ST. LOUIS TRUST
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Estate and Income Tax Planning After the Tax Cuts and Jobs Act

The Tax Cuts and Jobs Act ("TCJA") passed by Congress and signed by President Trump at the end of 2017 contained some major changes to the tax code. Its effect on wealthy families is a mixed bag:

The Good

- Ordinary income tax rates have declined (not just the top rate, but the thresholds and intermediate rates have also changed)
- AMT exemptions have doubled
- Corporate tax rate is significantly reduced from 35% to 21%
- 20% deduction set for pass-through entities, with exceptions
- Pease Limitation (3% haircut on deductions) is gone
- Estate, gift and GST tax exemptions have increased to $11.18million per person ($22.36 million for married couples)!

The Bad

- Affordable Care Act tax of 3.8% on investment income remains
- There are no more Miscellaneous Itemized Deductions (investment management fees, tax advice and preparation, etc.)
- Individual provisions are set to sunset in 2026

The Ugly

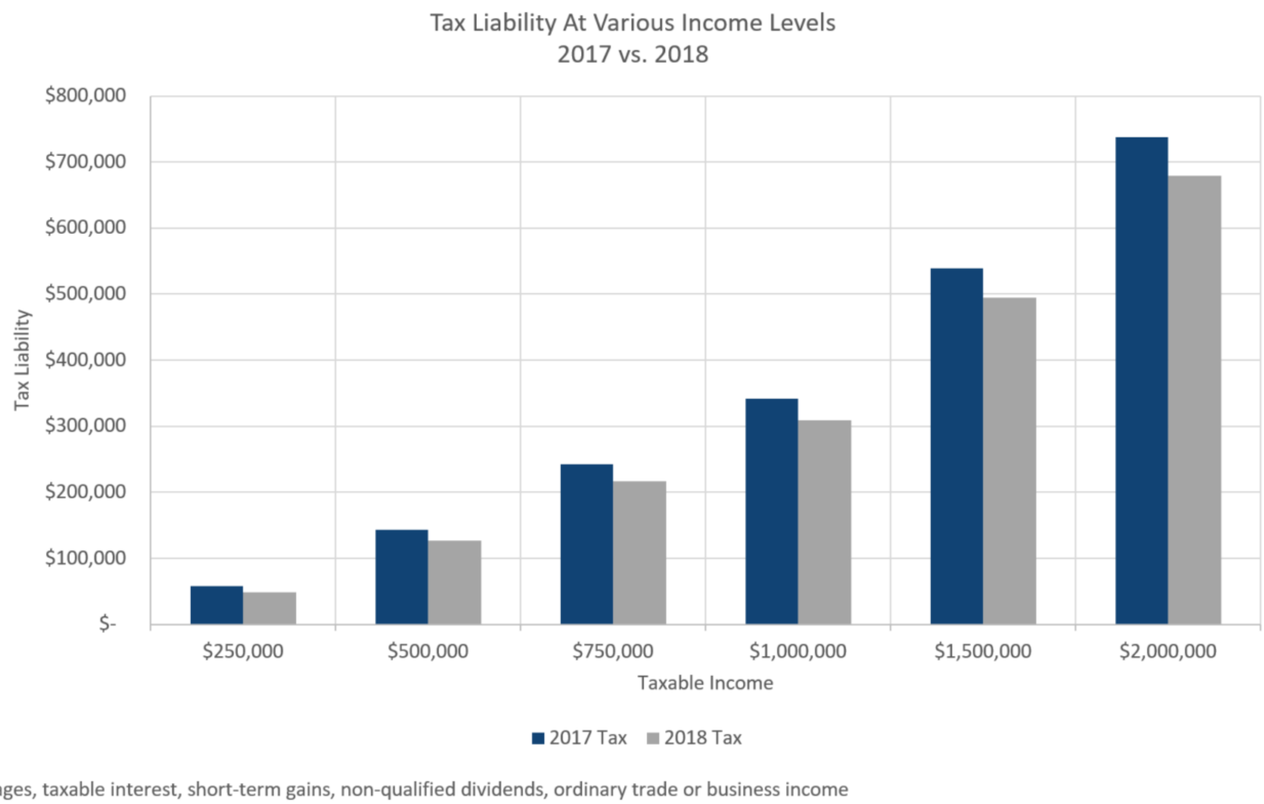
- State income and property tax deductions are limited to $10,000. OUCH.

The increase in estate, gift and GST tax exemptions provides a great planning opportunity for families of wealth. However, use of these exemptions during a taxpayer's life comes with a tradeoff. Assets transferred out of a taxpayer's estate do not enjoy a step-up in income tax basis at the taxpayer's death. Since the primary focus of this article is the prudent use of exemptions and the importance of step-up basis planning, we will first address how the TCJA might affect some wealthy families from an income tax perspective.

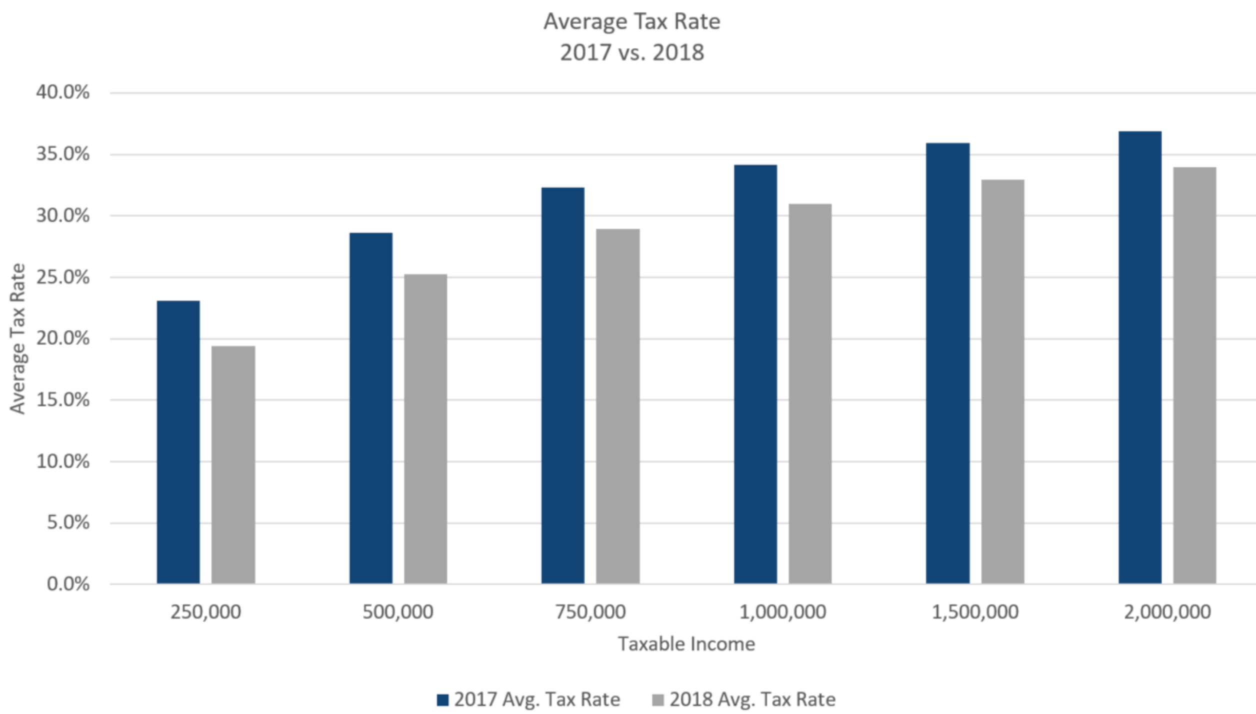
Income Tax Aspects of the TCJA – It's Really Ugly for Some Taxpayers

As mentioned above, ordinary income tax rates are generally lower, with the top rate moving from 39.6% to 37%. The reduction in rates and increase of thresholds beneath those top rates also confer benefits. Below are graphs showing the potential federal income tax liability and effective tax rates at various levels of taxable income (i.e. income after all deductions and exemptions but before any credits):

*Federal Income Tax Liability (Ordinary)**



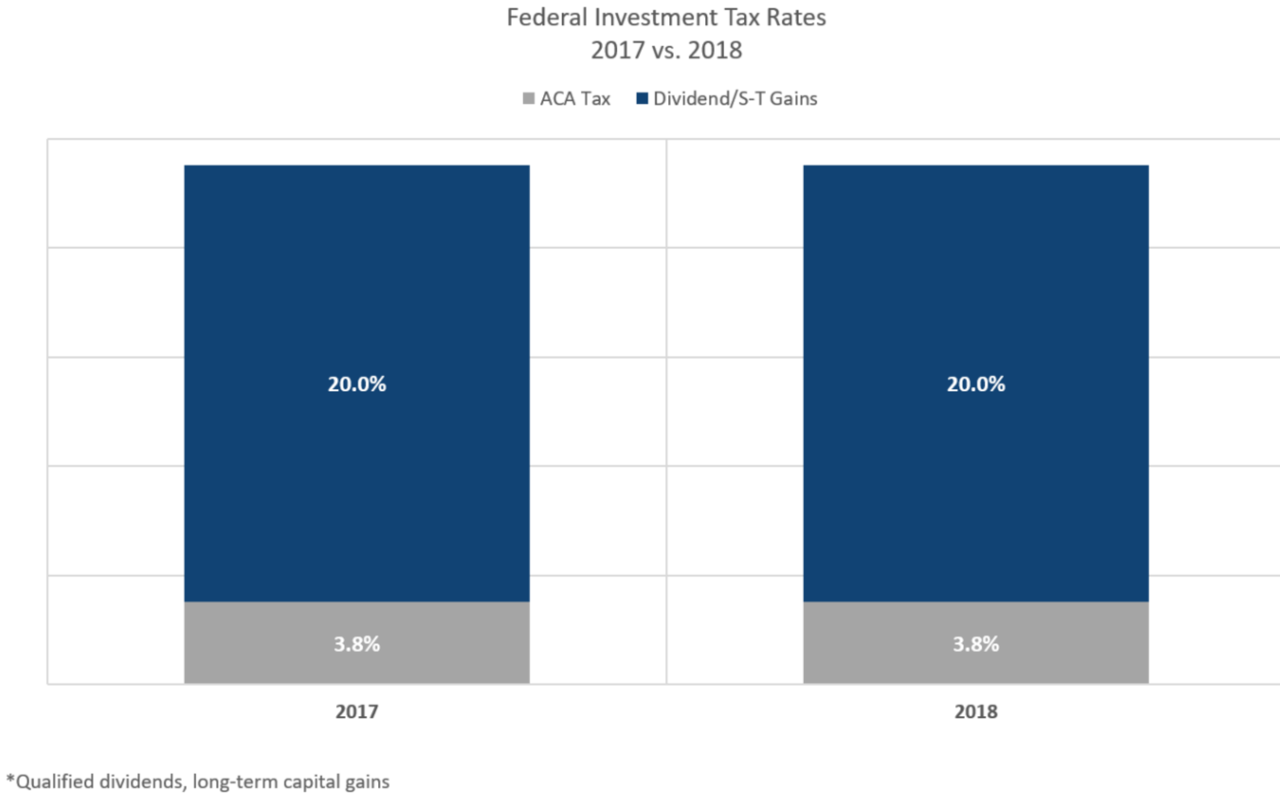
*Federal Income Tax Rates (Ordinary)**



*Wages, taxable interest, short-term gains, non-qualified dividends, ordinary trade or business income

As the graphs above illustrate, from a tax rate perspective, the new tax law provides a benefit for taxpayers to the extent their taxable income is ordinary taxable income (wages, taxable interest, non-qualified dividends, short-term capital gains and ordinary trade or business income). For taxpayers with qualified investment income (qualified dividends and long-term capital gains), the new tax law provides no benefit in terms of a decrease in rates:

*Federal Income Tax Rates (Investment Income)**



For wealthy taxpayers the fact that state income and property taxes now are subject to a $10,000 cap on deductibility is a major setback, with an especially negative effect on wealthy taxpayers living in states with an income tax. Additionally, for those wealthy taxpayers whose taxable income is mainly qualified dividends and long-term capital gains, the reduction of deductions is not offset by lower tax rates.

Here's an example. Assume a California resident with no wages, living off her investment portfolio of $100 million. Assume the $100 million is invested 70% in stocks, 25% in municipal bonds (50% of which are California municipal bonds) and 5% in cash. The resulting income generated by the portfolio and the taxpayer's deductions are listed in the below table.[1]

INCOME	2017	2018
Muni Interest (exempt 100% fed/50% CA)	750,000	750,000
Taxable Interest	100,000	100,000
Qualified Dividends	1,000,000	1,000,000
Non-Qualified Dividends	250,000	250,000
Short-Term Capital Gains	50,000	50,000
Long-Term Capital Gains	600,000	600,000
Federal Adjusted Gross Income (AGI)	**2,000,000**	**2,000,000**
DEDUCTIONS		
Property Taxes	(240,000)	(10,000)
California Income Taxes	(241,067)	-
Charitable Contributions	(200,000)	(200,000)
Miscellaneous 2% Items (50bps on $100mm)	(460,000)	-
Total Deductions	(1,141,067)	(210,000)
Pease Limitation	50,586	-
Total Federal Itemized Deductions	(1,090,481)	(210,000)
Federal Taxable Income	909,519	1,790,000
Total Tax (Fed + CA)	**457,533**	**747,595**

The difference in total tax is breathtaking: a $290,000 and 63% increase in taxes! This drastic difference occurs because: (1) this taxpayer is mainly taxed at the qualified dividend and long-term capital gains tax rate so reaps very little benefit from the reduction of ordinary tax rates and (2) the TCJA eliminates the deduction for Miscellaneous Itemized Deductions and caps the deductibility of state income and property taxes at $10,000.[2]

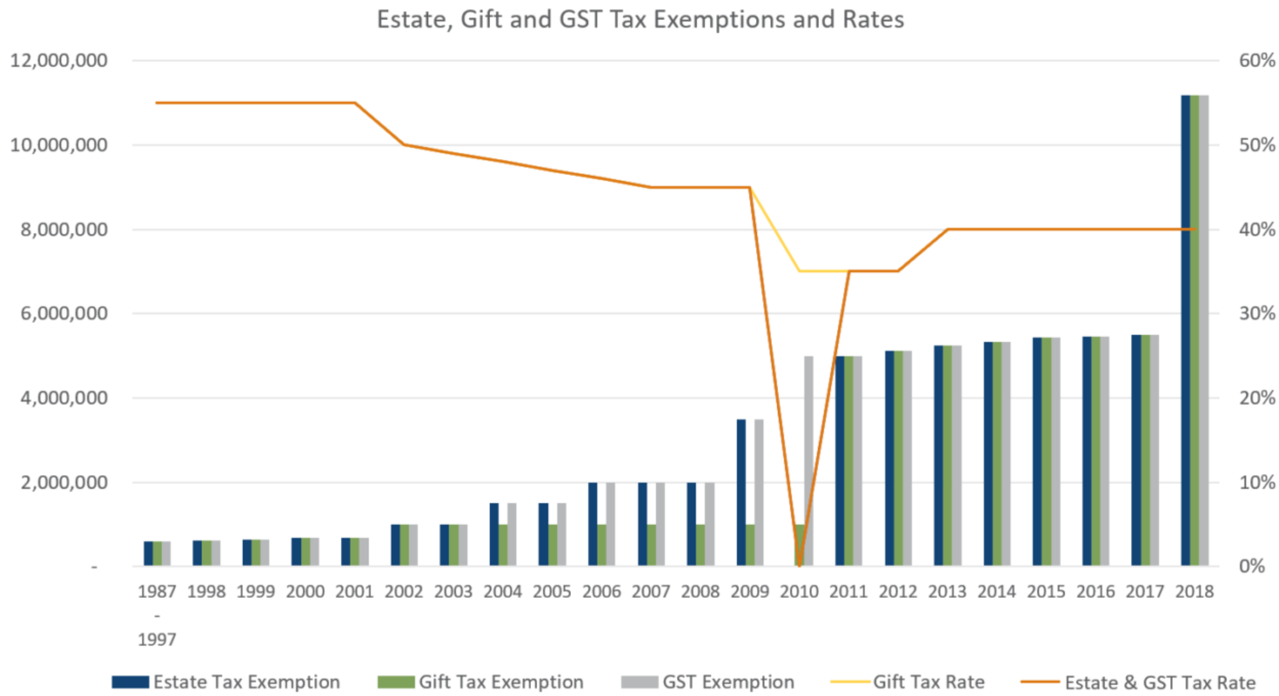
While the TCJA's changes will be beneficial for many taxpayers, it will have a major negative impact on those taxpayers living in states with an income tax and/or high property taxes and whose income is comprised primarily of qualified dividends and long-term capital gains as they will not enjoy much of the benefit of reduced ordinary income tax rates. While the intricacies of income tax planning after the TCJA is beyond the scope of this article, it is important to focus on the income tax liability produced by the investment portfolio and thus redouble efforts to reduce portfolio taxable income. Some ideas in this regard include:

- Shift investments with higher turnover to those with lower turnover, which generate less capital gains.
- Make use of tax-managed index separate accounts to generate capital losses (while tracking an index) to minimize taxable income.
- Use municipal bonds instead of taxable bonds.
- Consider investing through private placement life insurance and private placement annuities. These vehicles allow investments to grow tax-deferred.
- Increase the use of deductions that are still available – mainly the charitable contribution. If a taxpayer is planning to give to charity at death, consider funding a donor-advised fund or foundation during life to enjoy the income tax deduction.
- Pay attention to, and take steps to reduce, investment management fees. Their non-deductibility has now increased the effective cost of investment advisors and managers and increases their hurdle rate as compared to lower-cost investments. Hedge funds and other alternatives with high fees are even more costly.

Estate Planning

While the income tax aspects of the TCJA are not advantageous for some wealthy families, the doubling of the estate, gift and GST tax exemptions to $11.18 million per taxpayer (or $23.36 million for a married couple) is universally beneficial. Because these exemptions are so large, they now should alter the focus of estate planning based on the following reasoning:

- When estate, gift and GST tax exemptions were smaller, their most effective use was as leverage, in effect "throwing the ball down the field as far as possible." With larger exemptions, more exemption can be retained/preserved while still engaging in effective transfer tax planning.
- Reduction of the estate/gift/GST tax rates from 55% to 40% has reduced the benefit of transfer tax planning vis-à-vis income tax planning, as the federal capital gains tax rate is 23.8% and often over 30% for taxpayers in many states.
- Thus, it is ESSENTIAL to focus on the income tax aspects of estate planning, chiefly related to basis step-up planning. This is not a new concept, but the expanded exemptions provide new opportunities and tradeoffs with respect to their use.



Basis Step-up Planning

Assets that pass from a decedent at death receive a step-up in basis to the fair market value (FMV) at the date of death. "Passing from the decedent" means those assets included in the decedent's estate for estate tax purposes. If assets are transferred out of the decedent's estate during life, they will not receive a basis adjustment at the decedent's death. Here's a simple example:

IN-ESTATE		DYNASTY TRUST (OUT-OF-ESTATE)	
FMV:	$50mm	FMV:	$50mm
Basis:	$30mm	Basis:	$30mm
Built-in Gain:	$20mm	Built-in Gain:	$20mm
AT DEATH, BASIS ADJUSTS:		**AT DEATH, BASIS DOES NOT ADJUST:**	
FMV @ Death:	$50mm	FMV @ Death:	$50mm
New Basis:	$50mm	Same Basis:	$30mm
Built-in Gain:	**$0**	**Built-in Gain:**	**$20mm**

Below are a few other rules about basis step-up to note:

- There is no step-up on “Income in Respect of a Decedent” income items (IRAs, deferred comp, etc.).
- For joint property, there is a partial step-up at the first spouse’s death in common law states. There is a full step-up at the first spouse’s death with respect to community property.
- According to the One Year Rule, there is no step-up for property received by gift that passes back to donor within one year of the gift.
- The step-up basis rule is applied on an asset-by-asset basis at death.
- Assets with a FMV lower than basis will “step-down” to FMV at the decedent’s death. As such, it may be prudent to sell these assets, recognize the loss and use it to offset the decedent’s other income during her last year of life.

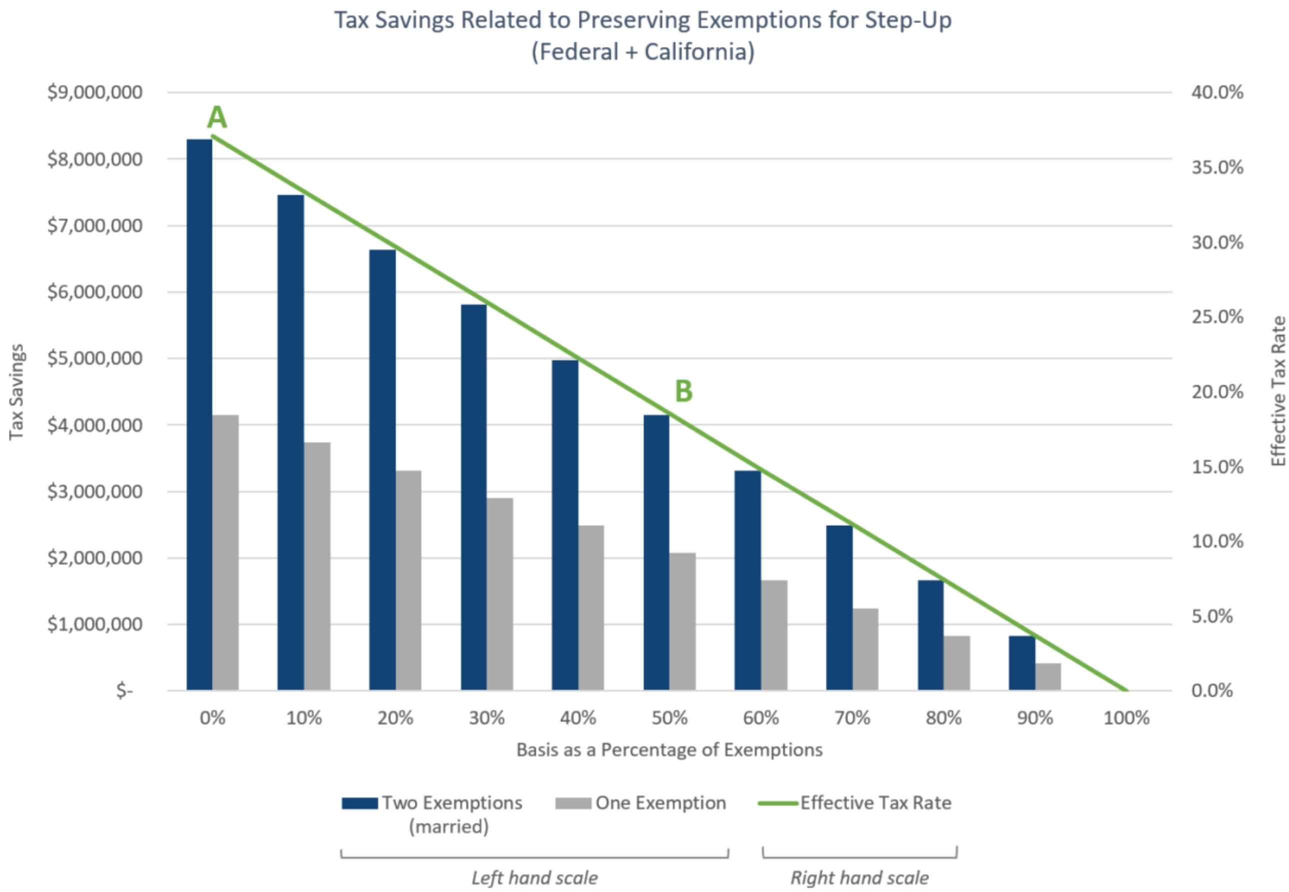
Note that there is a time element associated with evaluating the benefit of step-up basis planning. Because there is no forced realization for appreciated assets outside of a decedent’s estate at her death, the benefit of the basis step-up is not realized until the assets are sold. For assets outside of the estate which a decedent’s family may wish to hold long-term, such as real estate or an operating business, the benefits of basis step-up planning are less valuable than in a situation where selling assets with a higher basis will allow for more immediate benefits through diversification, changing investment strategy, or meeting liquidity needs.

Five Categories of Transfer-Tax Focused Estate Planning

If you boil down the various estate planning techniques that are focused on transfer taxes, they fit within five strategies, as follows:

1. **Make Gifts.** Gifts reduce the size of the donor's estate, provide assets to donees and remove future appreciation of gifted assets out of a donor's estate. Additionally, if gift tax is paid three years or more before the donor's death it is effectively one-third cheaper than the estate tax due to a technicality regarding how it is calculated as compared to the estate tax. Merely making gifts can be very powerful, but gifted assets are received by the donee (whether individual or trust) with a carryover basis and receive no step-up at the donor's death.
2. **Engage in Estate Freeze Transactions.** A "freeze" transaction shifts potential asset appreciation out of the donor's estate in exchange for an asset with little or no appreciation potential. A common freeze transaction is transferring equity with growth potential out of the estate in return for a debt obligation paying relatively low interest.
3. **Discount Asset Values.** Transfer taxes are an excise tax on the "fair market value" of the assets transferred by the donor or decedent. Various strategies can be used to reduce the value of assets at the time of transfer. The most common relate to creating discounts for lack of marketability and lack of control by using entities such as LLCs or fractionalizing ownership.
4. **Maximize Use of Deductions and Exemptions.** Utilizing the $11.18 million estate and gift tax exemption and the $11.18 million GST tax exemption in a prudent manner is important. There are also smart planning opportunities with the marital deduction, charitable deduction and deduction for claims against the estate.
5. **Liquidity Plan/Fund.** An important part of transfer tax focused planning is to ensure that liquidity will be available to fund tax at the decedent's death. This is of the utmost importance for decedents who own substantial illiquid assets such as closely-held businesses and real estate.

It is also essential to analyze the tradeoff between using exemptions for lifetime gifts to remove future appreciation from the taxpayer's estate and retaining exemptions in order to enjoy basis step-up at the taxpayer's death. The value of step-up depends on the basis of the assets used in the planning. The below graph illustrates the benefits of basis step-up in relation to the exemptions:



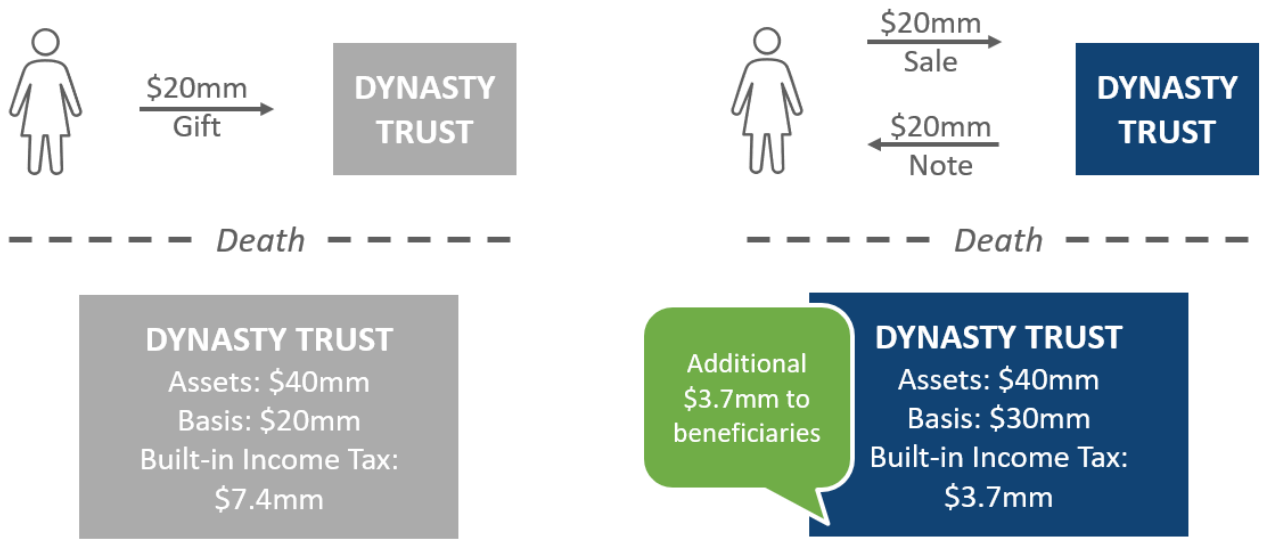
So, if zero basis assets are retained in the estate instead of gifted away (point "A" in above graph), the estates of a married couple with two exemptions between them would enjoy over $8.2 million of benefit from basis step-up – which is about a 35% income tax benefit (federal + California tax rates). Similarly, assets with 50% basis (point "B" in above graph) would enjoy a bit over $4 million of income tax benefit and just under a 20% rate benefit.

Of course, the benefit of transferring appreciation out of one's estate is substantial, as any appreciation of gifted assets enjoys a 40% transfer tax savings. Thus, planning to remove future appreciation out of the estate for estate tax purposes is more powerful than planning for step-up.

A key point, however, is that **moving appreciation out of one's estate and basis step-up planning are not mutually exclusive!** It is possible to have your cake and eat it too!

How to Have Your Cake and Eat It Too!

One of the most powerful and popular estate planning strategies for wealthy families is to engage in an "installment sale to intentionally defective irrevocable trust" transaction. This strategy typically involves a combination of the first three strategies listed above: a gift and sale of discounted assets to a grantor trust outside the donor's estate which acts as an estate freeze. An effective way to preserve exemption for step-up and move future appreciation out of the estate is to engage in an installment sale and leave as much exemption as possible unused. Here's an example of a $20 million gift by a married couple as compared to a $20 million installment sale to an intentionally defective irrevocable trust (referred to in the remainder of this article as a "Dynasty Trust").[3]

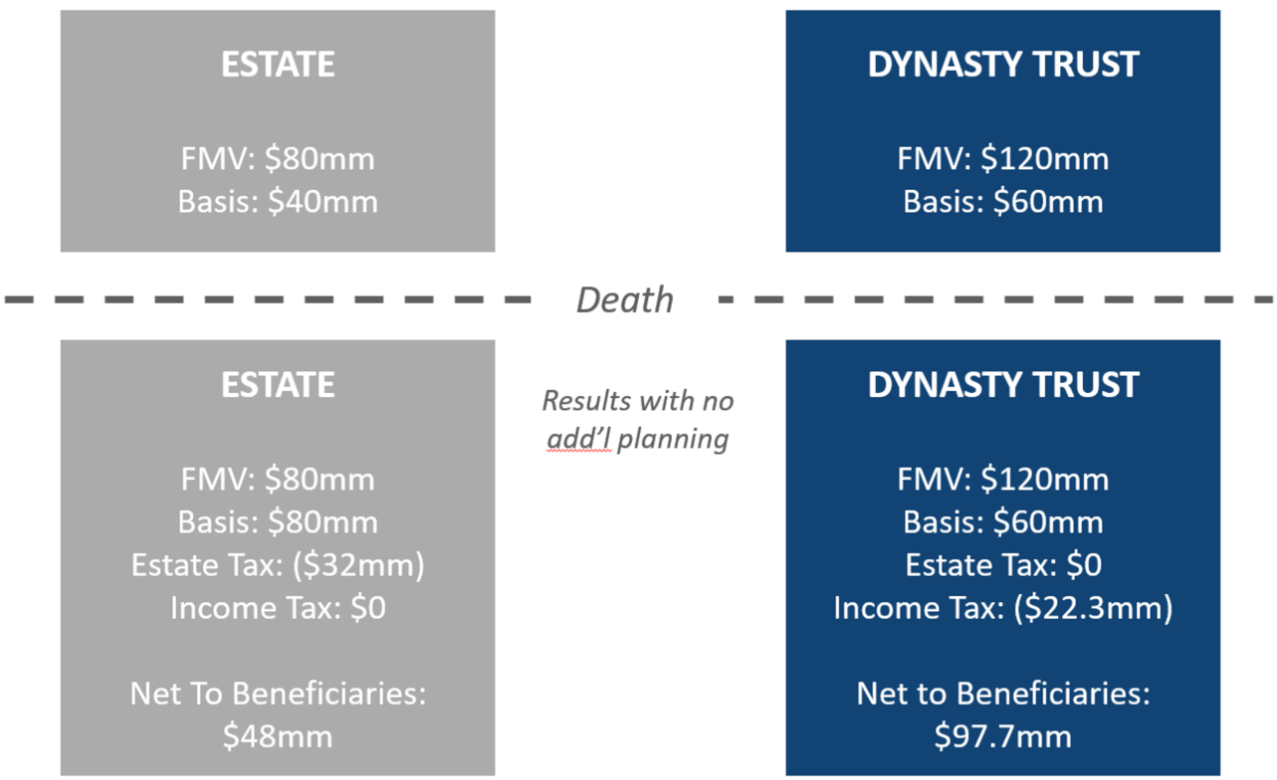


In the example above, the Dynasty Trust ends up with the same amount of assets at death, $40 million. However, in the sale scenario, $20 million of those assets make a round trip journey as the "Sale" Dynasty Trust owes back $20 million.[4] If this note is paid off with assets that have appreciated prior to the taxpayer's death, $20 million of assets that received a step-up then will be added back to the Dynasty Trust (with GST exemption allocated) to bring the total assets to $40 million just like the Dynasty Trust that received the outright gift, but with basis of $30 million (a fully stepped up $20 million from the estate and $10 million in the Dynasty Trust).[5]

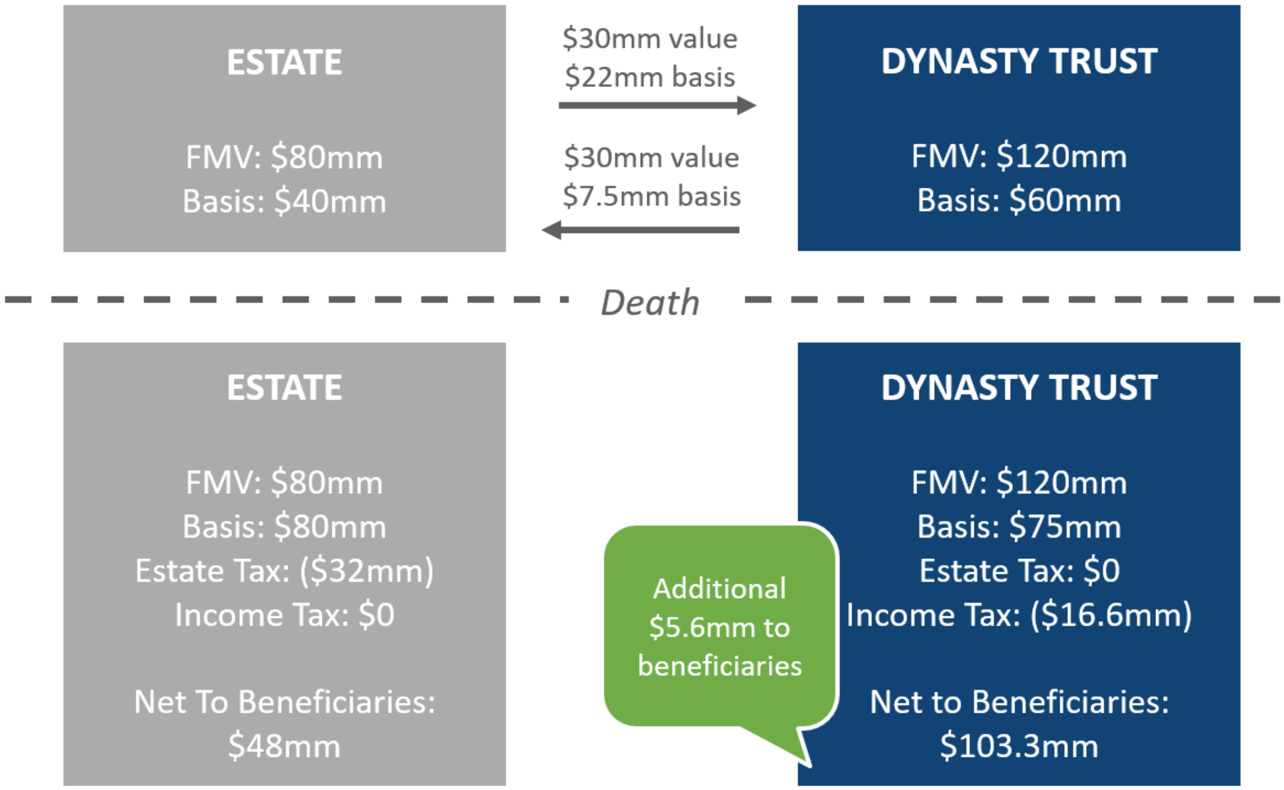
Smart Administration of Existing Grantor Trusts

A key planning opportunity exists for long-standing Dynasty Trusts that are grantor trusts where the grantor has a short life expectancy. Often low basis assets in these existing Dynasty Trusts have enjoyed great appreciation over the years. Because a grantor trust and the grantor are not separate taxpayers for income tax purposes, transactions between a grantor and her grantor trust are not realization events. Thus, it is possible for a grantor to swap higher basis assets out of her estate in exchange for lower basis assets from the grantor Dynasty Trust, allowing the Dynasty Trust to continue with a higher basis portfolio.

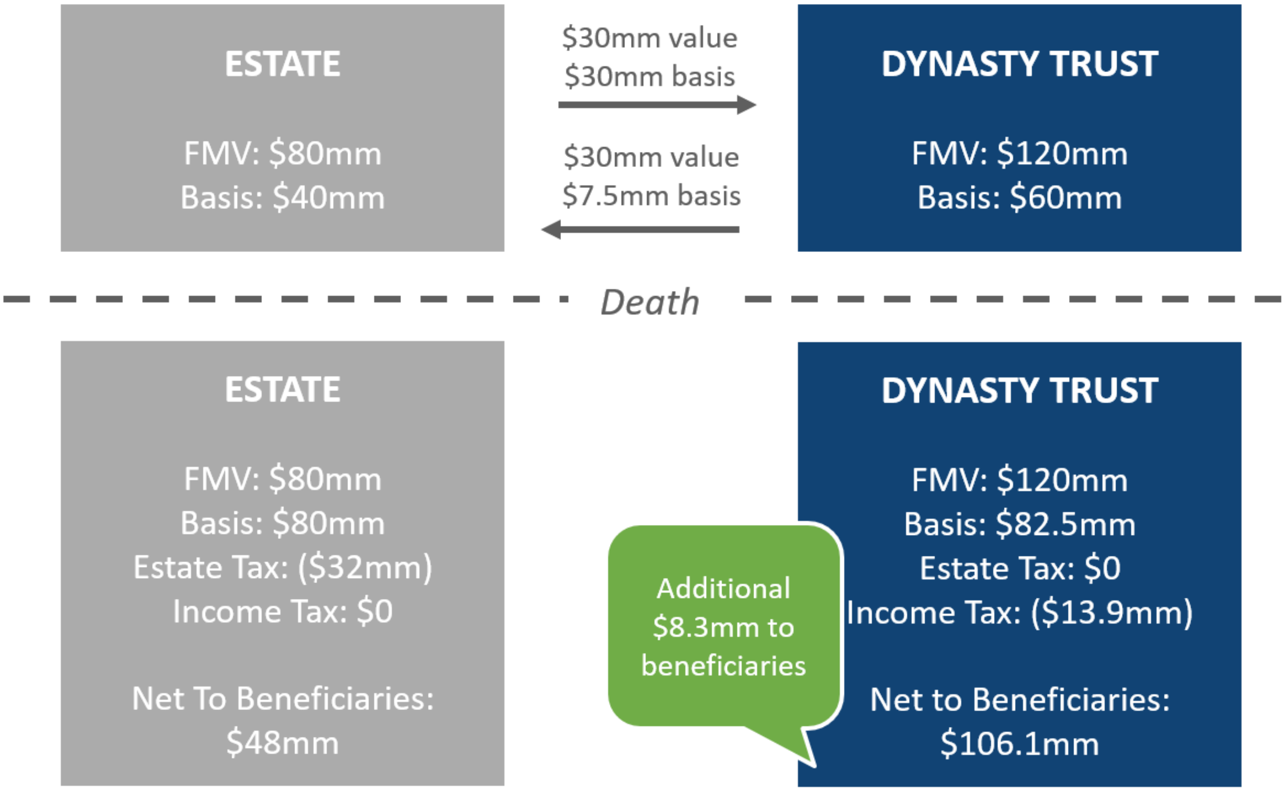
Below are three examples. In each example the Dynasty Trust has assets totaling $120 million and the grantor has assets totaling $80 million in her estate. The average basis of the assets in both the Dynasty Trust and her estate prior to death is 50%. The below diagram shows what happens at the grantor's death with no additional planning. The subsequent two examples show what happens if higher basis assets from the estate are swapped for lower basis assets from the Dynasty Trust before the grantor's death.



Assume now that prior to death the grantor swaps assets with 75% basis out of her estate for assets with 25% basis in the Dynasty Trust. Here's what happens:



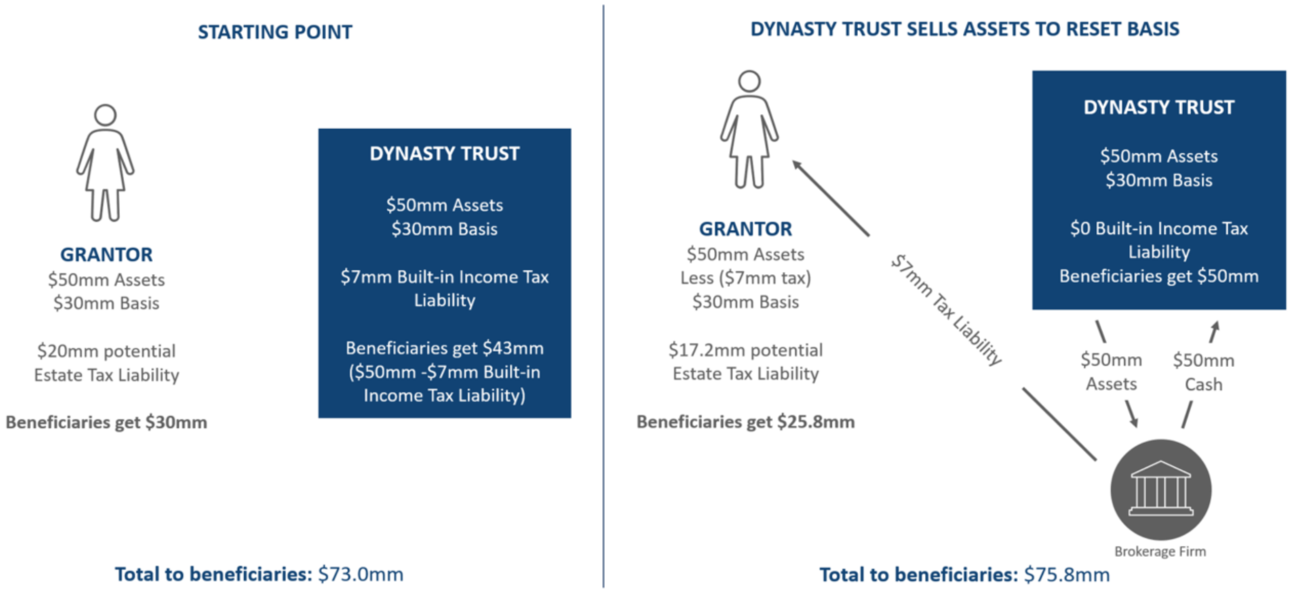
Assume now that prior to death she swaps assets with 100% basis out of her estate for assets with 25% basis in the Dynasty Trust. Here's what happens:



As these scenarios illustrate, swapping low basis assets for higher basis assets can materially increase the assets passing to beneficiaries on a net of income tax basis.

However, engaging in an asset swap is not always an option. Perhaps there is not enough time to effectuate a swap before a grantor's death. The Dynasty Trust may own interests in partnerships or other entities which makes a swap administratively unfeasible. Or, the grantor may have very few higher basis assets to swap with the Dynasty Trust. In these situations, a Dynasty Trust could sell low basis assets and intentionally recognize gain prior to the grantor's death. This resets basis for the Dynasty Trust assets and payment of the resulting income tax by the grantor (or grantor's estate if she dies soon thereafter) removes the income tax paid from her estate which is an estate tax benefit.[6]

Here is an example of a sale of low basis assets by a Dynasty Trust before death:



This strategy of selling low basis assets prior to the grantor's death can be used in conjunction with an asset swap – merely swap assets with higher basis and then, after the swap, sell the assets to gain the rest of the step-up in the Dynasty Trust.[7]

Conclusion

The TCJA provides substantial estate planning benefits with its increased estate, gift and GST exemptions. Somewhat incongruously, these increased exemptions lead to greater opportunities to engage in effective basis step-up planning. It is important to add an income-tax sensitive focus to estate planning and to refrain from giving away increased exemptions without considering the effects on step-up basis planning. Finally, older taxpayers with grantor trusts should consider swapping higher basis assets in their estates for lower basis assets in grantor trusts outside of their estates. Additionally, realizing gains in Dynasty Trusts can be effective planning.

APPENDIX: *Five Categories of Transfer Tax Focused Planning*

	GIFT	FREEZE	DISCOUNT	MAXIMIZE DEDUCTIONS & CREDITS	FUND / LIQUIDITY PLANNING
GOAL / PURPOSE	- Reduce size of estate - Provide assets to donees - Removes appreciation of gifted assets out of estate	Shift appreciation out of estate (or freeze a portion value in donor's estate)	Reduce tax values of assets	Take advantage of the deductions and credits provided in the Tax Code	Ensure there are the appropriate amount of assets in the right place to fund estate taxes and bequests
EXAMPLES OF TECHNIQUES	**"Non-Gift" Gifts:** - Annual Exclusion Gifts ($14k per done per year) - Tuition pmts - Medical pmts - Payment of income taxes on behalf of Grantor Trusts **Other Gifts:** - Gifts beyond the "Non-Gifts" either use exclusion (currently $5mm) or require pmt of gift tax	- Grantor Retained Annuity Trusts (GRATs) - Installment Sales to Grantor Trusts - Charitable Lead Annuity Trusts (CLATs)	- Use of LLC/LP interests with limited rights / marketability - Use of non-voting stock - Transfers of minority interests - Fractionalization of real estate	- Marital Deduction - Charitable Deduction - Deduction for debts & claims against estate - Exclusion against Estate and Gift Taxes - GST Exemption	- Use of life insurance - Shift illiquid assets into entities outside of estate - Use of appropriate and thoughtful tax funding clauses - Planned post-mortem asset sales - Analysis of basis step up / income tax liability
ADVANTAGES	- Simple (usually) - Where tax is paid, gift tax is cheaper than estate tax because gift tax paid is removed from estate - Can provide immediate benefit, use and enjoyment for donees	- Leveraged techniques meaning limited or no use of gift/estate tax exemptions - May be able to leverage GST exemption - Very effective if assets go up in value - No gains usually triggered with techniques	Can have big impact on value reduction	Typically low risk	- Advanced planning can preserve integrity of family entities - Avoid forced sales of assets
DISADVANTAGES	- No leverage (unless use discounted assets) - Limited amount of exclusion	- If assets do not increase in value, techniques will not work - More complex - Installment sales have more risk (but more reward)	- Audit risk/often challenged by IRS - Often adds significant administration, complexity costs - Liquidity / cash flow constraints	- Marital deduction is merely a timing rather than a permanent benefit - Charitable requires a gift of the assets	- Life insurance can turn our to be a poor investment

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[1]*Note that all income and deduction items are the same from 2017 to 2018. The only differences are due to tax law changes from the TCJA.*

[2] *Note that the above example did not consider the Alternative Minimum Tax for simplicity purposes, but its effects on the analysis would be minor.*

[3] *For purposes of this example the following assumptions are utilized:*

- *Assumes basis is 75% of FMV now and 50% at death due to appreciation.*
- *Assets double from transaction until death. No discounting is utilized for simplicity of example.*
- *Exemption remaining at death is used to fund the Dynasty Trust and the amount of exemption does not increase.*
- *Promissory note in the sale scenario is paid off with appreciated assets prior to death.*
- *Interest on note is ignored for simplicity.*
- *Income tax rates: federal: 23.8%, state: 13.3 %*

[4] *Attention should be paid to the one-year rule of IRC Sec. 1014(e) in making these transfers/transactions.*

[5] The interest payments the Dynasty Trust would have paid have been ignored for simplicity, so this example isn't quite apples-to-apples, but the lesson of the example holds – it is possible to shift appreciation out of one's estate while still preserving exemption. We find that a larger installment sale with retained exemptions is superior planning to a gift of exemptions with a smaller installment sale when basis step-up planning is considered.

[6] Note that the grantor can avoid selling low basis assets to fund the income tax bill by going on margin and then having the grantor's estate pay off the margin loan with stepped-up assets after the grantor's death.

[7] Note that an important point in deciding to partake in this planning is how long the grantor is expected to live as there is an opportunity cost related to the monies used to pay the income tax (if a margin loan is used, the cost and risks of the leverage should be considered).