TRUSTS AND ESTATES

The "Tax Reform Act:" What Happened to Estate, Gift and GST Taxes

The official title of what had been 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, and so we will refer to the legislation as "the Act." The Act was signed into law by President Trump on December 22.

The Act increases the amount of estate, gift and generation-skipping transfer exemption of an individual from $5 million (unindexed) to $10 million, effective January 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.

What Congress gives, Congress can take away. The Act has a sunset. For deaths and transfers after December 31, 2025, the prior level of exemption will apply. The reduced level of exemption will reflect the indexing with respect to the lower amount of exemption. Effectively, the exemption will be halved from the amount in 2025.

The legislation contemplates that the Internal Revenue Service will write regulations to deal with the following situation: an individual makes lifetime gifts that use exemption; at death, the individual's estate would not be subject to estate tax but for the prior use of exemption. The regulations apparently will be written to avoid the imposition of estate tax in that instance. The regulations presumably will also apply to gift tax situations.

WHAT DID *NOT* HAPPEN

The Act does not change the structure of the estate tax. As under current law, everything that a person owns (whether alone or jointly) or has the right to designate the beneficiary of (an IRA or life insurance) is potentially subject to federal estate tax.

The Act does not change the unlimited marital deduction—whatever is given outright to a spouse or in the form of certain trusts is not subject to tax. The Act did not change the unlimited charitable deduction. The Act does not change estate tax rates.

The Act continues "portability" of estate 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. To illustrate: assume that the first spouse to die had a $6,000,000 estate and left $2,000,000 to children and $4,000,000 to the surviving spouse. Only $2,000,000 of the deceased spouse's exemption would be used because the disposition to the spouse qualifies for the marital deduction. With portability, the survivor would "inherit" the unused balance of the exemption, or $4,000,000. Thus, at the death of the surviving spouse, his or her estate would have an additional $4,000,000 of exemption available.

The Act does 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 does 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.

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

WHAT DOES THE ACT MEAN FOR YOUR ESTATE PLANNING?

We assume 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.

More immediately, 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.

As a practical matter, an increase in the exemption only affects the estate plans of married couples. An unmarried individual cannot change the estate tax other than by leaving assets to charity at death. Of course, an unmarried individual can also reduce his or her estate's exposure to estate tax by lifetime estate planning.

The increase in the exemption has immediate implications for Wills and Living Trusts with formula clauses. What is a formula clause? It is a provision disposing of property by reference to a federal tax provision: for example, the amount exempt from federal estate tax, the marital deduction ("I give to my spouse the least amount necessary to eliminate the federal estate tax"), the GST exemption or the charitable deduction.

With a formula clause, the assets not subject to tax pass to a family trust. The dispositive provisions of the family trust may vary. In some instances, the surviving spouse is the exclusive beneficiary during his or her life; in others, the spouse and children or grandchildren are the beneficiaries.

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.

In 2011, New York passed a law that interpreted tax formulae dispositions in light of federal legislation in 2010. By its terms, the New York law does not now apply. It may well be that New York will pass similar legislation in the future. It is impossible to determine what the Legislature might do (or when it might act). Moreover, a statutory rule of interpretation may or may not fit any particular client's intent.

Many married clients have "disclaimer planning," where everything is left to the surviving spouse but the spouse has the right to disclaim some or all of the disposition so that it passes to a trust (where typically the spouse is the exclusive beneficiary). The Act does not affect disclaimer planning.

For those clients who are facing the prospect of paying estate tax, the increase in the gift tax exemption may present a good opportunity for lifetime planning.

EFFECT ON NEW YORK ESTATE TAX

In a word, none. The New York estate tax is based on the federal estate tax as it existed on January 1, 2014. Changes after January 1, 2014 are not automatically incorporated into the New York estate tax. The current threshold for the New York estate tax is $5,250,000.

It remains to be seen whether (and how) the Legislature reacts to the various changes in the Act that have implications for New York tax—perhaps the most prominent being the limitation on the deductibility for income tax purposes of state and local income and property taxes.

ONE ASPECT OF THE ACT: INCOME FROM PASS-THROUGH ENTITIES

The Act contains many provisions that affect the income tax. Discussion of those provisions is beyond the scope of this LEGALcurrents®. We do want to mention one: a provision that provides for a deduction for some income from a "pass-through entity," such as partnerships, S corporations and limited liability companies. In some sense, Congress just made it more attractive for owners of closely held businesses to hold onto their interests, rather than give them away in an effort to reduce exposure to the estate tax.

The provision contains some fairly elaborate rules for qualifying for the favorable treatment. In considering planning with new or existing pass-through entities, clients should be sensitive to the structure of the entity.

Conclusion

As you consider how the Act affects your estate planning, please contact a member of the Trusts and Estates group.