CUMMINGS & LOCKWOOD LLC

CLIENT ALERT - THE TAX CUTS AND JOBS ACT OF 2017

December 2017/January 2018

Dear Clients and Friends:

As you are aware, on December 22, 2017, the Federal government enacted The Tax Cuts and Jobs Act of 2017 (the "2017 Tax Act") changing, among other things, the estate, gift and generation-skipping transfer ("GST") tax regime once again. Unfortunately, much like the tax legislation passed in 2001 and in 2010, the 2017 Tax Act does not provide us with complete certainty as the individual tax provisions of the Act are in effect for only eight years. Beginning January 1, 2026, the estate, gift and GST tax provisions of the Internal Revenue Code will revert to their pre-2018 versions unless there is further legislative action to make the 2017 Tax Act changes permanent or otherwise alter the transfer tax system yet again. This letter will outline some of the ways the new law can be used to a taxpayer's advantage. However, because the law may revert to its pre-2018 version in 2026, the opportunities created by the 2017 Tax Act may not be what they appear to be, and you should consult with your Cummings & Lockwood attorney to determine which strategies are appropriate to best meet your goals before implementing any of the suggestions in this letter.

Estate, Gift and GST Tax Rates and Exemptions for 2018 to 2026

Under the 2017 Tax Act, the estate, gift and GST tax rates all are set at a maximum rate of 40% as they have been since 2013. The 2017 Tax Act increased the amounts exempt from these taxes to $10,000,000 (indexed for inflation from 2011 and currently estimated to be approximately $11,000,000 in 2018[1]). Because the gift and estate tax exemptions have been unified since 2011, this $11,000,000 exemption can be used during lifetime or at death or some combination in between.

For those clients who had already used the entire 2017 gift tax exemption of $5,490,000, these increased exemptions offer an opportunity to make additional gifts tax free and to shelter gifts from the GST tax as well. Even for those clients who have not yet used their lifetime gift exemptions, the increased exemption amounts make the coming eight years a good time to consider making lifetime transfers.

When making gifting decisions, remember that if you live in Connecticut, the only state that currently has a separate gift tax system, it is important to take state taxes into account as well. For example, Connecticut's gift tax exemption will increase to $2,600,000 as of January 1, 2018, meaning that if a Connecticut resident makes an $11,000,000 gift in 2018, a tax of $843,000 will be due on the $8,400,000 difference between the federal and Connecticut exemptions.

DO NOT ASSUME THE NEW EXEMPTIONS AUTOMATICALLY HELP YOUR ESTATE PLANNING WITHOUT FURTHER CONSIDERATION

Although in general the increased federal estate, gift and GST exemptions will help make estate plans more tax efficient, it is important to be certain that existing plans and future gifts are reviewed carefully in light of the new exemptions.

Tax Formula Clauses under Wills and Trusts

If your current Will or Trust divides your estate so that the share exempt from estate tax passes to a beneficiary other than a trust for the benefit of your spouse or the share of your estate exempt from GST Tax does not pass to a trust or trusts for the benefit of your children, you should contact your Cummings & Lockwood attorney as soon as possible to consider whether the increase of the exemptions to $11,000,000 reduces the property passing to or in trust for your spouse or children to less than you would want.

Gifting Assets Means Losing a Step-Up in Basis

The potential estate tax savings from gifting always needs to be balanced against the fact that assets gifted during life do not receive a new “stepped-up” basis at death. For this reason, it is always good to consider not only how much is being given, but what assets should be considered for the gift, what the current tax basis of the gifted assets is and what the likely appreciation of the gifted asset will be between the date of the gift and the expected death of the donor to be sure an estate tax savings is not likely to be lost to income taxes upon the sale of the gifted assets.

The Benefits and Myths of Using your $11,000,000 Gift Tax Exemption(s) between 2018 and 2026 (Is this eight-year opportunity too good to be true?)

The first reaction of many of our clients to the news of the increase in the gift tax exemption is a desire to take advantage of it before it disappears in 2026. While this reaction may be good news for their children because they may receive substantial assets sooner, it is important to understand that such gifts may not necessarily save taxes or increase the total assets passing to such children during their parents’ lifetimes and at their deaths. The reason is that given the temporary nature of the increased exemptions and the way the estate tax appears to be coordinated with the gift tax under the current unified structure, what is tax-free now may be taxed later.

To illustrate one possible way this could result in a future tax, let’s assume (i) an unmarried client uses his or her $11,000,000 gift tax exemption to make $11,000,000 of gifts to children in 2018, (ii) the federal estate and gift tax exemptions each revert back to $5,000,000 in 2026 and (iii) the maximum estate tax rate is fixed at 40%. The client dies in 2026 with $5,000,000 of other assets. Calculating the federal estate tax under the current required method, the client’s taxable estate consists of the $5,000,000 of assets owned at death **plus** the $11,000,000 of gifts made in 2018. The estate tax exemption in effect at death avoids the imposition of tax on only $5,000,000 (as indexed for inflation) and the resulting federal estate tax is in the neighborhood of $4,000,000 (depending on the inflation adjustment to the exemption in 2026). Assuming the property gifted in 2018 does not increase in value between 2018 and 2026, the estate tax is exactly what it would have been if the client had not made the gifts. On the other hand, if the future growth and income (“total return”) on the property between 2018 and 2026 had annualized at 7%, the total return of $7,900,000 would not be taxed in the client’s estate and a tax savings of approximately $3,100,000 would be achieved. Note that the benefit of the exemption gift is solely attributable to appreciation of the gift outside the client’s estate.

There is a much different, and potentially devastating, result, however, if the same client is married and wants to leave his or her estate to a surviving spouse at death. The $11,000,000 in gifts will be subject to tax at the death of the donor spouse even though the client’s remaining estate was intended for the surviving spouse and would have qualified for the marital deduction. This will result in federal taxes being due at the death of the first spouse in excess of $3,600,000, leaving less than $1,400,000 for the spouse. In the absence of the gift, this tax could have been postponed until the death of the surviving spouse.

Unless there is corrective legislation to prevent this outcome, the use of the $11,000,0000 exemption could jeopardize the amount left to take care of the surviving spouse in our example. Married clients will want to be sure the surviving spouse has sufficient funds in all situations.

Exemption gifts are not as powerful as gifts that qualify for the $15,000 annual exclusion from gift tax. Annual exclusion gifts are not included in the taxable estate at death. Consequently, exemption gifts should be carefully considered if they will jeopardize the client's financial wherewithal to continue making the maximum annual exclusion gifts of $15,000 per beneficiary.

Since the tax benefit of exemption gifts is limited to avoiding estate tax on the future income and appreciation on the gifted property, it may be better to transfer the property using a "freeze" technique designed to use the exemption, such as a QPRT, a GRAT or a sale or loan to a trust. A freeze technique may also reduce the potentially negative consequence of the gifted property declining in value after the gift is made and may permit a client to transfer assets without risking his or her financial security by limiting the transfer to the future total return on the transferred property in excess of a fixed return retained by the client, rather than the full current value of the property.

For example, let's assume a seventy-year-old client has a net worth of $20,000,000. If the client gifts $11,000,000 to his children in 2018, the client will avoid estate tax on the future growth and income on the $11,000,000 of transferred property, but will also reduce his net worth by more than 50%. Alternatively, the additional exemption amount can be employed to provide principal in a trust that could be used as security for a loan. The client could then sell the bulk of his assets to the trust, taking back from the trust some combination of cash and a promissory note. The client would avoid estate tax on the future income and growth on the assets in the trust in excess of the interest rate paid on the note, which over the client's life expectancy should be far greater than the future growth and income on the $11,000,000 gifted in the first example. The client would also have the security of having gifted only a fraction of his net worth, while entering a secured transaction on the balance. There are many different ways to utilize the new gift tax exemption (some others are discussed below) and you should consult your Cummings & Lockwood attorney to consider strategies that may benefit you and your family.

Strategies for taking Advantage of Increased Exemptions

Using the $11,000,000 GST Exemption before 2026

Unless the $11,000,000 GST Exemption is extended to 2026 and beyond, we would recommend that clients consider taking advantage of it before 2026. Unlike the gift tax exemption recapture discussed above, there is no "recapture" of the GST Exemption at death if the exemptions decline in 2026.

While gifts to your grandchildren can be structured to qualify for both the gift tax annual exclusion and the generation-skipping tax annual exclusion, such gifts must either be made outright to grandchildren or to a specially designed trust for the grandchild's sole benefit and includible in the grandchild's estate. Gifts to trusts for a spouse and/or children that pass to grandchildren upon the deaths of the spouse and children require the allocation of GST exemption to avoid the GST tax when distributions are eventually made to grandchildren. If you are interested in using the increased GST Exemption before 2026, a number of the estate planning techniques discussed below may be ideal for this objective.

If you have previously created ongoing trusts which are not GST Exempt the increased GST Exemption that will be effective in 2018 may provide an opportunity to do a "late GST allocation" in order to prospectively inoculate these trusts from future GST taxes.

Lifetime Gifting Options under the Potentially Temporary Law

There are a number of ways (some of which have already been mentioned above) to take advantage of the increased gift and GST tax exemptions both to initiate or continue lifetime gifts at greater speed and to take

advantage of the window to make larger gifts without an immediate tax before the gift tax exemption possibly returns in 2026 to $5,000,000 or some amount less than $11,000,000. None of the techniques described below are new or unique to the temporary tax regime, and you may have considered or implemented some of them already. The temporary increase in gift and GST tax exemptions, however, may make these techniques more attractive and effective. Depending on your financial circumstances, the nature of your assets and your intended beneficiaries, one or more of the techniques listed below may be an appropriate way to utilize this new gifting opportunity.

Gifts to Estate Reduction Trusts for Spouse and/or Other Family Members

An Estate Reduction Trust is an irrevocable trust created by you for the benefit of your spouse and/or other family members. Gifting assets to such a trust removes the assets and their appreciation from your taxable estate. If you are married, a gift to such a trust can be particularly attractive because your spouse can be the primary beneficiary of the trust. This allows the assets to be segregated from your estate while still being available to your spouse, and through your spouse to you, while your spouse is alive. With careful planning and some restrictions, each spouse can create and fund his or her own Estate Reduction Trust so that each can use their respective $11,000,000 gift exemption. In addition, if you choose to allocate GST exemption to the gifts to an Estate Reduction Trust, the trust assets, and their appreciation can also be removed from the GST tax system for as long as the trust exists, meaning that eventual transfers from the trust to grandchildren and more remote descendants can be made without any tax.

Gifts to Lifetime Marital or “QTIP” Trusts

If you want to be more certain of your access to the assets in your estate reduction trust, even if your spouse predeceases you or you are later divorced, certain types of trusts can be established by you during your lifetime for the benefit of your spouse to which you can transfer assets without gift tax because the trust qualifies for the marital deduction. These trusts are commonly referred to as Qualified Terminable Interest Property (“QTIP”) trusts. While Lifetime QTIP trusts do not use gift tax exemption and therefore are not an effective vehicle for locking in the temporarily increased exemption, these trusts allow you to take advantage of your GST exemption in a manner that allows your spouse, and through your spouse, you, to enjoy the assets while you are alive. Unlike the Estate Reduction Trust, however, the QTIP can continue for your benefit if your spouse predeceases you.

The Lifetime QTIP would initially be a trust for your spouse which would pay the income of the trust to your spouse at least annually. The Trustee of the trust would be able to make principal distributions to your spouse in any amount as well. This trust would last for your spouse’s lifetime. At your spouse’s death, the trust could continue on the same terms for your benefit, and at your later death (or at the death of your spouse if you predecease your spouse), the remaining trust property would be transferred to grandchildren and more remote descendants or to trusts for the benefit of multiple generations (which could include your children). With the temporary increase in the GST exemption, a transfer to a Lifetime QTIP can be an especially effective GST tool because by creating the QTIP you are locking in the increased GST exemption and allowing the trust assets to grow during your and your spouse’s remaining lifetimes so that the appreciated value of the trust upon the death of the surviving spouse is exempt from generation-skipping tax.

Lifetime QTIPs are very versatile. They are often used for a different purpose. Lifetime QTIP trusts can be used to build up the estate of a spouse who does not have sufficient property to use available gift, estate or GST tax exemptions should he or she predecease you. With those exemptions increasing to $11,000,000, the Lifetime QTIP will have appeal in situations where the transferor spouse wants to determine the ultimate disposition of property using the exemptions of the other spouse.

Gifts to Self-Settled Trusts

Under certain circumstances and in certain states it may be possible to create and fund a trust and to include yourself as a beneficiary of that trust. Such a structure may be desirable if you want to maximize your gifting potential while the exemptions are $11,000,000 but you are reluctant to part with assets you may need in the future. While self-settled trusts can offer the "best of both worlds" in terms of giving away assets while retaining them, the law governing both the ability to create such trusts and their effectiveness for tax purposes is still evolving, and creating such a trust will require a determination as to not only the terms but also the location of the trust.

Qualified Personal Residence Trusts ("QPRTs")

A Qualified Personal Residence Trust is designed to be a tax-efficient means of transferring a personal residence to your intended beneficiaries. The concept of a QPRT is relatively simple: the owner of the personal residence transfers it to a trust but retains the right to live rent-free in the residence for a specified number of years. At the end of that period, ownership of the residence is transferred to the beneficiaries (or a trust for their benefit) and is removed from the estate of the original owner. At that time, the original owner can rent the property from the beneficiaries if he or she wishes to remain in the house.

The tax advantage of the QPRT comes primarily from the way in which the value of the residence is calculated for gift tax purposes. The value of the gift is not the full value of the residence on the date of the gift, but rather the gift is valued based on the beneficiaries' right to receive the residence only after the specified number of years. The value is calculated based on a number of factors including the age of the donor, the number of years the donor can remain in the house rent-free, the value of the residence at the time of the gift and the IRS prescribed interest rate required for the calculation.

However, no matter how a QPRT is structured to reduce the gift, the gift will still be substantial. With the increased gift exemptions, QPRTs may be an appropriate gifting opportunity for people who otherwise would not consider such a gift because they did not have enough gift exemption remaining or did not want to use the more limited exemption on such a gift but now find themselves with "extra" exemption to spare.

Grantor Trusts

To further enhance the potential for appreciation of gifted property outside of the donor's taxable estate, many of the trusts described in this letter can be designed as "grantor trusts" which would cause the trust to be treated as the grantor/client for federal income tax purposes. Grantor trust status will cause the grantor/client to be personally taxable on all income earned by the trust and relieves the trust from any liability for income taxes to the government during the grantor/client's lifetime. This substantially increases the growth potential of the trust.

Asset Selection

While the increase in the gift and GST tax exemptions offers new opportunities, it is always important to consider not only the proper amount to give, but also what assets should be used to fund gifts. Assets that are likely to appreciate make better gifts because they are valued for gift tax purposes at the value on the date of the gift. Future appreciation occurs outside of your estate. Likewise, gifts whose value is discounted, such as a minority interest in a business enterprise or otherwise restricted assets, are also good choices. The cost basis of assets for income tax purposes does not change when those assets are gifted, so assets with higher cost basis are generally better candidates for gifting than those with lower basis, all else being equal.

Conclusion

The 2017 Tax Act changed the estate, gift and generation-skipping transfer tax regime once again. Since the transfer tax provisions of the Act are effective for eight years, we still lack the true certainty for which we had hoped. The Internal Revenue Code will revert to its pre-2018 version without further legislative action. But the

2017 Tax Act does create opportunities for clients who plan ahead despite its pitfalls.

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In this Update, we have deliberately simplified technical aspects of the law in the interest of clear communication. Under no circumstances should you or your advisors rely solely on the contents of this Update for legal advice, nor should you reach any decisions with respect to your personal tax or estate planning without further discussion and consultation with your advisors.

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[1] The IRS has not yet calculated and provided the official inflation adjusted exemption amount for 2018. For purposes of the discussion and examples in this letter, we are assuming an $11,000,000 federal gift, estate and GST exemption in 2018.

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