Basis Basics

Before pulling out the tools, it's important to understand a few general rules about basis.

1. If an asset would be includable in a decedent's taxable estate (regardless of whether the estate is large enough to require an estate tax return), then the asset will receive a stepped-up basis upon the decedent's

death to the date-of-death value.[2]

2. When dealing with jointly-owned property, only that portion of the jointly-owned property that is includable in the decedent's estate receives the new stepped-up basis. In the case of a decedent spouse, one-half of property held as tenants by the entirety with the surviving spouse or as joint tenants with right of survivorship owned only by the spouses is included in the decedent's estate and thus receives a new stepped-up basis.[3] The surviving spouse's one-half interest retains the existing basis.
3. IRC 1014(e) provides an exception to the new-basis-at-death rule. This exception seeks to prohibit deathbed transfers which would otherwise receive a stepped-up basis. IRC 1014(e) applies to transfers within one year of the decedent's death when the donor gives a gift to the decedent and upon the decedent's death, the gifted asset returns to the donor.

Tools in the Toolbox

Once a practitioner understands the general rules regarding basis, his or her eyes should be opened to circumstances in which stepped-up basis may be possible and desirable. In those instances, the practitioner should be aware of the tools made available by IRC 1014 to achieve stepped-up basis.

Testamentary General Powers of Appointment

General powers of appointment result in the inclusion of the assets over which the powers apply within the powerholder's estate. In the case of a taxable estate, practitioners work carefully to avoid general powers of appointment for this reason. However, in non-taxable estates, the general power of appointment will lead to a favorable result of stepped-up basis.

The Internal Revenue Code defines a general power of appointment as a power that may be exercised in favor of the powerholder, the powerholder's estate, the powerholder's creditors, or the creditors of the powerholder's estate.[4] While the results of including a general power of appointment can be powerful and the general power need not be exercised to achieve a step-up, a client may be concerned that the powerholder may exercise the power in an undesirable fashion. These concerns may be addressed by requiring the consent of a third party who does not have a substantial interest in the property subject to the power that is adverse to the exercise of the powerholder, the powerholder's estate, the powerholder's creditors, or the creditors of the powerholder's estate.[5]

Another solution lies in a trust giving an independent third party, not related or subordinate to the grantor or the beneficiary within the meaning of IRC 672(c), the power to create a testamentary general power of appointment. This method allows for a third party to analyze the beneficiary's circumstances and trustworthiness along with the income tax and estate tax situation to determine whether the creation of a testamentary general power of appointment is likely to lead to a favorable result.[6]

Outright Gifts to (Slowly) Dying Individuals

This strategy does not come without a healthy share of risk. As a result, this strategy will only apply in a few circumstances and should only be employed after extensive documented conversation with the client about the risks. Understanding that IRC 1014(e) denies stepped-up basis for assets given to a decedent within one year of death which assets are then returned to the donor, the donee should be expected to live for more than one year. Beyond the risk of the donee failing to survive for one year, the majority of the risk lies in releasing control of the assets. Once the donee receives an asset outright, it is the donee's asset free of restriction. As a result, the donee could, in turn, give the asset to a third party. It is of course subject to the donee's spending habits and within reach of the donee's creditors as well.

Changing an Irrevocable Trust

Existing irrevocable trusts with appreciated assets are often candidates for basis planning. Given the drastic increase in the estate tax applicable exclusion amount over the last two decades, many trusts created for the purpose of estate tax planning are no longer needed for that purpose, but the trust assets are subject to unrecognized gains. In such cases, you may consider a modification of such a trust to include a testamentary general durable power of appointment to trigger inclusion in a beneficiary's gross estate, resulting in stepped-up basis, elimination of the capital gains tax liability, and achieving the settlor's intent to minimize the impact of taxes on the trust assets. In many cases, such a modification may achieve tax objectives that the trust's settlor could not have envisioned.

A modification to add a testamentary general power of appointment may be achieved by petitioning the probate court. Careful consideration should be given to the settlor's intent in creating the trust, the beneficiary's circumstances including marital status, the existence of creditors, vulnerability to undue influence, and likelihood of exposure to estate taxes. In circumstances where contingent remainder beneficiaries are willing to consent to the modification, judicial modification can be a particularly cost-effective method of achieving tax savings for your client.

In some instances, an irrevocable trust may be distributed and terminated to achieve the same stepped-up basis. A common scenario in which this may be desirable is when spouses establish conventional AB trusts for each other, one spouse dies, and the surviving spouse survives for many years. The surviving spouse's longevity affords the trust assets the time to appreciate significantly, but the trust was created to avoid inclusion in the surviving spouse's estate for estate tax minimization purposes. Since those assets will not be included in the surviving spouse's estate, the gains will be taxable regardless of the surviving spouse's death. In this instance, it may be appropriate to distribute the assets outright to the surviving spouse so that they will be included in the surviving spouse's estate at death. Unless a trustee has full discretion to distribute trust principal, a nonjudicial settlement agreement should be used to memorialize the qualified trust beneficiaries and trustee's agreement to fully distribute and terminate a trust.

Planning for a Dynamic Environment

If the fluctuations in estate taxes over the past two decades have taught us anything, it's that flexibility is priceless. While clients often ask whether anyone will be able to change their trusts after they die out of fear that their intent will not be carried out, we must explain to them the importance of clearly documenting their intent while also drafting trust terms which allow for adjustments to account for unforeseen changes in circumstances. Fortunately, we have several options for achieving this flexibility.

Review AB Trust Formula Clauses

In days of yore, when the estate tax exemption amount applied to a larger portion of the population, "AB Trusts" that maximized the use of both spouses' exemptions were commonplace. These trusts often used word formulas to divide the trust estate into two separate shares. One share represented the maximum amount that could pass to future generations estate tax-free. This share is usually known as the "exempt" or "family" trust. The other share consisted of the rest of the estate which was subject to estate taxes and known as the "non-exempt" or "marital" trust. Because of its tax-sheltered status, it was not uncommon for the family share to be subject to more stringent standards for distributions to the surviving spouse to avoid dissipation or being subject to taxation as a result of being included within the surviving spouse's estate.

Only twenty years ago, the estate tax exemption amount was $625,000 and the top estate tax rate was 55%. If a trust was established around this time for a married individual's estate worth $3 million, it likely included a word formula providing that the full exempt amount be set aside in the family trust at the first spouse's death with the remaining $2,375,000 being available to the surviving spouse in the marital trust. The family trust terms could have provided for the exclusion of the surviving spouse, instead making the couple's children the beneficiaries of the $625,000. In 1999, this may have been a good result.

However, in 2018, if that $3 million is now $8 million (or even $11.18 million) and both spouses are surviving, the result would be the complete disinheritance of the surviving spouse. That is a devastating result and likely not at all what the settlors intend. Thus, with the higher exemption amounts, a critical review of formula clauses is crucial. Consider drafting in structures that allow for the division between the marital and family shares based on the circumstances in the months following the first spouse's death. Clayton QTIP, disclaimer, and absence of estate tax provisions may provide your clients the right amount of flexibility for their circumstances.

Decanting

In instances where a trust is irrevocable but was established at a time when the tax universe was different, or a settlor's estate or family circumstances have not developed as they thought, our clients often think they have to live with a less-than-optimal trust because they understand that it is irrevocable. Michigan law provides several avenues by which these 'broken' trusts may be "fixed," including a process generally known as "decanting". As the term implies, decanting is a technique by which one trust transfers ('decants') all of its assets to a second trust. Decanting may be available to existing trusts by way of the statutory authority within the Michigan Trust Code (MCL 700.7820a(9)) and the Michigan Powers of Appointment Act (MCL 556.115a(7)). Although these statutes provide relief in some circumstances, they have limitations and should not be relied upon. If we are to learn from and adapt to our dynamic planning environment, estate planning attorneys should consider including express powers allowing a trustee to establish and transfer trust assets to a new trust. By including decanting powers, the settlor may draft broad powers to decant in excess of the powers afforded by statute.

Power to Grant Testamentary General Power of Appointment

As discussed above, in light of changed tax law, trusts which have been irrevocable for some time likely have assets which have appreciated significantly. If these assets were transferred to the trust as a gift, the basis is likely the same as what the donor paid for the asset when first acquiring it. If the trust acquired the asset following the donor's death, the basis is likely equal to the asset's date of death value. When that asset is sold, any appreciated value will be subject to capital gains taxes. However, if the trust assets are counted in the estate of a beneficiary, following the beneficiary's death, the assets will receive a stepped-up basis. In order to provide the flexibility to achieve that result, planners should consider including a trustee power to grant a general power of appointment.

Trust Protector

Trust protectors are a strategy commonly cited as a tool for maintaining flexibility to adapt otherwise irrevocable trusts. Trust protectors may have wide-ranging powers such as the removal of a trustees, appointing trustees, adding beneficiaries, or the management of a closely-held business. While trust protectors can be afforded tremendous power, which can provide valuable flexibility, planning with trust protectors can be exceedingly complex. As a result, when drafting a trust with trust protector provisions, careful consideration should be given to the extent of a trust protector's powers. See the reporter commentary for MCL 700.7809 for insightful discussion of trust protectors in Michigan.

Power to Change Trust Situs

As Michigan attorneys, it's natural that we almost always draft trusts according to Michigan law with the expectation that the trusts will be administered in Michigan. Nevertheless, including the power to change the trust situs adds a layer of flexibility for the trustee to take advantage of the laws of other jurisdictions for purposes such as planning for state income taxes, more favorable administrative statutes, and creditor protection.

Conclusion

We live in turbulent and complex times where life and the law are ever-changing. Planners who wish to provide their clients with valuable advice and service beyond filling in blanks on templates have more tools than ever to deliver just that. When you provide an unexpected roadmap to save thousands of dollars of capital gains taxes, you'll make a lasting impact on your client. And, the next time a client ribs you for charging for "boilerplate," take the opportunity to explain the careful consideration you've given to including decanting, trust protector, and change of situs provisions in their trust document.

Notes

1. The Joint Committee of Taxation estimates that in 2018 only 1800 of the estimated 2.6 million decedents will have to pay estate taxes, representing less than .07% of the population.
2. See IRC 1014(a)(1), IRC 2031(a). A personal representative may make an election to use the alternate valuation date for estate tax purposes or make a special-use valuation election in which case the basis is the elected value rather than the date-of-death value.
3. IRC 2040(b)(1).
4. IRC 2041(b)(1), 2514(c).
5. IRC 2041(b)(1)(C)(iii); Treas. Reg. 20.2041-3(c)(2).
6. For an excellent explanation of powers of appointment, see *Basics of Powers of Appointment*, Bearup, George F. and Gregory, George W., ICLE 27th Annual Drafting Estate Planning Documents, February 15, 2018.

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