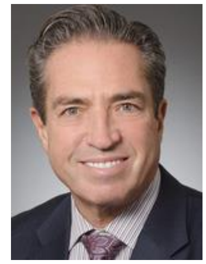
2018 Year-End Estate Planning: Part 1

By **Joshua Rubenstein and Diane Burks** December 4, 2018, 2:31 PM EST



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This year brought sweeping change to our country's tax system. On Dec. 22, 2017, President Donald Trump signed the law commonly known as the Tax Cuts and Jobs Act. The TCJA and its resulting tax reform have dominated the legislative and planning landscape for much of 2018. The act made significant changes to the individual and corporate income taxes, restructured international tax rules, provided a deduction for pass-through income and eliminated many itemized deductions.

Most significantly for estate planning purposes, the act has temporarily doubled the estate, gift and generation-skipping transfer tax exemptions. Absent legislative action, many of the changes imposed under the act — including the increased exemptions — will sunset after Dec. 31, 2025, with the laws currently scheduled to revert back to those that existed prior to the act. This temporary increase in exemption amounts has created an unprecedented opportunity for valuable estate planning.

There were also significant cases decided in the past year. In 2017, the case of Estate of Powell vs. Commissioner,[1] represented the first time in which the U.S. Tax Court included limited partnership interests (rather than general partnership interests) in a decedent's estate under Internal Revenue Code Section 2036(a)(2), under the theory that the partners could unanimously agree to terminate the partnership. In 2018, the Powell case was cited as precedential authority in Estate of Cahill vs. Commissioner,[2] in which the Tax Court determined that a decedent's right, in conjunction with others, to terminate a split-dollar agreement was a retained right under Section 2036(a)(2) and 2038(a). Additionally, state courts have addressed the limits of the constitutionality of state taxation of trusts. The case of Kaestner 1992 Family Trust vs. North Carolina Department of Revenue,[3] decided by the North Carolina Supreme Court, has the potential to impact trust taxation in states that tax trusts based solely on the residence of the trust beneficiaries.

While the permanency of the act's provisions remains uncertain, the current environment provides a great deal of opportunity for new planning. We are encouraging clients to build flexibility into their estate plans and to use this window of opportunity to engage in planning to take advantage of the increased estate, gift and generation-skipping transfer, or GST, tax exemptions.

The following are some key income and transfer tax exemption and rate changes:

Federal Estate, GST and Gift Tax Rates

For 2018, the estate, gift and GST applicable exclusion amounts are $11.18 million. For 2019, the estate, gift and GST applicable exclusion amounts are projected to be $11.4 million. The maximum rate for estate, gift and GST taxes is projected to remain at 40 percent.

Annual Gift Tax Exemption

Each year individuals are entitled to make gifts using the “annual exclusion amount” without incurring gift tax or using any of their lifetime applicable exclusion amount against estate and gift tax. The annual exclusion amount is $15,000 per donee in 2018. Thus, this year a married couple together can gift $30,000 to each donee without gift tax consequences. In 2019, the annual exclusion for gifts is projected to remain at $15,000. The limitation on annual gifts made to noncitizen spouses is projected to increase from $152,000 in 2018 to $155,000 in 2019.

Federal Income Tax Rates

- The TCJA provides for seven individual income tax brackets, with a maximum rate of 37 The 37 percent tax rate will affect single taxpayers whose income exceeds $500,000 (indexed for inflation) and married taxpayers filing jointly whose income exceeds $600,000 (indexed for inflation). Estates and trusts will reach the maximum rate with taxable income over $12,500.

- Capital gains will be taxed at 20 percent for single taxpayers whose income exceeds $425,800, and married taxpayers filing jointly whose income exceeds $479,000. There is a 0 percent capital gains rate that applies for single filers with income up to $38,600 or married taxpayers filing jointly with income up to $77,200. There is also a 15 percent rate that applies for income above this threshold up to $425,800 (for single filers) or

$479,000 (for married taxpayers filing jointly).

- The standard deduction was increased to $24,000 for married individuals.
- In 2018, the threshold for the imposition of the 3.8 percent Medicare surtax on investment income and 0.9 percent Medicare surtax on earned income is $200,000 for single filers, $250,000 for married filers filing jointly and $12,500 for trusts and estates.

Tax Cuts and Jobs Act

The TCJA has many implications for domestic corporate and individual income tax, as well as federal gift, estate and GST tax, fiduciary income tax and international tax implications. In light of the changes discussed below, it is important to review existing estate plans, consider future planning to take advantage of the increased exemption amounts and maintain flexibility to allow for future strategic planning.

Gift, Estate and GST Exemptions, Rates and Stepped-Up Basis

The act retained the federal estate, gift and GST tax rates at a top rate of 40 percent, as well as the marked-to-market income tax basis for assets includable in a decedent's taxable estate at death.

While the federal gift, estate and GST taxes were not repealed by the act, fewer taxpayers will be subject to these transfer taxes due to the act's increase of the related exemption amounts. Under the act, the base federal gift, estate and GST tax exemptions have doubled from $5 million per person to $10 million per person, indexed for inflation. As noted above, the relevant exemption amount for 2018 is $11.18 million per person, resulting in a married couple's ability to pass $22.36 million worth of assets free of federal estate, gift and GST taxes. These amounts will increase each year until the end of 2025, with inflation adjustments to be determined by the chained Consumer Price Index, or CPI, (which will lead to smaller increases in the relevant exemption amounts in future years than would have resulted from the previously used traditional CPI). Without further legislative action, the increased exemption amounts will sunset and the prior exemption amounts (indexed for inflation, using the chained CPI figure) will be restored, beginning in 2026.

While the federal estate tax exemption amount has increased, note that multiple U.S. states impose a state level estate tax. The estate tax exemption amount in some of these states matches, or will match, the increased federal estate tax exemption amount. However, in other states, such as Illinois and New York, the state estate tax exemption amount will not increase with the federal estate tax exemption amount, absent a change in relevant state law. Additionally, states may have their own laws that impact planning in that state. For example, in New York, for decedents dying in 2018, gifts made from April 2014 until January 2019 will be included in the base amount for calculation of state estate tax.

It should also be noted that the federal estate tax exemption that applies to nonresident aliens was not increased under the act. Under current law, the exemption for nonresident aliens remains at $60,000 (absent the application of an estate tax treaty).

There is uncertainty about whether future legislation will address the sunset, either by extending the new exemption amounts beyond 2025 or changing the exemption amounts further. There is also uncertainty on how the IRS will address differences between the exemption amounts at the date of a gift and exemption amounts at the date of a taxpayer's death (often referred to as a "clawback"). As of the date of this advisory, the IRS has not yet addressed how, or if, additional gift and/or estate taxes may be due on planning that takes advantage of the increased exemption. The IRS has also not addressed the impact of the increased exemption amounts on the portability election if one spouse dies before 2026 but the surviving spouse dies after the sunset of the increased exemption amounts. The act directs the U.S. Department of the Treasury to issue regulations addressing a difference in the basic exclusion amount at the time of a taxpayer's gift and the time of the taxpayer's death. While most believe that clawback is not the intent of the act, the potential of clawback should be discussed with advisors as taxpayers entertain planning to take advantage of the increased federal exemptions.

Income Taxation of Trusts and Estates

The act added new Code Section 67(g), which applies to trusts and estates as well as individuals, and provides that no miscellaneous itemized deductions (all deductions other than those specifically listed in Code Section 67(b)) are available until the act sunsets after Dec. 31, 2025. While the act doubled the standard deduction for individuals, taxpayers that are trusts and estates are not provided a standard deduction. Under the act, trust investment management fees will no longer be deductible. After the enactment of the act, there was uncertainty about the deductibility of fees directly related to the administration of a trust or estate (e.g., fiduciary compensation, legal fees, appraisals, accountings, etc.). Historically, these fees had been deductible under Code Section 67(e) and without regard to whether they were miscellaneous itemized deductions or not. In Notice 2018-61, the Treasury issued guidance on whether new Code Section 67(g) eliminates these deductions. This notice provides that expenses under Code Section 67(e) are not itemized deductions and, therefore, are not suspended under new Code Section 67(g). Note that only expenses incurred solely because the property is held in an estate or trust will be deductible. While the notice went into effect July 13, estates and nongrantor trusts may rely on its guidance for the entire taxable year beginning after Dec. 31, 2017.

New Code Section 67(g) may also impact a beneficiary's ability to deduct excess deductions or losses of an estate or trust upon termination. Prior to the act, it was common tax planning to carry out unused deductions of a trust or estate to the beneficiary upon termination, so the deductions could be used on the beneficiary's personal income tax return. Under new Code Section 67(g), these deductions are miscellaneous itemized deductions and, therefore, would no longer be deductible by the beneficiary. Notice 2018-61 notes that the IRS and the Treasury recognize that Section 67(g) may impact a beneficiary's ability to deduct unused deductions upon the termination of a trust or an estate and the IRS and Treasury intend to issue regulations in this area and request comments on this issue. In the interim, taxpayers should consult with their advisors about whether it would be prudent to engage in planning to utilize (to the extent permissible) these deductions at the trust or estate level.

Finally, the act made a number of taxpayer-friendly changes to the taxation of electing small business trusts, or ESBTs. Nonresident aliens are now permissible potential beneficiaries of ESBTs. Also, the charitable deduction rules for ESBTs are now governed by Code Section 170 instead of Code Section 642(c), which means that several restrictions imposed by Code Section 642(c) (e.g., that the charitable donation be paid out of income and pursuant to the terms of the trust) no longer apply.

Additionally, an ESBT's excess charitable deductions can now be carried forward five years, but the percentage limitations and substantiation requirements will now apply.

Income Tax

The TCJA made significant changes to the federal income tax. While many federal income tax changes under the act are beyond the scope of this article, some are particularly relevant to estate planning. The deduction for state and local taxes, or SALT, was retained, but is now limited to $10,000 for jointly filing taxpayers or unmarried taxpayers. The $10,000 limit also applies to trusts. Almost immediately after the act's passage, a number of states implemented workarounds to the SALT deduction limit by allowing residents to "contribute" to state-controlled charitable funds in exchange for SALT credits. The aim of these workarounds is to allow residents to characterize such contributions as fully deductible charitable contributions for federal income tax purposes, while simultaneously permitting a credit for state or local income, real estate or other taxes for the same contribution. In the proposed regulations released in August, the IRS responded to these workarounds by limiting federal income tax deductions that taxpayers, including trusts or estates, are able to take upon charitable contributions to such state-controlled charitable funds under Section 170 of the code.

Under the proposed regulations, a taxpayer that makes payments or transfers property to an entity eligible to receive tax deductible contributions would have to reduce its charitable deduction by the amount of any state or local tax credit the taxpayer receives or expects to receive. Therefore, a tax credit received in return for the contribution is treated as a quid pro quo benefit for the contribution, reducing the amount of the charitable income tax deduction otherwise available dollar-for- dollar. However, there is a de minimis exception: if the amount of the SALT credit does not exceed 15 percent of the amount of the contribution, the taxpayer's charitable income tax deduction is not required to be reduced.

The proposed regulations state that they are to apply to contributions to all SALT credit programs made after Aug. 27. While the proposed regulations target recently enacted state and local legislative efforts seeking to circumvent the new annual $10,000 SALT limitation, their application may also extend to long-standing programs across the country in which state and local tax credits have been provided for donations to certain community organizations and private schools where taxpayers have been claiming charitable contribution deductions notwithstanding the tax credits provided in return.

Additionally, the deduction for home mortgage interest for acquisition indebtedness of a residence has been reduced. For indebtedness incurred after Dec. 15, 2017, the deduction is limited to the interest on $750,000 of debt (rather than $1 million of debt, as under prior law). The Pease limitation — which reduced most itemized deductions by 3 percent of the amount by which a taxpayer's adjusted gross income exceeded a certain amount (in 2017,

$313,800 for married taxpayers), with a maximum reduction of 80 percent — is also eliminated for years 2018–2025. The act also eliminates many itemized deductions through 2025, while “above the line” deductions are generally not impacted.

The act also has implications for married couples who are divorcing or contemplating a divorce. The act changes prior law to provide that alimony payments will not be deductible by the payor and will not be deemed to be income to the recipient. The act also repealed Code Section 682, which generally provided that if a spouse created a grantor trust for the benefit of his or her spouse, the trust income would not be taxed as a grantor trust as to the grantor-spouse after divorce to the extent of any fiduciary accounting income the recipient-spouse is entitled to receive. Due to the repeal of Section 682, a former spouse’s beneficial interest in a trust may cause the trust to be taxed as a grantor trust as to the grantor-spouse even after divorce.

These changes to the taxation of alimony and the repeal of Code Section 682 do not sunset after 2025; they apply to any divorce or separation instrument executed after Dec. 31, or any divorce or separation instrument executed before year-end but later modified, if the modification expressly provides that changes made by the act should apply to the modification.

Charitable Deduction

The act increases the percentage limitation on cash contributions to public charities from 50 percent of the donor’s contribution base (generally, the donor’s adjusted gross income) to 60 percent. This 60 percent limitation applies if only cash gifts are made to public charities. The deduction limitations remain the same for donations of other assets, such as stock, real estate and tangible property.

Business Entities

The act reduced the top corporate income tax rate to 21 percent. To decrease the discrepancy in the tax rates between C corporations and pass-through entities, the act also addressed taxation of pass-through entities (partnerships, limited liability companies, S corporations or sole proprietorships) that would typically be taxed at the rate of the individual owners. Generally, new Section 199A provides a deduction for the individual owner of 20 percent of the owner’s qualified business income, or QBI. This deduction has the effect of reducing the effective income tax rate for an owner in the highest tax bracket from 37 percent to 29.6 percent. The deduction is subject to numerous limitations and exceptions. Notably, the deduction may be limited for taxpayers over a certain taxable income threshold ($315,000 for married taxpayers filing jointly and $157,500 for other taxpayers, to be adjusted for inflation in future years). For these taxpayers, the deduction may be subject to limitations based on whether the entity is a specified service business (an SSTB, which is generally a trade or business involving the performance of services in health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, investing and investment management, trading, or where the principal asset is the reputation or skill of one or more employees), the W-2 wages paid by the business entity and the unadjusted basis immediately after acquisition, or UBIA, of qualified property held by the trade or business. On Aug. 8, the IRS issued 184 pages of proposed regulations on new Section 199A, as well as Notice 2018-64 that addresses issues on computations under these provisions. The rules surrounding the deduction, as well as the proposed regulations, are very complex, and taxpayers should consult with their tax advisors to determine the implications of the Section 199A deduction. Section 199A is effective until Dec. 31, 2025.

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[1] Estate of Powell vs. Comm’r, 148 T.C. No. 18 (May 18, 2017).

[2] Estate of Cahill vs. Commissioner (T.C. Memo 2018-84.

[3] Kaestner 1992 Family Trust vs. North Carolina Department of Revenue, No. 307PA15-2 (N.C. S.Ct. June 8, 2018).