2019 Wills, Trusts & Estates Winter Alert

A year has elapsed since the Federal Tax Cuts and Jobs Act (the "TCJA") became effective[1] and it has been nearly five years since New York's estate tax law was last overhauled. Since New York's estate tax law changes were scheduled to become fully phased-in as of January 1 of this year, now is an excellent time to review the key principles under the Federal and New York State transfer tax laws, along with planning opportunities to which taxpayers may avail themselves in the current favorable wealth transfer environment.

Federal

- The Federal estate and gift tax exemption for 2019 has increased to $11.4 million per person, from $11.18 million in 2018. The exemption, which is indexed annually for inflation, was temporarily doubled in 2018 from $5 million (indexed for inflation) under the TCJA and is set to return to $5 million (indexed for inflation) at the end of 2025.
- Federal estate and gift taxes are "unified" under a single transfer tax system, with a unified rate schedule, and a unified credit. Taxable gifts made during lifetime reduce the amount of the exemption available for estate tax purposes at death.
    - Because of the structure of the unified gift and estate tax system, the TCJA recognized the possibility that taxpayers may prior to 2025 make sizeable gifts that are within the TCJA's increased exemption amount, but die after 2025 when the exemption has reverted to $5 million, resulting in the deceased taxpayer having used more than the available exemption. This circumstance is commonly referred to as a "clawback" scenario, and the TCJA includes language authorizing the Treasury to prescribe IRS regulations to address the issue. The IRS issued proposed regulations in November of 2018 that provide that taxpayers who take advantage of the increased exemption will not be adversely affected by the post 2025 decrease in the exemption. The regulations have not yet been adopted as final.
    - Present interest gifts that do not exceed the statutory gift tax exclusion amount will not reduce the amount of exemption available for estate tax purposes at death. The gift tax exclusion amount is $10,000, indexed for inflation occurring after 1997. The exclusion amount for 2019 is $15,000, unchanged from 2018. The exclusion covers gifts a donor makes to each donee, each year. If the donor of the gift is married, gifts to donees made during a year can be treated as split between the spouses, even if the gift is actually given to a donee by only one of them, by the filing of a gift tax return signed by both spouses.
- Federal Provisions For Married Taxpayers.
    - Married taxpayers may leave an unlimited amount of assets to a spouse and qualify for the marital deduction, if such assets are given outright, or in a qualifying trust, typically a "qualified terminable interest property trust" ("QTIP Trust"). At the surviving spouse's death, such assets may be subject to estate tax depending upon the surviving spouse's available exemption.
    - Under the portability provisions initially implemented in 2010, any Federal gift and estate tax exemption that remains unused at the death of a spouse is generally available for use by a surviving spouse, as an addition to the surviving spouse's exemption, through the timely filing of a Federal estate tax return. A surviving spouse may use the predeceased spousal carryover amount in addition to his or her own Federal exemption for taxable transfers made during life or at death. The amount received by the surviving spouse is called the deceased spousal unused exclusion, or DSUE amount.

[1]The Tax Cuts and Jobs Act, which became effective on January 1, 2018, implemented sweeping changes to the Internal Revenue Code, including the doubling of the estate, gift and generation-skipping tax exemptions from $5 million to $10 million per person, indexed for inflation occurring after 2011. The inflation adjustment index was also changed. Prior law based the computation on the Consumer Price Index for all Urban Consumers ("CPI-U"). Under the Tax Cuts and Jobs Act, the inflation adjustment is based on Chained CPI-U ("C-CPI-U"), which generally produces a slower growing CPI calculation than the CPI-U calculation.

- The Generation-Skipping Transfer Tax (GST) is the Federal transfer tax which may be imposed on transfers that "skip" a generation (generally transfers by gift or at death to grandchildren and more remote descendants). The GST tax is in addition to gift and estate taxes. Currently, the GST exemption amount runs in tandem with the gift and estate tax exemption and is $11.4 million as of January 1, 2019, scheduled to revert to $5 million at the end of 2025, as indexed for inflation. The portability rules do not apply to the GST Exemption.
- The Federal estate, gift and GST tax rate remains at 40%.

New York State

- The NYS estate tax exemption (the "NYS Basic Exclusion Amount") for 2019 has increased to $5.74 million from its previous level of $5.25 million. In future years, the exemption will be adjusted annually for inflation, to equal the amount of the Federal exemption prior to and as if the TCJA had not been enacted.[2]
  - New York's estate tax law includes a quirky feature commonly known as the "cliff." If the New York taxable estate exceeds the Basic Exclusion Amount by more than 5%, the credit is phased out completely and the entire taxable estate will be subject to NYS estate tax. This tax structure has been referred to as "confiscatory," in that it can lead to the absurd result of causing the beneficiaries of estates between $5,740,000 and approximately $6,286,700 to receive, after estate taxes, less than the beneficiaries of an estate valued at $5,740,000. Taxpayers whose estates are valued near the "cliff" may wish to include a formula provision, sometimes referred to as a "Santa Clause," pursuant to which a portion of the estate will pass to charity if the formula results in the imposition of less NYS estate tax.
- New York does not impose a gift tax. A temporary provision requiring inclusion of gifts made within 3 years of death in the gross estate of a New York resident decedent sunsetted on January 1, 2019, but the recently released Fiscal Year 2020 NYS Executive Budget includes proposed legislation that would extend the sunset to January 1, 2026, to coincide with the expiration of the increased exemptions under the TCJA. The proposed law must now make its way through the NYS Legislature, but passage seems likely in light of the current political configuration in Albany.
- NYS Provisions For Married Taxpayers.
  - An unlimited marital deduction is available under New York's estate tax law.
  - New York law does not provide for spousal "portability" to allow a surviving spouse to use his or her deceased spouse's unused gift and estate tax exemption.
- New York does not impose a GST tax for transfers made on or after April 1, 2014.
- The top New York estate tax rate is 16%.

Planning Considerations

- Credit Shelter Planning. While the federal exemption amount, coupled with federal spousal portability, currently renders it possible for married couples to shelter from federal estate tax up to $22.8 million without the need to rely on complex testamentary documents, credit shelter trust planning for married couples nevertheless continues to occupy a vital estate planning role for several reasons.
  - State Estate Taxation. New York is one of a handful of states that continues to impose a separate estate tax, and does not recognize spousal portability. Accordingly, credit shelter planning is necessary so as not to lose the benefit of the NYS exemption of the first spouse to die.
  - Trust Protection. Establishment of any trust can provide protections not present with an outright distribution. These include protecting assets from both the beneficiary, a divorcing spouse, and third-party creditors, and providing greater assurance that children and grandchildren will receive an inheritance.

[2] Unlike Federal law under the TCJA, the State of New York continues to base its inflation adjustment computation on the Consumer Price Index for all Urban Consumers ("CPI-U").

- ♦ Asset Appreciation. The potential for asset appreciation is a consideration which runs across a range of planning concerns. Establishment of a credit shelter trust may prevent the post-transfer appreciation in the value of the assets from being subject to estate tax on the death of the survivor. However, no income tax basis step-up will be available for the assets held in a credit shelter trust upon the death of the surviving spouse.

- ♦ Formula Planning Caution. Testamentary formulas based on the federal exemption amounts, including credit shelter planning (as well as GST formula planning), must be reviewed periodically, particularly in times such as the last several years when exemption amounts have changed dramatically. The new exemptions may result in overfunding or underfunding the amount passing to or for the benefit of a surviving spouse, and may result in an unnecessary state estate tax.

- Sunsetting and Potential Earlier Repeal. The increased estate, gift and GST exemptions, currently at $11.4 million per person, are temporary and set to expire automatically on December 31, 2025. Currently available planning options may be lost if action is deferred until the eleventh hour. Moreover, in the present unsettled political climate, it is conceivable that the increased exemption amount could be lowered prior to 2025. A Presidential election will be held in 2020, and several potential Presidential candidates have voiced proposals to ratchet the exemptions back to $5 million and lower. For instance, Senators Cory Booker, Bernie Sanders and Elizabeth Warren have each floated separate proposals that would lower the exemption to the pre-2010 threshold of $3.5 million, coupled with higher maximum rates.

  - ♦ Gifting. Lifetime gifting, outright or in trust, can result in substantial transfer tax savings. Gifting provides the benefit of removing the post-transfer appreciation in the value of the assets from the donor's estate. For New York domiciliaries, since a State estate tax is imposed but not a gift tax, gifts can result in a substantial reduction in State estate tax liability. Many gifting vehicles, moreover, offer discounting advantages that may be absent from or less effective than those associated with transfers at death. However, since the recipient of a gift receives the donor's income tax basis in the gifted assets — as opposed to the recipient of a testamentary transfer receiving an income tax basis as of the date of death — any proposed gift must measure the potential capital gain consequences as against potential gift and estate tax savings.

    - ◊ Dynasty Trusts. For taxpayers who wish to establish a Dynasty Trust, substantial gifts of $10 million (indexed for inflation), after factoring in any prior taxable gifts, may be made to a Dynasty Trust to which GST exemption may be allocated, exempting the trust assets from further estate, gift and GST taxation. Creation of the trust in a jurisdiction that has repealed or liberalized its Rule Against Perpetuities can allow the trust assets to provide for future generations without being burdened by further estate, gift or GST taxes. For those who have previously established a Dynasty Trust, consideration should be given to making additional gifts to the Dynasty Trust to take advantage of the increased federal exemption and the inflation adjustment.

    - ◊ Spousal Lifetime Access Trusts. The Spousal Lifetime Access Trust (SLAT) can enable married couples who wish to make large lifetime gifts to descendants without a dramatic impact on their current lifestyle. With a SLAT, one spouse makes a gift to an irrevocable trust using the donor-spouse's gift tax exemption. The non-donor spouse is named as a current beneficiary, which allows the trustee to make distributions of trust funds to the beneficiary-spouse during his or her life.

    - ◊ Qualified Personal Residence Trusts (QPRTs). QPRTs are a popular vehicle for making a gift transfer, in trust, at a reduced gift tax cost of a personal residence in exchange for its continued use rent-free for a term of years. At the expiration of the term, the residence passes to family members at no additional gift or estate tax cost. The effectiveness of a QPRT generally increases with higher interest rates.

◊ Grantor Retained Annuity Trusts (GRATs). A GRAT is a trust to which a donor irrevocably gifts assets, and in return receives an annuity for a fixed term of years. The value of the gift is equal to the fair market value of the property transferred to the GRAT minus the value of the retained annuity, calculated using the monthly interest rate under Internal Revenue Code §7520 in effect at the GRAT's inception. Where the present value of the annuity equals the original contribution (a "near zeroed-out GRAT"), the value of the taxable gift will be nominal. Upon expiration of the fixed term, provided the donor is living, any remaining assets in the GRAT pass to the beneficiaries free of gift tax. GRATs are interest rate sensitive (the January 2019 rate is 3.4%) and as rates rise, the ability to outperform the §7520 rate becomes increasingly difficult. Thus, a GRAT may be suitable only for gifts of high income and/or appreciating assets.

◊ Intentionally Defective Grantor Trusts (IDGTs). Assets gifted to an IDGT are removed from the donor's estate for gift and estate tax purposes, but the donor remains responsible for payment of income taxes, which payments are, in effect, additional non-gift taxable transfers to the IDGT. In addition, an IDGT provides a vehicle for selling assets of the donor to the IDGT, without incurring a capital gain, in exchange for a promissory note.

Current law provides tremendous opportunities to transfer wealth, and should be taken as a call to action to review your existing estate plan and, where appropriate, to implement planning opportunities provided by the temporary increased Federal exemptions.

For more information on Meyer Suozzi's Wills, Trusts & Estates Law practice, click here.

Our Wills, Trusts & Estates Law practice group includes the following attorneys:

Patricia Galteri
pgalteri@msek.com
(516) 592-5790

Nathaniel L. Corwin
ncorwin@msek.com
(516) 592-5740

Jayson J.R. Choi
jchoi@msek.com
(516) 592-5799

Elisa Santoro
esantoro@msek.com
(516) 592-5724

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