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December 2017

Hoffman, Sabban & Watenmaker strives to keep its clients and friends informed of important developments affecting their estate, gift and tax planning. This letter summarizes some of those developments.

I. <u>2018 TAX AMOUNTS</u> (Subject to change due to pending federal legislation; see below)

A. <u>Gift Tax Annual Exclusion</u>. The annual exclusion for gifts increases to $15,000 per recipient (up from $14,000). The exclusion for gifts to a foreign citizen spouse is increased to $152,000 per year (up from $149,000). As before, the annual exclusion for gifts to a U.S. citizen spouse is unlimited.

B. <u>Estate/Gift Tax Exemption (Lifetime)</u>: The estate/gift tax lifetime exemption is increased to $5,600,000 (up from $5,490,000 - an increase of $110,000).

C. <u>Generation-Skipping Transfer (GST) Tax Exemption (Lifetime)</u>: The exemption from the generation-skipping transfer tax continues to be the same as the estate/gift tax lifetime exemption, and is therefore likewise increased to $5,600,000.

D. <u>Estate/Gift/GST Tax Rate</u>: Tax rate on transfers in excess of exemption amounts mentioned above continues to be 40%.

II. <u>PROPOSED SENATE TAX REFORM</u>

The Tax Cut and Jobs Act has passed both the House and Senate, with numerous differences between the two bills that should be reconciled. It is likely that some version of the Act will be enacted soon. The following is a brief description of the provisions of the pending bills that affect estate planning.

A. <u>Federal Estate, Gift and GST Taxes</u>: Both bills double the exemption from gift, estate and generation-skipping transfer (GST) taxes starting in 2018 (indexed for inflation from 2011). Thus, these exemptions would be $11.2 million in 2018, or $22.4 million for a married couple. The rate on estate, gift and GST tax in excess of the exemption amounts will remain at 40%. The House bill would repeal the estate and GST taxes (but not the gift tax) in 2024; the Senate bill would not repeal those taxes.

B. <u>Capital Gains Tax on Death and Step Up in Basis</u>: Under current law, the income tax basis of assets (except for retirements plans and similar benefits) inherited from a deceased person is “stepped up" or "stepped down" to the date of death fair market value. Both the House bill and the Senate bill keep this basis adjustment.

C. Other Important Provisions: The Senate bill further:

1. Reduces the maximum individual income tax rate to 38.5% (from 39.6%);

2. Eliminates the deduction for state and local income taxes for individuals, but keeps the deduction for property taxes (capped at $10,000);

3. Changes the requirement for the $250,000 ($500,000 for a married couple) capital gains exclusion on the sale of a principal residence, so that you must live in the home for at least five of the last eight years (rather than two of five years);

4. Eliminates the ability to deduct home mortgage interest on $100,000 of debt incurred for reasons other than the purchase or substantial rehabilitation of a home; and

5. Adopts complex rules reducing the tax on a portion of passive "pass through" business income.

There are many other provisions of the Senate bill that may affect clients. We would be happy to inform you about these changes in greater detail once the Act is signed into law.

III. PORTABILITY AND MARITAL TRUST PLANNING

There are several reasons a person may want to establish an irrevocable trust for a surviving spouse, rather than making an outright gift to the spouse: protecting the assets from the surviving spouse's creditors; making sure the assets eventually pass to certain remainder beneficiaries determined by the first spouse (perhaps children from a prior marriage); minimizing generation-skipping transfer taxes; and in California, taking advantage of the property tax exclusion from reassessment for parent-child transfers. In the past, creating an irrevocable trust was the only way to preserve the deceased spouse's exemption from estate taxes. However, now that "portability" of a deceased spouse's exemption is possible, that is no longer the case.

A. Portability: As of 2011, a surviving spouse can "inherit" the unused portion of the deceased spouse's estate tax exemption (but not the GST tax exemption). This is referred to as "portability." To utilize the unused exemption, a federal estate tax return (IRS Form 706) must be timely filed for the deceased spouse, even if the return is not otherwise required. **However, the IRS recently announced that a surviving spouse may file a late federal estate tax return to claim portability for a deceased spouse dying in 2011 or later, if a return was not required to be filed (i.e., if the gross estate was below the exemption amount in the year of death). The return must be filed on or before January 2, 2018, or two years after the date of the decedent's death (whichever is later).**

B. Marital Trust Planning: After portability was enacted into law, estate planners wanted to know if their married clients could leave assets in an irrevocable trust for a spouse without using the deceased spouse's estate tax exemption, so that the surviving spouse could utilize the portability rules to apply both exemptions at the second death. In 2016, the IRS answered "yes" to this question. (Rev. Proc. 2016-49)

A married client can now leave some or all of his or her assets in a marital "QTIP" trust for a surviving spouse, without using his or her estate tax exemption. With this new option, clients must now decide whether it would be better to use the deceased spouse's estate tax exemption at the first death or the second death. There are advantages to each approach.

1. Capital Gains Tax Versus Estate Tax: Two potential taxes to consider are capital gains taxes and estate taxes. Applying the first spouse's exemption to an irrevocable trust for the surviving spouse could result in lower estate taxes at the second death because the appreciation of those assets will not be taxed. On the other hand, using portability to apply both exemptions at the second death could reduce capital gains taxes upon sales of the assets after the second death, because the income tax basis of each asset is adjusted to fair market value as of the second death. Note, however, that the basis adjustment at the surviving spouse's death could result in a lower basis, if the assets have declined in value. Of course, one cannot know, at the time of the first death, whether assets will appreciate or depreciate in the future.

   It is important to compare the estate tax rate to the capital gains rate. In California, the highest combined capital gains tax rate (federal and California) is only a few percentage points lower than the estate tax rate of 40%. If the surviving spouse moves to a state with lower (or no) state capital gains tax, then the benefit of excluding appreciation from estate tax on the survivor's death may make more sense than obtaining a second basis adjustment. Also, the beneficiaries may control the timing of the capital gains tax event for investment real property by doing a Section 1031 tax-deferred exchange, or in any case by delaying a sale of assets or offsetting gains against losses.

2. Generation-Skipping Transfer Tax Planning: If spouses want to plan for the eventual passing of assets to grandchildren with minimal tax, they will want to preserve both their exemptions from the GST tax. The GST tax exemption is not "portable," and therefore an irrevocable trust would have to be established at the first death to preserve the first spouse's GST tax exemption.

3. Property Tax Reassessment Exemption Planning. Setting up an irrevocable trust on the first spouse's death (as opposed to leaving the assets outright to the survivor) may preserve the parent-child exemption from property tax reassessment for $1 million of "assessed value" of the first spouse's real property.

C. Planning: As you can see, there are many factors to consider in deciding what type of trust to use. Some of these factors are not known before the first spouse dies. However, there are many planning opportunities that may be pursued, even after the first spouse dies, such as making a QTIP election for a bypass trust so that portability may be utilized, or opting to pay estate tax at the first death to obtain a credit in the second spouse's estate for previously taxed property (if the deaths are within 10 years of each other).

Also, if a surviving spouse benefits from an existing bypass trust, and the total of the surviving spouse's assets plus the bypass trust assets is likely to be less than the surviving spouse's estate tax exemption, it might make sense to petition the Probate Court for authority to terminate the bypass trust. If the bypass trust was created solely for tax planning, and that planning is no longer needed, the court is likely to grant this authority, especially if the surviving spouse has the ability to change the ultimate disposition of the bypass trust assets in favor of essentially anyone he or she wishes by exercising a power of appointment. On the other hand, if there is a blended family and the ultimate beneficiaries of the bypass trust are different than the surviving spouse's beneficiaries (e.g., children from a prior marriage), the court may not grant the authority to terminate (especially if the step-children file objections to the petition). Again, there are other reasons to retain a bypass trust, including creditor protection, use of the GST tax exemption, and California real property reassessment exemptions. If you wish to evaluate your situation and determine whether or not terminating a bypass trust makes sense, please contact us.

IV. ESTATE TAX PLANNING

A. Fractional Discount Planning: As we discussed in last year's letter to clients, in 2016 the Treasury Department proposed the issuance of regulations that would dramatically limit the use of valuation discounts. On October 4, 2017, the U.S. Treasury Department announced that it would not issue those regulations. For clients who have estates large enough to give rise to estate tax, and who own real property or closely held businesses, it might make sense to arrange your affairs to create valuation discounts. For those clients and others who wish to make transfers of these interests to family members, we encourage you to contact us.

B. Gifting. As always, lifetime gifts can reduce the estate taxes that may be due at your death. Annual exclusion gifts are "free" gifts (no reporting and no gift tax). In addition, if you have used your full lifetime exclusion (currently $5,490,000), you may give an additional $110,000 next year without paying tax, due to the increased exemption. If the current tax bill passes, you can gift another $5,600,000 (or $11,200,000 for married couples) in 2018 without paying tax.

C. Other Planning Steps: For clients with large (i.e., taxable) estates, certain transfers can reduce taxes. For example, setting up a Grantor Retained Annuity Trust (GRAT), making low interest rate loans to children (or trusts for their benefit), and creating a Charitable Lead Trust (CLT), still make sense. Please contact us to discuss these and other tax savings techniques.

V. ESTATE PLAN CHECK-UP. This might be a good time to review your trust and other estate planning documents to see if they still accomplish your goals.

A. Remember that changes in your circumstances, such as a marriage or divorce, a change in your financial situation or liquidity, retirement, births and deaths, might necessitate revisions to your estate plan. Your life insurance needs might have also changed.

B. You might have an old estate plan that makes gifts based on a formula tied to an exemption amount that has changed, such as gifts to grandchildren, children from a prior marriage, charity or others. The amount of those gifts may be drastically different under current law than what you envisioned. You should review these formulas and determine whether they still make sense, especially if the exemptions double under the pending tax bill. Please let us know if we can help you in this analysis.

C. Check your beneficiary designations of retirement accounts and life insurance policies, and consider whether they need to be changed.

D. Make sure your assets are titled in the name of your living trust. If you have refinanced your home or other real property, the lender might have had you take your property out of your trust to process the loan. Be sure to put title back into your trust. Also, for married couples, how you hold title (i.e., joint tenancy or community property) may affect the basis adjustment on the first death. You should check to see how title is held and let us know if we can help you with any of this.

E. If you have created an irrevocable trust, remember that your gifts to that trust might trigger withdrawal rights for the beneficiaries. Notice of those rights must be documented in writing (called "Crummey" notices). Failure to send these notices may result in adverse tax consequences. If the trustee of the trust has not been sending these notices, please contact us so that we can help you properly document this.

F. Check your estate planning documents to make sure that the people you have named to hold certain positions are still the individuals you wish to serve (e.g., the guardians for minor children, trustees of your trust, executors under your wills, financial agents under your durable powers of attorney, and health care agents under your advance health care directives). Please contact us if you wish to make any changes to these individuals.

VI. <u>FIRM RECOGNITION</u>

We are pleased to have been recognized for the quality of our work by the following:

A. *U.S. News - Best Lawyers®* - Our firm received a Tier One (highest) ranking in its 2017 Edition of "Best Law Firms" for:
Tax Law
Trusts & Estates Law

B. Paul Gordon Hoffman, Alan S. Watenmaker, Erin L. Prouty and Chang H. Chae are Fellows of the American College of Trust and Estate Counsel (ACTEC).

C. *Super Lawyers Magazine* listed Paul Gordon Hoffman, Alan S. Watenmaker, Erin L. Prouty, Chang H. Chae and Mary Ramsden as "*Super Lawyers*" and Megan Ferkel Earhart and Garen L. Kirakosian as "*Rising Stars*" for 2017.

D. The following attorneys have been selected for inclusion in the 2018 edition of *Best Lawyers in America*:
   - Paul Gordon Hoffman, Alan S. Watenmaker, Erin L. Prouty and Chang H. Chae - *Trusts and Estates*
   - Paul Gordon Hoffman - *Tax Law*

We would be happy to discuss with you the best options for taking advantage of any of the opportunities described above. If you are interested in discussing these opportunities or in reviewing your estate plan to ensure that it meets your current objectives, please contact us.

We wish you all a happy and healthy new year!