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Tax Reform

Implications of the "Tax Cuts and Jobs Act"

PROFESSIONAL OPINION

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The official title of what is widely known as the "Tax Cuts and Jobs Act" is "An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018." That is a mouthful: the legislation will be referred to as "the Act."

The Act increases the amount of estate, gift and generation-skipping transfer exemption of an individual from $5 million (unindexed) to $10 million, effective Jan. 1, 2018. With indexing, the figure should be approximately $11.2 million for 2018. Thus, a married couple now has over $22 million of exemption.

The Act has a sunset. For deaths and transfers after Dec. 31, 2025, the prior level of exemption will apply with the reduced level of exemption reflecting post-2017 indexing. Effectively, the exemption will be halved from the amount in 2025.

The Act is significant for what it did not change. The Act did not change the structure of the estate tax. What was subject to estate tax in 2017 continues to be subject to estate tax in 2018. The Act did not change estate tax rates.

The Act did not change the unlimited marital deduction for transfers to spouses who are U.S. citizens—whatever is given outright to a spouse or in the form of certain trusts is not subject to tax. The Act continued "portability" of estate and gift tax exemption between spouses. Portability provides that the amount of federal estate tax exemption that a deceased spouse did not use is effectively inherited by the surviving spouse.

The Act did not change the unlimited estate and gift tax charitable deduction.

The Act did not change the provisions of the federal gift tax. There is still an unlimited exclusion for payments of tuition and medical expenses; there is an "annual exclusion" that allows for tax-free gifts ($15,000 for 2018); and there is an unlimited marital deduction for gifts to spouses who are U.S. citizens.

The Act did not change the GST tax, other than to double the exemption against the GST tax.

Perhaps most important, the Act did not change "step-up in basis." Under current law, for income tax purposes the basis of most assets is changed to their value for federal estate tax purposes. In that instance, the basis is stepped up, eliminating tax on capital gains accruing before a decedent's death.

Even prior to the Act, the federal estate tax applied to relatively few estates. So, the doubling of the federal estate tax exemption means that the federal estate tax will only be of theoretical concern to many for the next eight years.

At first blush, the doubling of the exemption would seem to be a non-event for many individuals whose wealth was less than the exemption before the Act. The temporary increase in the transfer tax exemption affords some income tax planning opportunities.

Assume that a family member has low basis assets; he or she gives the assets to an older member of the family. The gift could be in the form of an outright transfer or, more likely, a transfer in trust. A transfer in trust would present less risk with respect to the older member's creditors (including long-term-care costs). The last assumption is that the estate of the older member would not be sufficiently large, following the gift, to generate estate tax.

Assuming that actuarial odds play out as expected, the older member dies before the younger member. As a result of the step-up in basis, the younger member now has assets with a stepped-up basis.

There is a provision of the Internal Revenue Code that denies the step-up when a donor receives back assets from a donee within one year of the initial transfer. The planning may be structured to deal with this provision.

With the reduction in exposure to federal estate tax, the Act may provide an incentive for individuals to retain assets, so that their heirs will receive assets with stepped-up basis for income tax purposes. As a hedge against the possible decrease in the exemption, those individuals may wish to establish revocable trusts, retaining rights in the trust. If the individual became concerned about a decrease in the exemption, the individual would make the trust irrevocable, triggering the gift tax—and using the exemption before it was eliminated. Care would have to be taken to avoid estate tax inclusion for the now irrevocable trust.

The Act's increase in the exemption has immediate implications for wills and living trusts with formula clauses. A formula clause is a provision disposing of property by reference to a federal tax provision: for example, the amount exempt from federal estate tax.

With a formula clause, the assets not subject to tax typically pass to a family trust. For all but the wealthiest of individuals, a formula clause will result in all of a decedent's assets (other than those passing by beneficiary designation or joint ownership) passing to a family trust. This may not be a desirable outcome depending on who are the beneficiaries of the trust.

The Act has no direct effect on the New York estate tax, which is based on the federal estate tax as it existed on Jan. 1, 2014. The current threshold for the New York estate tax is $5.25 million and will remain so until Jan. 1, 2019. Beginning in 2019, the New York exemption is to be indexed for inflation. The indexing will conform the New York exemption to the federal exemption—under the pre-Act law—after 2019.

It remains to be seen whether (and how) the New York State Legislature reacts to the various changes in the Act that have implications for New York taxes.

It may safely be assumed that Congress will revisit the estate, gift and GST taxes sometime in the next eight years. Given what would be a significant increase in tax, at least for those who would be affected by the sunset, preservation of the sunset would seem to be politically unpalatable. We will not attempt to guess what a future Congress might do.

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