6 Top Insights on the New World of Tax Reform

#1 Lifetime Estate/Gift/GST Credit: Inflation Indexing + Clawback Risk

- While the approximate effect of the new tax law on the lifetime estate/gift/GST credit was a doubling, the exact effect is different because the new law changes the inflation indexing mechanism. The new law calls for inflation indexing based on the Chained Consumer Price Index for All Urban Consumers. Carol Harrington stated that based on her calculations, that would mean that starting on January 1, 2018, individuals effectively have $11.18 million of exclusion amount, but that final IRS guidance has yet to be issued.

- The law calls for an increase in the lifetime estate/gift/GST credit through 2025, with the credit snapping back on 1/1/2026 to the pre-2018 level, adjusted for inflation. Many estate practitioners are asking if a "clawback" risk exists. Imagine someone who makes gifts prior to 2026 using up the full $11+ million of effective gifts tax exclusion, but then dies after 1/1/2026. When filing the estate tax return, you are required to include all assets held at death and all assets gifted away during life in your gross taxable estate.

  The amount of estate tax payable is calculated based on laws in effect at the time of death. You then initially "pay" your estate tax by using (1) previous gift taxes paid and (2) your lifetime gift/estate tax credit, as stated by law at the time of death. Jeffrey Pennell addressed this issue at length, concluding that the risk of clawback is very low based on pre-existing law and his reading of the new law. He cited the language in the new law that calls for the Treasury Secretary to prescribe regulations that may be necessary or appropriate "to carry out this section with respect to any difference between (A) the basic exclusion amount under section 2010(c)(3) applicable at the time of the decedent's death, and (B) the basic exclusion amount under such section applicable with respect to any gifts made by the decedent.''

#2 Opportunities Under New Tax Law

- In the session on "Recent Developments 2017," Steve Akers stated that while many people are still digesting the changes (and it will take time to understand the full ramifications), there is a "window of opportunity" due to the possibility that the exclusion goes back down by law on 1/1/26 or before that by an act of Congress. During this window, Mr. Akers stated that some taxpayers may want to consider:

    1. using the additional exclusion amount to forgive outstanding loans;
    2. equalizing gifts between family members or vehicles;
    3. engaging in split-dollar agreements; or
    4. making gifts to non-Grantor Trusts.

  In the case of the latter, Mr. Akers stated that due to the $10,000 SALT deduction limitation, there may be cases where it would be prudent, for income tax purposes, to put property in trust for the benefit of, say, five different children, enabling use of $50,000 in SALT deductions rather than $10,000. Although this technique may disqualify taxpayers from "homestead" tax exemptions in certain states, the recapture of full SALT deductions is likely a far greater benefit.

- Many commentators addressed the opportunities and complexities of the new IRC Section 199A, which provides a 20% deduction on qualified business income in certain circumstances. Given the limitations contained in the law, advisors will likely be pursuing restructurings to take full advantage of the deduction. Martin Shenkman stated that it is common for large real estate organizations to have all the management services provided by one entity. He said, given the wage rules within 199A, some clients may be wise to consider alternative structures to maximize the deduction across their various business entities.

#3 Buy-Sell Agreements in Family Businesses

- Louis Mezzullo stated that the most difficult piece of the Buy-Sell Agreement is often setting the price. Mr. Mezzullo's preferred method of dealing with this quandary is to obtain a business appraisal. Upon obtaining that appraisal, the owners of the business and their advisors can then construct a formula to compute price based on the computations contained in the appraisal. This might mean acceptance of the appraised value (say, for a period of one year), with annual changes thereafter pegged to changes in earnings, cash flow or otherwise. Mr. Mezzullo often will suggest that the client attach the business appraisal to the buy-sell agreement, leaving no doubt as to where the price and formula were derived.

- Many business owners believe they can proceed without obtaining a third-party business appraisal. While this might be true in some cases, there are potential pitfalls. Business owners want to peg their buy-sell agreement price formula to book value, but book value in most cases does not reflect fair market value, and may not even be close. There are also issues around compensation that may arise. Owners may structure compensation to themselves in such a way to maximize tax efficiency. However, such a compensation structure could distort earnings up or down, having an impact on the valuation process. Often, a third party can navigate the compensation issue, ultimately to determine the true earnings power of the business, after market levels of compensation are paid to owners and other executives.

- Owners should also be aware that the price under a buy-sell agreement may not be the price that is applicable for estate tax purposes. Section 2703 of Chapter 14 of the IRC deals with how buy-sell agreements are treated in the estate tax context.

- Mr. Mezzullo says that it is not uncommon for taxpayers owning non-controlling interests to come to him saying, "I am paying taxes on earnings from this pass-through business and not getting distributions of those earnings. What can I do?" His answer is: "Nothing!" Unless, of course, the agreement mandates tax distributions. This is a common risk that MPI cites in its analyses of pass-through businesses. Unless there are mandatory distributions called for by an operating agreement, there is no guarantee that the business will distribute amounts sufficient enough for the owner to cover his or her pass-through tax liability. One can imagine this being a major burden that could continue for years depending on how the company is using its cash and its overall distribution policy.

#4 DSUE Scenarios

- During a Q&A session, Mr. Akers addressed a question about the DSUE (deceased spousal unused exclusion): What if one spouse dies before 2026 and has $8mm of unused exclusion amount, which ports over to the surviving spouse, but the second spouse to die passes away after 1/1/26? Does the second spouse to die still get to use the $8mm of DSUE from the first spouse since the lifetime gift/estate tax credit snapped back to the lower level? Mr. Akers stated, and Jeffrey Pennell agreed, that the $8mm of DSUE is essentially locked in at the time of the first spouse's death and will still port over to the second spouse despite the snap back of the lifetime credit amount.

#5 Higher Exclusion Amounts: Use it or Lose it

- With respect to the higher exclusion amounts that are now available through 2025, Mr. Akers addressed the concept of "use it or lose it" in a unique way. Mr. Akers stated that in order to take full advantage of the higher exclusion amount before the snap back on 1/1/26, a taxpayer must use 100% of his or her lifetime credit amount before that time. In other words, individual taxpayers that make gifts of $8 million before 2026 will be considered to have used their exclusion amount from the "bottom up" rather than from the "top down." Assuming an $11.18 million individual exemption, this taxpayer will have foregone $3.18 million of available exclusion and, effective 1/1/26, will have zero exclusion remaining.

#6 Check the Box

- Mr. Akers mentioned a valuable article published by the American Bar Association: Section of Real Property, Trust and Estate Law entitled: “Gift Tax Return Review: Ten Common Mistakes,” authored by Raj A. Malviya and Brandon A.S. Ross. One of the common mistakes made in filling out a gift tax return is forgetting to check the box for valuation discounts on Schedule A, Question A, which relates to whether valuation discounts were applied to the transfer at issue. The question is easily missed because it is only one line at the top of Page 2 of the gift tax return. Malviya and Ross point out that discounts are being heavily scrutinized by the IRS. If the question is not answered or missed when valuation discounts have been applied, it may look like the taxpayer is trying to hide something, even if the discounts are disclosed elsewhere on the return and the question was really just missed. Importantly, the authors further note, that if the “Yes” box has been checked on the return to advise the IRS that a discount was used, an explanation of that discount needs to be attached to the return, often in the form of a qualified third-party valuation report.

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