Year-end planning in the aftermath of the election

Estate and gift tax considerations

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The following is companion piece to RSM's 2016 year-end tax and estate planning webcast held Nov. 16, 2016. This white paper addresses the estate and gift tax considerations individuals should consider when reviewing their current estate plan.

It's that time of year again, time for year-end estate and gift tax planning. But, as happens from time to time or in any given year, some of the traditional planning constants can unexpectedly become variables. This is one of those years. Indeed, as we go to press, the planning environment might be summed up quite nicely by Buffalo Springfield's famous lyric, "There's something happening here, what it is ain't exactly clear..."

Yes, in the aftermath of the 2016 election, the tax planning scene is murky at best. Much, if not all of the existing wealth transfer tax structure, meaning the estate, gift and generation-skipping transfer (GST) taxes, could be repealed or recast in the coming year by the Trump administration and Congress. But, we don't know what will be repealed. Nor do we know when any repeal would be effective. What's more, certain key income tax aspects of estate planning may be in play. So, it's difficult for individuals to determine whether their estate planning objectives are better served by acting before year-end or by deferring any action until they can more clearly assess the long-term implications of a major gift or other estate planning transaction.

One thing that does remain constant, however, is that estate and gift tax planning is only a subset of an individual's broader financial and estate planning. The tax planning component serves the larger, more personal objectives of the plan — not vice-versa. Therefore, year-end is as good a time as any for people to confirm that their overall plan still suits them as individuals first, spouses second, parents third and taxpayers fourth. After all, while the estate tax might be repealed, there will be no repeal of death itself, incapacity, the need for guidance and management, the need for protection from creditors including divorcing spouses and, for many, the need for state estate tax planning. In other words, one of the unfortunate byproducts of repeal could be that people figure that if there is no longer a reason to do estate tax planning, then the often more critical planning isn't necessary either or, at least, it can wait. Of such stuff misfortune is made, as is probate litigation. The point is, there would still be need for and benefits from traditional estate planning. That's why we will include some observations about general estate planning in the course of this discussion.

The current wealth transfer tax system

Let's start with a brief overview of the current wealth transfer tax system, which is comprised of the estate, gift and GST taxes, respectively. After all, it is what we have for the balance of the year and it is the context in which steps taken between now and the end of the year will be formulated and implemented. And, as noted, repeal may only encompass portions of the wealth transfer tax system. What's more, if the estate tax is repealed, every estate plan that was essentially fashioned by and shaped around the existing estate tax structure will need to be reviewed for its functionality in an estate tax-free setting.

In 2016, an individual can give away during lifetime or die owning $5.45 million of property. This number is indexed annually for inflation and will increase next year to $5.49 million. Once past that threshold, the tax rate is 40 percent. Mechanically, Uncle Sam lets an individual run a tab, i.e., whatever exemption is not used during lifetime is available at death. The individual can also make annual exclusion gifts of up to $14,000 in 2016 (and 2017) to as many individuals as he or she chooses. The annual exclusion is also available for payments directly to the providers of health care services and education. Annual exclusion gifts do not consume gift or estate tax exemption.

No overview of the existing wealth transfer tax system would be complete without mentioning portability and income tax basis, respectively. Portability refers to the ability of a surviving spouse to add to his or her own exemption whatever amount of exemption the deceased spouse had not used during lifetime. Portability is an important concept because it can eliminate the need for a credit shelter or so-called "bypass" or "B" trust that has been a staple of many estate plans. (For more information, refer to RSM's 2016 year-end tax and estate planning appendix section, slide 50 which includes an overview of the relative merits of portability versus the B trust.)

In the estate planning context, discussions about income tax basis generally focus on the rules for determining the basis of property acquired by inheritance versus gift. Under current law, the income tax basis of an asset acquired by inheritance is its value at the date of the decedent's death. If that value is higher than what the decedent paid for it, then the basis is said to be "stepped up." The basis of an asset acquired by gift is the same basis as the donor had, i.e., it's a "carryover" basis. As we'll note later on, these rules could be in play next year, and a change could have significant planning implications.

Estate and gift tax reform proposals

That's an overview of the existing wealth transfer tax system. Now let's talk about what "could be." At a very high level, it's generally acknowledged the GOP would like to repeal the estate tax. However, a closer look at the positions put forward by the Republican-controlled House and the proposals advanced by now President-elect Trump reveals some interesting differences. The House would repeal the estate tax and the GST tax. Mr. Trump would repeal the "death tax," though we don't know if that refers just to the estate tax or the GST tax and the gift tax as well. If past is prologue, it would not be surprising to see repeal of the estate tax (and perhaps the GST tax) but not the gift tax. Obviously, we'll have to wait and see. In addition to not knowing *what* will be repealed, we don't know *when* anything will repealed and what the *effective dates* of repeal will be. Repeal could be fully effective in 2017 or 2018 or it might be phased-in over a period of years to cushion the hit to the Treasury

The basis question is a wildcard. Mr. Trump's plan calls for a tax on unrecognized capital gains at death, with an exemption of its own and exceptions for family businesses and farms. But we don't know if that tax would actually be due and payable at death or would just create a carry-over basis for those who inherited the assets, with the tax triggered only if they sell. There are just too many variables in play now to be able to plan with the kind of "visibility" that most individuals require before making significant transactions.

We also see that Mr. Trump's plan would disallow an income tax deduction for contributions of appreciated assets into a private charity established by the decedent or the decedent's relatives. The bottom line is we don't know the bottom line. The best we can do is to forge a set of guidelines for planning that can make sense today without running afoul of our sensibilities tomorrow.

Checking the foundation of the current estate plan

To reinforce the notion that estate planning is about a lot more than taxes, we suggest individuals think of their plan as an artful blend of documents, asset titling arrangements and income streams that create and fund a structure that will:

- Prepare them for living dependently, just in case they lose their capacity to manage affairs;
- Provide for and protect surviving spouse, children and any others whom they wish to provide for and protect. The full scope of the term "provide for and protect" being in the eye of the beholder of course;
- Prevent family disharmony (or cause it, if that's the objective), bearing in mind that there is no amount of money too small for people to fight over;
- Reduce survivors' stress, a point often discussed in the popular press but conspicuously absent as a component of many estate plans;
- And finally, and only finally, preserve estate from taxes, if there are any, and expenses, which there will be.

That definition can serve as a template for the rest of our discussion.

The point to be made here is that before we work on the design of the gables and turrets in the house (that's the tax planning), let's be sure we don't have a fire in the basement (that's the comprehensive estate plan). So, here is a list of questions that individuals should ask about their estate plans.

- Do they know what happens if they can't manage their affairs? Do they know who would be in charge of their money if, by accident or ill health, they no longer knew what time it is or didn't care, as it were? Are they as comfortable with someone having that power of attorney now as they used to be?
- Can they describe what goes to whom when they die, how it goes and, if there are trusts, how they work? Granted, the terms of any trusts are likely to be of more interest to a surviving beneficiary than a deceased grantor, but a trust done, say, 10 years ago when the children were just graduating for college may not make much sense now that they are married with children. And what about the trustee? Is the individual named as trustee years ago as wise and reliable today as he or she was then? Is the institution named, now two or three acquisitions removed, the same institution they knew 10 years ago?
- Do they have a diagram or flowchart that shows how their plan works, where survivors' money will come from and on what terms, etc.? Pictures have a way of getting a message across more clearly than words, especially if those words are laced with technical jargon.
- Do they have a letter of instructions for their survivors? (For more information, refer to RSM's 2016 year-end tax and estate planning appendix section, slide 49 that lists what should be in such a letter.)

- Here's a little side bet. If they sit down to write out that letter, it's more likely than not that they will be disturbed by the "holes" they'll discover in their estate plan.
- If they are married, do they know, just in general terms, the income and estate tax implications of their plan, i.e., what will be subject to income or estate tax and when? Do they know what gets a stepped-up basis, for example? What they don't know could cost their surviving spouse a lot of money. And, of course, among other things they probably don't know is which of them will be the surviving spouse.

Sharpening the focus on the estate plans of married couples, consider plans that include a qualified terminable interest property (QTIP) trust and/or a B trust. Individuals should read the documents and then imagine they are not the spouse who dies first. They are the survivor, and access to much of what was left to them is governed by the trusts they've just read. Are they comfortable with that structure?

If their plans include B trusts that were used largely to avoid wasting lifetime exemption, then such a B trust may be unnecessary now because of portability. Or, forgetting portability, maybe after a closer look at it, they can't abide by the constraints that would be imposed on *their* money. And what about the QTIP, which may hold a much larger portion of what was left by their spouse than the B trust? Now that they understand how that works, do they still like it? Can they still live with it? If not, then now would be a good time to explore other options.

Before individuals turn to further estate tax planning, which essentially means giving away money and assets to reduce the estate tax on what will eventually pass to the children, we'd suggest that they ask themselves two questions:

- First, are they sure they will always have more than enough money for their own needs? Have they actually seen the numbers?
- Second, 15 or 20 years from now, which would be their bigger regret, having given too much to the kids or leaving them a big estate tax bill? If the individuals/parents are not sure, then they shouldn't give anything anyway…yet!

Tax planning for year-end and beyond

Moving to the next level

A core principle of estate tax planning is that if individuals want to arrest the growth of their taxable estate, then the only game in town is to remove as much appreciation from their estate as possible. That can be accomplished by making gifts and, if needed and feasible, "estate freezing." Estate freezing is a process by which an appreciating asset is converted into a fixed asset and any future appreciation takes place out of the individual's estate. Common techniques for estate freezing are intra-family loans, grantor retained annuity trusts (GRATs), sales to intentionally defective grantor trusts (IDGTs) and charitable lead annuity trusts (CLATs). As a general rule, always start with the least invasive, least complicated and least administratively expensive technique. After all, it's much easier to go incremental than to have to scale back because key assumptions didn't pan out. (For more information, refer to RSM's 2016 year-end tax and estate planning appendix section which includes brief overviews of GRATs, sales and CLATs.)

What about large taxable gifts as a technique for removing appreciation? There's a lot to be said on this topic, but for now we can only cover some essential points. Even before the notion of repeal came onto the radar screen, the question of whether to make large taxable gifts was not so easily answered. Yes, when the estate tax rate was 55 percent and capital gains rates were 15 percent, it was pretty clear that there was much to be gained by transferring appreciation out of the taxable estate. But when the estate tax rate dropped to 40 percent and the capital gains rate bumped up to 20 percent plus 3.8 percent as applicable (plus state tax where applicable), that clarity became, well, less clear. In some cases, when the numbers and the nature of the asset and the children's intentions for the property align in a certain way, it can make sense to transfer. In others, it won't. But now we have new variables to consider, including potential repeal of the estate tax, retention of the gift tax and perhaps some form of carryover basis. With all that uncertainty, about the only thing that is at least fairly certain is that if someone wants to make a gift, they should do so, but just don't trigger a gift tax, which could be an early payment of an estate tax that is repealed.

The proposed regulations under section 2704 have certainly been a topic of conversation, to say the least, among business owners, estate planners, appraisers and others who would have to deal with the loss of some gift and estate tax discounts. (For more information, refer to RSM's 2016 year-end tax and estate planning appendix section which includes slides that explain key aspects of these proposed regulations.) However, with the GOP in control of the government in the very near future, the future of these regulations is uncertain, especially in light of the GOP's urging Treasury to abandon the project.

Charitable planning

Charitable giving is always a popular topic for year-end planning. Although the focus is usually on the income tax planning side of the equation, charitable giving is also an integral part of the estate plans of many individuals and families. However, whether that will continue to be true if the estate tax is repealed is an open question. Anyway, we pose here some questions that, if explored in depth with their advisors or the planned giving staff at their favorite charity, could enable individuals to make their charitable giving that much more effective and impactful, let alone tax and administratively efficient.

- Why do they want to give? What are they really trying to accomplish? Are they just interested in supporting some organizations whose mission they admire or is there a broader purpose, some change that they would like to affect?
- When do they want to give? Basically, this boils down to making gifts during lifetime, at death or maybe both. Oftentimes, the primary focus is on giving in connection with an anticipated liquidity event. Whatever, it's just helpful for individuals to identify their timeframe for giving.
- What do they want to give? The choices here extend well beyond cash or public securities. Individuals can give retirement accounts, closely-held business interests, life insurance policies, real estate and more. But once they do go beyond the usual assets (cash and securities), there are rules that can dictate how a particular asset can and should be given to charity. And the less liquid the asset, the more the charity may have to say about the terms on which it will accept the asset. The point is that a lot of discussion/planning may be required here.
- How do they want to give? This part of the discussion often breaks down into two inquiries.
  - First, do they want to retain an income stream from any major charitable transaction?
  - Second, what are the characteristics of their preferred charitable approach, i.e. do they want to be a visible donor or an anonymous donor? Do they want to make outright to a public charity or outright to donor advised funds or other vehicles where they can consolidate their giving, involve family in their philanthropy and engage in what some planned giving professionals call "participatory giving."
- How much do they want to give?

At the end of the day, planned giving professionals will tell you that if these questions can be thoroughly explored early on, donors will be much more satisfied with their charitable planning than if they learn on a piecemeal basis.

Life insurance planning

Life insurance is another topic not necessarily on the year-end planning list, but of vital importance nonetheless, largely because we don't get a Mulligan on this one. We'll skip the more fundamental questions about whether an individual has enough life insurance and focus on what is often a more troubling subject, i.e., whether he or she has the right kind of policy. Many people do not have the right kind of policy, but find that out too late to do anything about it. Simply put, there are four principal characteristics that comprise the suitability of a life insurance policy for a given individual: premium flexibility, guarantees, investment flexibility and use of the policy for cash accumulation and distribution. Just as they wouldn't buy a suit or a coat without having it measured and tailored to fit them, no one should buy such an expensive and enduring asset like a life insurance policy without first getting the right "fit."

Another important question about life insurance is whether the right person is insured. Many wealthy people whose estate plans will postpone taxes until the death of the second spouse to die have second-to-die policies. Those policies can absolutely be appropriate in a given setting. But if, actuarially, there could be a couple of decades or more between one spouse's death and the other, maybe that second-to-die policy is the wrong type. There could be a huge opportunity cost if the deaths (and receipt of insurance proceeds) are separated by many years (and many premium payments).

Another important inquiry about life insurance involves irrevocable life insurance trusts (ILITS). Many life insurance policies held in ILITs are living lives of quiet desperation, requiring higher premiums or premiums for more years than ever anticipated. If an individual's ILIT-owned policy still requires significant premiums, there are some things that he or she should check out, though the options for remediation will vary by policy type. For example, certain kinds of policies can be managed more efficiently. Maybe the premium on a policy that is currently funded until the insured is 121can be reduced to support the death benefit to an age just reasonably beyond life expectancy. Meanwhile, individuals can consider transferring discounted income-producing property to the ILIT so that it will have its own cash flow to contribute to premiums without requiring more taxable gifts from the individual. A GRAT with the ILIT as remainderman could be a sensible way to do that, especially if the gift tax is not repealed.

Every split-dollar arrangement should be reviewed for its long-term tax and economic feasibility. There is a lot of split-dollar out there and a lot of that is in trouble, is not getting better with age and needs to be looked at seriously. If the estate tax is repealed but the gift tax isn't, split-dollar will go from being problematic to problematic squared.

Finally, there are undoubtedly many individuals who are now considering the purchase of insurance for estate tax liquidity (and only for estate tax liquidity). These individuals are peering out at the possibility of repeal of the tax they are buying the policy to cover. Rather than proceeding with the purchase of a heavily funded permanent policy that involves a lot of sunk cost if they don't need it, these individuals might consider setting up their ILIT and having the trustee apply for a convertible term insurance policy, meaning one that can be exchanged for a permanent policy without evidence of insurability. This approach will protect their insurability while they assess the situation over the coming months. If the estate tax is repealed, maybe they'll just stop funding the premiums. If it isn't repealed, they can either support the term policy until a combination of the death benefit, rising exemption and continued planning suggest that they no longer need the liquidity. Or, they can exchange it for a permanent policy and "go long", as it were. Many individuals are uncomfortable about the risks associated with converting a term policy, perhaps because they don't know what kind of products will be available for conversion in the future. Such individuals might consider having the ILIT buy a flexible premium product and fund it at the minimum premium to support the death benefit for a while, somewhat mimicking the term policy approach. If they have to go long, they can just increase the funding without evidence of insurability and without the risks of conversion.

Beyond that, individuals should be very careful about surrendering a policy until the coast is clear and they are satisfied that the benefits of that policy, tax and otherwise, aren't valuable enough to retain even if there is no estate tax. And, finally, there is likely to be a major effort to get those with high cash value policies to exchange them for "something "better." Policyholders should lash themselves to the mast on that one until they have really checked out the merits of any exchange.

Closing thoughts

There will obviously be much to learn in the coming weeks and months, Hopefully, these few precepts will enable individuals to make informed decisions that will leave them well-positioned to shape their estate and gift planning no matter what the wealth transfer tax system looks like at this time next year.

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