WRMarketplace

An AALU Washington Report

The *WR Marketplace* is created exclusively for AALU members by experts at Greenberg Traurig and the AALU staff, led by **Jonathan M. Forster, Steven B. Lapidus, Martin Kalb, Richard A. Sirus, and Rebecca S. Manicone.** WR Marketplace #18-11 was written by **Shareholder Jonathan M. Forster and Associate Jennifer M. Smith.**

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TOPIC: Legacy Planning Post-Tax Reform - Part 1: Let Me Count the Ways: 5 Questions for Non-Taxable Estates.

MARKET TREND: Higher estate tax exemptions may lead more individuals to disregard the importance of legacy and life insurance planning, to their detriment.

SYNOPSIS: The doubling of the federal gift, estate, and generation-skipping transfer ("GST") tax exemptions ($11.18 million in 2018) has drastically reduced the number of individuals whose estates will incur a federal estate tax. Yet, potential estate tax exposure should not be the sole motivator for legacy and life insurance planning. Even individuals well below the new exemptions should still have legacy and life insurance plans to ensure their family's financial security during incapacity or after death. Various options exist to increase the flexibility of plans for these individuals and to ensure they remain workable when these transfer tax changes expire in 2026.

TAKE AWAYS: Post–tax reform, families with non-taxable estates should still meet with their advisors to review (1) their current planning needs, (2) whether their existing plans still function as intended, (3) the preferred structure for estate distributions (outright or in trust), and (4) the options for incorporating flexibility into their legacy plans, including the use of spousal disclaimers, "QTIP" trusts, and exemption portability. Life insurance continues to play a key role in this process, as it offers a simple and flexible solution to address many planning needs, minimize later conflicts, and promote family security.

Legacy plans should be reviewed periodically and especially ***after any major tax law changes***. Yet, after the Tax Cuts and Jobs Act (the "**Tax Act**"), individuals with estates

below the higher federal estate tax exemption may believe they no longer need to actively engage in legacy planning. Failure to connect with advisors to review their plans could result in unintended and adverse consequences for their families. Here are five questions to consider with advisors.

1. ***Why Do I Still Need a Legacy Plan?*** The most important aspects of legacy planning typically do not involve tax issues. Legacy plans help ensure a family's financial security and minimize conflict among family members during an individual's incapacity or after death by addressing the following:

   - **Incapacity Planning**. Ensure the family's access to financial assets and the ability to manage an incapacitated individual's health care with: (1) financial powers of attorney that appoint agents to handle financial affairs, (2) health care powers, living wills, and advance directives that authorize an agent to make medical decisions and express the disabled individual's preferences for his or her care, and (3) authorizations naming persons who can access the incapacitated individual's medical and health information.

   - **Estate Distribution/Administration.** Ensure distribution of an individual's estate to desired beneficiaries and avoid misunderstandings among family members about what the decedent wanted. Otherwise, state intestacy laws will apply and may result in undesirable distributions.

   - **Fiduciary Appointments**. Minimize confusion and conflict over who handles estate administration and other matters by appointing various fiduciaries, including (1) personal representatives/executors to handle estate administration, (2) guardians for any minor children, and (3) trustees to administer any trusts created for family members.

   - **Future Changes**. The Tax Act's transfer tax changes will expire in 2026. Failure to plan in the interim may result in missed opportunities and exposure to additional taxes.

2. ***Does My Current Plan Work?*** Legacy plans for many married couples use a formula that leaves the federal estate tax exemption in a "bypass" or "credit shelter trust" ("**CST**"), typically benefiting the surviving spouse and/or descendants, and the balance to the surviving spouse, either outright or in a marital trust. The CST was used to preserves the trust assets (and any appreciation thereon) from subsequent taxation in the surviving spouse's estate. As the Tax Act may have altered the economics of these formula approaches, potentially leaving far more assets than intended to the CST, individuals should review any funding formulas in their legacy plans to confirm they still produce the desired distributions.

   Example: Alex and Beth are married and living in Massachusetts with their daughter, Chloe. Alex has two children from a prior marriage. Alex's estate is worth $11 million. Alex's will provides that, at his passing, his remaining federal estate tax exemption will pass to a CST benefiting his

descendants from his prior marriage, with the balance of his estate passing to a marital trust for Beth. Upon Beth's passing, the remaining marital trust assets (after payment of any estate taxes and expenses) pass to Alex and Beth's descendants.

If Alex passed in 2017, the above formula would have placed approximately $5.49 million in the CST, leaving $5.51 million for the marital trust. In 2018, however, this formula will fund Alex's entire $11 million into the CST, leaving nothing for Beth in the marital trust (and possibly triggering an elective share claim by Beth under applicable state law to avoid her disinheritance).

Formula-based funding of a CST may result in additional state estate tax at the first spouse's passing if the state imposes a separate estate tax with an exemption smaller than the new federal amount. In Alex and Beth's example, Massachusetts has a separate estate tax and provides only a $1 million exemption. Full funding of Alex's CST in 2017 would have generated a Massachusetts estate tax on a taxable amount of $4.49 million of assets ($5.49 million - $1 million state tax exemption), but in 2018, that taxable amount increases to $10 million, since all Alex's assets are now funded into the CST.

3. ***Should I Leave My Estate Outright or in Trust?*** Individuals with estates under the new federal estate tax thresholds may simply default to leaving assets outright to a surviving spouse or other beneficiaries for simplicity. But simplicity comes at a cost. Individuals should actively consider the various benefits and issues associated with distributions outright versus in trusts before making the decision:

	Outright Distributions	**Trusts**
Potential Benefits	• Simple to implement, no ongoing administration • Assets receive a basis step-up at death • Beneficiaries have immediate access to/control over assets • Unused federal estate tax exclusion is portable to surviving spouse and can be used during his or her life or at passing	• Centralized financial management • Beneficiaries learn financial stewardship (can act as co-trustees) • Confidentiality and protection from creditor/marital claims • Control the flow of information and assets to younger beneficiaries • Consolidate assets to ease transfers and avoid fractional ownership • Provide for business succession and governance of shared family assets

	Outright Distributions	Trusts

		• Preserve assets from applicable state and/or future federal estate taxes
		• Can allocate deceased spouse's GST tax exemption so it is not lost
		• Can incorporate flexibility by giving:
		  ○ Beneficiaries powers to appoint trust assets
		  ○ Independent trustees broad distribution powers
		  ○ A trust protector powers to modify select trust provisions

Considerations	• Control of assets is left to the surviving spouse, who may remarry • Not ideal for blended family planning • No creditor protection • Assets subject to mismanagement or loss by young, financially unsophisticated, and/or troubled beneficiaries • Assets (and appreciation thereon) are not protected from federal and/or state estate tax in recipients' estates • GST tax may still apply to transfers and GST exemption is not portable between spouses	• Ongoing trust administrative and accounting requirements and related costs (may be economically impractical for smaller amounts) • No automatic basis step-up for assets at beneficiary's passing (requires basis management) • Beneficiary-trustee's control over trust distributions limited to ascertainable standard (e.g., for health, education, maintenance, and support)

4. ***Can We Make These Decisions When I Pass?*** There are several "hybrid" options that can allow either the surviving spouse or the decedent's executor to make the choice of how amounts are distributed to beneficiaries or federal estate tax exemptions applied, based on the family's circumstances and the tax laws existing at an individual's passing. This flexibility comes at a cost and requires additional planning after the first spouse's passing:

- **<u>Spousal Disclaimers</u>**. The disclaimer approach typically leaves the predeceasing spouse's assets outright to the surviving spouse but allows him or her to disclaim assets into a CST-like trust benefiting the surviving spouse and/or other beneficiaries. The surviving spouse can decide to disclaim only the amount needed to achieve optimum results, such as limiting the disclaimer to the state estate tax exemption if the spouses reside in a state with a separate estate tax.

  A disclaimer, however, leaves sole control of the assets with the surviving spouse, who may opt not to disclaim. The requirements for an effective disclaimer also are highly technical and must be satisfied within nine months of the decedent's passing, which may be easily overlooked when a surviving spouse is distracted by the other's death.

- **<u>"QTIPable" Trust(s)</u>**. This approach provides the benefits of a trust but gives the predeceasing spouse's executor (not the surviving spouse) 15 months to decide whether to make the QTIP election to qualify part/all of the trust for the marital deduction. The election results in inclusion of the "QTIPped" assets in the surviving spouse's estate and a corresponding basis step-up. To the extent a QTIP election is not made, the predeceasing spouse's federal estate tax exclusion applies to the trust, and any unused exemption is portable to the surviving spouse. The executor also can allocate the decedent's GST election to the QTIP trust, if desirable, by making a so-called "reverse" QTIP election.

  Making a QTIP election, however, typically requires the filing of a federal estate tax return, even if one is not otherwise due. The costs and time requirements for this filing must be balanced against the benefits of the QTIP election.

- **<u>Portability</u>**. Portability allows the transfer of a predeceased spouse's unused federal gift and estate tax exemption to the surviving spouse. It can work in tandem with disclaimer or QTIP planning to prevent the loss of any unused federal estate tax exemption of a predeceased spouse (e.g., because a QTIP election was made to qualify a trust for the marital deduction or a disclaimer was not made to a CST). Portability allows the surviving spouse to retain assets in his or her estate for a basis step up while benefiting from both spouses' federal estate tax exemptions.

  Like a QTIP trust, however, portability requires the predeceasing spouse's executor to make an election by filing a federal estate tax return, even if one is not otherwise due. Further, portability typically will not be preferred in blended family planning or in the case of younger individuals, where remarriage of the surviving spouse is probable. It also does not apply to the federal GST tax exemption or to state estate tax exemptions (unless applicable state law provides a separate portability election).

5. ***Do I Still Need Life Insurance?*** As with legacy plans, life insurance addresses a wide variety of needs, including:

- **Estate Liquidity & Family Security**. Non-taxable estates still have expenses, such as funeral costs, outstanding medical expenses, and family support. Ensuring sufficient liquidity for expenses can minimize conflict, provide a source of lost income for the family, and avoid untimely sales of estate assets simply to cover costs.
- **Equalizing Beneficiaries**. Life insurance can facilitate disproportionate asset distributions, such as distributions of real estate or business interests to certain family members while equalizing other heirs with cash.
- **Blended Families**. Life insurance can easily provide for children from prior marriages while leaving sufficient assets to the surviving spouse to maintain his or her lifestyle.

Any existing life insurance coverage should be periodically reviewed with a life insurance advisor and coordinated with any review of an individual's estate plan.

TAKE AWAYS

Post–tax reform, families with non-taxable estates should still meet with their advisors to review (1) their current planning needs, (2) whether their existing plans still function as intended, (3) the preferred structure for estate distributions (outright or in trust), and (4) the options for incorporating flexibility into their legacy plans, including the use of spousal disclaimers, "QTIP" trusts, and exemption portability. Life insurance continues to play a key role in this process, as it offers a simple and flexible solution to address many planning needs, minimize later conflicts, and promote family security.
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