

Estate Planning In 2018

December 20, 2017

New 2018 Federal Transfer Tax Rules

The Tax Cuts and Jobs Act (the “Act”) was passed by Congress earlier today under a modified title and is currently awaiting signature by President Trump. Among its many changes to the Federal tax code, the Act will double the Federal estate, gift and generation-skipping transfer (“GST”) tax exemption amounts from \$5 million to \$10 million per individual, with additional inflation adjustments as under prior law.

The increased, inflation-adjusted exemption amounts – approximately \$11.2 million for an individual, or a combined \$22.4 million for a married couple – are effective for estates of decedents dying, and gifts made, after December 31, 2017 (with potential future inflation adjustments for 2019 and subsequent tax years), but are scheduled to expire on December 31, 2025, after which the relevant Federal estate, gift and GST tax exemption amounts would revert to the prior \$5 million amounts, plus the relevant inflation adjustments.

We anticipate that estate planning in 2018 will be focused on reviewing Wills and other testamentary documents in light of the increased Federal exemption amounts, taking into account:

- The continued availability of a “step-up” in income tax basis at death;
- The possibility that current plans may include one or more “formula dispositions” of the type described below that may require immediate attention because they are no longer appropriate or otherwise have unintended consequences;
- Any relevant state level estate taxes;
- The scheduled January 1, 2026 reduction in the new Federal exemption amounts (and the possibility of sooner changes as part of future tax legislation); and
- Any other changed family or financial circumstances.

We expect to see a renewed interest, especially by those individuals who have already exhausted their prior exemption amounts, in making lifetime gifts to take advantage of the Act’s increased exemption amounts while they are available.

We also anticipate increased attention to certain state level income tax planning, including whether any state income tax savings can be achieved through the use of certain “non-grantor trust” structures.

Attached as an appendix is a comparison of the new 2018 Federal estate, gift and GST tax regimes, and certain related income tax rules, with those that would have been in effect absent the enactment of the Act. Included below is a further explanation regarding “formula dispositions” and, while it is too soon to predict how particular states might adjust their state level taxes in light of the Act, a summary overview of the current Connecticut, New York and New Jersey transfer tax rules.

Formula Dispositions

Some testamentary plans may include so-called “formula dispositions” in an amount equal to the Federal or applicable state estate tax exemption amount, or other tax influenced dispositions, that should be reviewed to determine whether they continue to be appropriate.

For example, in the past it was not uncommon for a decedent’s Will to include a “credit shelter disposition” to a “credit shelter trust” that included children as beneficiaries, with the balance of the estate passing to

or in trust for a surviving spouse. Credit shelter dispositions were often defined by a formula expressed in terms of the maximum amount that could pass at death from the decedent's estate free of Federal estate tax. With a significantly increased Federal estate tax exemption amount, such a disposition could result in unanticipated state level estate tax or, if a spouse is not a named beneficiary of the credit shelter trust, in significantly reduced assets being available to a surviving spouse. Formula dispositions tied to a decedent's unused estate, GST or other exemption potentially could have similar results.

Accordingly, we suggest that individuals consult with their advisors to determine whether their estate planning documents contain any dispositions determined by a formula referring to an "exemption equivalent amount," "applicable credit amount," or "unused GST exemption," or other dispositions that could have unintended consequences in light of tax or other changes that have taken place since those documents were first executed.

State Transfer Tax Developments

It is too soon to predict how particular states might adjust their state level taxes in light of the Act. However, included below is a summary overview of the current Connecticut, New York and New Jersey transfer tax regimes. By way of comparison, Florida does not impose any state level income, estate or inheritance taxes.

Connecticut

The Connecticut biannual budget signed into law on October 31, 2017 included certain changes to Connecticut's estate and gift tax laws.

Connecticut remains the only state in the nation that imposes a gift tax. Currently, the Connecticut estate and gift tax exemption amount is \$2 million, with a \$14,000 gift tax annual exclusion in 2017 (increasing to \$15,000 in 2018). Under the budget law, the Connecticut estate and gift tax exemption amount is scheduled to increase to \$2,600,000 on January 1, 2018, to \$3,600,000 on January 1, 2019 and to match the Federal estate and gift tax exemption equivalent on January 1, 2020. Unlike the New York rules mentioned below, the Connecticut rules are not expressly tied to the pre-2018 Federal tax rules. Accordingly, absent new Connecticut legislation, it appears that the Connecticut exemption amount would increase in 2020 to the relevant 2020 Federal exemption amount (which under the Act would be approximately \$11.2 million, plus the Federal inflation adjustment relevant for 2020).

Connecticut estate and gift tax rates range from 7.2% (for estates and gifts exceeding the exemption amount) to 12% (for estates and gifts exceeding \$10.1 million). Currently, the Connecticut gift and estate tax is capped at \$20 million. Under the new law, the gift and estate tax cap will be lowered to \$15 million on January 1, 2019. Estate taxes paid to Connecticut may be deducted for Federal estate tax purposes (to the extent a Federal estate tax would otherwise be payable), but there is no corresponding Federal gift tax deduction.

New York

The Act does not change New York's estate tax rules. The New York estate tax exemption equivalent is currently limited to a maximum of \$5,250,000, and is scheduled on January 1, 2019 to begin tracking the amount of the Federal estate tax exemption equivalent as determined under the Federal rules in effect prior to the enactment of the Act (\$5 million, indexed for inflation experienced since 2010). In addition, the New York estate tax exemption equivalent continues to be phased out for New York taxable estates valued between 100% and 105% of the exemption amount, with no exemption being available for taxable estates in excess of 105% of the exemption amount. There is no New York gift or GST tax, but special estate tax rules apply to gifts of property made within three years of death.

Although the top New York estate tax rate continues to be 16%, the effective rate can be lower due to the continued deductibility for Federal estate tax purposes of any New York estate tax paid. Starting in 2018,

however, estates that are no longer subject to Federal estate tax by reason of the increased Federal exemption will no longer benefit from the deduction, resulting in a higher effective rate for New York estate tax purposes.

New Jersey

The New Jersey estate tax is scheduled to be repealed effective January 1, 2018.¹

New Jersey will, however, retain its separate inheritance tax, which does not generally apply to transfers to a spouse, child or grandchild. The New Jersey inheritance tax is based on the relationship between the decedent and the beneficiary receiving assets from the decedent. Under the inheritance tax, transfers to siblings are generally taxed at a rate beginning at 11% (top rate is 16%) and transfers to others are taxed at a rate of 15% or 16% (New Jersey inheritance tax is also deductible for Federal estate tax purposes, to the extent a Federal estate tax would otherwise be payable).

If you have any questions regarding this update, would like to explore any of the matters mentioned above or want a detailed review of your current estate plan, please contact any of the lawyers listed below or your regular Davis Polk contact.

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¹ New Jersey decedents dying in 2017 with estates exceeding \$2 million are subject to New Jersey estate tax, with a top rate of 16%.

Appendix: Comparison of New 2018 Federal Transfer Tax Rules With Those That Would Have Otherwise Been in Effect

	Old 2018 Rules (under prior law)	New 2018 Rules (under Tax Cuts and Jobs Act)
Federal Estate, Gift and GST Tax Exemption Equivalents	\$5.6 million (\$5 million indexed for inflation)	Approximately \$11.2 million (\$10 million indexed for inflation ¹), with further inflation adjustments in subsequent years through December 31, 2025 Starting January 1, 2026 - exemptions scheduled to revert to prior \$5 million amounts, indexed for inflation
Highest Federal Marginal Estate, Gift and GST Tax Rate	40%	40%
Per Donee Gift Tax Annual Exclusion	\$15,000 (\$10,000 indexed for inflation)	\$15,000 (\$10,000 indexed for inflation ¹)
Gift Tax Exclusion for Direct Payment of Qualified Tuition and Medical Expenses	Yes	Yes
Spousal Portability at Death of Deceased Spouse's Unused:		
Estate/Gift Tax Exemption	Yes	Yes
GST Tax Exemption	No	No
Gift and Estate Tax Marital and Charitable Deductions	Yes	Yes
Federal Estate Tax Deduction for State-Level Estate Taxes Paid	Yes	Yes
Valuation Discounts, Family Loans at Applicable Federal Rate, "Zeroed Out" GRATs, Qualified Personal Residence Trusts, Charitable Lead and Remainder Trusts, "Perpetual" GST Tax Exempt Trusts and Income Tax "Grantor Trusts" Permitted	Yes	Yes
"Step-Up" in Income Tax Basis for Property Passing at Death²	Yes	Yes

¹ The relevant inflation adjustment provisions were modified as part of the final changes to the Act prior to its passage by Congress. While official calculations have not been released, we do not expect the change to be material for 2018.

² Except for items of "income in respect of a decedent" (e.g., inherited traditional IRA).