PRODUCT & SERVICE GUIDE

Estate Planning and the 2018 Tax Reform Law

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Craig Smalley • Feb. 07, 2018

For most practitioners the estate tax hasn't come into play for many years. Instead of eliminating the estate tax, the estate tax exemption has been raised to $11 million for an individual, and $22 million for a married couple that elects portability. For a majority of people the estate tax doesn't come into play. However, let's take a moment to explain how the estate tax exemptions and gift tax works.

The estate tax exemption and the gift tax work together in a sense that you have a unified lifetime credit for gifts, which match the estate tax exemption. The unified credit increases each year, along with the estate tax exemption. Each year there is an amount that you can gift, in a sense that you are removing assets from your taxable estate. For instance, in 2018 the amount that you can gift is $15,000. If you are married and elect to split your gifts, you can give someone $30,000. These amounts can be given without having to file a gift tax return. If you give a person an amount over the exemption, then you must file a gift tax return, and the amount over what you could give is deducted from your unified lifetime credit. If you go over this unified lifetime credit then you have to pay a gift tax of 40%.

There are a ton of steps that you can take to eliminate the estate tax, if you are subject to it. I used to help clients with their taxable estates, back in the days when the estate tax exemption was $600,000. However today, estate planning serves a couple of purposes.

First of all, if you make no plans at all, you die intestate, which is a legal term that means you had no will or estate plan. Your estate goes through a probate process and your assets pass according to the laws of the state, and no one wants that. Another reason to do estate planning would be to avoid as much of the probate process as possible.

Each state is different and probate works differently in each one. Generally, every estate is probabated in some form. In probate, the hearing is made public, so that creditors or anyone that feels that they have a right to the assets of the decedent can make a claim against your estate. For example, if you have a will, and that is your estate plan, the will must be probated before the assets can be disbursed. If you specifically exclude someone that has a legal right to the assets of the estate, they can contest the will, and tie up the distribution of your assets until the probate court determines what will happen to them.

Famous probate cases would be Anna Nicole Smith, who married a wealthy man, who changed his will to leave all of his assets to his new wife. Her husband's adult children, who were excluded in the will contested the will, and the case was tied up until Anna Nicole Smith's death.

There are two ways that assets can pass. One is through probate, and the other is through an act of law. For instance, if you formed a revocable living trust, and titled your biggest assets to that trust, there can be no claim made against the trust, because a trust is a legal document, and the assets passed to the intended beneficiaries by an act of law.

A revocable living trust is a legal document that has three parties. Then grantor, or trustmaker is the person(s) making the trust. The trustee is the person or entity that controls the assets, and the beneficiaries are the ones that are inheriting the assets.

Revocable means that the document can be changed during the grantor's lifetime, living is because you are alive, and trust is a legal document. Typically, during your lifetime, you are the trustee of the trust. At death, a contingent trustee will become the trustee. The trust becomes irrevocable, meaning that it can't be changed, and the assets are protected from creditors or anyone else that is not named as a beneficiary. Then it becomes a taxable entity. During your lifetime, the grantor is responsible for any taxes due on the income earned while in the trust. At death, if the assets aren't distributed, then the beneficiaries are responsible for any taxes due.

For the smaller assets, like personal effects, you would have a pour-over will, that would be probated, but the probate process doesn't matter too much, because you have removed the biggest assets already through the trust.

The other reason for estate planning for an estate that isn't subject to the estate tax, is for the person that is self-employed, and wants to pas their business to someone else, in the most tax advantageous way possible. For instance, if you own a business and you want to pass the business to your children, it would be a taxable event unless you have made some arrangements.

One of the most popular ways to pass a business on to someone is through a grantor retained annuity trust or a GRAT. Basically, the owner of the business, the grantor in this case, would form an irrevocable trust, and transfer their shares of stock if a corporation, or membership units if an LLC to the trust. The trust would have a trustee, other than the grantor to protect the assets from creditors and to remove the assets from the taxable estate, if it exists.

The trust would have a term of ten to twenty years. The ownership vehicle would be placed in the trust at a value determined by the grantor. The trust would then pay the grantor an amount each year, as an annuity, until the end of the trust term. When the trust ends, the ownership of the business would pass to the beneficiaries.

The problem a GRAT creates is that the annuity amount that is paid to the grantor is taxable to the grantor, and if the grantor dies while the GRAT is in effect, the assets are removed from the trust and added back to the estate, and could be taxable if the grantor is subject to the estate tax, and will pass through probate.

There are other ways to pass the business to the beneficiaries, that is a little more complicated, but protect the assets, and the owner retains control of the business, and the profit of the business is used to pay the grantor for the assets, and the tax to the grantor is better than that of a GRAT.

Most businesses are set up as S-Corporations, now that can change with the new tax law, but the theory behind this'd way of passing along the business would remain intact. The grantors forms an intentionally defective grantor trust (IDGT). What make the trust defective is that it is irrevocable, unlike most grantor trusts that are revocable. In the case of an S-Corporation, you can only have one class of stock, and its common stock. You would split the stock, into voting and non-voting shares. This split does not create a separate class of stock, it just has to do with voting rights. You would take 99% of the shares and make them non-voting shares. You would transfer those shares to the trust, and the beneficiaries would be the ones inheriting the stock. The left over 1% of stock, would be the voting shares, and remain with the grantor.

The point of this is to pass the majority of the business to the beneficiaries, and the owner of the business to retain control of the business.

The 99% of the stock that was transferred would be transferred at whatever amount the grantor determines. The grantor would become a passive owner, not required to pay themselves reasonable compensation, however the owner would take distributions from the S-Corp, until such a time as owner is paid for the business, and then relinquishes their stock, the shares in the trust are distributed to the beneficiaries, and the business is removed, and passed to the intended beneficiaries.

Just because most of your clients are not subject to the estate tax, doesn't mean that estate planning is a dying skill. Estate planning is a hard sell to a client, partially because the estate tax isn't a big deal to most people, and with estate planning a client has to come face to face with their own mortality. However, knowing the ins and outs is still important.

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