



Warner Norcross + Judd

ESTATE PLANNING FOCUS

Tax Reform Creates Plenty of Opportunities

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WINTER 2018

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THE NEW RULES

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The Tax Cuts and Jobs Act (Act) was signed by the president on December 22, 2017, and is the most sweeping tax legislation since the

Reagan era. The Act impacts all taxpayers, from individuals to businesses, and the rules for each category are different. Even though they are different, they unfortunately are uniformly complicated. Generally, the changes made for individual taxpayers, including the pass-through rules for business entities, are effective from January 1, 2018, to December 31, 2025. If no changes are made by December 31, 2025, the tax laws revert back to the 2017 rules. The exception is that the changes that apply to corporations are permanent. Well, as permanent as a tax law can be. Many have indicated that the Act is "fragile" in that it was passed without any Democratic support and a change of control would result in a repeal or further changes. For now, the Act provides opportunities for taxpayers to significantly benefit from paying less tax. A thorough review of your financial and business structures will likely maximize the opportunities that the Act provides. The Act doubles the estate, gift and generation-skipping transfer tax exemption amounts. The new exemption amounts apply to taxpayers dying or making gifts after 2017 and before 2026, and will be adjusted for inflation on an annual basis during this period.

Because the exemption amount is indexed for inflation from a 2010 base year, the expected exemption amount for 2018 is \$11,180,000 per individual or \$22,360,000 for married couples.

We are still waiting for the Internal Revenue Service to issue the final figures, but are confident these estimates are very close to what will be issued as final for 2018. The changes sunset in 2026 and go back to the \$5,000,000 per individual, subject to inflation adjustments.

Subject to certain limitations and qualifications, pass-through entities are eligible for a deduction equal to 20% of taxable income. This applies to partnerships, S corporations, sole proprietorships, other qualified dividends and trusts and estates. Tax for these entities is determined on the individual taxpayer's personal return and subject to the revised individual tax rates. For a taxpayer in the top tax bracket, the deduction results in a top marginal rate of 29.6%, plus the 3.8% net investment tax, if it applies.

The corporate tax rate is reduced from a top tax rate of 35% to a flat rate of 21%. Dividends from the corporation are taxed at capital gain tax rates. The capital gain rates remain at 0%, 15% and 20%. For a taxpayer in the top tax bracket, the corporate tax in conjunction with the capital gains tax results in a top marginal rate of 39.8% (which includes the 3.8% net investment tax).



IT'S TIME TO REVIEW YOUR ESTATE PLAN

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The Act contains sweeping changes that will impact all aspects of tax planning to minimize estate, gift and generation-skipping transfer taxes.

The significant new opportunities created by the Act, and avoidance of some of the pitfalls of an estate plan developed under old law, require careful review of existing estate plan documents with knowledgeable estate planning counsel.

The new estate, gift and generation-skipping transfer tax exemptions are a significant increase over the exemptions available under old law. For example, the exemption was only \$1,000,000 per person in 2002, and only \$2,000,000 per person in 2008. Many older estate plans developed in years with these lower exemptions provided for the establishment of "exempt" or "credit shelter" trusts for children and/or grandchildren in an amount equal to the exemption amount effective at the time of the trust settlor's death. Under the old rules, these "exempt" trusts would generally include only a fraction of a decedent's assets, with the remaining assets typically passing to a marital trust for the benefit of the surviving spouse. However, the new and significantly higher exemptions may result in overfunding of the "exempt" trust (perhaps with all of the trust assets) and a failure to provide sufficient assets to the surviving spouse. You should carefully review your estate plan to ensure there are no concerns for the surviving spouse.

In addition, the higher estate, gift and generation-skipping transfer tax exemptions may also result in funding inheritances in ways you did not intend. For example, an older estate plan may fund a trust for grandchildren equal to your remaining generation-skipping transfer tax exemption, with the remaining assets passing to trusts for children. A grandchildren's trust funded using a formula tied to your remaining generation-skipping transfer tax exemption could result in a substantial underfunding of the trusts for children.

Improper funding could also result if a portion of your child's inheritance was to pass outright, while the other portion is held in trust. In this case, the increased exemption might result in the entire share being held in trust based on the funding formula.

HOW EVERYONE CAN BENEFIT FROM TAX REFORM

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The Act provides planning opportunities for taxpayers with varying levels of wealth. Clearly, very wealthy families should consider taking advantage

of the significant increase in the estate, gift and generation-skipping transfer tax exemptions, particularly in light of the scheduled sunset of the higher exemptions beginning in 2026. For example, a married couple that has not made prior taxable gifts could gift up to \$22,360,000 to their children in 2018. Gifts to trusts for grandchildren and later generations could also take advantage of the increased generation-skipping transfer tax exemption. Assets in these “generation-skipping” trusts would not be taxable in the children’s generation and potentially more distant generations. Gifts in trust can offer asset protection benefits, transfer tax savings and the opportunity for leveraged gifts, but gifts may also be made outright.

Sophisticated estate planning strategies allow you to leverage the tax savings available with the increased estate, gift and generation-skipping transfer tax exemptions.

These include gifts of business interests valued using discounts for lack of control and marketability, sales to “intentionally defective grantor trusts,” transfers to grantor retained annuity trusts (GRATs) and other strategies.

For married couples who are below the current estate and gift tax exemption amounts but still have significant assets and may have taxable estates if the exemption reverts back in 2026, there are planning opportunities to use the increased exemption without losing full control over the assets.

For example, you can fund one or more spousal lifetime access trusts (SLATs). The permissible beneficiaries of such trusts include your spouse and descendants (and perhaps other family members or charity). If structured properly, it is possible for each spouse to create and fund an SLAT. Direct gifts using exemption can be coupled with other estate freeze strategies such as GRATs and sales to “intentionally defective grantor trusts.”



Families with assets below the estate and gift tax exemption amount should focus on maximizing the income tax basis of assets held by a decedent at the time of death. In general, at death, your assets receive a “stepped-up” basis equal to the date of death value of the assets. This tax basis is used to determine the gain or loss on the eventual sale of the inherited assets, so a “stepped-up” basis will reduce the gain on the sale. Couples with assets below the exemption amount should therefore consider modifying their estate plans to include provisions under which family assets will receive a new “stepped-up” basis upon the death of the second spouse. If an “exempt” trust, as discussed above, has already been created upon the death of a spouse, the trustee and trust beneficiaries should consider a judicial modification or other change to the terms of the trust that would result in the inclusion of the assets in the second spouse’s estate and a new stepped-up basis.

PLAN NOW—THE WINDOW OF OPPORTUNITY MAY DISAPPEAR

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Although certain provisions of the Act relating to gift and estate taxes will not disappear until 2026, there are numerous reasons to act now instead of later. In addition to taking advantage of annual exclusion gifts (\$15,000 per recipient) and making direct payments to medical and educational providers, it might make good sense to use a portion or all of the increased exemption from gift and/or generation-skipping transfer tax.

THE POWER OF EARLY GIFTING.

Under almost any circumstance it is beneficial to gift earlier rather than later. Transferring an asset earlier means that any subsequent appreciation will occur outside of your estate and may result in a greater benefit to the recipients of the gift. This alone can result in significant tax savings. From a non-financial standpoint, you can participate in the enjoyment of the gift while you are alive.

Because we are living longer, making lifetime gifts to children and grandchildren now may help them when they need it most.

Finally, gifting assets earlier allows the next generations to become familiar with the investment process, trust administration and tax strategies, better preparing them to handle a larger inheritance in the future.

UNCERTAINTY.

Remember that any exemption used for lifetime gifting will reduce the amount that can be used for the estate tax. Under current law, the gift and estate provisions will revert back to the 2017 exemption amounts (inflation adjusted) in 2026. In reality, the provisions could be adjusted before then due to a change in party control or other congressional act. Although there is a question about whether gifted assets may be “clawed back” if

an individual dies when the exemption is lower, estates of individuals who make gifts likely won't be in a worse position than if they had not made the gifts at all. Notwithstanding this uncertainty, we recommend you take advantage of the increased exemption if you are able.

CHEAPER DURING LIFE THAN AT DEATH.

Because of the structure of the gift and estate tax law, it is less expensive to make lifetime gifts than to make gifts upon death. The reason is that lifetime gifts are tax "exclusive" whereas gifts at death are tax "inclusive." In other words, the amount of tax paid by the transferor as a gift tax (if any) during life is not subject to transfer tax, whereas, in the case of a transfer at death, the amount paid in estate taxes is also subject to estate tax so the overall taxes paid are greater.

Lifetime gifting can be a great strategy (from a financial and non-financial perspective). Advanced wealth-transfer strategies need to be planned carefully and take time to implement.



WHY YOU SHOULD REVIEW YOUR TAX STRUCTURE

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In the Act, Congress included a 20% deduction for individuals against certain business income, including income earned through a sole proprietorship or single-owner LLC, such as an independent contractor or as an owner of a flow-through entity (i.e., a multi-owner LLC or S corporation). This deduction parallels the reduction in the corporate rate, from 35% to 21%. However, the deduction does not make the taxation of an individual business income and corporate income the same, and there will continue to be certain differences between individuals with business income versus corporations. Special limitations apply to certain service businesses but otherwise the language of the law appears to be available to all businesses, including real estate.

At certain levels of taxable income of the individual, all business income will be eligible for the 20% deduction. In the simplest form, the deduction will be 20% of the qualified business income. However, there are several limitations and exclusions over certain dollar thresholds.

For married taxpayers filing jointly who have taxable income of \$315,000 (\$157,500 for all other filers), limitations and exclusions will apply. It is important to emphasize that the threshold is based on an individual's taxable income, which will include all sources of income (wages, other business income, investment income and gains, retirement income, etc.) and all deductions available to individual taxpayers. Also, for taxpayers with multiple businesses, the deduction is computed separately for each business.

For service-type businesses, the deduction is eliminated when taxable income is greater than \$415,000 for married taxpayers filing jointly (\$207,500 for other taxpayers). Architectural and engineering firms are excluded from the definition of a service business. In general, service businesses are defined as professional businesses as well as investment advisory and related types of businesses.

Other types of businesses will continue to be eligible for the 20% deduction when taxable income exceeds \$415,000; however, there are significant potential limitations based on the amount of W-2 wages related to the business and the amount of capitalized tangible assets involved with the business. Much planning will need to be done to maximize the deduction for such taxpayers exceeding the initial \$315,000 and the \$415,000 thresholds.

Every business should review its current tax structure to maximize potential tax savings provided by the Act. If any thought is being given to changing the form of business from or to a partnership, S corporation or C corporation, action should be taken promptly.



THE GOOD, THE BAD AND THE UGLY OF TAX REFORM



- **Maximize the power of 529 plans.**

You may now use 529 accounts for tuition, fees, books and related expenses for elementary and secondary schools, including public, private and religious schools, up to \$10,000 per year per student.

- **No looking back for Roth conversions.**

If you convert a pre-tax traditional IRA to a post-tax Roth IRA, you no longer have until October 15 of the year following the conversion to reverse that decision. An unfortunate tax situation could result if the value of the IRA drops after the conversion.

- **Standard deduction just doubled.**

Your standard deduction almost doubles, from \$6,350 to \$12,000 for single individuals and from \$12,700 to \$24,000 for married couples, indexed for inflation. For this reason, fewer taxpayers will be itemizing deductions.

- **Limitation for mortgage interest deduction.**

If your mortgage was signed after December 15, 2017, your interest deduction is limited to interest paid on the first \$750,000 of the acquisition indebtedness. Interest paid on a home equity loan is no longer deductible regardless of when it was acquired.

- **Limitation for local taxes.**

If you itemize deductions, you may only deduct state and local sales, income and property taxes of up to \$10,000.

- **Increased credit for children.**

For each child, you will receive a \$2,000 child tax credit. This is phased out if you make more than \$400,000 for married taxpayers filing jointly (and \$200,000 for all other taxpayers).

- **Potential to deduct larger gifts to charity.**

You may now deduct annual gifts to public charities and certain other organizations of up to 60% of your adjusted gross income. Note that this only helps if you itemize deductions on your tax return. Remember you need to obtain a contemporaneous written acknowledgment for all charitable gifts.

- **College athletic tickets are now more expensive.**

You are no longer permitted to deduct the purchase of tickets to college athletic events on your return.

- **Trap for divorces.**

For divorce agreements executed after December 31, 2018, the paying spouse may no longer deduct alimony payments and those payments are no longer included in the recipient's income.

If you would like to know how the Tax Cuts and Jobs Act specifically impacts you and what planning opportunities it might offer, please contact your attorney at Warner Norcross + Judd. If you are not currently working with an attorney, please contact Jennifer Remondino, Chair of the Trusts and Estates Practice Group, at 616.396.3243 or jremondino@wnj.com. She will refer you to an attorney best suited to help you. The estate planning attorneys at Warner Norcross + Judd are well qualified to assist with the review and revision of your estate plan.



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