Pitfalls and Opportunities Under the New Federal Tax Law

Part 1: Pitfalls

By temporarily increasing the federal exemption from $5.5 million to $11.18 million for the gift, estate and generation-skipping taxes, the Tax Cuts and Jobs Act of 2017 (the "Act") has created estate tax and income tax planning opportunities as well as traps for the unwary. In this multipart series, we explore all of these in depth.

First we will look at potential pitfalls, including the risks that the Act: (i) could thwart a goal to make your spouse the first priority under your estate plan, (ii) might inadvertently prioritize grandchildren over children, and (iii) may trigger estate tax at the state level for a married couple when the first spouse passes away. We also describe the risks of a few cutting edge approaches that some advisors are advocating.

Favoring Children Over Your Spouse

Many trusts established by married couples use a formula upon the death of the first spouse that assigns assets into two separate funds within the trust – a fund that benefits only the surviving spouse, and a fund that benefits the children (which can also benefit the surviving spouse but doesn't always do so). Sometimes the fund for the surviving spouse passes outright to that spouse, rather than being held in trust for him or her. Either way, the dividing line between the two funds is typically based on the estate tax exemption in place at the time of the death of the first spouse. The fund for children would receive an amount equal to the exemption and the fund for the surviving spouse would receive the rest of the trust's assets. The strategy is for the exemption to eliminate estate tax on assets passing to the fund for children and the "marital deduction" to defer tax on assets passing to the fund for the surviving spouse until after his or her subsequent death.

With increased exemption amounts, the size of the fund for children might be much larger than anticipated, leaving less – perhaps nothing at all – for the surviving spouse or forcing him or her to share among other beneficiaries. As such, it may make sense to cap the amount passing to the fund for children.

Favoring Grandchildren over Children

Similarly, after both spouses have died, the increased generation-skipping tax exemption may inadvertently favor grandchildren over children. Trusts designed to minimize tax for multiple generations will place the exemption amount into a long-term trust that prioritizes distributions to grandchildren, and either distribute the remaining assets outright to children or place them into a trust for their benefit. Some of these long-term trusts may only allow children to receive distributions for urgent needs such as medical emergencies, or they may even exclude children altogether. The exemption's dramatic increase means there would be far more assets passing to these long-term trusts and therefore less assets passing to children. A cap on funds passing to the trust for grandchildren may be advisable.

Triggering Unnecessary Tax

As irrational as it might sound, the Act might actually increase estate tax at the state level for some people by accelerating that tax from the death of the surviving spouse to the death of the first spouse. This is a risk for married couples who live in certain states that have their own estate tax, including Massachusetts, New York, Connecticut, Vermont, Rhode Island and Illinois. More specifically, if a trust's funding formula uses the higher federal exemption level to divide the assets between a fund for children and a fund for the surviving spouse, rather than using the lower state exemption amount for that division, the assets in the fund for children will far exceed the state's exemption level and the state will tax that excess.

For example, in Massachusetts, unless the value of an estate is below $1 million, every dollar in the estate is subject to estate tax so it is critical to apply the marital deduction to the proper amount of assets. If a trust's formula allocates the federal exemption amount to the fund for children, then that fund would receive $11.18 million. The marital deduction cannot apply because the fund for children is not held for the sole benefit of the surviving spouse. The net result is that nearly $1.25 million of estate tax would be due to Massachusetts at the first spouse's death. If instead the formula allocates just $1 million to the fund for children and the rest of the assets to the fund for the surviving spouse, there would be no tax due until after the surviving spouse's death.

It's worth noting that even where a trust holds all assets in a single fund for the surviving spouse, an executor who does not make the proper elections on the federal and state estate tax returns could inadvertently cause unnecessary tax. The rules here vary by state so it's important to pay careful attention before submitting the returns.

Risks of Cutting Edge Approaches

A few states, including New York, Connecticut and New Jersey, are allowing taxpayers to recharacterize some payments of state and local taxes (SALT), including payment of state income tax, as charitable contributions. By way of background, the Act imposes a $10,000 limit on deductions for SALT payments but it also increases charitable deductions for gifts of cash to public charities. In theory, this technique could not only allow some taxpayers to get around the $10,000 limit on SALT deductions but it could also result in larger overall deductions than what was allowable prior to the Act. However, the IRS has already indicated that it will issue new regulations that apply "substance over form" principles in determining whether these are actually tax payments and will disregard the charitable contribution "label" assigned by the state. It remains to be seen whether there will be penalties attached to this.

Some practitioners are advocating a different strategy to get around the $10,000 SALT cap as it applies to property tax: place your residence into a limited liability company (LLC) and create multiple new irrevocable trusts as owners of the LLC. That way each separate trust will be able to independently deduct $10,000 of property tax payments and in the aggregate all property tax payments for that residence would be deductible. But there is a good chance that the IRS will be able to defeat this strategy using existing regulations, and one must question whether the complexity and expense of setting up an LLC and multiple trusts outweighs the potential savings here.

Conclusion

With so much uncertainty in the estate tax laws in recent years, many have deferred updating their estate plans, but certainty continues to evade us. At the end of 2025, the increased federal exemption is slated to revert to 2017 levels and that schedule could be accelerated or the current level may be made permanent; we just don't know. In the meantime, a host of non-tax reasons may have developed that warrant making revisions to your plan, including children becoming adults, marriages, births, deaths, divorce, creditor protection and others. Trusts are flexible documents that you can revise to keep current with all of these issues. A variety of other techniques, including "disclaimers" and "powers of appointment" provide additional flexibility so that a surviving spouse or children may make informed decisions at a time when variables, such as the value of assets and the amount of exemption available, are known. You may wish to incorporate some or all of those strategies into your plan.

Additional Resources

This multipart series, explores estate tax and income tax planning opportunities and pitfalls created by the Tax Cuts and Jobs Act of 2017.

- Part 2 in this series explores new income tax opportunities under the Act.
- Part 3 will explore advanced estate tax planning strategies to consider as a result of the Act.

Contact Us

To review your plan, feel free to contact a member of our Private Client Group, or the authors of this advisory:

Dennis Delaney
617.557.9722
ddelaney@hembar.com

Kevin Ellis
617.557.9736
kellis@hembar.com

Private Client Group

Brad Bedingfield
Joseph L. Bierwirth, Jr.
Brian C. Broderick
Paul M. Cathcart
Dennis R. Delaney
Nancy E. Dempze
Mark B. Elefante
Kevin M. Ellis
Charles Fayerweather

Joan Garrity Flynn
Nancy B. Gardiner
Stephen W. Kidder
Harry F. Lee
Edward Notis-McConarty
Arthur B. Page
Charles R. Platt
Michael E. Porter
Michael J. Puzo

John J. Siciliano
Kurt F. Somerville
Sarah M. Waelchli

Of Counsel
Timothy F. Fidgeon
Frederic J. Marx
R. Robert Woodburn, Jr.

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