The Trump Effect – How Do We Hedge our Estate Planning Bets in this Unstable Tax Environment

By Lowenhaupt & Chasnoff, LLC

March 2017

LOWENHAUPT & CHASNOFF

ATTORNEYS AT LAW

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President Trump's Tax Plan calls for a major departure from current Federal Estate Tax Law:

> "The Trump Plan will repeal the death tax, but capital gains held until death and valued over $10 million will be subject to tax to exempt small businesses and family farms. To prevent abuse, contributions of the appreciated assets into a private charity established by the decedent or the decedent's relatives will be disallowed." [1]

While the above provides insight into Trump's vision, many unanswered questions remain, including whether the gift tax and/or the generation skipping tax might also be repealed, whether assets falling below the proposed $10 million exemption for capital gains would get a step-up in basis or carry-over basis treatment, or whether other income tax provisions affecting the taxation of estates might be revised or enacted. Repeal of the so called "death tax" would likely have support, and would probably be packaged within the scope of a broad tax reform effort.[2] "Permanent" repeal, however, would require a vote by a much stiffer margin as opposed to reform that would contain a sunset provision (similar to the 2001 tax legislation which resulted in the one-year federal estate tax repeal in 2010), which means we would face potential reenactment. How do we hedge our estate planning bets in this unstable tax environment when faced with such a wide array of potential scenarios, including:

- No Change Occurs
- Repeal of the Federal Estate Tax with Stepped-Up Basis Maintained
- Repeal of the Federal Estate Tax with Capital Gains Tax Imposed At Death
- Repeal of the Federal Estate Tax with Capital Gains Tax Imposed Upon Sale by Heir (Carry-over Capital Gains Tax)
- Inheritances Characterized as Income
- Simultaneous Repeal of the Federal Gift Tax
- Simultaneous Repeal of the Generation-Skipping Transfer Tax
- Repeal, and Then a Return of the Federal Estate Tax

[1] Trump Tax Plan, recently available at: https://www.donaldjtrump.com/policies/tax-plan/. President Trump's proposal is similar to the Canadian system where death is considered a "sale" but without the $10 million exemption.
[2] Secretary of the Treasury, Steven Munchin, recently stated that the administration's comprehensive tax reform proposal is expected to be released by August 2017, with implementation beginning either in 2017 or 2018.

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Well before the election of Trump, flexibility had already become a rally cry of estate planners. Over the last few decades, increased volatility in the estate tax laws has sparked heightened focus in developing and fine-tuning techniques to enhance flexibility, including statutory solutions (such as disclaimer, decanting and trust protector statutes) to help afford flexibility to estate plans that become "stuck" with outdated provisions or unintended consequences.

To illustrate, let us take a closer look at flexibility planning in our current tax environment.[3] The federal estate tax exemption is currently at an historic high of $5.49 million per person, (effectively $10.98 million per married couple with "portability"), which is estimated to result in approximately 99.8% of all estates owing no estate taxes. The stepped-up basis rules also apply which provide that a decedent's basis in appreciated (or depreciated) assets adjust to their fair market value without taxation at death. Cognizant of the fact that a change in tax laws can reap significant unintended results, including a significant loss in alternate tax savings, estate planners have sharpened their focus on mechanisms that can function "automatically" to adapt to tax law changes. If, for example, an estate plan can provide for a timely decision or trigger at death (perhaps as an election or a formula automatically based on the exemption amount), causing assets to be either included in the gross estate and so receive stepped-up basis treatment, or conversely, to be excluded from the gross estate, the estate plan has created a win-win scenario.

Drafting techniques to incorporate flexibility into an estate plan might include the designation of a non-adverse party or a trust protector to hold a power exercisable to cause stepped-up basis, the use of a formula general power of appointment to automatically "do the math" at death for estate inclusion purposes or use of a disclaimer option or formula disclaimer that could, for example, allow QTIP assets to pour back into a credit shelter trust. Additionally, tried and true estate planning tools remain popular due to their effectiveness under a wide range of different tax scenarios such as GRATS, for example, which are very effective tools to provide the combined benefit of removing assets from the taxable estate and avoiding taxation on appreciation, or intentionally defective grantor trusts along with the careful inclusion of provisions or powers such as "swap powers" to incorporate flexibility. Of course, any planning techniques employed must be appropriate and specifically tailored to the estate plan at hand.

[3] The first $5.49 million of a taxpayer's estate is exempt from tax when transferred upon death, and this exemption amount is indexed for inflation annually. The value of the taxpayer's estate above the exemption amount is taxed at up to 40%. At the same time, assets with an unrealized gain or loss receive what's referred to as a "step-up in basis" (which can also result in a "step down" if the asset has depreciated below basis) and the capital gains "clock" is reset at fair market value as of the taxpayer's date of death (or alternate valuation date if elected). To receive this treatment, assets must be includable in the decedent's gross estate at death.

If we consider for a moment the scenario where the stepped-up basis rules go away and the generation skipping transfer (GST) tax is also repealed, the estate tax planning coin will have been significantly flipped. Although the capital gains tax rate (currently 20%) is likely to be lower than the current estate tax rate, trusts, for example, that have been carefully designed to make use of the GST tax exemption (currently equal to the estate tax exemption) to provide for the use of tax exempt assets for multiple generations would now be subject to a whole new basis for taxation. If efforts to promote capital gains tax savings then caused this planning to be undone and carefully placed pillars of GST protection removed, the generational assets could again be exposed to the onerous GST tax if repeal were to sunset or the GST tax reenacted. As we can see, flexibility planning must consider a wide array of estate planning "bets."

A key tenant of estate planning is that in order for your estate plan to truly "work," periodic review of your plan is essential. A review of your estate plan will allow you to run hypothetical tax scenarios through your existing plan and identify areas where flexibility is needed and can be incorporated. Non-tax goals can also be revisited, as we must remember that not only do tax laws change, but non-tax issues change -- families change, investments change and goals change. Likewise, non-tax benefits are often designed to coexist within tax savings vehicles like family trusts, charitable trusts, QTIPs and lifetime trusts for children, and serve to provide non-tax benefits such as asset protection, re-marriage protection and spend-thrift protection, which are also very important to families. A review allows all of these goals to be weighed and assessed.

Of course, it is possible that we see no change in the federal estate tax laws under the Trump Administration. It certainly would not be the first time that the estate planning community has braced itself for a significant estate tax law outcome that failed to materialize.[4] But regardless of whether or not tax law repeal occurs, a review of your estate plan will serve you well. With an eye toward flexibility planning, perhaps we can hedge our bets in this unstable tax environment.

[4]For example, on January 1, 2010 we saw the EGTRRA provisions sunset into a full year of federal estate tax repeal while most estate planners had anticipated a significantly lowered estate tax exemption would be enacted instead.