THE ESTATE PLANNER

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Flex plan

In an unpredictable estate planning environment, flexibility is key

Last year's tax reform legislation — the Tax Cuts and Jobs Act (TCJA) — made only one change to the federal gift and estate tax regime, but it was a big one. The act had the effect of more than doubling the combined gift and estate tax exemption, as well as the generation-skipping transfer (GST) tax exemption, from $5.49 million in 2017 to $11.18 million in 2018. This change is only temporary, however. Unless Congress takes further action, the exemptions will return to their inflation-adjusted 2017 levels starting in 2026.

What does this mean for your estate plan? If your estate is well within the 2017 exemption amount, the higher exemption won't have a big impact on your estate planning strategies. But if your estate is in the $6 million to $11 million range ($12 million to $22 million for married couples), it's important to build some flexibility into your plan to address potential tax liability after 2025.

An uncertain future

Anything can happen between now and 2026. Lawmakers may allow the exemption amount to revert to its pre-TCJA level, reduce it even further (some have suggested $3.5 million) or make the current amount permanent. Or they may repeal the gift, estate and GST taxes altogether.

This uncertainty makes planning a challenge. Let's say your estate is worth $8 million. If you die between now and 2025, you'll avoid estate taxes. But suppose you live beyond 2025 and the exemption drops to an inflation-adjusted $5.75 million. Your estate will be hit with a $900,000 tax liability. A $3.5 million exemption would double the tax to $1.8 million.

One option is to take advantage of the higher exemption by giving away assets (either outright or in trust) during your lifetime. These gifts would be shielded from gift and GST taxes by the current exemption. And the assets (together with any future appreciation in

Estate tax clawback: What are the chances?

What happens if you make substantial gifts between now and 2025 to take advantage of the higher exemption but the exemption is reduced in 2026? Some people are concerned that the IRS will impose estate taxes on the amount by which these pre-2026 gifts exceed the post-2025 exemption — known as a "clawback." The Tax Cuts and Jobs Act seems to open the door to this possibility by directing the Treasury to issue regulations addressing differences between the date-of-gift and date-of-death exemption amounts.

Most experts believe a clawback is unlikely, although we won't know for certain until regulations are issued. However, keep in mind that, even if there is a clawback, making gifts now is still advantageous because it allows the assets to grow free of gift and estate taxes. In fact, it's difficult to imagine a situation in which you'd be worse off tax-wise by making gifts now.

value) would be removed from your estate, avoiding estate taxes even if the exemption decreases in the future. Just watch out for a potential "clawback" of those gifts into your estate. (See "Estate tax clawback: What are the chances?" above.)

There are several strategies you can use to build flexibility into your plan, enabling you or your representatives to switch gears once the future of the estate tax becomes more clear.

The problem with this approach is that gifts of appreciated assets retain your tax basis, subjecting your beneficiaries to capital gains taxes if they're sold. Assets transferred at death, on the other hand, enjoy a "stepped-up basis" and can be sold with little or no capital gains. If you make substantial lifetime gifts and the exemption amount remains at its current level in the future (or the estate tax is repealed), you'll have triggered capital gains taxes needlessly.

Staying flexible

There are several strategies you can use to build flexibility into your plan, enabling you or your representatives to switch gears once the future of the estate tax becomes more clear. Here are a few examples:

Irrevocable trusts. You transfer assets to an irrevocable trust, taking advantage of the current exemption amount. But you give the trustee the authority to take certain actions that would cause the assets to be included in your estate — such as granting you a power of appointment or naming you as successor trustee. The trustee would exercise this authority if it turns out that estate inclusion would produce a better tax outcome.

Or, you could retain the right to exchange cash or high-basis assets for low-basis trust assets. This would allow you to bring appreciated assets back into your estate if Congress repeals the estate tax or extends the current exemption beyond 2025.

QPRTs. A qualified personal residence trust (QPRT) is a great tool for removing the value of your home, including future appreciation, while you continue to

live in it for a term of years. At the end of the term, the home is transferred to your children or other beneficiaries, but you can arrange to continue living there in exchange for fair market rent. If you establish a QPRT but discover later that you won't be subject to estate tax, you can bring the home back into your estate by neglecting to pay rent, allowing your beneficiaries to enjoy a stepped-up basis.

Disclaimers. A carefully designed qualified disclaimer gives your beneficiaries the power to reject inherited assets, allowing them to pass to another beneficiary in a more tax-efficient manner. Let's say you leave your $8 million estate outright to your daughter with a disclaimer provision that allows her to redirect some or all the assets into a trust for the benefit of her children. At the time of your death in late 2025, Congress has passed legislation reducing the exemption to $3.5 million in 2026. Your daughter disclaims $4.5 million of her inheritance, causing those assets to pass into a trust for her children and avoiding taxes as part of her estate.

Plan now

There are many techniques you can use to give your estate plan the flexibility to adapt to changing tax laws. Start planning now to ensure that your plan is prepared for an uncertain future. ∎

Does your estate include intellectual property?

If you've invented something during your lifetime and had it patented, your estate includes intellectual property (IP). The same goes for any copyrighted works. These assets can hold substantial value, and, thus, must be addressed by your estate plan. However, bear in mind that these assets are generally treated differently than other types of property.

4 categories of IP

IP generally falls into one of four categories: patents, copyrights, trademarks and trade secrets. Let's focus on only patents and copyrights, creatures of federal law intended to promote scientific and creative endeavors by providing inventors and artists with exclusive rights to benefit economically from their work for a certain period.

In a nutshell, patents protect inventions. The two most common are utility and design patents:

1. A utility patent may be granted to someone who "invents or discovers any new and useful process, machine, manufacture or composition of matter, or any new useful improvement thereof."
2. A design patent is available for a "new, original and ornamental design for an article of manufacture." To obtain patent protection, inventions must be novel, "nonobvious" and useful.

Under current law, utility patents protect an invention for 20 years from the patent *application filing* date. Design patents last 15 years from the patent *issue* date. For utility patents, it typically takes at least a year to a year and a half from the date of filing to the date of issue.

When it comes to copyrights, they protect the *original* expression of ideas that are fixed in a "tangible medium of expression," typically in the form of written works, music, paintings, sculptures, photographs, sound recordings, films, computer software, architectural works and other creations. Unlike patents, which must be approved by the U.S. Patent and Trademark Office, copyright protection kicks in as soon as a work is fixed in a tangible medium.

For works created in 1978 and later, an author-owned copyright lasts for the author's lifetime plus 70 years. A "work-for-hire" copyright expires 95 years after the first publication date or 120 years after the date the work is created, whichever is earlier. More complex rules apply to works created before 1978.

Valuing and transferring IP

Valuing IP is a complex process. So, it's best to obtain an appraisal from a professional with experience valuing this commodity.

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After you know the IP's value, it's time to decide whether to transfer the IP to family members, colleagues, charities or others through lifetime gifts or through bequests after your death. The gift and estate tax consequences will affect your decision.

But you also should consider your income needs, as well as who's in the best position to monitor your IP rights and take advantage of their benefits.

If you'll continue to depend on the IP for your livelihood, for example, hold on to it at least until you're ready to retire or you no longer need the income. You also might want to retain ownership of the IP if you feel that your children or other transferees lack the desire or wherewithal to take advantage of its economic potential and monitor and protect it against infringers.

Whichever strategy you choose, it's important to plan the transaction carefully to ensure your objectives are achieved. There's a common misconception that, when you transfer ownership of the tangible medium on which IP is recorded, you also transfer the IP rights. But IP rights are separate from the work itself and are retained by the creator — even if the work is sold or given away.

Revise your plan accordingly

If you own patents or copyrights, you probably have great interest in who'll take possession of your work after you're gone. Discuss with your estate planning advisor before taking any action. ▮

The net investment income tax is alive and well

The Tax Cuts and Jobs Act (TCJA) reduced individual income tax rates, but it left the 3.8% net investment income tax (NIIT) in place. It's important to address the NIIT in your estate plan because it can erode your earnings from interest, dividends, capital gains and other investments, leaving less for your heirs.

How it works

The NIIT applies to individuals with modified adjusted gross income (MAGI) over $200,000. The threshold is $250,000 for joint filers and qualifying widows or widowers and $125,000 for married taxpayers filing separately. The tax is equal to 3.8% of 1) your net investment income, or 2) the amount by which your MAGI exceeds the threshold, whichever is less.

Suppose, for example, that you're married filing jointly and you have $350,000 in MAGI. Presuming $125,000 in net investment income, your NIIT is 3.8% of $100,000 (the excess of your MAGI over the threshold, which is less than your net investment income), or $3,800.

Nongrantor trusts — with limited exceptions — are also subject to the NIIT, and at a much lower threshold: For 2018, the tax applies to the lesser of 1) the trust's undistributed net investment income, or 2) the amount by which the trust's AGI exceeds $12,500.

Reducing the tax

You can reduce or eliminate the NIIT by lowering your MAGI, lowering your net investment income, or both. Techniques for doing so include:

- Reducing this year's MAGI by deferring income, accelerating expenses or maxing out contributions to retirement accounts,
- Selling poor-performing investments to offset the losses against investment gains you've realized during the year, or
- Reducing net investment income by investing in tax-exempt municipal bonds or in growth stocks that generate little or no current income.

If you own an interest in a business, you may be able to reduce NIIT by increasing your level of participation. Income from a business in which you "materially participate" isn't considered net investment income. (But keep in mind that increasing your participation may, in certain cases, trigger self-employment tax liability.)

Another potential strategy is to shift investment income to children or other family members whose income is below the MAGI threshold. But watch out for the "kiddie tax," which currently applies the trust income tax rates to most investment income received by dependent children under age 19 (age 24 for full-time students). If the kiddie tax applies, a child will be subject to the NIIT if his or her investment income exceeds $12,500.

For trusts, you can reduce or eliminate the NIIT by:

- Structuring them as grantor trusts,
- Distributing the trust's income to its beneficiaries (remember, the NIIT applies only to *undistributed* income), or
- Shifting the trust's investments into tax-exempt municipal bonds, growth stocks or tax-deferred investments (such as life insurance).

Keep in mind that, if you use a grantor trust, its income will be passed through to *you* as grantor, potentially increasing your personal liability for NIIT.

Review your plan

The NIIT can affect the financial performance of your personal investments as well as your trusts. To maximize the amount of wealth available for your family, be sure to consider strategies for reducing the impact of this tax.

ESTATE PLANNING RED FLAG

You're borrowing from your retirement plan

If you have a substantial amount of money socked away in a 401(k) or other qualified retirement plan, it may be tempting to borrow from those funds to pay college tuition, credit card bills or other expenses. Before you do, however, be sure to discuss your options with your financial advisor. Given the risks and hidden costs of borrowing from a retirement plan, it should generally be viewed as a last resort.

Not all qualified plans permit loans, but, if your plan allows them, you can borrow up to $50,000 or 50% of your *vested* account balance, whichever is less. Generally, the loan must be repaid in five years. Often, interest rates are lower than those of comparable bank loans.

Many people view borrowing from a retirement plan as "free." After all, you're paying the interest to yourself. But there are costs involved. For one thing, you'll lose the benefits of tax-deferred growth on the amount you borrow. Unless the interest rate you pay on the loan equals or exceeds the growth rate of the plan assets, your account's value will end up lower than it would have been without the loan.

Another potential cost is the loss of contributions to the plan (plus earnings on those amounts), either because you can't afford them while you're repaying the loan or because your plan prohibits contributions until the loan is repaid. If that's the case, you'll also lose any matching contributions your employer offers.

Costs aside, the strongest argument against borrowing from a retirement plan is the risk that the loan will be accelerated if you lose your job or quit. Many employers require you to repay the outstanding balance in the event your employment terminates. If you can't, the balance will be treated as a distribution and subject to taxes and, if applicable, penalties.

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