Financial Alternatives
integrated wealth management

Jim Freeman, CFP® / Chris Jaccard, CFP®, CFA **April 2018**

Estate Tax Update

On January 1, 2018 the amount a person can pass to their heirs without owing federal estate taxes increased from $5,490,000 to $11,180,000 – this is often referred to as the "exclusion amount" because it is excluded from estate taxes. Together, a married couple can now pass $22,360,000 estate tax free to their heirs – more than double the $10,980,000 in 2017. Note that transfers to a spouse or charity are not subject to the estate tax.

Once the value of an estate exceeds $11,180,000 for an individual and $22,360,000 for a couple, it will be subject to the federal estate tax shown in the table on page 2. As you can see, the estate tax starts at 18% on the first $10,000 and increases to 40% on anything over $1,000,000.

If an individual died today with a taxable estate of $13,180,000, the estate would owe tax on the excess $2,000,000. The tax due on the first $1,000,000 would be $345,800, plus $400,000 for the second $1,000,000; resulting in a total federal estate tax due of $745,000.

The exclusion amounts that can pass estate tax free will increase each year by an inflation rate. This new law, if not changed by congress, will expire on December 31, 2025 and we will revert to the pre-2018 rules.

Estate Planning Considerations in Light of the New Law

The 2018 changes to the law did not change the fact that everyone should have essential estate documents in place – these may include:

- Will/Living Trust – helps you avoid more extensive probate costs and provides directions on how to distribute your estate.
- Durable Powers of Attorney – allows you to appoint others to handle your financial affairs if you are unable to.
- Beneficiary Designations – allows you to decide who will inherit your retirement accounts.
- Letter of Intent (Instruction) – this non-binding document will help further clarify and communicate to your executor and successor trustees the intentions of your estate plan.
- Healthcare Directives – allows you to appoint others to make health care decisions for you when you are unable to.
- Guardianship Nominations – allows you to recommend who you would want to raise your minor children if something happens to you.

Executive Summary

- The amount you can pass without owing estate taxes essentially doubled as of January 1st thanks to the recently passed Tax Cuts and Jobs Act of 2017.
- This estate tax provision will expire at the end of 2025.
- Estate plans based on prior tax law should be re-evaluated to ensure your intentions match the current law.
- Older estate plans may ultimately cost your beneficiaries more in taxes and/or unnecessary recordkeeping requirements.

If you have an estate plan that includes more than one trust, like a Bypass or "B" trust, you may want to re-evaluate your plan. In recent decades, Bypass trusts were often included in an estate plan to reduce or eliminate the federal estate tax. As the law has allowed for even larger estates to be passed to heirs without incurring estate taxes, many families now have Bypass trusts included in their estate plans that they probably don't need. If you have not reviewed your estate plan within the last few years, we encourage you to work with your professional team to check your plan.

How a Bypass Trust Works - an Example

Let's take the example of a married couple that has a $22,360,000 community property estate. The husband dies in 2018, and their estate plan includes a typical Bypass trust that is funded with his share of the community property.

In a community property state, at the death of the first spouse, the first thing that happens to community property assets is they receive a new "step up" in cost basis. Assuming this couple bought their $2,000,000 home or rental property for $150,000 40 years ago, the new cost basis would automatically increase to the current date of death value of $2,000,000. In other words, the survivor can now sell their home or rental property and have no capital gain income tax due.

As you can see from the diagram on page 3, one half of the community property up to $11,180,000 will be moved into the Bypass trust. As described above, this is the amount the husband can pass on to his heirs without having to pay any estate taxes. The wife's half, will go into the Survivor's trust or "A" trust which we'll refer to later.

The assets in this Bypass trust can now grow to any amount, and they will not be included in his wife's estate for estate tax purposes. Hence the name Bypass trust – the assets will forever bypass the estate tax regardless of the growth of

If Taxable Estate...		Tentative Tax Is...		
Is Over...	But Not Over...	Tax	Plus %	Of Excess Over...
$0	$10,000	$0	18.00%	$0
10,000	20,000	1,800	20.00%	10,000
20,000	40,000	3,800	22.00%	20,000
40,000	60,000	8,200	24.00%	40,000
60,000	80,000	13,000	26.00%	60,000
80,000	100,000	18,200	28.00%	80,000
100,000	150,000	23,800	30.00%	100,000
150,000	250,000	38,800	32.00%	150,000
250,000	500,000	70,800	34.00%	250,000
500,000	750,000	155,800	37.00%	500,000
750,000	1,000,000	248,300	39.00%	750,000
1,000,000	and up	345,800	40.00%	1,000,000

the assets inside the Bypass trust. This is the good news concerning Bypass trust assets and possible estate taxes. The bad news is that the assets inside the Bypass trust will not receive a second step up in basis at the death of the surviving spouse. This means that a capital gain tax will be due on any appreciation of the Bypass trust assets, even if sold right after the death of the surviving spouse.

So in our simplified example, if the $11,180,000 used to fund the Bypass trust had a cost basis of $11,180,000 initially but grew to $21,180,000 when the surviving spouse died. The cost basis at the spouse's death would remain the same at $11,180,000 and if the assets were sold, there would be capital gain taxes due on the $10,000,000 of appreciation.

The wife's $11,180,000 of assets in the Survivor's trust would be subject to estate taxes at the time of her death – that is the potentially bad news. The good news is that these assets would receive a step up in cost basis and there would be no capital gain tax due on any of these assets if they were sold immediately after she passed away.

As the diagram on page 3 shows, at the death of the second spouse, the assets would be distributed to the children or held in trust for the children until they reached the ages specified by their parents at which time they would receive the assets outright free of trust.

Estate Tax Benefits of a Bypass Trust

In the above example, having a Bypass trust allows the surviving spouse to get $11,180,000 out of her growing estate and ensure that these assets would not be subject to the estate tax again. Even if the law reverts back to the lower 2017 exclusion amounts in 2025 these Bypass trust assets will not be subject to estate taxes. This is a significant benefit to larger estates. However, for smaller estates that are unlikely to have to pay estate taxes even if we revert back, it may not be worth the hassle of maintaining a Bypass trust.

Each family should review this issue with his or her advisors to make an informed decision. Bypass trusts add other protections for heirs and there could be several other reasons to maintain a this type of trust besides avoiding federal estate taxes. Still, Bypass trusts typically require additional tax reporting, and as described above do not benefit from another step up in tax basis when a surviving spouse passes away; so the costs and benefits must be weighed carefully.

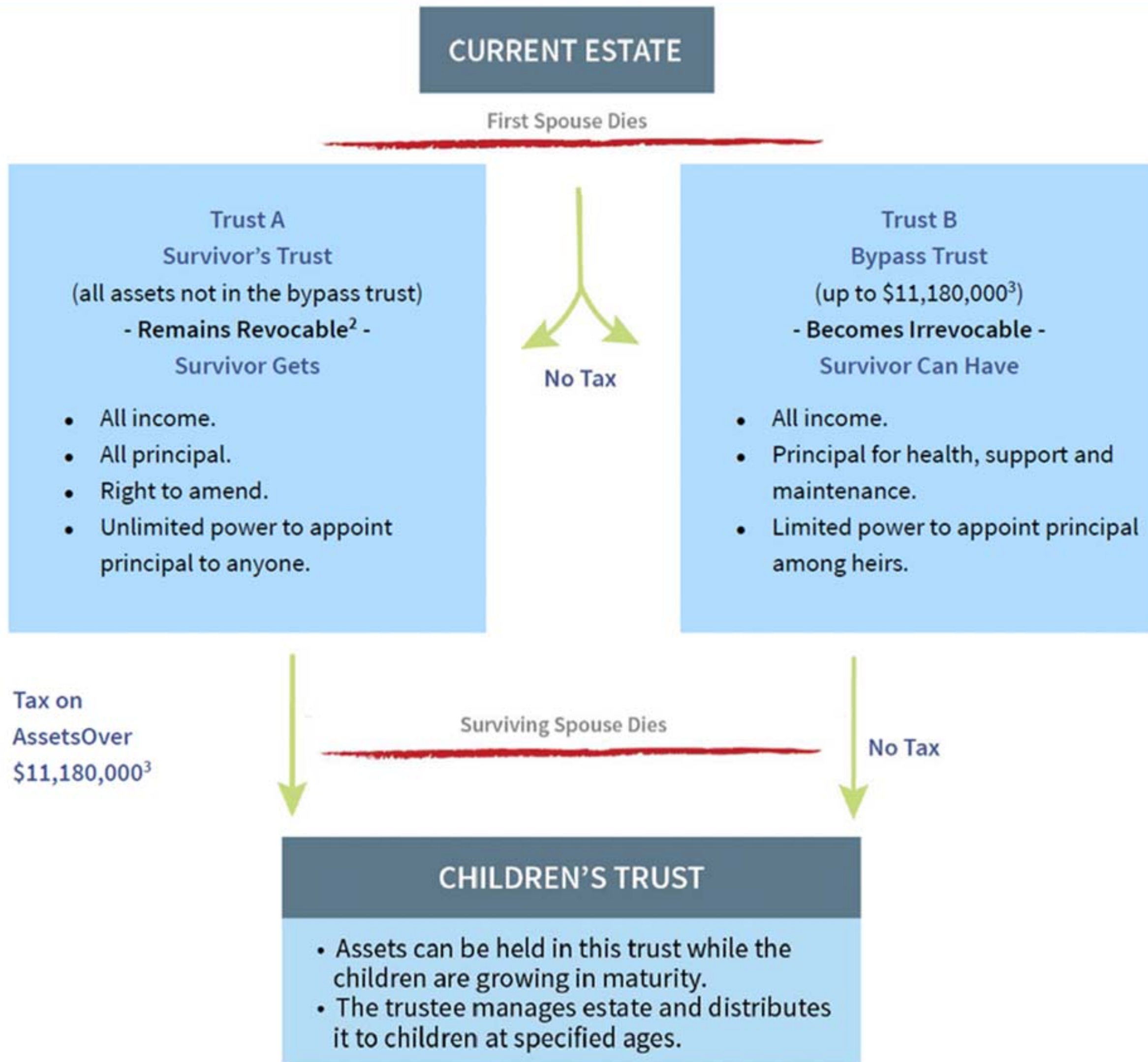
We have helped several clients close their Bypass trusts, but the ability to do this is highly dependent on individual client circumstances. It is complicated, but it can be done.

Portability

Let's now assume in our above example that the couple's community property estate was only $10,000,000. In this case only $5,000,000 would be moved into the Bypass Trust and $5,000,000 would go to the Survivor's trust. Each individual is entitled to pass up to $11,180,000 estate tax free at death and if they don't pass that much on, their surviving spouse is entitled to add the unused amount to what they can pass on estate tax free at their death.

In this case, the husband did not use $6,180,000 at his death. His wife, by filing the proper estate tax forms, can claim his unused exclusion amount and add that to her $11,180,000. She would now be able to pass on $17,360,000 to her heirs estate tax free. It's important to remember that this does not happen automatically, an election must be made to claim this portability option and get credit for the unused amount.

Having this portability option is another reason that



some people will decide to eliminate the Bypass trust from their estate planning.

Unlimited Marital Deduction

A husband or wife can leave each other any amount of assets and these assets will not be subject to estate taxes until the death of the second spouse. This only applies to US citizen spouses however.

Irrevocable Life Insurance Trusts (ILIT)

Using life insurance along with a special trust is a strategy that will set aside cash for heirs to pay anticipated estate taxes. Let's assume a married couple has an estate valued at $32,360,000 and they die in an auto accident in 2018. As we already know from above, they can pass $22,360,000 estate tax free to their heirs. This would leave $10,000,000 of their estate subject to estate tax and the tax would be $3,945,000.

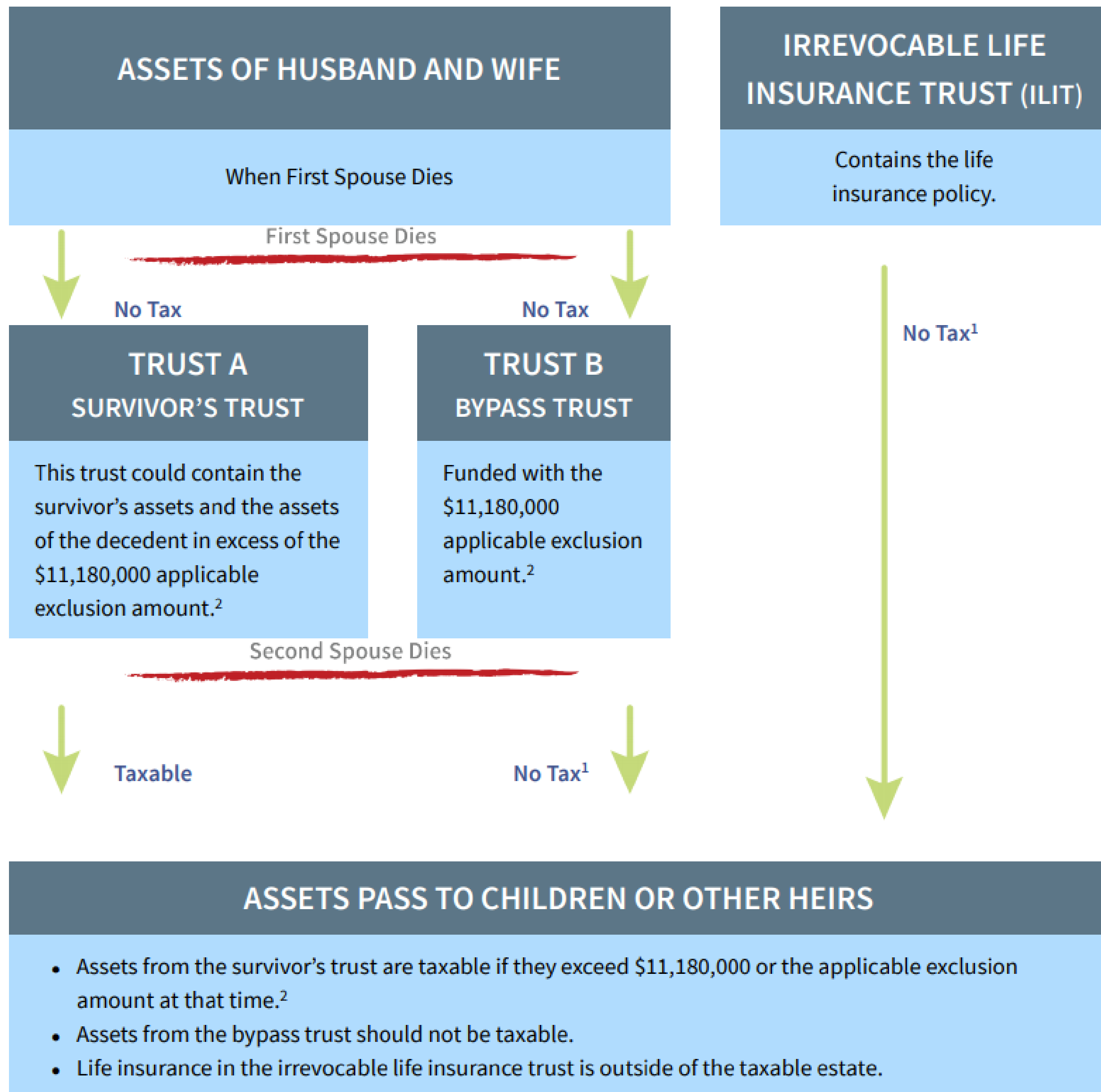
Instead of having to sell estate assets to pay the taxes, one option would be to buy a second to die life insurance policy that would provide the cash to pay the taxes. If the couple buys a $4,000,000 insurance outright in their own names, it would be included in their estate triggering another $1,600,000 in taxes!

To get around this, an Irrevocable Life Insurance Trust (ILIT) is used to hold the insurance policy outside of the estate and gifts are made to the trust to pay the premiums. The diagram on page 4 illustrates how this strategy it works.

There are certain procedures that must be followed to make sure this life insurance asset is not pulled back into the estate, but these are relatively easy to abide by.

Keep Your Estate Plan Up to Date and Practical

Is it important to review your estate planning on a regular basis, and with the recently enacted estate tax law, now is a good time to do so again. For larger, taxable estates above the $22,360,000 exclusion amount, there are many complex strategies to consider in an effort to reduce future estate taxes. We encourage our clients to make sure they first have all the basics in place and then to keep the more complicated planning as simple as they can. Advanced estate planning often involves permanent decisions, and we know tax laws are anything but permanent.



Let us know if you have any additional estate planning questions you'd like to discuss and we'll be happy to do so.

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FA Financial Alternatives
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7825 Fay Avenue, Suite 210
La Jolla, CA 92037

858 459 8289
www.financialalternatives.com