Estate Planning in 2019

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The Tax Cuts and Jobs Act (the "Act"), which took effect January 1, 2018, made sweeping changes to the federal tax landscape. Of particular relevance in the estate planning context were the significant increases to the federal estate, gift and generation-skipping transfer ("GST") tax exemption amounts, currently scheduled to be in effect through the end of 2025.

In this general context, we anticipate that much of estate planning in 2019 will be similar to 2018, with clients, especially those who have already exhausted their prior exemption amounts, focused on making lifetime gifts to take advantage of the Act's increased exemption amounts while they are available. Lifetime gifts can remove both the value of the gifted property, as well as future appreciation, from the donor's taxable estate, thus reducing the estate taxes that might otherwise be payable at death. Income tax, state level tax and other issues, however, should also be taken into consideration.

As a reminder, some existing testamentary plans may include provisions known as "formula dispositions," which are typically defined by a formula expressed with reference to the federal or applicable state estate tax exemption amount, GST exemption amount or other tax influenced variables. Such provisions should be reviewed to determine whether they continue to be appropriate. With a significantly increased federal estate tax exemption amount, a formula disposition could result in unanticipated tax and non-tax consequences. Therefore, we suggest that individuals consult with their advisors to determine whether their estate planning documents contain any dispositions determined by a formula referring to an "exemption equivalent amount," "applicable credit amount," or "unused GST exemption," or other dispositions that may require immediate attention to account for tax or other changes that have taken place since those documents were first executed.

Included below are additional reminders about certain estate planning strategies, and information regarding recent transfer tax law developments.

Federal Transfer Tax Developments

Federal Exemption Amounts and Rates

For 2019, the inflation-adjusted federal estate, gift and GST tax exemption amounts are $11.4 million for an individual (up from $11.18 million in 2018), or a combined $22.8 million for a married couple. The highest federal marginal estate, gift and GST tax rate continues to be 40%.

Absent legislative action, the increased exemption amounts are scheduled to expire on December 31, 2025, after which the relevant federal estate, gift and GST tax exemption amounts will revert to the pre-2018 $5 million amounts, plus the relevant inflation adjustments. Last November, the IRS issued proposed regulations clarifying that individuals who make gifts of the increased exemption amounts will not be adversely impacted for estate tax purposes if they die after 2025 when the exemption amounts are reduced.

For individuals with estates in excess of the available exemptions who have not yet fully used their exemptions, gifts of their remaining exemptions, perhaps combined with loans or other leveraged transactions, will continue to provide an opportunity to remove very significant amounts from their estates in a manner that may permit property to pass to descendants free of any additional estate or gift tax, and in some cases GST tax, and remove post-gift earnings and appreciation from their taxable estates. Those concerned with their own financial security in the context of additional lifetime giving might consider including a spouse as a trust beneficiary or exploring the creation of a "self-settled asset protection trust" in a jurisdiction, such as Delaware, which permits such a trust. Those who have exhausted their exemptions might "top up" existing structures in 2019 and in future years as additional inflation adjustments are made to the relevant exemption amounts.

For individuals living in states such as New York, that impose estate taxes with significantly lower exemption amounts than the federal exemption amount, making lifetime gifts, and even paying federal gift tax, can significantly reduce state level estate taxes.

Before making significant lifetime gifts, a donor should compare the income tax effects of a gift with the estate, gift and GST tax savings.[1]

It is also advisable for donors to consider the relative benefits of making gifts to a "grantor trust" rather than outright or to a "non-grantor" trust.[2] In addition, certain strategies, such as GRATs and CLATs, may be attractive in the current interest rate environment but may be less so if interest rates continue to rise. More information regarding these structures is included further below.

Annual Exclusion Gifts

The 2019 gift tax annual exclusion amount will remain unchanged from 2018, at $15,000 per donee.[3]

For gifts by a U.S. citizen or domiciliary to his or her non-U.S. citizen spouse, the available annual exclusion amount will increase from $152,000 to $155,000 in 2019.[4]

Individuals already planning to make an annual exclusion gift to an account for a minor may wish to consider a 529 Plan. Under the Act, 529 Plan account owners enjoy income tax-free distributions not only for qualified higher education expenses, as was permitted under prior law, but now also for up to $10,000 per year for elementary and secondary school tuition and expenses. Some states, such as New York, however, do not conform to the new federal rules, which can require the recapture of state level tax benefits if distributions are made for elementary and secondary school tuition and expenses.

Direct Payment of Tuition and Certain Medical Expenses

Direct payments to the relevant service provider of certain qualified tuition and medical expenses on behalf of the individual receiving the related goods and services will continue to be exempt from gift tax.

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[1] The current federal income tax rules provide for the income tax basis of a decedent's assets to be reset to estate tax values (sometimes referred to as a "step-up" in basis) and the non-recognition of gain on appreciated property transferred at death or by lifetime gift. Due to the continued availability of a "step-up" in income tax basis at death, income tax basis planning should be considered before making significant lifetime gifts, which generally receive "carry-over" basis treatment. The "carry-over" basis rules for gifts create the potential for taxable gain on a subsequent sale by the donee of appreciated property.

[2] A "grantor trust" is structured so that the donor is treated as the owner of the trust for income tax purposes and continues to pay income tax on the trust's ordinary income and capital gains, thereby maximizing the after-income-tax returns available for the beneficiaries. Transactions between the donor and the grantor trust are also generally disregarded for income tax purposes. In some circumstances, however, non-grantor trusts can be structured to avoid state-level income taxes that would otherwise be payable by the donor if the trust were a grantor trust.

[3] Spouses may elect to split gifts and claim a combined exclusion of $30,000 with respect to a particular donee, even if one spouse funds more than half of that combined exclusion in respect of the same donee.

[4] There is a larger annual exclusion for such gifts because, unlike gifts to a U.S. citizen spouse, gifts to a non-U.S. citizen spouse that exceed the annual exclusion cannot qualify for the unlimited gift tax marital deduction.

State Transfer Tax Developments

Included below is a summary overview of the current New York, Connecticut and New Jersey transfer tax regimes. By way of comparison, Florida does not impose any state level income, estate or inheritance taxes.

New York

The New York estate tax exemption equivalent increased from $5.25 million to $5.74 million effective January 1, 2019, but continues to be phased out for New York taxable estates valued between 100% and 105% of the exemption amount, with no exemption being available for taxable estates in excess of 105% of the exemption amount.

Although the top New York estate tax rate continues to be 16% for estates over $10.1 million, the effective rate can be lower due to the continued deductibility for federal estate tax purposes of any New York estate tax paid. However, estates that are no longer subject to federal estate tax by reason of the increased federal exemption will no longer benefit from the deduction, resulting in a higher effective rate for New York estate tax purposes.

Beginning January 1, 2019, gifts made within three years of death are no longer subject to New York estate tax.

There is currently no New York gift or GST tax.

Connecticut

The Connecticut estate and gift tax exemption amounts increased to $3.6 million effective January 1, 2019.

In 2018, Connecticut enacted new legislation that extended the timeline for increases in the Connecticut gift and estate tax exemption amounts. Under this legislation, the Connecticut gift and estate tax exemption amounts are scheduled to increase to $5.1 million on January 1, 2020, $7.1 million on January 1, 2021 and $9.1 million on January 1, 2022. Starting January 1, 2023, the Connecticut exemption amounts are expected to match the federal estate and gift tax exemption amounts (approximately $11.4 million, plus the additional federal inflation adjustment relevant for 2023).[5]

Connecticut estate and gift tax rates range from 7.8% (for estates and gifts exceeding the exemption amount) to 12% (for estates and gifts exceeding $10.1 million). As the Connecticut exemption amounts increase, the lower end of this rate range will increase correspondingly, to eventually reach 12% on all taxable estates in 2023 and thereafter. The Connecticut gift and estate tax is now capped at $15 million, down from $20 million in 2018. Estate taxes paid to Connecticut may be deducted for federal estate tax purposes (to the extent a federal estate tax would otherwise be payable), but there is no corresponding federal gift tax deduction. Moreover, estates that are no longer subject to federal estate tax by reason of the increased federal exemption will no longer benefit from the deduction, resulting in a higher effective rate for Connecticut estate tax purposes.

[5] In an unusual twist, the Connecticut legislature and Governor Dannel P. Malloy passed *two* different bills with respect to the Connecticut estate and gift tax, which contain the same exemption amounts for 2019 but conflicting exemption amounts for 2020 and future years. Public Act 18-81, effective May 15, 2018, provides for Connecticut estate and gift tax exemption amounts which will eventually match the federal exemption amounts (currently $11.4 million), whereas under Public Act 18-49, effective May 31, 2018, such amounts would be capped at $5.49 million on January 1, 2020 and thereafter. The legislative conflict has not yet been resolved.

Connecticut remains the only state in the nation that imposes a gift tax, with a $15,000 gift tax annual exclusion. Connecticut does not impose a GST tax.

New Jersey

The New Jersey estate tax has been repealed, effective January 1, 2018.

New Jersey has, however, retained its separate inheritance tax, which does not generally apply to transfers to a spouse, civil union or domestic partner, child or grandchild and certain other close family members. The New Jersey inheritance tax rates depend on the amount received and the relationship between the decedent and the beneficiary receiving assets from the decedent. Under the inheritance tax, transfers to siblings are generally taxed at a rate beginning at 11% (top rate is 16%) and transfers to others are taxed at a rate of 15% or 16%. New Jersey inheritance tax is also deductible for federal estate tax purposes, to the extent a federal estate tax would otherwise be payable. There is currently no New Jersey gift or GST tax.

Estate Planning Strategies

The first three strategies described below, which do not involve payment of gift tax, may be particularly attractive in anticipation of future interest rate increases. In order to lock in a still relatively low interest rate, it may be advantageous to use the following strategies sooner than later, depending on one's general interest rate and market return expectations.

Intra-Family Loans. An intra-family loan is a simple technique for transferring wealth to children or grandchildren without generating gift or GST tax. To avoid making a gift, the lender must charge interest at the applicable federal rate ("AFR") published by the IRS.

- For January 2019, the AFRs (based on annual compounding) used in connection with intra-family loans are 2.72% for loans with a term of three years or less, 2.89% for loans with a term of up to nine years and 3.15% for loans with a term longer than nine years.
- For example, if a nine-year loan is made to a child in January 2019 and that child can invest the funds and obtain a return in excess of 2.89%, the excess will effectively be transferred to the child free of gift tax. The lender must include the interest payments on the note in the lender's taxable income.
- Making a loan to a grantor trust for the benefit of a child where the grantor continues to be subject to tax on the trust's taxable income, including capital gains, may be even more tax efficient than making a loan to the child outright. Since transactions between the grantor and the grantor trust are generally disregarded for income tax purposes, the grantor/lender will not have to include the interest payments on the note in the lender's taxable income and the trust beneficiaries can also benefit from the grantor's payment of income taxes on the trust's investments.
- Grantors can also sell assets to a grantor trust in exchange for a note without incurring any current income tax liability; such assets may include interests in family businesses and investment vehicles that, currently, may be valued giving effect to certain valuation discounts.

GRATs. A grantor retained annuity trust ("GRAT") may currently be structured to result in a taxable gift of zero (or close to zero).

- In creating a GRAT, the grantor transfers assets to a trust while retaining the right to receive an annuity for a term of years specified by the grantor.
- The amount of each year's annuity payment (which under the applicable rules can increase by up to 20% each year) required to reduce the taxable gift to zero (or close to zero) is calculated based on the term of the GRAT, the percentage, if any, by which each year's annuity payment differs from the prior annuity payment, and an interest rate published by the IRS (the "7520 rate").

- If the trust's assets appreciate at a rate greater than the 7520 rate (3.4% for transfers made in January 2019), at the end of the GRAT term the excess appreciation will be distributed to the remainder beneficiaries (e.g., children or a trust for children) free of gift tax.

CLATs. For the charitably inclined, a charitable lead annuity trust ("CLAT") is another technique that works well in a low interest rate environment and is similar to a GRAT, except that each year's annuity payment is made to charity instead of to the grantor.

- Like a GRAT, a CLAT can be structured to generate little to no gift tax.
- A CLAT can also be structured to result in a current income tax deduction for the grantor equal to the actuarial value of the future annuity payments to be made to charity, but this treatment also requires the grantor to be subject to income tax on the trust's ongoing ordinary income and capital gains.
- In the alternative, a CLAT can be structured so it is respected as a separate taxpayer and is entitled to its own income tax charitable deduction in respect of amounts distributed to charity during the relevant tax year, in which case the grantor is not entitled to any income tax charitable deduction in connection with the initial funding of the trust (and is not subject to tax on the trust's ordinary income and capital gains).

QPRTs. Unlike a GRAT or CLAT, a qualified personal residence trust ("QPRT") can become more attractive when interest rates are high. This strategy is a potentially effective way to make a gift of a personal residence in order to take advantage of the current exemption amounts without giving up liquidity.

- Under this arrangement, an individual transfers a personal residence to a trust and retains the right to use the residence for a specified number of years, after which the residence typically passes to or in further trust for the donor's children. If the donor dies during the specified term, the residence reverts to the donor's estate.
- The initial transfer of the residence to the trust is a taxable gift equal to the fair market value of the residence less the value of the donor's retained interest, based on the donor's age, length of trust term and IRS applicable interest rate in effect for the month of the gift. The higher the interest rate, the lower the value of the gift.

More generally, while an estate plan should be appropriately tax influenced, it should also address other non-tax family concerns, goals and objectives. In this regard, we generally urge our clients to review their estate plans at least every five years, and more frequently in the event of significant personal, family or financial developments and changes in the tax laws.

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

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