Estate Planning Insights

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CHANGES, PLUS UNCERTAINTY

The Tax Cuts And Jobs Act. On December 22, 2017, Public Law No. 115-97, better known as the "Tax Cuts and Jobs Act," was signed into law. The Tax Cuts and Jobs Act (the "New Law") made many changes to the federal tax laws. We are not going to discuss all of those federal tax law changes. In fact, we are only going to discuss the changes the New Law made to the federal estate tax exclusion amount.

Double the Exemption. The New Law has increased the basic estate tax exclusion amount from $5 million (adjusted for inflation) to $10 million (adjusted for inflation). The New Law also changed the index used to calculate inflation adjustments. Inflation adjustments are calculated from a base year of 2011. For simplicity, we will refer to the basic estate tax exclusion amount as the "estate tax exemption" or the "exemption" and will not continue to repeat "adjusted for inflation," even though the exemption amount is adjusted annually for inflation. As a result of the New Law, the 2018 estate tax exemption amount (which is also the current gift tax and GST exemption amount) is $11,180,000.

One of the "disappointing" facts about the New Law is that these provisions will "sunset" (i.e., expire) at midnight on December 31, 2025. Thus, if Congress makes no changes to the estate tax laws prior to 2026, the estate tax exemption will revert back to $5 million in 2026. Some financial analysts believe the 2026 estate tax exemption amount will be approximately $6.5 million (i.e., the $5 million exemption, with inflation adjustments starting from 2011).

The tax laws seem to be a "political football." Thus, if more Democrats are elected to Congress in 2018 and 2020 and, especially, if a Democratic President is elected in 2020, the estate tax exemption may be changed (i.e., reduced) long before 2026.

Estate Planning Considerations. Very few individuals and married couples have an estate that exceeds the current $11,180,000 estate tax exemption. Of course, per the New Law, the exemption will drop back down to $5 million (and will likely be in the $6 million range) in 2026. Most people assume they will still be alive in 2026. Thus, when doing estate planning, does one consider the current $11.18 million exemption or the ±$6.5 million exemption that will apply in 2026? The huge change in the exemption amount from 2025 to 2026 makes it almost impossible to do estate planning now that won't have to be changed–or at least reconsidered–in the relatively near future.

Size of Estate. *Assuming Congress does not reduce the exemption below $5 million*, both single people and married couples with **an estate less than $5 million** can create the estate plan they want without regard to estate taxes. The primary planning issues for most of these people will be (i) who should be in charge of carrying out your final wishes (i.e., who should be the Executor in your Will and/or the successor Trustee of your revocable trust); (ii) who should receive your assets when you die (i.e., which individuals and/or charities do you want to receive your assets when you die); (iii) what assets or shares should each beneficiary receive; and (iv) should any beneficiary have his/her share held and administered in a trust (e.g., due to being too young or a spendthrift, suffering from a disability, having creditors' claims or having a "shaky" marriage). Couples in second marriages and, especially, couples with children from their prior marriages, need to consider "ultimate control" issues as well (*see* below).

Single people and married couples **with more than $11.18 million** should still do estate planning that considers ways to reduce estate taxes payable on death. Single people with taxable estates who want to reduce estate taxes usually include charitable planning as part of their estate plan. Married couples in this category often use both the marital deduction and charitable deduction, as well as a lot of "lifetime" techniques.

The most difficult people to plan for are individuals and married couples **with estates between $5 and $10**

million. Why this difficulty? In view of the fact that the New Law will expire, we don't know whether the exemption amount will be $5 million or $10 million when they die. The estate tax rate on transfers above the exemption amount is currently 40%. So, the amount of estate taxes payable if more than the exemption amount is transferred can be significant.

REMINDER: No "Automatic" Doubling of Exemptions for Married Couples. As we have explained many times before, married couples do not "automatically" get 2 exemptions from the federal estate tax. Married couples must *do something* to avoid ending up with just 1 exemption per couple. Of course, assuming a minimum exemption of $5 million, one exemption per couple may be sufficient in many cases. However, if a couple has an $8 million estate and the surviving spouse dies when the exemption is only $5 million, a 40% estate tax will be payable on the $3 million "excess" *unless prior planning was done*.

Before 2011, the most common way that most married couples obtained two exemptions from the estate tax was to use a "Bypass Trust" (also called a "Credit Shelter Trust" and/or a "Family Trust"). The Bypass Trust provisions were included in each spouse's Will or in the couple's joint revocable trust, to become effective on the death of the first spouse (the "Deceased Spouse"). The Bypass Trust was designed to support the surviving spouse for the rest of her life. It usually allowed distributions to be made to children and grandchildren as well. On the Deceased Spouse's death, his share of the assets, up to a maximum equal to his exemption amount, was directed to go into the Bypass Trust. Of course, it was not enough simply to plan for the Bypass Trust. When the Deceased Spouse died, the Bypass Trust had to be set up and "funded" (i.e., the Deceased Spouse's share of the assets had to be placed in the trust). This planning method kept the Bypass Trust assets from being included in the surviving spouse's estate upon her death. In other words, the transfer to the Bypass Trust made by the Deceased Spouse was covered by his exemption and, due to the structure of the trust, the assets in the Bypass Trust were not taxable in the surviving spouse's estate when she died, *no matter what those trust assets were worth at that time*. In addition, the surviving spouse had her own exemption to cover her own assets that she would be transferring on her death. In this way, each spouse got to "use" his/her exemption from the estate tax (resulting in two exemptions per couple, not just one). That was especially important during the many years when the estate tax exemption was less than $1 million and the top estate tax rate was 55%. In those days, *wasting* exemption usually translated into ultimately paying too much in estate taxes.

In 2011, for the first time, married couples could use a different method for obtaining two exemptions: file a Form 706 in a timely manner after the Deceased Spouse's death and make the "portability election." This new method for obtaining two exemptions became "permanent" with the passage of the American Taxpayer Relief Act of 2012 in January 2013.

How the Marital Deduction Works. If the Deceased Spouse's assets pass directly (outright) to the surviving spouse (rather than into a Bypass Trust), no federal estate taxes are payable on that transfer *due to the marital deduction*. The marital deduction is unlimited in amount if the surviving spouse is a US citizen. The marital deduction does not eliminate estate taxes, however, it merely defers them until the death of the surviving spouse. Further, use of the marital deduction when the Deceased Spouse dies means that he is "wasting" (i.e., not using) his own estate tax exemption. The result of transferring the Deceased Spouse's assets directly to the surviving spouse on his death is that 100% of the assets will be included in the surviving spouse's estate. Thus, unless the portability election was made when the Deceased Spouse died, the surviving spouse will have only one exemption (her own) to shelter *all* of the assets from estate taxes upon her death.

When the portability election is made for the Deceased Spouse's estate, the Deceased Spouse's unused estate tax exemption (called the "DSUE Amount") is transported to the surviving spouse. This means the surviving spouse has two exemptions–her own exemption and the Deceased Spouse's unused exemption. She can use these exemptions during life or at death. Assuming no taxable gifts, if the total of those two exemptions exceeds the total value of the surviving spouse's assets when she dies, no estate taxes should be payable on that transfer.

We have discussed the portability election before. We have also compared the portability election to use of a Bypass Trust. There are pros and cons of each technique. *See* our newsletters dated January 31, 2013, April 30, 2013, January 31, 2016, and April 30, 2016.

Technically, it's not as simple as "Bypass Trust versus portability," however, because some couples prefer to use a Marital Trust instead of a Bypass Trust to receive the Deceased Spouse's assets when he dies. The primary reason for using a Marital Trust instead of a Bypass Trust is to obtain a second adjustment to income tax basis for the capital assets held in the Marital Trust when the surviving spouse dies. When a person dies and capital assets are included in her estate, the tax basis of each such asset is adjusted to its fair market value as of the date of death (or alternate valuation date). If the asset is worth more on that date than its prior tax basis, that adjustment is a "step up" in basis. Unlike a Bypass Trust, however, a Marital Trust can only make distributions to the surviving spouse during her life. Further, a Marital Trust does not protect the growth in the value of the Deceased Spouse's assets from estate taxes like a Bypass Trust does. Yet, again, a Marital Trust in the form of a "QTIP Trust" can be treated like a Bypass Trust if the QTIP election is *not* made. However, if the QTIP election is not made, the Marital Trust assets will not obtain a "step up" in basis when the surviving spouse dies.

A preliminary hurdle (before weighing the pros and cons of Marital Trust versus Bypass Trust) is whether the assets belonging to the Deceased Spouse should go into a trust for the surviving spouse or not. Besides estate taxes, some other considerations between placing the Deceased Spouse's assets in a trust and distributing them outright to the surviving spouse are:

1. Simplicity. Many older couples prefer simplicity over everything else. This weighs against a trust.
2. Ultimate Control. How important is it for the Deceased Spouse to "control" where her assets end up? Does the Deceased Spouse want to make sure her assets end up with her children when the surviving spouse dies rather than with a new spouse of the surviving spouse or the surviving spouse's own children?
3. More Income Tax Options. Depending on the type of trust and how it is drafted, trust income could be distributed to any one or more beneficiaries (spouse, descendants, charities), allowing trust income to be taxed at lower rates (or not taxed at all).
4. Creditor Protection. A trust can protect the assets from loss due to a divorce or other lawsuit.

Obviously, there is no "one size fits all" when it comes to estate planning in view of the New Law. Nearly everyone will have to review his/her estate plan in view of the New Law.

Texas Law Changes. During its most recent legislative session, the Texas Legislature made changes to both the Medical Power of Attorney and the Statutory Durable Power of Attorney (among other changes). The Medical Power of Attorney changes became effective January 1, 2018. The Statutory Durable Power of Attorney changes became effective September 1, 2017.

Medical Power of Attorney. The new Medical Power of Attorney promulgated by the Texas Legislature is a mandatory form. It cannot be changed or altered. Note, however, that Medical Powers of Attorney signed *prior to* January 1, 2018, that are in the "old"form are still valid. In other words, only persons who sign a Medical Power of Attorney *on or after* January 1, 2018, must use the new version of the Medical Power of Attorney.

Statutory Durable (Financial) Power of Attorney. The new version of the Statutory Durable (financial) Power of Attorney is *not* a mandatory form. Thus, a person may sign a financial durable power of attorney (POA) that is in the "new" form *or* in the "old" form.

In a POA, the *principal* (the person granting the POA) appoints one or more primary agents and one or more successor agents to handle her property and financial affairs. The POA can be made effective immediately (the better choice in most cases because it covers more situations and is easier to use) or effective only in the future–i.e., if and when the principal becomes mentally incapacitated and her doctor is willing to write a letter saying that. Note that a good POA is *durable*, which means that it is still valid even after the principal loses her mental capacity.

Some of the noteworthy changes to the Texas POA are the following:

1. If co-agents are appointed in a POA, each co-agent may act independently of the other (i.e., without the joinder of the other agent) *unless the POA provides otherwise*.
2. If the principal appoints his spouse as his POA agent and the principal and his spouse later get divorced, that appointment is revoked *unless the POA specifically provides otherwise*.
3. A person serving as POA agent is a *fiduciary* under Texas law. Fiduciaries are held to the highest level of behavior. However, merely being named as an agent in a POA does not make the named agent a fiduciary until the agent actually accepts the appointment. In other words, to become a fiduciary, the agent would have to take some action on behalf of the principal that indicates she has accepted her appointment as POA agent.
4. Agents acting under a POA are entitled to compensation and reimbursement of expenses *unless the POA provides otherwise*. Compensation is payment for services rendered (usually based on the amount of time spent by the agent). Reimbursement of expenses means the agent will be reimbursed for his expenses incurred in handling matters for the principal, such as travel expenses, postage, long distance telephone charges, copying costs, legal fees, accounting fees, etc.

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5. Certain so-called "hot powers" may be included in the POA. No "hot powers" are presumed, however. They must be expressly granted. Hot powers include (but are not limited to) these powers:

a. The power to create, amend or revoke a trust on behalf of the principal.

b. The power to make gifts using the principal's assets.

c. The power to create or change survivorship rights on accounts and other assets.

d. The power to create or change beneficiary designations on "beneficiary designation assets" (i.e., life insurance policies, employee benefit plans, IRAs and annuities).

6. NOTE: A financial institution (a "third party") may no longer simply say it will not accept a Texas POA based on its policies. A third party must provide a written refusal to accept the POA that contains an authorized reason per Texas law. The allowable reasons for not accepting a Texas POA are set out in Section 751.206 of the Texas Estates Code. If the third party does not follow these rules, it can be sued and the principal and agent can recover costs and reasonable attorneys' fees of that lawsuit.

Most Clients Should Review Their Estate Plans NOW. Many clients will need to schedule an "estate planning check up" during 2018 in view of the tax law changes. The most "at risk" clients are those whose estate plan gives the estate tax exemption amount to one beneficiary (or set of beneficiaries) and the rest of their assets to another beneficiary (or other set of beneficiaries). A newsletter is not a substitute for a review of your particular estate plan. Thus, if you would like to review your existing estate plan in view of the changes made to the federal tax laws (and state laws), please contact our office to schedule that appointment.

Contact us:

If you have any questions about the material in this publication, or if we can be of assistance to you or someone you know regarding estate planning or probate matters, feel free to contact us by phone, fax or traditional mail at the address and phone number shown above, or by email sent to:

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