THE ESTATE PLANNER

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AVOIDING THE KIDDIE TAX IS MORE IMPORTANT THAN EVER

Estate Planning Red Flag

Your estate plan includes a formula funding clause

Expanded 529 plans offer unique estate planning benefits

Leave your mark

The Tax Cuts and Jobs Act enhances the power of a dynasty trust

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Avoiding the kiddie tax is more important than ever

The "kiddie tax" was added to the tax code in 1986 to discourage parents from shifting income to their children in order to reduce the family's tax liability. It effectively eliminated the benefits of income-shifting by taxing all but a small portion of a child's *unearned* income at the *parents'* marginal tax rate.

Under the Tax Cuts and Jobs Act (TCJA), the kiddie tax has become even harsher for many families: Now, a child's unearned income is taxed according to the tax brackets for trusts and estates, under which the highest tax rates kick in at far lower income levels. For example, the highest tax rate — 37% — applies when a child's taxable unearned income tops $12,500. In contrast, for a married couple filing jointly, that rate doesn't apply until their taxable income reaches $600,000.

This means that, in some cases, children will be subject to *higher* tax rates than their parents. (See the table on page 3 for a comparison of the tax brackets for individuals, joint filers and trusts and estates.) Fortunately, there are strategies you can use to shift income to children in lower tax brackets without triggering the kiddie tax.

Background

Transferring investments and other income-producing assets to your children can be an effective estate-planning technique. Not only are the assets removed from your taxable estate, but any income they generate is taxed at your child's presumably lower tax rate. The Tax Reform Act of 1986 introduced the kiddie tax in an effort to recover this lost tax revenue. If the kiddie tax applies, all of a child's unearned income above a specified threshold (currently, $2,100) is taxed at the kiddie tax rate (originally, the parents' marginal rate; now, the trusts and estates rate) — assuming

it results in a higher tax than the child would pay without the kiddie tax.

Originally, the kiddie tax applied to children under 14, but in 2007 Congress expanded the tax to include all children age 18 or younger plus full-time students age 19 to 23. The tax doesn't apply, however, to 1) children who are married and file joint returns with their spouses, or 2) children age 18 or older whose earned income exceeds half of their living expenses.

Impact of the tax

Before the TCJA, the kiddie tax simply erased the benefits of income shifting. But in its current form, the tax can often be punitive. For example: Dave and Ann are a married couple filing jointly with taxable income of $300,000 per year. They transfer several investments to their 18-year-old daughter, Julia, which generate $20,000 in income annually. As the table below indicates, if the kiddie tax didn't apply (and assuming her total taxable income is less than $38,700), Julia would be in the 12% tax bracket. Under the pre-TCJA kiddie tax rules, and using the current brackets, Julia's unearned income would be taxed at Dave and Ann's marginal rate of 24%. But under the current version of the kiddie tax rules, which apply the estate and trust brackets, most of Julia's income is taxed at 35% or 37%.

2018 tax brackets

Ordinary income

Rate	Filing Status – Single – Taxable income over:	Filing Status – Married filing jointly – Taxable income over:	Estates and trusts – Taxable income over:
10%	$ 0	$ 0	$ 0
12%	$ 9,525	$ 19,050	
22%	$ 38,700	$ 77,400	
24%	$ 82,500	$165,000	$ 2,550
32%	$157,500	$315,000	
35%	$200,000	$400,000	$ 9,150
37%	$500,000	$600,000	$ 12,500

Long-term capital gains

Rate	Filing Status – Single – Taxable income over:	Filing Status – Married filing jointly – Taxable income over:	Estates and trusts – Taxable income over:
0%	$ 0	$ 0	$ 0
15%	$ 38,600	$ 77,200	$ 2,600
20%	$425,800	$479,000	$ 12,700

Avoiding the tax

There are several potential strategies for avoiding the kiddie tax while still taking advantage of income-shifting benefits. They include:

Delaying investment income. The kiddie tax ceases to apply in the year your child turns 19 (24 for a full-time student). So you can avoid kiddie tax by delaying investment income until your child reaches the applicable age. For example, you might transfer investments that emphasize capital appreciation over current income — such as growth stocks, unimproved real estate, or interests in closely held businesses that pay little or no cash dividends. Or you might give your child savings bonds that offer deferral of income until the bonds mature or are cashed in.

Using tax-exempt investments. Income on tax-exempt municipal bonds or bond funds is exempt from all income taxes, including the kiddie tax. One advantage of this strategy over income deferral is that your child can use the income for tuition or other expenses. Other options include 529 plans (see "Expanded 529 plans offer unique estate planning benefits" on page 5) and Coverdell Education Savings Accounts, which offer tax-deferred growth and tax-free withdrawals for qualified educational expenses.

Increasing earned income. Remember, the kiddie tax applies only to unearned income. Income your child earns from a job is taxed at the child's tax rate, and earnings up to the standard deduction (currently, $12,000) are tax-free. Plus, if your child is 18 or older and has enough earned income to cover more than half of his or her living expenses, the kiddie tax doesn't apply to any of the child's income, earned or unearned.

If you own a business, consider hiring your child. Doing so increases the child's earned income and, so long as the wages are reasonable, your business gets a deduction. And if your child is under 18 and your business is unincorporated, this strategy avoids payroll taxes on your child's wages and reduces self-employment taxes.

Not a game

It may sound harmless, but the kiddie tax can be costly. Your estate planning advisor can help you avoid the hazards.

ESTATE PLANNING RED FLAG

Your estate plan includes a formula funding clause

The estate tax exemption is higher than it's ever been, thanks to the Tax Cuts and Jobs Act (TCJA), which temporarily doubled the exemption to an inflation-adjusted $10 million ($20 million for married couples who design their estate plans properly). This year, the exemption amount is $11.18 million ($22.36 million for married couples).

If you're married and you executed your estate planning documents years ago, when the exemption was substantially lower, review your plan to ensure that the increased exemption doesn't trigger unintended results. It's not unusual for older estate planning documents to include a "formula funding clause," which splits assets between a credit shelter trust and the surviving spouse — either outright or in a marital trust.

Although the precise language may vary, a typical clause funds the credit shelter trust with "the greatest amount of property that may pass to others free of federal estate tax," with the balance going to the surviving spouse or marital trust. Generally, credit shelter trusts are designed to preserve wealth for one's children (from an existing or previous marriage), with limited benefits for the surviving spouse.

A formula clause works well when an estate is substantially larger than the exemption amount — but, if that's no longer the case, it can lead to undesirable results, including inadvertent disinheritance of one's spouse. Suppose, for example, that Mike and Elaine, a married couple, each own $10 million in assets, and their estate plan contains a formula funding clause. If Mike died in 2017, when the estate tax exemption was $5.49 million, that amount would have gone into a credit shelter trust and the remaining $4.51 million would have gone to a marital trust for Elaine's benefit. But if Mike dies in 2018, when the exemption has increased to $11.18 million, his entire estate will pass to the credit shelter trust, leaving nothing for the marital trust.

Expanded 529 plans offer unique estate planning benefits

If you're putting aside money for college or other educational expenses, consider a tax-advantaged 529 savings plan. Also known as "college savings plans," 529 plans were expanded by the Tax Cuts and Jobs Act (TCJA) to cover elementary and secondary school expenses as well. And while these plans are best known as an educational funding vehicle, they also offer estate planning benefits.

What are 529 savings plans?

These plans allow you to contribute a substantial amount of cash (lifetime contribution limits can reach as high as $350,000 or more, depending on the plan) to a tax-advantaged investment account. Like a Roth IRA, contributions are nondeductible, but funds grow tax-deferred and earnings may be withdrawn tax-free provided they're used for "qualified higher education expenses."

As a completed gift, a 529 plan contribution is eligible for the annual gift tax exclusion (currently $15,000).

Qualified expenses include tuition, fees, books, supplies, equipment, room and board and, under the TCJA, up to $10,000 per year in elementary or secondary school expenses. Earnings used for other purposes are subject to income tax and a 10% penalty.

Many states offer state income tax breaks for residents who invest in plans sponsored by their states.

In addition to tax breaks, a 529 plan also provides a financial aid advantage, because it's considered an asset of the parent, not the student, for financial aid purposes.

What are the estate planning benefits?

529 plans are unique among estate planning vehicles. Ordinarily, to shield assets from estate taxes, you must permanently relinquish all control over them. But contributions to a 529 plan are considered "completed gifts" — which means the assets are removed from your taxable estate, together with all future earnings on those assets — even though you retain considerable control over the money. For example, unlike most other estate planning vehicles, you can control the timing of distributions, change beneficiaries, move the funds into another 529 plan, or even cancel the plan and get your money back (subject to taxes and penalties).

As a completed gift, a 529 plan contribution is eligible for the annual gift tax exclusion (currently $15,000). But unlike other vehicles, you can bunch up to five years' worth of annual exclusions into one year. This allows you to contribute up to $75,000 in one year, without triggering gift or generation-skipping transfer (GST) taxes and without using up any of your lifetime exemption. There are implications, however, if you don't survive the five years.

Why does it matter?

You might think that these benefits are of little value now that the TCJA has temporarily doubled the lifetime gift and estate tax exemption to an inflation-adjusted $10 million ($20 million for married couples who design their estate plans properly). This year, the exemption amount is $11.18 million ($22.36 million for married couples).

After all, few families are currently affected by these taxes. But it's still a good idea to shield wealth from potential estate taxes and to make the most of your annual exclusion. This is because the new exemptions are scheduled to return to their previous levels after 2025 and there's nothing to stop lawmakers from reducing the exemption in the future. 529 plans and other traditional estate planning tools provide some insurance against future estate tax changes.

A powerful tool

Given the exorbitant costs of a college education, as well as many private elementary and secondary schools, it's important to plan for these expenses. A 529 plan is a powerful, tax-efficient tool you can use to save for education expenses. And the estate planning benefits are the icing on the cake. ▮

Leave your mark

The Tax Cuts and Jobs Act enhances the power of a dynasty trust

If a prime objective of your estate plan is to leave a lasting legacy, a dynasty trust may be the right estate planning vehicle for you. And, thanks to the substantially increased generation-skipping transfer (GST) tax exemption amount established by the Tax Cuts and Jobs Act, a dynasty trust is more appealing than ever.

GST tax and dynasty trusts

A dynasty trust allows substantial amounts of wealth to grow and compound free of federal gift, estate and GST taxes, providing tax-free benefits for your grandchildren and future generations. The longevity of a dynasty trust varies from state to state, but it's becoming more common for states to allow these trusts to last for hundreds of years or even in perpetuity.

Avoiding GST tax liability is critical to a dynasty trust's success. An additional 40% tax on transfers to grandchildren or others that skip a generation, the GST tax can quickly consume substantial amounts of wealth. The key to avoiding the tax is to leverage your $11.18 million GST tax exemption.

For example, let's say you haven't used any of your $11.18 million combined gift and estate tax exemption. In 2018, you transfer $10 million to a properly structured dynasty trust. There's no gift tax on the transaction because it's within your unused exemption amount. And the funds, together with all future appreciation, are removed from your taxable estate.

Most important, by allocating your GST tax exemption to your trust contributions, you ensure that any future distributions or other transfers of trust assets to your grandchildren or subsequent generations will avoid GST taxes. This is true even if the value of the assets grows well beyond the exemption amount or the exemption is reduced in the future.

Other benefits

Regardless of the tax implications, there are several nontax reasons to set up a dynasty trust. First, you can designate the beneficiaries of the trust assets spanning multiple generations. Typically, you might provide for the assets to follow a line of descendants, such as children, grandchildren, great-grandchildren, etc. You can also impose certain restrictions, such as limiting access to funds until a beneficiary earns a college degree.

> *Avoiding GST tax liability is critical to a dynasty trust's success.*

Second, by placing assets in a properly structured trust, those assets can be protected from the reach of a beneficiary's creditors, including claims based on divorce, a failed business or traffic accidents.

Setting up a dynasty trust

A dynasty trust can be established during your lifetime, as an inter vivos trust or part of your will as a testamentary trust. An inter vivos transfer to a dynasty trust may have additional benefits associated with transferring assets that have greater appreciation potential out of your taxable estate.

After creating the trust, you must determine which assets to transfer to it. Because the emphasis is on protecting appreciated property, consider funding the trust with securities, real estate, life insurance policies and business interests. You should retain enough assets in your personal accounts to continue to enjoy your lifestyle.

Finally, you must appoint a trustee. Your choices may include a succession of family members or estate planning professionals. For most people, however, a safer approach is to use a reputable trust company with a proven track record, as opposed to assigning this duty to family members who aren't yet born.

Don't try this at home

If you think a dynasty trust might be right for your family, talk to your estate planning advisor before taking action. A currently effective dynasty trust is irrevocable — meaning that, once you create it, you may be unable to modify the arrangement if your family dynamic changes, such as a divorce. ■

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Significant [Temporary] Changes in the New Tax Law

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The Tax Cuts and Jobs Act (TCJA) represents the most comprehensive reform of the U.S. tax code in over thirty years and includes significant changes which will likely impact your estate plan. Some of the significant changes include the following:

Exemptions Amounts Doubled: The TCJA doubles the federal estate, gift, and generation-skipping transfer (GST) tax exemptions from $5 million to $10 million per individual, with additional inflation adjustments. The IRS has not yet released the exemption amounts for 2018 with the inflation adjustment. It is anticipated that the estate, gift, and GST tax exemptions for 2018 will be between $11.18 and $11.2 million for individuals and $22.36 and $22.4 million for married couples.

However, the increased exemption amounts are ***temporary*** – they will sunset (or expire) on December 31, 2025, at which time the exemptions will revert to the prior $5 million per individual, plus the relevant inflation adjustments, unless Congress acts to extend it.

Tax Rates and Step-Up in Basis at Death Unchanged: The TCJA does not change the federal estate, gift, and GST tax rates. The highest marginal federal estate and gift tax rates will remain at 40% and the GST tax rate will remain a flat 40%. Further, the TCJA does not change the ability to obtain a step-up in basis of assets at death. The cost basis of assets received from a decedent is the fair market value of the asset on the date of the decedent's death and not his or her cost basis. Gifts made during life do not receive a step-up in basis but instead the cost basis of the gift is the same as the donor's cost basis.

Annual Gift Amount Increased: For 2018, the annual gift tax exclusion amount for gifts to individuals increased from $14,000 to $15,000. This change is due to inflation and not the TCJA.

In light of these significant changes, your estate plan should be reviewed to ensure that it still accomplishes your objectives. You may want to simplify your existing estate plan due to the increased exemption amounts. If you are no longer likely to have a taxable estate, married couples may consider changing the focus of your estate plan from federal estate tax planning to federal income tax planning to maximize the step-up in cost basis. If you have a family trust or credit shelter trust established at the death of your spouse, you may consider options to revise the trust so that the assets can receive a step-up in basis at your death.

You may want to take advantage of the increased tax exemptions by making gifts of your assets now and avoid federal estate tax on future appreciation. Any significant gifts should be made sooner rather than later because there is only a window of opportunity under the TCJA.

It is important to keep in mind that some of the significant changes to the U.S. tax code under the TCJA are not permanent and are scheduled to expire in eight years. Your estate plan should be flexible. Please speak with an attorney at our office to determine how best to take advantage of the increased exemption amounts or plan for its possible sunset to ensure your estate plan is coordinated with these significant changes.