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2016 Year-End Estate Planning: Times They Are A-Changin' — But Not Before Year-End

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If there is a single word that could be chosen to describe year-end 2016 and 2017 planning, it is "uncertainty." In our annual end-of-year estate planning alert, we explore strategies that individuals, families and family offices can employ to address existing, new and emerging tax, wealth-transfer and business-succession issues.

2016 Election

Donald Trump (Republican) has been elected the 45th President of the United States. The Republican party will continue to control the U.S. House of Representatives and Senate. The new administration has signaled its intent to overhaul U.S. tax policy, but to date, the extent of the potential changes remains unclear.

President-elect Trump's proposed tax plan includes repealing the federal gift and estate taxes. His tax plan also would modify the basis rules (*i.e.*, the current "step-up" in basis) for appreciated assets owned by a decedent at death. The result of these changes would be to make death a deemed "sale" of the assets owned by a decedent, thereby causing capital gains to be realized upon such an event. However, only capital gains in excess of $10 million would appear to be taxable. Additionally, contributions of appreciated assets to a private charity (established by the decedent or a member of the decedent's family) at an individual's death would not avoid the capital gains tax

President-elect Trump's overhaul of the transfer-tax system is just a small portion of the comprehensive changes to the tax system that he promoted during his campaign. His proposals have created significant uncertainty regarding the future of the federal gift and estate taxes. As Trump's plan progresses, one must consider the following:

- It is likely that any elimination of (or change to) an existing tax will be accompanied by some form of trade-off. For instance, Trump has already proposed that estate tax repeal be accompanied by a repeal of the step-up in basis for assets acquired from a decedent. Because Trump's plan seeks broad reform in individual, corporate, capital gains and transfer taxes, there are potentially unlimited variations in how that may be accomplished.
- Although Republican control of Congress will continue, there are important differences of opinion within the Republican party on the extent of potential changes to individual, corporate, capital gains and transfer taxes. These differences will likely impact any new legislation that is ultimately enacted.
- Additionally, the effective date of any new legislation is unknown. For example, would new legislation be effective immediately upon being signed into law or beginning January 1 of the following year?
- It is also unknown whether any new tax laws will be permanent or temporary. Even if the estate tax is currently repealed, there is no guarantee that it will not return. The estate tax has been enacted and repealed several times over the past 225 years, and was most recently repealed for a one-year period in 2010.

Because repeal of the estate tax is anything but certain, it still makes sense to implement basic year-end estate planning, including the techniques discussed below. Additionally, it is prudent to review your current estate planning documents to determine whether you want to make any changes.

Annual Exclusion Gifts

Making use of annual exclusion gifts remains one of the most powerful — and simplest — estate planning techniques. For 2016 and 2017, individuals can make an unlimited number of gifts of up to $14,000 per recipient, per calendar year, without any gift tax consequences. However, an individual cannot carry over unused annual exclusions from one year to the next. If such exclusions are not utilized by the end of the year, the balance of any annual exclusion gifts that could have been made for that year are lost.

By removing the amount of the gift itself and any income and growth thereon from the donor's estate, without paying any gift tax or using any transfer tax exemption, these gifts can result in substantial transfer tax savings over time. These transfers may also save overall income taxes for a family, when income-producing property is transferred to family members in lower income tax brackets (who are not subject to the "kiddie tax").

Tuition and Medical Gifts

Individuals can make unlimited gifts on behalf of others by paying their tuition costs *directly* to the school or paying their medical expenses *directly* to the health care provider (including the payment of health insurance premiums).

Transfer Tax Exemption and GST Exemption

The exemption amount that individuals may transfer by gift and/or at death without being subject to federal transfer taxes increased in 2016 to $5,450,000; it will further increase to $5,490,000 in 2017. The maximum federal estate tax rate remains 40%. Illinois imposes a state estate tax based upon a $4,000,000 threshold (which is not adjusted for inflation). The rates of Illinois estate tax range from 8% to 16% (with the Illinois estate tax paid allowable as a deduction for federal estate tax purposes). Both the federal and Illinois estate tax laws allow for a marital deduction for assets passing outright to a spouse or to qualifying trusts for the benefit of a surviving spouse. Illinois allows this deduction to be claimed even if a marital deduction is not elected for federal purposes.

To impose a death tax at each successive generational level, a generation-skipping transfer (GST) tax equal to the highest estate tax rate is assessed on transfers to grandchildren or more remote descendants. However, every taxpayer is also given a separate federal GST exemption equal to the federal transfer tax exemption (*i.e.*, $5,450,000 in 2016 and $5,490,000 in 2017).

Lifetime Utilization of Transfer Tax Exemption

The ability to transfer $5,450,000 ($10,900,000 per married couple) in 2016, after annual exclusion and medical and tuition gifts and without having to pay gift taxes, paves the way for many planning opportunities. When combined with valuation discounts (while still available; see below) and leveraging strategies (*e.g.*, family partnerships, sales to grantor trusts, grantor retained annuity trusts), tremendous amounts of wealth may pass for the benefit of many generations free of federal and Illinois transfer taxes. Lifetime gifts utilizing the exemption amounts will almost always result in overall transfer tax savings, unless the assets that have been transferred decline in value. The main reason for these savings is that the income and growth on such transferred assets are removed from the taxable estate.

For individuals who fully used their transfer tax exemptions in prior years, consideration should be given to making gifts of the additional inflation-adjusted amount (*i.e.*, the $20,000 increase in the transfer tax exemption from 2015 to 2016, and an additional $40,000 increase in the exemption from 2016 to 2017).

Valuation discounts in the family context. "Minority interest," "lack of marketability" and "lack of control" discounts can be applied under current law to the valuation of interests in family-controlled entities that are transferred to family members. Such discounting provides for estate and gift tax savings by reducing the value of the transferred interests. Please note that the Internal Revenue Service (IRS) recently released proposed regulations that, if finalized, will significantly limit (and perhaps entirely eliminate) the use of valuation discounts that are typically applied with regard to transfers of interests in many family-controlled entities for gift, estate and generation-skipping transfer tax purposes. In light of the election, it is unlikely that these proposed regulations will become final. In any event, owners of closely held businesses should give strong consideration to making gifts of interest in the business before these proposed regulations become final.

Benefits of acting early. The benefit of making gifts that utilize the transfer tax exemption is to remove from the taxable estate the income and appreciation on those assets from the date of the gift to the date of death. The earlier the gifts are made, the more likely that additional income and growth on such assets will escape taxation.

Gifts in trust. Despite potential tax savings (and even if the estate tax should be repealed), many individuals are uneasy about making outright gifts to their descendants. Such concerns are usually addressed by structuring the gifts in trust, which allows the donor to determine how the assets will be used and when the descendants will receive the funds. The use of gift trusts can also provide the beneficiaries with a level of creditor protection (including protection from a divorcing spouse) and additional transfer tax leverage. This is particularly effective when coupled with applying GST exemption to the trust (discussed above) and making the trust a "grantor trust" for income tax purposes (discussed below).

The gift trust technique is not limited to trusts for descendants, but may also include a spouse as a beneficiary (or as the sole primary beneficiary). Making the spouse a beneficiary of a gift trust (generally referred to as a spousal lifetime access trust, or SLAT) provides indirect access to the trust assets, while allowing the income and growth to accumulate in the trust (if not otherwise needed) and pass free of estate and gift taxes.

One of the most powerful estate planning strategies is the use of a "grantor trust." Significant additional transfer tax benefits can be obtained by structuring a gift trust as a grantor trust for income tax purposes. The creator (or grantor) of a grantor trust is required to report and pay the tax on the income earned by the trust. This allows the grantor to pass additional funds to the trust beneficiaries free of gift and estate taxes *and* income taxes, as the grantor's payment of the trust's income taxes each year would be considered his or her legal obligation and would not be considered additional gifts.

Making Use of Historically Low Interest Rates

As of this writing, interest rates remain historically low, although it is likely that the rates will increase in the near future. The current interest rates continue to create an environment ripe for estate planning and transferring wealth to descendants on a tax-advantaged basis. Techniques such as grantor retained annuity trusts (GRATs), charitable lead trusts (CLTs), intra-family loans (bearing the minimal interest in order to avoid a gift of 0.74% for loans of less than 3 years, 1.47% for loans of 3 to 9 years, and 2.26% for loans of 9 years or more as of December 2016), and sales to grantor trusts, are sensitive to interest-rate changes and are very beneficial in a low-interest-rate environment.

Estate Plan Review and Illinois QTIP

From a tax and planning standpoint, there is no "magic" to reviewing your estate planning documents at year end. There is, however, no time like the present to make certain that your current documents accurately reflect your wishes. Estate planning documents should be reviewed to make certain that beneficial use of the federal and state transfer tax exemptions to the extent not utilized during lifetime, federal and/or state marital deductions, and federal GST exemption are being utilized. Revisions may also be needed if your circumstances have changed since you initially executed your documents (births, deaths, marriages, divorces, etc.)

Given the disparity between the $5,450,000 federal estate tax exemption and the $4,000,000 Illinois estate tax exemption, married couples domiciled in Illinois should make certain that their estate plans are structured to take advantage of the Illinois QTIP marital deduction. Otherwise, an estate plan that is designed to fully utilize the federal $5,450,000 exemption can inadvertently cause an Illinois estate tax of approximately $395,000 upon the death of the first spouse.

Net Investment Income (Medicare) Tax

Higher-income earners should also plan for the 3.8% surtax on certain unearned income and the additional 0.9% Medicare tax that applies to individuals earning in excess of $200,000 ($250,000 for married couples filing jointly and $125,000 for married couples filing separately). While the 0.9% additional tax on wages is only imposed on individuals, the 3.8% tax on net investment income is imposed on individuals, estates and trusts. Individuals are only subject to this new 3.8% Medicare tax if their "modified adjusted gross income" exceeds $250,000 for joint filers ($125,000 for a married individual filing a separate return) and $200,000 for single individuals. In 2016, trusts and estates are subject to this tax at a $12,400 threshold ($12,500 in 2017).

The approach to minimizing or eliminating the 3.8% surtax depends on each taxpayer's unique situation. Some taxpayers should consider ways to minimize (*e.g.*, through deferral) additional net investment income for the balance of the year, while others should review whether they can reduce modified adjusted gross income other than unearned income. In contrast, others may want to accelerate net investment income and/or modified adjusted gross income that would be received next year, so that it is included this year (*e.g.,* to take advantage of deductions in 2016). Year-end planning (such as timing the receipt of net investment income, the receipt of modified adjusted gross income and the payment of deductible expenses) can save significant taxes.

Retirement Plans and Beneficiary Designations

Legislation was enacted in 2016 making permanent the ability of taxpayers that have attained the age of 70½ to transfer $100,000 directly from their IRA to a public charity (often referred to as a "charitable IRA rollover"). For clients making significant charitable contributions, utilizing a charitable IRA rollovers would result in income tax savings.

Consideration should also be given to maximizing contributions to retirement plans. For 2016, you can contribute up to $18,000 to a 401(k) or 403(b) plan ($24,000 if you are age 50 or older) and/or up to $5,500 to a traditional IRA ($6,500 if you are age 50 or older). These contribution limits remain the same for 2017. Elective deferral contributions to a 401(k) or 403(b) usually must be made by December 31, but contributions to traditional IRAs generally can be made until April 15 of the following year.

The end of the year also is a good time to review the beneficiary designations on your pension plan and other retirement accounts, as well as your life insurance policies. Failing to name beneficiaries or keep designations current to reflect changing circumstances can create substantial difficulties and expenses (emotionally and financially), and may lead to unintended estate, gift and income tax consequences.

You should make certain to designate beneficiaries when participating in a new retirement plan and update beneficiary designations when circumstances dictate (*e.g.*, death of a spouse). Finally, it is prudent to maintain a current list of accounts with beneficiary designations. Such lists should specify the types of assets, account numbers, account custodians/administrators and beneficiaries designated for each account (primary and contingent).