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Estates & The New Tax Law: Blue Skies or Unintended Consequence?

The Tax Cuts and Jobs Act of 2017 legislation provides the opportunity for wealthy Americans to leave more behind for their heirs and give less to the government.

While some in Congress had advocated outright repeal of the estate tax, lawmakers ultimately settled for doubling the exemption to roughly $11.2 million for individuals and $22.4 million for married couples. The rates revert to the 2017 amounts, adjusted for inflation, in 2026 unless congress passes a new law to make them permanent. However, for some who have already had their estate planning documents finalized and utilized strategies to minimize their estate tax liability under the previous tax laws, the changes could have hidden adverse consequences that create potential conflicts amongst beneficiaries or distort the intended allocation of estate assets.

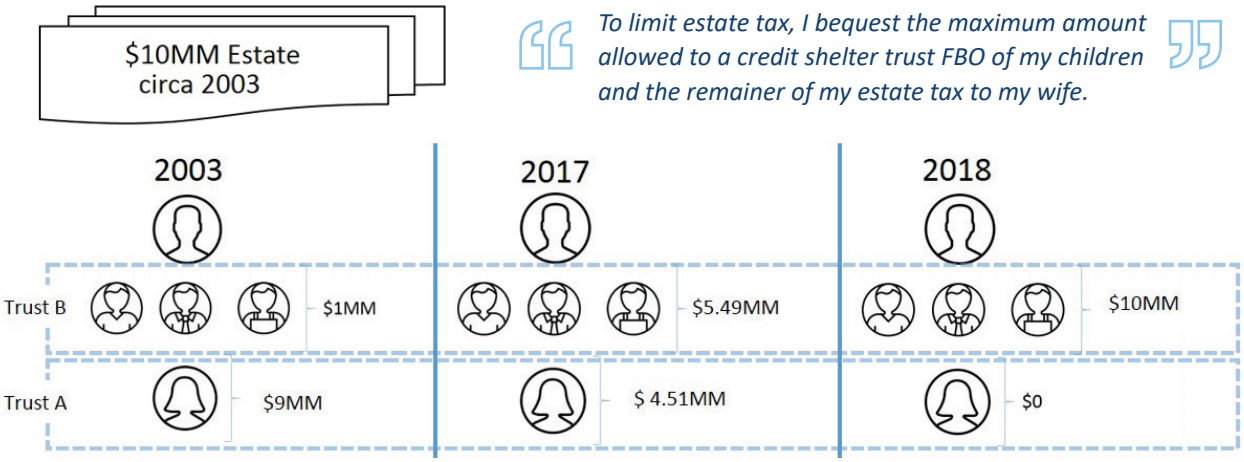
Possible pockets of turbulence: Credit Shelter Trusts

Perhaps the best example of unexpected consequences of the new tax law could be for estate plans that include credit shelter trusts. In many cases, these structures name multiple beneficiaries, including spouses and children (sometimes even ex-spouses), and were structured as part of a "waterfall," whereby they get funded first up to the amount of the then-operative estate tax exemption, with the remainder of the estate's assets then spilling over to a marital trust for the benefit of the spouse.

For estate plans drawn up prior to 2010 and then left untouched after Congress modestly raised the exemption, these waterfall structures were already problematic to the extent the credit shelter trusts might take more off the top then the benefactor wished, leaving less money to go directly to their spouse. Now, with Congress having doubled the estate exemption, there is a risk that in extreme cases—with wording left in its original state—the credit shelter trusts that were structured to take in the maximum amount up to the exemption would consume the entirety of the estate.

The graphic below illustrates this potential problem. For this purpose, we have assumed a $10 million estate at three points in time, with the prevailing estate tax exemption

Good Intentions Gone Bad



amounts. We also have assumed that the credit shelter and deferral trusts have distinctly different beneficiaries. The three children are beneficiaries of the credit shelter (Family or "B") trust; the surviving spouse is beneficiary of the deferral (Marital or "A") trust.

As you can see, the children and surviving spouse would stand to inherit distinctly different and separate amounts over the years as these funding formulas self-adjust. For this reason alone, estate plans should be reviewed even when a taxpayer's exemption exceeds the total estate value.

However, in most cases, credit shelter trusts were funded with legacy in mind, as those assets are protected from estate tax and usually exempt from generation-skipping tax. The marital trust is structured so there were fewer administrative hurdles for the spouse to distribute funds in order to maintain their standard of living. For example, in a marital trust, the net income is distributed to the surviving spouse at least annually, where a credit shelter trust provides for Trustee discretion and sometimes requires a review of other sources of income. In addition, there is the possibility that the spouse and children have equal beneficial interest that can force the trustee to do what is in the interest of all beneficiaries and not primarily benefit the surviving spouse. The devil is in the details!

The good news is that trusts set up more recently do not have quite such a rigid structure and give more flexibility and discretion to the trustee to adjust the funding mechanism. Although there is standard language used by Trust & Estate attorneys, they vary based on personal preference and drafting style, which is why it is important to review and ensure the language is appropriate for your unique situation.

The new tax law also may afford individuals who funded trust accounts with low-basis/highly appreciated stock, an opportunity to swap out those assets to bring them back into the surviving spouse's estate and receive a step up in basis upon their passing.

Flying blind: Don't focus on taxes, alone

Beyond the tax changes, there are plenty of evergreen reasons to put aging estate plans through a periodic review. For example, as beneficiary children grow older and their earnings increase, it is worthwhile to take into account how your estate plan dovetails with their financial and estate planning. Many older plans have rigid formulas for distributing assets at set intervals and age attainment that force the assets out of the trust and make those assets attachable by creditors (financial, ex-spouse and the IRS).

Clear for landing

It has always been a good idea to have an estate plan in place and, because circumstances change, to review it every few years. After all, who is to say that the political pendulum doesn't swing back in the opposite direction with the next Congress or Administration? Therefore, with the new tax changes, a review is most definitely in order for certain individuals with estate plans that were charting a course under very different conditions.

About the Author

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