US Tax Reform—Changes Impacting High Net Worth Individuals

January 2018

Authors: Michael E. Kavoukjian, Cecily P. Maguire, John M. Olivieri, Kerry O'Rourke Perri, Winthrop Rutherfurd, Jr.

On December 22, 2017, the Tax Cuts and Jobs Act (the "Act") was signed into law, accomplishing the most far-reaching US tax reform in decades. While the Act contains significant changes that will impact all US taxpayers, this overview is intended to highlight those developments likely to be of greatest interest to high net worth individuals and families.

Doubling of the Gift, Estate and Generation-Skipping Transfer ("GST") Tax Exemptions for US Citizens and Residents

While stopping short of full repeal, the Act doubled the gift, estate and GST tax exemptions for US citizens and residents to historic levels. These exemptions had been scheduled to increase to $5.6 million in 2018 prior to the Act but will instead double to approximately $11.2 million[1] in 2018 under the Act. On December 31, 2025, the exemption amounts will "sunset," *i.e.*, revert to prior levels ($5 million, indexed for inflation), in the absence of further legislation.

Lifetime Giving to "Lock In" the Increased Exemption

Because the increased exemption amounts may not be available after 2025 or may be reduced even sooner by subsequent legislation, individuals may wish to consider making significant lifetime gifts now in order to "lock in" the current exemption levels. Lifetime gifts also allow a donor to shift future appreciation in the gifted property out of the donor's estate. A variety of options are available to individuals who wish to make lifetime gifts; the best option will depend upon the individual's circumstances and preferences. Issues to consider include:

"Stepped-up" v. "Carryover" Income Tax Basis

The Act retained the existing income tax basis rules, which provide that recipients of lifetime gifts receive the donor's "carryover" basis in the gifted property (meaning that the recipient may have to pay substantial capital gains tax when the property is sold) whereas recipients of bequests at death receive a "stepped-up" basis equal to the fair market value of the bequeathed property at the time of the decedent's death. It is therefore normally advantageous for estate planning purposes to make lifetime gifts of high-basis assets, such as cash. Alternatively, a donor may make lifetime gifts to a "grantor trust" so that the donor—rather than the trust or beneficiary—will be liable for paying any capital gains tax.

[1] The Act also changed the manner in which inflation adjustments will be determined for purposes of the Internal Revenue Code. Instead of using the standard Consumer Price Index ("CPI"), the Act uses the "chained" CPI, which takes into account the likelihood that consumers will shift their buying patterns as prices increase. The precise amount of the current exemption using this new methodology is not yet known although it is expected to be approximately $11.2 million.

In the face of the increased exemption amounts and uncertainty about the amount of future exemptions, it may not be clear whether it would be more beneficial to gift an asset so as to avoid estate tax on future appreciation or retain the asset to receive a basis step-up and avoid future capital gains tax. Individuals holding assets with large unrealized gains or assets projected to appreciate significantly may wish to gift such assets to trusts that are excluded from the individual's taxable estate but that provide flexibility to allow the assets to be brought back into such individual's taxable estate and receive a stepped-up basis. Whether the trust assets should be brought back into the individual's estate will depend on whether the individual's estate is projected to be subject to the estate tax, the estimated estate tax savings as compared to the income tax savings, and whether the individual's family plans to retain or sell the trust assets.

Access to Gifted Assets

Some individuals may be hesitant to give away the significant sums necessary to fully utilize their increased exemptions for fear that they may need the funds in the future while they are still alive. Such individuals may wish to consider making lifetime gifts to a trust such as a Spousal Lifetime Access Trust ("SLAT"), which permits gifted assets to be distributed to the donor's spouse.

State Tax Issues

Many states impose a separate state-level estate tax for which the exemption is lower than the new federal estate tax exemption. This means that an individual whose estate is below the new federal exemption amount could still incur a state-level estate tax. However, to the authors' knowledge, no state except Connecticut currently imposes a state-level gift tax. An individual may therefore be able to avoid substantial state-level taxes by making lifetime gifts.

"Clawback"

Because the lower exemption amounts are scheduled to return at the end of 2025, there is some concern that individuals who make lifetime gifts now, based on the current exemption, will later become subject to estate tax when the increased exemption is reduced to prior levels. In this case, the prior gifts could be "clawed back" and taxed in the donor's estate. However, the Act demonstrates congressional intent that the current exemptions not be subject to later clawback and directs the Secretary of the Treasury to enact implementing regulations. Donors seeking absolute certainly in this regard may wish to wait until such regulations are in place before utilizing the increased exemptions.

Impact on Existing Wills and Trusts

The increases in the federal estate and GST tax exemptions may impact the amounts that pass under formula allocation clauses and other provisions in current estate planning documents. It is therefore important that individuals contact their estate planning counsel to initiate a review of their current will, revocable trust and other estate planning documents to determine how the Act may impact them.

Don't Forget About Non-Tax Considerations and Traditional Planning Techniques

In all of the excitement surrounding the increased exemption amounts, it is easy to forget about the many non-tax considerations that inform estate planning decisions. There are also many traditional planning techniques that will continue to be useful notwithstanding the increased exemption amounts. Remember to consider these issues in your planning.

Impact on International and Multinational Clients

Non-Resident Aliens

The Act did not increase the estate tax exemption available to non-resident aliens ("NRA"s). That exemption remains at $60,000, unless increased by treaty. Accordingly, NRAs must continue to plan carefully for the ownership and transfer of US situs assets to avoid unexpected US gift and estate tax liabilities.

There has been an important change, however, in the US corporate tax provisions under the Act that may impact the foreign "blocker" corporation structures commonly used by NRAs to avoid direct ownership of US situs assets. Persons subject to US income tax have historically been required to pay tax on the undistributed income of a "controlled foreign corporation" ("CFC") under the so-called "Subpart F" rules. The Act expands the number of foreign corporations ("FC"s) that will be deemed CFCs and, importantly, rescinds the threshold requirement that an FC be a CFC for 30 consecutive days before the Subpart F rules will apply. A US citizen or resident who inherits from an NRA assets that are held in an FC may thus face a new immediate and unavoidable tax liability upon the NRA's death in the absence of planning.

Multinational US Citizens and Residents

US citizens and residents who are also citizens or residents of another country that imposes its own gift or estate taxes may be disappointed to discover that they are unable to take full advantage of the increased US gift, estate and GST tax exemption without triggering offsetting additional taxes in the other country of citizenship or residence. Such persons should consult counsel in all relevant jurisdictions.

Provisions Impacting Charitable Organizations and Charitable Giving

The Act has been widely criticized as "bad" for charities, largely due to speculation that it will cause a decline in charitable giving. However, opportunities and benefits for both charities and donors remain.

Charitable Giving

There are still potential tax savings from charitable giving. While the increased standard deduction for US individual income taxpayers under the Act ($12,000 for individuals or $24,000 for a married couple filing jointly) means that fewer people will benefit from itemized charitable deductions, income tax benefits from charitable gifts remain available to many taxpayers, especially the wealthy. For example:

- Larger donors with high incomes will continue to benefit from itemized charitable deductions.
- Even smaller donors may be able to benefit by aggregating several years' worth of donations into a single year.
- By giving to a donor-advised fund, any donor can obtain an upfront deduction even if the benefits are paid out to charity over several years.
- Charitable remainder trusts ("CRT"s) remain a viable option for disposing of low-basis assets in an income tax-efficient manner while also helping charity.
- Donors over age 70½ can avoid income tax on up to $100,000 donated from a traditional IRA each year.

The Act increases the deduction limitation for cash contributions to public charities and certain private foundations from 50% of Adjusted Gross Income to 60% under the Act. In addition, the Act repeals the so-called "Pease" limitation that previously capped the charitable deduction available to high-income taxpayers.

The wealthiest donors will continue to benefit from the estate tax charitable deduction in the wake of the Act, despite the expectation that the increased estate tax exemption will mean that fewer taxpayers are subject to estate tax and are therefore able to benefit from an estate tax charitable deduction. In particular, donors may continue to make significant tax-free transfers by contributing assets to a charitable lead annuity trust ("CLAT") that benefits both charity and family members.

The above changes impacting charitable giving will remain in effect through December 31, 2025, when they will "sunset" in the absence of further legislation.

Charitable Organizations

The Act contains several provisions that will impact the administration of charitable organizations, including:

- A new 21% excise tax on most compensation in excess of $1 million or "excess parachute payments" paid to a non-profit executive.
- A new 1.4% excise tax on the investment income generated by certain private university endowments.
- Changes in the calculation of unrelated business taxable income ("UBTI") and the ability to offset losses against UBTI.

Planning Opportunities Created by Changes in Personal Federal Income Tax Deductions

The dramatic changes in the personal income tax deductions available to taxpayers have been well-publicized. These too are scheduled to remain in effect through December 31, 2025, when they will "sunset" in the absence of further legislation. Whether viewed as favorable or unfavorable, these changes may create planning opportunities. For example:

- It may be possible to lessen or avoid the impact of the reduced deduction for state and local taxes ("SALT") by relocating to a lower tax state or shifting certain SALT deductions to other taxpayers, such as a business, that can utilize them. Of course, the state of former residency has an incentive to challenge aggressively any purported relocation so steps should be taken to reduce the risk of a successful challenge.

- Some taxpayers may be able to reduce their tax liability by taking advantage of the new 20% deduction for certain income from "passthrough" entities (such as partnerships, limited liability companies, S-corporations and trusts) or the reduced tax rate for C-corporations (which was lowered from 35% to 21%). However, there are significant restrictions on the new passthrough income deduction that limit its availability. Many other tax and non-tax factors must also be considered before making business and investment structuring decisions.

White & Case LLP
1221 Avenue of the Americas
New York, New York 10020-1095
United States

T +1 212 819 8200