Bloomberg BNA

Daily Tax Report®

Reproduced with permission from Daily Tax Report, 04 DTR J-1, 1/6/17. Copyright © 2017 by The Bureau of National Affairs, Inc. (800-372-1033) http://www.bna.com

Estate Taxes

Joshua E. Steinberg and Elizabeth C. Corder of Duane Morris look at the continuing uncertainty on the federal estate tax front and potential outcomes from President-elect Trump's proposal that the tax be repealed. Estate planners have adapted to a world ''where tax laws could change dramatically at any time,'' the authors write. Repeal, too, could raise pitfalls that require planning, they say.

Estate Planning Under a Trump Administration

BY JOSHUA E. STEINBERG
AND ELIZABETH C. CORDER

Since the short-lived sunset of the federal estate tax in 2010, the federal transfer tax system has existed in a state of constant uncertainty, which has led estate planners to adapt to a world where tax laws could change dramatically at any time.

Now, President-elect Donald Trump has proposed a complete repeal of the federal estate tax. Despite the potential tax savings for wealthy Americans, a number of pitfalls may be unavoidable without proper planning. Practitioners and clients alike should be aware of both the tax and non-tax strategies available to optimize their estate plans.

Federal Estate Tax May Return

The federal estate tax system is all about politics. Even if there is a full repeal of the federal estate tax, it is unlikely to be permanent. In 2017, Republicans will control both chambers of Congress and the White House, yet they will hold only a slim majority in the Senate and won't have the 60 seats necessary to overcome a Democratic filibuster—which could prevent Republicans from being able to repeal the federal estate tax directly.

Joshua E. Steinberg and Elizabeth C. Corder practice in Duane Morris LLP's Wealth Planning Group.

This article is prepared and published for informational purposes only and should not be construed as legal advice. The views expressed in this article are those of the authors and do not necessarily reflect the views of the authors' law firm or its individual partners.

To avoid a Democratic filibuster, Republicans could attempt to pass federal estate tax repeal through the budget reconciliation process, which requires only a simple majority to pass through the Senate. However, such a maneuver wouldn't result in a permanent estate tax repeal and instead likely would be accompanied by a sunset of the repeal in 10 years (as was the case with the Bush tax cuts in 2001). Given the turbulence in the current political climate, in the event Democrats later retake Congress, such a repeal could easily be reversed.

Alternatively, changes to the estate tax law could be passed as part of an overall reform of the tax code, which could be done on a bipartisan basis.

In the midst of all of this, it is entirely unknown what President-elect Trump plans to do with the tax on lifetime gifts, making it challenging to predict whether it is helpful to pursue sales to defective grantor trusts and other lifetime gifting strategies.

State Estate Taxes

Even if the federal estate tax is repealed, several states currently impose their own transfer taxes on estates of individuals who were domiciled in their states. Currently, 15 states and the District of Columbia still impose an estate tax, while six states impose an inheritance tax (Maryland and New Jersey currently impose both, though New Jersey's estate tax is slated to be eliminated in 2018).

Each state's death tax rules bring with them their own idiosyncrasies, including unique estate tax exemptions. Some states have exemptions that are tied to the federal exemption, so those states may have to adjust their laws if the federal estate tax is repealed.

Determining whether a state estate tax is applicable to an individual's estate will be dependent on where that individual was domiciled at death. Domicile for estate tax purposes isn't solely dependent on the number of days spent in a given state; the term is more abstract, but generally means a person's permanent abode.

Some factors that weigh on a domicile determination are the state where an individual is registered to vote, where the person does his or her banking, the state that issued his or her driver's license and where the individual attends religious services or participates in civic activities. Knowing one's domicile is paramount in estate planning since the tax law, as well as the probate law, varies dramatically from state to state.

Capital Gains

President-elect Trump's estate tax repeal proposal also includes an elimination of the step-up in basis on capital assets held by an estate, with an exemption for the first $10 million of assets. It is unknown whether a capital gains tax would be imposed immediately upon death for estates meeting this threshold, or only when such assets are sold.

President-elect Trump's estate tax repeal proposal includes an elimination of the step-up in basis on capital assets held by an estate, with an exemption for the first $10 million of assets.

Nonetheless, an additional tax would become applicable to the estates of wealthy individuals, requiring a new avenue of planning not implemented today. Under such a proposal, capital assets would be ripe for use in charitable giving, though Trump has also proposed a cap on itemized deductions, which would, in turn, affect the tax benefits of donations to charity. Trump's cryptic proposals will have to be fleshed out in order for planners to have firm footing in their counsel.

In the midst of all this uncertainty, there are still many estate planning issues on which to focus. Many non-tax benefits can be attained through diligent planning, and taxpayers may not want to take steps today that they might regret given the turbulent tax environment.

Efficient Administration of Assets During Life and at Death

A last will and testament is a document that dictates the disposition of a person's assets held at death. However, a will becomes effective only when it is filed with the court and the decedent's natural heirs are given an opportunity to object to its validity. This process, known as ''probate,'' can often be a time-consuming and costly process, depending on the state of domicile of the decedent.

In recent years in many states, estate planners have turned to revocable ''living'' trusts to supplement a simple ''pour-over'' will. The revocable trust agreement becomes the individual's foundational estate planning document, stating the dispositive terms of asset distribution that apply upon death. The revocable trust, however, can dispose only of the assets held by its trustee. Therefore, a necessary accompaniment to a revocable trust is the pour-over will, which states that all assets in the decedent's name at death (that don't designate a beneficiary) will be distributed to the revocable trust.

The advantages to using a revocable trust include the following:

- **Avoiding Probate Entirely.** If all assets that don't designate a beneficiary or pass by operation of law (e.g., joint assets) are retitled in the name of the revocable trust during life, then probate can be avoided entirely. Even if only some assets are transferred to the trust, those assets can be accessed immediately by the successor trustee at death.

- **Avoiding Probate in Multiple States.** In addition to the state of domicile, probate is required for each state in which the decedent owned real property. If such property is transferred to the revocable trust during life, probate can be avoided in all states other than the state of domicile.

- **Avoiding Future Court Involvement.** In some jurisdictions, a will that has been probated remains under the supervision of the court in perpetuity. If, for example, the will creates a trust for a beneficiary, that trust now must be administered under the court's watch. Thus, if a trustee needs to be changed many years down the road, the court must be petitioned to approve such a change. Changes to trustees or other future trust administration under a revocable trust avoids court involvement.

- **Incapacity.** To the extent that assets are transferred to the revocable trust during life, those assets can be used by a successor trustee to manage the finances of the trust's creator if he or she becomes incapacitated. This mechanism is superior to the reliance on a power of attorney, which is more heavily scrutinized by financial institutions.

Gifting

As noted above, President-elect Trump hasn't yet given any indication of whether or how he might change the federal gift tax. As a result, it can be challenging to determine whether gifts should be made now to utilize and maximize remaining federal gift and estate tax exemptions.

Making gifts today has the benefit of locking in the value of the asset for transfer tax purposes—any appreciation following the date of the gift belongs to the donee and isn't subject to transfer tax. A true balancing of the pros and cons can't be accomplished until Trump's plan is fleshed out, since it is unknown exactly how the proposed capital gains tax at death would be applied.

If an asset would receive a step-up in basis at death without incurring an estate tax or a capital gains tax, then it would be preferable for the taxpayer to continue

 COPYRIGHT © 2017 BY THE BUREAU OF NATIONAL AFFAIRS, INC. ISSN 0092-6884

to hold the asset until death rather than making a lifetime gift. If, on the other hand, the asset would be subject to an automatic capital gains tax at the taxpayer's death, it would be more advantageous to transfer the asset during life, thereby deferring the capital gains tax until the asset is sold or the donee dies.

One way to hedge against this uncertainty is to make a gift to a spousal lifetime access trust (SLAT). SLATs, which were popular planning vehicles in 2012 to hedge against the potential significant reduction in the federal estate tax exemption, are irrevocable trusts that permit distributions of income and/or principal to the donor's spouse (or to the donor's spouse and descendants).

SLATs enable donors to utilize their federal estate tax exemption—capturing the future appreciation on the transferred assets inside the SLAT—while still ensuring future access to the transferred assets if needed by the donor's spouse. If the federal estate tax is eliminated and it turns out that the assets otherwise would have received a tax-free step-up in basis at death, the assets can be distributed back out to the donor's spouse. SLATs also can be used to avoid state estate or inheritance tax on the transferred assets in states that have an estate or inheritance tax but not a gift tax, while still continuing to ensure that, if needed, the assets will be available to the donor's spouse in the future.

With assets that aren't appreciated, there seems to be little risk in continuing to pursue lifetime gifting strategies, including gifts of less than the gift tax annual exclusion (currently $14,000). Though the assets might ultimately be transferable at the donor's death without incurring a federal estate tax in the event of a complete repeal, there is the chance that the federal estate tax is later reinstated. Since there will still likely be a tax on assets at death in one form or another, strategies for reducing the size of the taxable estate continue to be relevant and important.

Trusts for Spouses and Descendants

Regardless of the state of the federal estate tax regime, creditor protection continues to be a key issue in estate planning. Transferring assets—whether during lifetime or at death—to trusts for the benefit of one's descendants can, if structured properly, prevent those assets from being subject to the claims of the descendants' creditors or to equitable division in the event of a divorce, events that perhaps are the greatest uncertainties in life.

Trusts for spouses also have the benefit of ensuring that assets pass downstream to one's descendants after the spouse's death as they don't get commingled with a potential new spouse's assets and avoid the descendants entirely.

Talk is cheap in politics and many of President-elect Trump's proposals are likely to run into the hard wall of political reality. The only certainties in life are death and taxes, but when they come and in what form are unpredictable. A sound estate plan can hedge against the tumult of both law and life.