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Tax Cuts and Jobs Act supercharges exemption portability

The Tax Cuts and Jobs Act (TCJA) completely rewrites sections of the tax code for individuals and businesses. Under the TCJA, the federal gift and estate tax exemption doubles from $5 million to $10 million, indexed for inflation to $11.18 million in 2018.

Somewhat lost in the clamor is the fact that the new law preserves the "portability" provision for married couples. Portability allows your estate to elect to permit your surviving spouse to use any of your available estate tax exemption that is unused at your death.

The long and winding road

In addition to the unlimited marital deduction that shelters asset transfers between spouses from federal estate tax, the $11.18 million gift and estate tax exemption covers asset transfers to other heirs, such as your children and grandchildren. (See the sidebar "Don't skip the generation-skipping transfer tax" on page 3.)

It doesn't seem possible, but at the turn of the century the exemption was a mere $675,000 before being hiked to $1 million. Subsequently, the Economic Growth and Tax Relief Reconciliation Act of 2001 gradually increased the exemption to $3.5 million, while reducing the top estate tax rate from 55% to 35%, among other changes.

After a one-year estate tax moratorium in 2010, the Tax Relief Act (TRA) of 2010 reinstated the estate tax with a generous $5 million exemption, indexed for inflation, and a top 35% tax rate. The American Taxpayer Relief Act (ATRA) of 2012 made these changes permanent, with the exception of increasing the top rate to 40%.

Along the way, the unified gift and estate tax exemption was severed and then reunified, as they remain under current law. Thus, any amounts used to cover lifetime gifts erode the remaining estate tax shelter.

Most important, for the first time, the TRA authorized portability of the estate tax exemption, which was then permanently preserved by ATRA. Under the portability provision, the executor of the estate of the first spouse to die can elect to have the "deceased spousal unused exclusion" (DSUE) transferred to the estate of the surviving spouse.

How DSUE works

A good way to explain the DSUE is to look at a hypothetical example. Let's say that Kevin and Debbie, who have two children, each own $5 million individually and $10 million jointly with rights of survivorship, for a total of

Don't skip the generation-skipping transfer tax

If you leave assets to your grandchildren or even younger heirs, either through your will or living trust, the transfer is subject to the generation-skipping transfer (GST) tax. This is separate from regular federal estate tax.

Fortunately, your estate is protected by the GST tax exemption. This exemption, which is the same figure as the estate tax exemption, is indexed to $11.18 million in 2018 under the Tax Cuts and Jobs Act. The GST tax rate is 40%.

But there's a potential pitfall for individuals. Unlike the estate tax exemption, there's no portability with the GST tax exemption. Each estate stands on its own. To avoid problems, ensure that the GST tax exemption is properly allocated when making transfers to heirs two or more generations below you.

$20 million. Under their wills, all assets pass first to the surviving spouse and then to the children.

If Debbie dies in early 2018, the $5 million in assets she leaves to Kevin is exempt from estate tax because of the unlimited marital deduction. Thus, her entire $11.18 million exemption is unused. However, if the election is made upon her death, Kevin's estate can later use the $11.18 million of the DSUE from Debbie, plus the exemption for the year in which Kevin dies, to shelter the remaining $8.8 million from tax, with plenty to spare for some appreciation in value.

What would have happened without the portability provision? For simplicity, let's say that Kevin dies later in 2018. Without being able to benefit from the unused portion of Debbie's exemption, the $11.18 million exemption for Kevin in 2018 leaves the $8.8 million subject to estate tax. At the 40% rate, the federal estate tax bill would amount to a whopping $3.52 million.

Although techniques such as a traditional bypass trust may be used to avoid or reduce estate tax liability, this example demonstrates the potential impact of the portability election. It also emphasizes the need for advance planning.

Other points of interest

Be aware that this discussion factors in only federal estate taxes. State estate taxes may also have a significant impact, particularly in some states where the estate tax exemption isn't tied to the federal exemption.

Also, keep in mind that, absent further legislation, the exemption amount is slated to revert to pre-2018 levels after 2025. Portability continues, although, for those whose estates will no longer be fully sheltered, additional planning should be considered.

Furthermore, portability isn't *always* the best option. All relevant factors should be considered, including nontax reasons that might affect the distribution of assets under a will or living trust. For instance, a person may want to divide assets in other ways if matters are complicated by a divorce, a second marriage or unusual circumstances. Your estate tax advisor can help you decide if portability is right for your estate plan. •

When a smart business decision also makes estate planning sense

Do you own a business with one or more individuals? Undoubtedly, your interest in the business represents a substantial part of your net worth and is likely your "pride and joy." So it's normal if your fondest wish is for the business to continue long after you're gone or for you to keep it running if a co-owner or partner dies first.

But circumstances can get in the way. If adequate provisions aren't made, the business may flounder if a leadership void isn't filled. Or bitter family disputes can tear the organization apart. In the end, a "distress sale" may leave your heirs with substantially less than the company's current value.

Fortunately, disastrous results may be avoided if you have a buy-sell agreement drafted during your lifetime. The agreement can dictate how the business is sold, to whom and for how much. Life insurance policies are often used to fund the transaction.

Buy-sells in a nutshell

A buy-sell agreement may be used for virtually every type of business entity, including C corporations, S corporations, partnerships and limited liability companies. Typically, it applies to the shares of stock and any business real estate held by respective owners. Although variations exist, the agreement essentially provides for the sale of a business interest to other owners or partners, the business entity itself or a hybrid. Alternatively, the agreement may cover a sale to one or more long-time employees.

The agreement, which is typically signed by all affected parties, imposes restrictions on the future sale of the business or property. For instance, if you intend to leave a business interest to your children, you may provide for each child to sell or transfer his or her interest to another party or parties named in the agreement, such as grandchildren or other relatives. Similarly, the agreement may include provisions relating to the distributions of assets to trusts and potential divorces of heirs. (Be aware that special rules may apply in community property states.)

Significantly, a buy-sell agreement often establishes a formula for determining the sale price of the business and its components. The formula may be based on financial statement figures, such as book value, adjusted book value, or the weighted average of historical earnings, or a combination of variables.

A buy-sell agreement essentially provides for the sale of a business interest to other owners or partners, the business entity itself or a hybrid.

Understanding the benefits

As you might imagine, having a valid buy-sell agreement in writing removes much of the uncertainty that can happen when a business owner passes away. It provides a "ready, willing and able" buyer who's arranged to purchase shares under the formula or at a fixed price. There's no argument about what the business is worth among co-owners, partners or family members.

The buy-sell agreement addresses a host of problems about co-ownership of assets. For instance, if you have one partner who dies first, the partnership shares might pass to a family member who has a different vision for the future than you do.

An agreement also provides for a smooth transfer of the business in advance of specified events, such as the death of an owner. This can help minimize disruptions while the business recovers from the loss.

Review your plan

Your estate planning advisor and an attorney can work with you to design a buy-sell agreement that helps preserve the value of your business for your family. After you have an agreement in place, review it periodically to be sure that it continues to meet your expectations. •

Picking up stakes

Understand the tax and estate planning implications of moving abroad

There are many good reasons to move abroad, such as retirement or to begin a new career. But before you finalize your plans, a thorough review of your financial and estate plans is in order. Let's take a look at what areas to focus on.

What are the income tax implications?

U.S. citizens and permanent residents (green card holders) generally are subject to taxes on their *worldwide* income, even if they're living and working abroad. This raises concerns about double taxation — by the United States and a foreign country — of the same income. Depending on the country, you may be able to claim a credit against U.S. taxes for taxes you pay to a foreign jurisdiction. Also, some countries have tax treaties with the United States that entitle you to a reduced foreign tax rate.

There may be tax planning strategies you can use to minimize your overall tax bite. For example, the United States provides exclusions from income for a certain amount of foreign earned income and foreign housing expenses. But, depending on the foreign country's income tax rate, you may be better off forgoing these exclusions and applying foreign tax credits to your total income.

What are the gift and estate tax implications?

As with income taxes, U.S. citizens and permanent residents are subject to gift and estate taxes on their worldwide assets. That means that a home or other assets you acquire in a foreign country may be subject to U.S. gift and estate taxes. Again, this can lead to double taxation, depending on the foreign jurisdiction's tax laws and any applicable tax treaties.

Should you expatriate?

One potential strategy for reducing U.S. taxes is to renounce your U.S. citizenship or permanent resident status. The advantage of doing so is that, rather than being taxed on your worldwide income and assets, you'll be subject to U.S. income, gift and estate taxes on only your U.S.-source income and U.S.-situs assets. But renouncing citizenship raises some significant tax issues of its own that you'll need to consider.

To prevent people from escaping taxes on appreciated assets, the U.S. imposes an "exit tax" on "covered expatriates." A covered expatriate is a U.S. citizen — or a permanent resident who's held that status for at least eight of the previous 15 years — who:

1. Has a net worth of $2 million or more,
2. Has an average annual net income tax liability for the preceding five years that exceeds $165,000 (for 2018), or
3. Fails to certify compliance with all U.S. tax obligations for the preceding five years.

Essentially, covered expatriates are treated as if they'd sold all their worldwide assets at fair market value on the day before they became an expatriate. While there are some exceptions — for instance, there's an exemption of $713,000 (for 2018) of any unrecognized gains — the tax liability is determined by calculating the value of the estate as though the person had died on that day. One consequence, therefore, is that any retirement accounts are deemed to have been distributed on the day before the person became an expatriate.

As with income taxes, U.S. citizens and permanent residents are subject to gift and estate taxes on their worldwide assets.

With some advance planning, however, it's possible to reduce or even eliminate the impact of the exit tax. Techniques include 1) selling your principal residence and taking advantage of the $250,000 capital gains exclusion, and 2) gradually converting appreciated property into liquid assets to spread out your taxable gains over several years.

Expatriation can also lead to some costly gift and estate tax traps. As previously noted, expatriates are subject to U.S. gift and estate taxes on only their U.S.-situs assets. But they're allowed an exemption of only $60,000, compared to the $11.18 million exemption that citizens and permanent residents enjoy in 2018. If you own a significant amount of real estate or other assets in the United States, expatriation could increase, rather than decrease, your gift and estate tax liability.

Plan carefully before relocating

Considering moving to another country? If so, before putting your house on the market, meet with your financial and estate planning advisors. There are many tax-related details to sort out before picking up stakes and making the move. •

ESTATE PLANNING PITFALL

You're not taking advantage of your lifetime gift tax exemption

Even though the Tax Cuts and Jobs Act (TCJA) doesn't include many revisions to estate tax laws, it does provide one major enhancement. Under the TCJA, the unified gift and estate tax exemption of $5 million, which is indexed for inflation, is doubled to $10 million. The indexed figure for 2018 is $11.18 million ($22.36 million for married couples). This means that only the wealthiest families run a risk of federal estate tax liability (although state taxes may offer additional challenges). Given the substantially increased exemption amount, consider re-examining your lifetime gift-giving strategies.

Previously, you may have been inclined to preserve your full exemption amount to offset potential estate tax liability, while making gifts using your annual gift tax exclusion. The annual gift tax exclusion applies to gifts of up to $15,000 per recipient in 2018. The amount doubles to $30,000 per recipient for joint gifts made by a married couple. Any excess lifetime gifts erode the exemption available for your estate.

That's no longer a major concern for most individuals. For example, let's say an elderly widow with an estate of $10 million gives each of her four children and six grandchildren $15,000 in 2018, for a total of $150,000. The gifts are covered by the annual gift tax exclusion. She also decides to shelter another $1 million in gifts to her heirs this year with the lifetime gift tax exemption. That still leaves an available estate tax exemption of $10.18 million for assets currently valued at $8.85 million.

The point is that tapping your $11.18 million exemption for lifetime gifts is less likely to result in estate tax liability. If it's beneficial to your heirs, make additional lifetime gifts.

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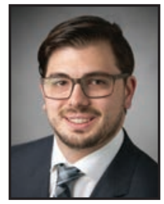

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