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Trust UPDATE

Stillman BANK

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Estate planning after tax reform

Estate planners and their clients will have a busy 2018

Important takeaways for estate planners from the December tax reform legislation:

• *The amount exempt from the federal estate and gift tax has doubled.* The exemption is now $10 million plus adjustments for inflation since 2011. Because the calculation of inflation adjustments also was changed by the new tax law, there is some slight uncertainty about the exact exemption, but it is generally believed to be about $11.2 million.

• *Complete repeal of the federal estate tax did not happen.* The initial House-passed version of tax reform called for zeroing out the estate tax entirely, but that idea was soundly rejected in the Senate. The majority of federal estate tax revenue comes from estates of $50 million and more, and that revenue stream was preserved

• *The larger estate and gift tax exemption expires in 2026.* In order to meet budgetary targets, all of the tax changes affecting individuals are scheduled to expire in 2026, including the doubled estate tax exemption. This creates a short window of opportunity for estate planners and their clients.

• *The annual gift tax exclusion for 2018 will be $15,000.* The new law did not change the amount that may be given to a beneficiary each year free of federal gift tax. The IRS announced last fall that the exclusion would be inflation-adjusted upward to $15,000 for 2018.

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• *Basis step-up at death is preserved.* There was a serious question about what would happen to the tax-free step-up in basis in the event of full repeal of the estate tax. Some countries, such as Canada, have required recognition of capital gains at death, as an alternative to the estate tax. During the campaign, President Trump hinted at such a possibility for larger estates. Because the estate tax won't be repealed after all, the issue did not come up.

• *No new restrictions on estate planning were imposed in the new law.* The Obama administration proposed several changes to the estate tax law intended to curtail planning strategies used by larger estates. Apparently, none of these were considered seriously by tax writers.

Some tax observers have wondered whether these estate tax changes will last until 2026 as scheduled. Should the Democrats gain control of the Congress before then, it is possible that they will push for an earlier sunset of the higher exemption. On the other hand, in the entire history of the estate tax in the United States, the amount exempt from the tax never has been reduced, though reductions have been seriously threatened.

According to the Congressional Research Service, only 0.2% of decedents' estate would have been subject to the federal estate tax under the old law. The new law drops that figure to 0.05%. Fewer than 1,000 estates are expected to be taxable in each of the next few years.

Smaller estates

Targeting the federal estate tax to those estates of $10 million and more does not mean that less affluent families are excused from their estate planning responsibilities. A wealth management plan built upon the foundation of a will and one or more trusts still will be essential to providing family financial security. Key points to consider:

• *Without a will the state's intestacy laws will control distribution of the estate assets.* Intestacy laws are drafted to provide what legislators assume the decedent would have wanted done with his or her property at death. Those assumptions may or may not be accurate for particular families. A will takes the guesswork out of the picture.

• *Some states still have their own death taxes.* Although a majority of states have eliminated their estate and inheritance taxes, many of those that retain such death duties do not coordinate with the federal exemption levels. Much smaller estates may be subject to tax. If you live in one of these states—or own property in one—tax planning may still be important to you.

• *Trusts remain very valuable.* Although many trusts have been adopted for tax reasons, there always have been important nontax benefits of using trusts for wealth management. Those reasons remain undisturbed.

• *Basis planning is now important.* Forgiveness of capital gains taxes at death is an important benefit that smaller estates should take into consideration. To maximize this benefit, highly appreciated assets should be kept until death.

Example. Grandfather's total estate will be less than $5 million. He has two blocks of stock that he plans to give to Grandchild, each worth $100,000. Block A was purchased many years ago for $10,000. Block B was purchased a few months ago for $100,000. If Grandfather gives Block A today, Grandchild's basis will be $10,000, and so there will be a $90,000 taxable capital gain if Grandchild sells the stock immediately. If Grandfather instead gives Block B today, and holds Block A until his death, the entire tax on that capital gain will be avoided.

Medium estates

A medium-sized estate today is one larger than $5 million and smaller than $20 million. In reality these are very substantial amounts of wealth, so "medium" may seem a misnomer. But for federal estate tax purposes, these estates occupy the middle ground.

All of the considerations for small estates apply with equal force to the medium estate. Other issues to consider:

• *Programs of annual gifts to take advantage of the gift tax annual exclusion.* An individual may give $15,000 to each of as many beneficiaries as desired each year without touching the lifetime exemption from the federal gift tax. Married couples may give $30,000 by splitting their gift. A couple with three children and five grandchildren may give them each $30,000—a total of $240,000—each year without affecting their federal gift tax exemption.

• *Portable exemptions.* For married couples, the election for the Deceased Spouse's Unused Exemption (DSUE) amount is going to be very important. The election may preserve the enlarged estate tax exemption into the years

beyond 2026, should one marital partner die before then.

Example. Husband and Wife have a combined estate of $16 million. Husband dies in 2018, leaving everything he owns outright to Wife. Thanks to the marital deduction, no estate tax is due at Husband's death. Husband has not used any of his estate tax exemption, so with a proper election Wife will inherit his $11.2 million exemption also.

Now assume that Wife dies in 2026, when the larger exemption has expired. The single exemption then may be perhaps $6 million, depending upon inflation in the next few years. If the election has been made, Wife's estate will have an exemption of $17.2 million, which may leave it free of estate tax. But if the DSUE election was not made, Wife's exemption would be only her own $6 million. That leaves $10 million exposed to federal estate tax, which at current rates comes to $4 million owed. Even if the larger exemption is extended, Wife will have some estate tax exposure.

There is no downside to making the DSUE election, other than the minor cost of hiring an experienced estate planner to supervise the filing of the estate tax return.

Large estates

Estates of $20 million and up will need to do some estate tax planning, even with the doubled exemption. The good news for these estates is that aggressive strategies remain available, such as gifts of minority interests in family limited partnerships, dynasty trusts, and short-term grantor retained income trusts.

The trickier question is whether a large taxable gift should be made before 2026 so as to "lock in" the enlarged lifetime gift tax exemption. This was a conundrum faced by the wealthy in 2012, when for a time it appeared that the federal exemption might drop all the way down to $1 million. As it turned out, a $5 million exemption was made permanent. Some of those who made irrevocable gifts in 2012 reportedly then regretted their actions.

Clawback. If the estate tax exemption is reduced in the future, as scheduled, tax savings of several million dollars could be achieved by making irrevocable gifts of assets before that happens. The new tax law includes a direction for the IRS to provide instructions on what happens if the exemption is reduced in the future.

Simplified example. Jim, a single taxpayer, makes a gift in 2018 of $11.2 million to his heirs. No gift tax is due, thanks to the doubled exclusion. Jim then dies in 2026, when the estate tax exemption is only $6 million, and his estate is then worth only $1. The estate tax is calculated by adding the taxable estate to the total of taxable lifetime gifts. Theoretically, then, Jim's estate will owe an estate tax on the $11.2 million, minus his $6 million estate tax exemption. If his estate has to pay a tax on the $5.2 million difference (about $2 million), the benefit of the larger exclusion would be "clawed back" by the IRS. If the estate already has been exhausted, it is unclear where the payment would come from. Most tax commentators do not believe that will happen, that the larger exemption will be preserved for gifts actually made in reliance upon it. We won't know for certain until the IRS issues regulations on the subject, and that won't happen any time soon.

Your next step

Confused? Don't feel bad. This is early days for what is shaping up to be a fairly radical restructuring of basic estate planning considerations. We're here to be your resource in all matters related to wealth management. In particular, keep us in mind for estate settlement and trusteeship services—that's our core expertise. ☐

Don't do this with your IRA

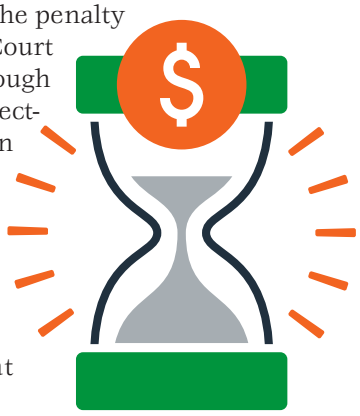
After Thomas Ozimkoski died, a will contest broke out between his surviving spouse, Suzanne, and a son from an earlier marriage. In the settlement, the son received his father's 1967 Harley-Davidson motorcycle and $110,000 cash, "free of income taxes."

The only liquid asset in the estate was an IRA worth $235,495. After the money was rolled into an IRA for Suzanne, she withdrew $110,000 to make the payment to the son. During that year she also withdrew about $64,600 for herself, which left about $60,000 in the IRA.

Suzanne's income was only about $15,000. She filed her tax return in May, 24 days late. Suzanne did not report the IRA withdrawals on her Form 1040, apparently believing that the son would have to pay the income tax on his $110,000 payment. She was mistaken.

The IRS assessed the following taxes on Suzanne: $3,100 for failing to file a timely return; $21,988 of income tax; $17,460 penalty for the premature distribution (Suzanne was not yet 59½); and $12,437 penalty for the substantial underpayment of tax. The total came to $62,185.

Suzanne lost her case in the Tax Court, as there is no provision in the tax code that allows for the payment of estate settlements from an IRA. The penalty tax was abated partially, as the Court held that it was reasonable (though mistaken) for Suzanne to have expected the son to pay income taxes on his share. The Court noted that Suzanne had not received very good tax counseling.



If Suzanne withdraws the $60,000 balance of the IRA to pay the IRS bill, she will owe additional income tax on that withdrawal. ☐

Trouble for long-term-care insurers

More than 400,000 long-term-care insurance policies were sold in 1992, according to figures published by *The Wall Street Journal.* At least 400,000 additional policies were purchased each year in the subsequent ten years, peaking at about 750,000 in 2002. Then sales collapsed. In 2016 only 105,000 such policies were sold, and just 34,000 in the first six months of 2017.

The need for long-term-care insurance never has been greater. What happened to the market?

Actuarial errors. A series of actuarial errors were made when long-term-care insurance was first introduced. The most important of these was the "lapse rate," the number of policies that will be terminated without ever paying a benefit. This occurs either because the insured stops paying premiums or the insured dies without making a claim. The actuaries chose a fairly conservative lapse rate of 5%. At that rate, if 1,000 policies were sold in year one, only 400 would be in force 20 years later. As it turned out, the buyers of long-term-care insurance thought of their purchase as an investment, not as insurance, and so the lapse experience was closer to 1%, which implies that 800 of every 1,000 policies still will be in force after 20 years. That led to far higher payouts than projected.

Two more errors compounded the damage. The first is that medical advances have lengthened life expectancies, which, in turn, increases the likelihood of making a claim on a long-term-care insurance policy. The second is that the actuaries generally assumed a 7% rate of return on the invested premiums on these policies. That assumption was fine in the 1990s, but interest rates have been at historic lows since 2008. Last year earnings on premiums came to just 4.6%, according to A. M. Best Co. When long-term-care policies are priced today, the projected rate of return on premiums is likely to be 2% to 3%, which drives premium costs still higher.

Getting coverage. If you already have a long-term-care policy, you probably want to hang on to it. For the most part those who have purchased these policies have profited from them.

New long-term-care policies are still available, although they are more expensive than in the past, and they may cover less. Hybrid policies that combine life insurance with long-term-care coverage have emerged, and have proved popular as well.

The poorest seniors may have the costs of their long-term care picked up by the government through Medicaid. The wealthiest may be able to cover the costs without insurance.

For everyone in the middle, planning is necessary. Despite the price increases, long-term-care insurance will prove an important part of that plan for many affluent families. ☐