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To Our Clients and Other Friends: February, 2018

We last wrote to you in December about the Tax Cuts and Jobs Act of 2017, which President Trump signed into law on December 22, 2017. The Act made a wide variety of changes to the Internal Revenue Code, perhaps the most wide-ranging changes to the Code since 1986. The changes to the Code cover a broad range of estate, income, corporate and other taxes, and affect most taxpayers in one way or another. In this Client Alert, we focus on changes in the Act that may impact our clients' estate planning.

The Act significantly increased the federal estate, gift and generation-skipping tax exemptions from $5,600,000 as of December 31, 2017, to approximately $11,180,000 as of January 1, 2018. (The exact amount may vary by a small amount depending on the final calculation of an inflation adjustment.) The tax rate on transfers in excess of the exemptions remains at 40%. This means that a married couple, with proper planning, has the use of $22,360,000 in gift tax and estate tax exemptions, provided that certain actions are taken when the first spouse dies (the unused exemption of the first spouse to die still can be "ported" to the surviving spouse). The increased exemptions are scheduled to sunset as of January 1, 2026, at which time the exemptions will revert back to the 2011 amounts of $5,000,000 each, adjusted for inflation.

Importantly, there is no change to the adjustment to federal income tax basis of certain assets owned at death (commonly referred to as the "basis step-up").

The annual gift tax exemption continues to be available, and has increased from $14,000 per recipient per year in 2017 to $15,000 per recipient per year in 2018.

There are clients who should review (and possibly revise) their estate plan in light of the very significant increase in the estate, gift and generation-skipping tax exemptions.

First and most importantly, many of our clients have estate plans that make transfers at death to certain individuals based on the size of the estate or generation-skipping tax exemption; those clients should consider revisiting those plans.

- <u>Disposition based on estate tax exemption</u>. For some couples, the estate plan envisions passing an amount equal to the available estate tax exemption directly to the children or other beneficiaries, and not to the surviving spouse, or including children or other individuals with the spouse as beneficiaries of a trust holding the exemption amount. Such plans may now pass significantly more assets in that manner. It is important to revisit these plans to make sure they reflect the couple's intent. For Pennsylvania residents, the allocation of assets among different beneficiaries also may impact the amount of Pennsylvania inheritance tax due upon the death of the first spouse to die.

- Disposition based on generation-skipping tax exemption. In some cases, an estate plan envisions an allocation of assets among classes of beneficiaries (for example, children and grandchildren), or passes such assets to beneficiaries in trust versus outright, based on the amount of the generation-skipping tax exemption. Based on the higher exemption amounts, such plans may now pass significantly more assets to grandchildren or reduce the amount of assets passing outright to beneficiaries. Again, it is important to revisit these plans.

For some clients, the increase in the federal gift tax exemption to $11,180,000 will make significant lifetime gifts an attractive planning opportunity. This opportunity involves a delicate balancing of estate tax and income tax considerations. An asset gifted during the donor's life carries with it the donor's cost basis rather than the stepped-up income tax basis that the asset would receive if held by the donor at death and transferred at that time. Making gifts to an irrevocable trust that contains mechanisms to trigger basis step-up and estate tax inclusion, or making other forms of gifts, may mitigate some of these concerns.

If you are the trustee or a beneficiary of a trust holding significantly appreciated assets, the increased exemption amounts also may present an opportunity to trigger basis step-up and estate tax inclusion. In some cases, it may be more beneficial from an income tax perspective to have assets included in the estate of the primary beneficiary to achieve a step-up in basis. For example, trusts funded for a surviving spouse when the exemption amount was much lower, such as a residuary trust (or "credit shelter" trust or "bypass" trust), should be reexamined. The top marginal income tax bracket for a trust (with income above $12,500) is now 37%, plus the 3.8% surtax on net investment income. The capital gain tax rate remains at 20% for trusts in the highest income bracket (with income above $12,700), plus the 3.8% surtax on net investment income. In other instances, it may make sense to terminate an old trust. Please contact us if you would like to review these opportunities.

Some clients will ask if it is still necessary to include trusts in their estate planning if they are below the new exemption amounts. First, we note that the current increased exemption amounts are scheduled to revert to their previous levels at the end of 2025 – if not sooner, if a new Congress enacts different legislation. There are many other considerations in estate planning that may still warrant the use of trusts, including the appropriate distribution of assets among different beneficiaries, planning for a special needs beneficiary, protecting your heirs from potential creditors and providing a form of asset management, to name a few. For many clients, trusts will continue to play an important role in their planning.

Lastly, we note that both the New Jersey estate tax and Delaware estate tax have been repealed for individuals dying on or after January 1, 2018. If your estate plan includes custom drafting to address either of these state death taxes, you should revisit your plan. We note that the New Jersey inheritance tax, which is based on the relationship between the decedent and beneficiary and is rarely applicable if assets are passing to a spouse or descendants, remains in place for both New Jersey residents and non-residents who own assets located in New Jersey.

We at HTT&S are committed to advising our clients through these Client Alerts about how they might be affected by the Act and other tax law changes. If you would like to discuss the specific aspects of how the Act might affect your estate plan, you always should feel free to contact your HTT&S lawyer, or any of us.