

Federal Estate, Gift and GST Taxes

2018 Estate Law Institute

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Bradley D. Terebelo, Esquire
Peter E. Moshang, Esquire
Heckscher, Teillon, Terrill & Sager, P.C.

100 Four Falls, Suite 300
West Conshohocken, PA 19428
Tel: (610) 940-4171
Fax: (610) 940-6042

Centre Square East, 12th Floor
1500 Market Street
Philadelphia, PA 19102

www.htts.com

HECKSCHER TEILLON
TERRILL & SAGER, P.C.
PERSONAL, TRUST & ESTATE LAW

(610) 940-2600
100 Four Falls, Suite 300
West Conshohocken, PA 19428

Introductory Comments

- New 2017 Tax Act introduced many changes
- The 2017 Tax Act has a sunset provision at the end of 2025
- Speculation about changes

2017 Tax Act – Key Provisions for 2018

- \$11.18 million exemption for federal estate tax (indexed for inflation)
- “Unified” estate & gift tax exemption
- \$11.18 million GST tax exemption (indexed for inflation)
- 40% tax rate
- Portability

Summary

Year	Gift Tax Exemption	Max Gift Tax Rate	Estate Tax Exemption	Max Estate Tax Rate	GST Exemption	Max GST Tax Rate
2008	\$1 million	45%	\$2 million	45%	\$2 million	45%
2009	\$1 million	45%	\$3.5 million	45%	\$3.5 million	45%
2010	\$1 million	35%	\$5 million or zero	35% or zero	\$5 million	0%
2011-2012	\$5 / \$5.12 million	35%	\$5 / \$5.12 million	35%	\$5 / \$5.12 million	35%
2013	\$5.25 million	40%	\$5.25 million	40%	\$5.25 million	40%
2014	\$5.34 million	40%	\$5.34 million	40%	\$5.34 million	40%
2015	\$5.43 million	40%	\$5.43 million	40%	\$5.43 million	40%
2016	\$5.45 million	40%	\$5.45 million	40%	\$5.45 million	40%
2017	\$5.49 million	40%	\$5.49 million	40%	\$5.49 million	40%
2018	\$11.18 million	40%	\$11.18 million	40%	\$11.18 million	40%

Overview of Federal Estate Tax

- 2018 Exemption Amount: \$11,180,000
 - Valuation Date
 - Deductions
- Unified with Federal Gift Tax Exemption
- Current Tax Rate: 40%;
- No tax on assets passing to a spouse (subject to certain limitations) or charity
- Imposed on all US citizens and resident non-US citizens on all world-wide assets, wherever located

Portability of Federal Estate Tax Exemption

- “Deceased Spouse’s Unused Exemption” or DSUE
- A surviving spouse can use the “leftover” estate tax exclusion of the first spouse to die under certain conditions
- Was introduced in 2010 under the Tax Relief, Unemployment Reauthorization and Job Creation Act of 2010, and made “permanent” in 2012 under the American Taxpayer Relief Act
- Essentially, married couples have \$22,360,000 of federal estate tax exemption to use.
- Does NOT apply to GST exemption.

Portability

- A “surviving spouse” now includes same sex couples that are legally married (*U.S. v. Windsor*).
- In order to for a surviving spouse to receive the “leftover” exemption, a 706 must be filed for the first spouse and the executor must make a portability election on the return.
- However, even with a portability election, a surviving spouse can lose the DSUE received from a spouse, if the surviving spouse remarries and is predeceased by the new spouse.

Portability Example

- Harold and Wendy are married. Harold owns \$15.18 million in his individual name, and Wendy owns \$1 million in her individual name.
- Harold and Wendy do not use any of their respective federal gift tax exemption amounts during their lifetimes.
- Wendy dies and leaves her entire estate outright to Harold and uses none of her federal estate tax exemption.
- Wendy's executor timely files a 706 electing portability of her unused exemption.

Portability Example

- Example 1: Harold does not remarry and dies with \$16.18 million in his name and \$22.36 million of federal estate tax exemption available. Harold's estate would not be subject to federal estate tax.
- Example 2: Harold marries Nancy, who has \$11.18 million in her own name and Nancy predeceases Harold. At Harold's death, he owns \$16.18 million in his name and has \$11.18 million of federal estate tax exemption and will pay \$2 million of federal estate tax.

Portability v. Credit Shelter Trusts

- The two main drawbacks to relying on portability are (1) a spouse's GST exemption is not portable and (2) the potential loss of the additional exemption in the event of remarriage.
- Additionally, to the extents assets pass to a credit shelter trust any appreciation on such assets will not be subject to federal estate tax at the surviving spouse's death.

Step Up in Tax Cost Basis

- Assets included in a decedent's estate for federal estate tax purposes receive a “step-up” (or “step-down”) in federal income tax basis.
- This includes trust assets includible in a beneficiary's estate because he or she has a general power of appointment.

Non-US Citizen Spouse

- Special rules apply for non-US citizen spouses
- A marital deduction is only allowed for assets passing to non-US citizen spouse if:
 - The surviving spouse becomes a US citizen following the first death but before the federal estate tax return is due, including extensions (i.e., within 15 months of death); or
 - The assets pass into a certain type of trust known as a “Qualified Domestic Trust” or “QDOT”

QDOTs

- In order to qualify as a QDOT, in addition to the marital trust requirements:
 - The trust must be created by the surviving spouse within 9 months of the first spouse's death
 - At least one trustee must be a US citizen or corporation
 - No distribution can be made unless the US trustee has the right to withhold tax from the distribution
 - Federal estate tax must be paid upon distribution on any principal distribution from the trust (but not income), except for “hardship” distributions
 - For QDOTs over \$2,000,000, certain security provisions must be satisfied
- If the non-US citizen spouse later becomes a US citizen (and has resided continuously in the US), the QDOT provisions essentially will no longer apply.
- Any principal remaining in the QDOT upon the death of the non-US citizen spouse's death is subject to federal estate tax.

ILITs

- An irrevocable life insurance trust (also known as an ILIT) is not included in a decedent's estate if administered correctly.
- If an individual gifts an existing policy to an ILIT, there is a 3-year "look back" period where the policy can still be included in the individual's estate. However, if the policy is sold to the ILIT there is no "look back" period.

2026 and Beyond for Federal Estate Tax

- The 2017 Tax Act includes a sunset provision would reduce the federal estate tax exemption amount return to the previous exemption amounts (i.e., \$5,000,000 adjusted for inflation).
- Accordingly, we will need to see whether additional legislation is enacted to make these changes “permanent” or whether the exemption will revert to the pre-2018 amount.

Overview of Federal Gift Tax

- 2018 Exemption Amount: \$11,180,000
- Unified with Federal Estate Tax Exemption
- Current Tax Rate: 40%
- No gift tax on assets passing to a spouse (with certain limitations) or charity
- A gift requires delivery and donative intent

Federal Gift Tax Annual Exclusion

- The annual exclusion amount is the amount that a donor may give to any donee in a calendar year without the imposition of gift tax.
- For 2018, the annual exclusion amount is \$15,000 (or \$30,000 from a married couple if a married couple files a federal gift tax return to “split” gifts).
- Accordingly, in 2018 each donor can give away up to \$15,000 per donee per year (\$30,000 per married couple) free of gift tax (and without using any part of the federal gift tax exemption amount).
- The annual exclusion is now increased periodically for inflation adjustments.
- Note that there is not an unlimited marital deduction for gifts to a non-citizen spouse. A donor is limited to a special annual exclusion for gifts to his or her non-US citizen spouse equal in 2018 to \$152,000 (which is adjusted from time to time for inflation).

Direct Payment of Tuition and Medical Expenses

- A donor can make unlimited gifts for a donee by making direct payments to providers for tuition and medical expenses.
- Again, the payments must be made DIRECTLY to the provider. For example:
 - A father pays his son's law school tuition directly to the law school. The gift is not subject to federal gift tax.
 - A father gives his son the amount of his law school tuition and the son uses the gifted amount to pay the tuition. The gift will be subject to gift tax to the extent it exceeds the annual exclusion amount.

Use of Portability in Gifting

- DSUE may be used by the surviving spouse for his or her lifetime gifting
- DSUE is applied before the surviving spouse's gift tax exemption
- Theoretically, a surviving spouse could take advantage of the DSUE of more than one deceased spouse, but only by making lifetime gifts

Splitting Gifts

- Married Couples can “split” gifts
- All gifts may be split on a gift tax return; cannot pick and choose.
- Requires spousal consent on a filed federal gift tax return
- If a couple divorces, only gifts prior to the divorce can be split and can't remarry during the year
- Gifts treated as one-half being made by each spouse
- NOTE: Watch for gifts to a trust of which one spouse is a beneficiary, as depending on the terms of the trust, it may not be possible to split the gift.

Gifts to Minors and 529 Plans

- Gifts to a minor should be made to a Uniform Transfers to Minors Act account for the minor, to a trust for the minor, or to a 529 Plan for the minor to avoid the appointment of a guardian by a court
- Currently, a donor can give up to 5 times the annual exclusion amount in year to a 529 Plan established for the benefit of a donee. The gift will “count” as five years’ worth of annual exclusion gifts to the donee and will not be subject to gift tax if the donor lives the five years (although a gift tax return must be filed to elect that 5 year treatment). Must make an election on a federal gift tax return (Form 709).

When to File a Federal Gift Tax Return (Form 709)?

- A gift of more than \$15,000 to a single non-spouse donee
- Spousal Gift – Terminable Interest (i.e., inter vivos QTIP)
- Gift to non-citizen spouse over \$152,000
- Future interest gifts
- To Split Gifts
- GST allocation/election
- Start statute of limitations
- “Superfund” 529 plans

Carryover Basis

- Unlike assets transferred at death, assets that are gifted do not receive a step up in cost basis for income tax purposes.
- Other options (gifting cash to purchase the asset)?

Overview of GST Tax

- IRS goal is to tax each generation
- GST tax first enacted in 1976
- In 1986, GST tax retroactively repealed, and new GST tax (what is now Chapter 13) implemented
- 2018 Tax Rate = Highest Estate Tax Rate (40%)
- GST Exemption – \$11,180,000 in 2018
- No portability of exemption

Grandfathered GST-Exempt Trusts

- Trusts that were irrevocable on September 25, 1985
- Certain wills and revocable trusts executed before October 22, 1986
- Certain trusts unchangeable due to mental disability

Identifying the Transferor

- In general:
 - Testamentary Transfer: Decedent is the transferor
 - Inter Vivos Transfer: Grantor is the transferor
- Gift Splitting: If gifts are split for gift tax purposes, then for GST purposes grantor transferor for 1/2 of the property and spouse is transferor for 1/2 of the property
- Multiple Transferors: If multiple transferors to one trust, portions of the trust attributable to different transferors are treated as separate trusts

Generational Assignments

- Skip Persons and Non-Skip Persons
- Skip Person:
 - Person: 2 or more generations below transferor
 - Trust: All interests in the trust are skip persons
- Non-Skip Person: Not a skip person

Generational Assignments

- Marriage to Transferor
- Lineal Descendant of Transferor's Grandparent
- Lineal Descendant of Grandparent of Transferor's Spouse or Former Spouse
- Marriage to Lineal Descendant of Grandparent of Transferor, Transferor's Spouse or Former Spouse
- Generational Step-Up

Generational Assignments

- All Others:
 - 0-12.5 years younger: same generation (non-skip person)
 - 12.5-37.5 years younger: 1 generation lower (non-skip person)
 - 37.5-62.5 years younger: 2 generations lower (skip person)
 - 62.5-87.5 years younger: 3 generations lower (skip person)

Example

- T (80) marries her fourth husband, H, age 25
- T and H are same generation
- H is a non-skip person

Example

- T (60) makes gift to his grandchild, G (25)
- G is 4 generations removed from T's grandparent
- T is 2 generations removed from T's grandparent
- G is a skip person as to T

Example

- T (80) makes gift to daughter of his ex-wife, Q (8); Q is not T's daughter
- Q is 3 generations removed from grandparent of ex-wife
- Ex-wife is 2 generations removed from grandparent of ex-wife
- Q is a non-skip person as to T

Example

- T makes gift to trust for his grandchildren; children of A (Gift 1)
- A is living
- Trust is a skip person as to Gift 1

Example (cont.)

- A dies
- T makes a subsequent gift to trust (Gift 2)
- Grandchildren now non-skip persons
- Trust is a non-skip person as to Gift 2
- Two trusts – one for Gift 1 and one for Gift 2
- Retroactive allocation available for Gift 1

Types of Generation-Skipping Transfers

- Direct Skip
- Taxable Distribution
- Taxable Termination

Direct Skips

- Transfer to a Skip Person
- Individuals or Trusts
- Example
 - T creates trust for grandchildren
 - Trust is a skip person
 - Transfer to trust is a direct skip

Taxable Distribution

- Distribution from a trust to a person who is a skip person with respect to the transferor
- Example:
 - Discretionary trust for T's children and grandchildren
 - Trust is a non-skip person (not a direct skip)
 - Trustee makes distribution to one of T's grandchildren
 - Distribution is a taxable distribution

Taxable Termination

- Termination of an interest in property in a trust, unless non-skip person has an interest
- Example:
 - Discretionary trust for T's children and grandchildren
 - Trust is a non-skip person (not a direct skip)
 - Last of T's children dies; remaining assets continue in trust for grandchildren
 - Death of last child taxable termination

Multiple Skips

- Property held in trust continues to be subject to GST tax after a generation-skipping transfer occurs
- Upon occurrence of generation-skipping transfer, transferor treated as 1 generation above highest generation of beneficiary immediately after transfer

Example – Multiple Skips

- T makes gift to trust for grandchild and great-grandchild
- Trust is a skip person (direct skip)
- T now 1 generation above grandchild and 2 generations above great-grandchild
- Grandchild dies; taxable termination occurs
- T now 1 generation above great-grandchild

GST Exemption

- Current exemption \$11,180,000
- Can Apply to Lifetime or Testamentary Transfers
- Formula Allocation Permitted
- Excessive Allocation Void
- Choice of Whether to Allocate
- No Portability of GST Exemption
- Only Transferor Can Allocate

Methods of Allocating GST Exemption

- Affirmative allocation
- Automatic Allocation at Death
- Lifetime automatic allocation at death (although there can be an election out of automatic allocation)
- Late allocation
- Retroactive allocation

Automatic Allocation at Death

- Any remaining GST exemption (after any affirmative allocation) allocated proportionately to direct skips
- Any GST exemption remaining after allocation to direct skips will be allocated to trusts where taxable distribution or termination might occur

Lifetime Automatic Allocation

- GST exemption automatically allocated to direct skips to bring inclusion ratio to 0
- Beginning 2001, automatic allocation rules apply to “indirect skips”
- Indirect skip is a transfer of property (other than a direct skip) to a “GST trust”
- GST Trust is a trust that could have a generation-skipping transfer
- 6 exceptions
- Most ILITS are GST Trusts because it is not known when beneficiaries will receive property
- Can “elect out”
- Can “elect in”

GST/Dynasty Trusts

- Allocating GST exemption to trusts can be used to create a “dynasty” or generation-skipping tax exempt trust which is long-lasting, saving one or more “layers” of death taxes at later deaths.

Planning Opportunities Under Current Tax Laws

- Gifting using some or all of gift/GST exemption amounts prior to 2026
- Modifying trusts to give a general power of appointment
- Terminating trusts

Example

- Ben, a PA resident who is the sole current beneficiary of a PA trust, owns \$3 million in his own name and has two children. The assets of trust consist of \$1 million worth of stock with a basis of \$0. Ben has the limited power to appoint the remaining assets of the trust to his descendants at his death. If Ben does not exercise his power of appointment, at his death the remaining trust assets will be distributed outright to his children.

Example

- Scenario 1: If Ben does nothing, at his death:
 - The trust assets will not be subject to federal estate tax or PA inheritance tax at his death.
 - However, if his children later sell the stock received from the trust, the sale will result in income tax on the gain:
 - \$200,000 of long term capital gains tax (20%)
 - \$38,000 of NII tax (3.8%)
 - \$30,700 of PA income tax (assuming the children are PA residents)
 - TOTAL TAX: \$268,700 (\$134,350 per child)

Example

- Scenario 2: Ben terminates the trust and receives all the assets outright (and assume the trust includes an early termination provision allowing this). At his death:
 - The \$1 million of stock will be included in Ben's estate for federal estate tax purposes and PA inheritance tax purposes.
 - However, no federal estate tax would be due.
 - \$45,000 in PA inheritance tax (4.5%)
 - The stock would receive a step-up in basis for federal and PA income tax purposes, so if the children sold the stock at Ben's death, no income tax would be due.
 - If the trust is terminated, assets owned outright by Ben are available to his creditors.
 - NOTE: If a trust is being terminated, remember to consider the potential gift tax implications of terminating the trust.

Example

- Scenario 3: The trust is modified to give Ben a general power of appointment. At Ben's death:
 - The assets will be included in Ben's estate for federal estate tax purposes but no estate tax is due.
 - The assets are not includible in Ben's estate for PA inheritance tax purposes so no PA inheritance tax is due. (NOTE: This can vary by state).
 - The assets receive a full step up in basis for federal income tax purposes, so if the children sold the stock immediately after Ben's death no federal income tax would be due.
 - The assets do not receive a full-step up in basis for PA income tax purposes (this can vary by state), so PA income (3.07%) tax of \$30,700 would be due.
 - QUERY: Can Ben's creditors reach the trust assets if he is given a general power of appointment?

Example

	Scenario 1 (Do Nothing)	Scenario 2 (Terminate Trust)	Scenario 3 (Modify Trust)
Income Tax	\$268,700	\$0	\$30,700?
Federal Estate Tax and PA Inheritance Tax	\$0	\$45,000	\$0
Total	\$268,700	\$45,000	\$30,700