The new tax environment in 2018

Usually a major tax package takes many months to work its way through the Congress. Just seven weeks elapsed from the initial presentation of the Tax Cuts and Jobs Act legislative language to the eventual enactment of the tax reform legislation. Of course, the broad tax reform principles were revealed much earlier, and these issues have been under study in the tax-writing committees for years.

In this issue of Trusted Insights, we look at key considerations, first for the residents of Connecticut and most Northeastern states specifically, then for estate planners in general. Our core theme: Even though the impact of federal estate taxes will be smaller, the need for an up-to-date estate plan will be as great as ever.

Let’s have a yearlong conversation about how this new tax law will affect our clients.

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First look at tax reform

The tax reform legislation signed by President Trump on December 22, 2017, is going to take some time to digest fully. One promise that did not get kept was tax simplification. The new tax law reportedly already kept CPAs and tax lawyers very busy through the holiday season. A new deduction for business income from pass-through entities is perhaps the most notorious example.

Three important points should be kept in mind about this law. First, with only minor exceptions, there will be no effect on tax returns for the 2017 tax year to be filed by April 2018. Second, IRS has promised new withholding tables by February, so most wage earners will begin to feel a benefit from the new law fairly quickly. The loss of deductions won’t show up until 2019, when tax returns are filed for the 2018 tax year. Finally, all the individual tax provisions will expire after 2025. This makes tax planning doubly tricky, because it almost guarantees a continuing debate in Congress over tax issues.

Impact on Connecticut and the Northeast

As welcome as lower tax rates and a higher standard deduction may be to the majority of taxpayers, two features of the new tax law may prove problematic for many Northeastern state residents. The new law lowers the cap for the mortgage interest deduction, down to $750,000 worth of mortgage debt from the prior law’s $1 million limit. The change is forward looking; existing mortgages (before December 15, 2017) are not affected by the new cap. However, deductions for home equity borrowing also are eliminated, beginning in 2018. These changes are likely to exert downward pressure on home values throughout the state.

Note that if the law expires in 2026 as scheduled, the limit goes back to $1 million, regardless of when the debt was incurred.

More problematic for the Northeastern states will be a $10,000 cap on the deduction for state and local taxes. The cap applies per tax filing; that is, singles and marrieds filing jointly both have the same $10,000 limit, which creates a new marriage penalty. Every tax bill has winners and losers, and those families with high incomes and correspondingly high state and local taxes are likely to

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CAUTION ON TAX PREPAYMENTS

As 2017 came to a close, taxpayers around the country reportedly were prepaying their property taxes so as to claim the unlimited SALT deduction available for the 2017 tax year. As welcome as early tax payments may have been to local governments, the IRS warned in late December that such payments were not automatically deductible [IR-2017-210]. Early tax payments are only deductible if a tax has been assessed, in the IRS’ view.

The Service provided an example in which taxes were assessed on July 1, 2017, for a fiscal year ending on June 30, 2018. Taxes due could be paid in installments in both years. An early payment in this situation would be fully deductible. However, if the taxpayer tried to add more funds to cover the subsequent fiscal year as well, that portion would not be deductible.

Some practitioners disagreed with the IRS’ warning, pointing out that the statute refers to taxes “paid or accrued,” not “assessed.”

In any event, anyone covered by the AMT would get no benefit from the prepayment, as SALT deductions have long been denied under the alternate tax system.

New treatment of alimony

Alimony has long been deductible by the payor and taxable income to the payee. As the higher-income spouse is usually the payee, the rule lowers the overall tax burden on the couple. It also may give the payee spouse greater bargaining power, leading to higher alimony payments. That rule has been upended. For agreements occurring after December 31, 2018, alimony will not be deductible or taxable.

Evidently, tax writers believed that while the payors were claiming their deductions, the payees were not always reporting the income. Should the new law be allowed to expire in 2026, divorce agreements reached in the interim may come undone.

Impact on estate planning

The amount exempt from the federal estate and gift tax had been scheduled to rise to $5.6 million so as to take into account inflation since 2011. The new law doubles that exemption, to $11.2 million in 2018. Should both partners of a married couple die in 2018, the exemption potentially could shield $22.4 million. However, the higher exemption expires in 2026. Complete repeal of the federal estate tax was not included in the final bill, and so the basis step-up at death remains intact.

It’s been estimated that perhaps only 1,000 estates will pay the federal estate tax in 2018. However, the higher exemption expires in 2026, and some Democrats already have announced an intention to reduce the exemption should they come into power. Estate plans will need to remain flexible as tax laws change.

None of this will be welcome news to state lawmakers, who are struggling to balance Connecticut’s budget.

Smaller estates.

News of the diminishing reach of the federal estate tax may reduce the urgency for attending to estate planning. The number of Americans who do not have wills is already disappointingly high, and it could go higher without a vigorous promotion of the inadequacies of intestacy.

The most important consideration for smaller estates will be planning for basis step-up. In general, assets with the greatest built-in appreciation will be held until death so as to enjoy forgiveness of taxes on capital gains.

Intermediate estates.

Families with a projected estate value in the $11 million to $22 million range may want to consider steps to keep the family fortune free from transfer taxes.

Impact on estate planning

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A program of tax-free annual gifts to descendants (up to $15,000 in 2018, $30,000 per couple) can be an easy and effective method for reducing future estate taxes. For example, grandparents with three children and seven grandchildren can give up to $300,000 to their descendants every year, or $1.2 million in just four years.

Beyond this level of estate reduction, families may want to consider making taxable gifts before 2026 so as to “lock in” the higher exemption amount. (But don’t overlook the gift tax in Connecticut, the only state to continue to tax lifetime asset transfers. The Connecticut estate and gift tax exemption is only $2.6 million in 2018; it will not match the federal exemption until 2020.) We’ve been on the precipice of a diminished federal estate tax exemption before, in 2011. Some clients who made large taxable gifts that year regretted the decision after the $5 million federal exemption was made permanent in 2012. Congress has never yet reduced the amount exempt from estate tax, despite its value as a political talking point.

The other question that arises in this situation regards “clawback.” What is the result for a taxpayer who makes a large taxable gift so as to consume his or her federal gift tax exemption, and who then dies at a time when the estate tax exemption has been reduced? What happens if the estate no longer has enough assets to pay the resulting estate tax? Such uncertainties may cause affluent families to hesitate before implementing their lifetime gifting plans.

Large estates. For very large estates, the increase in the amount exempt from the federal estate tax is relatively unimportant. The lion’s share of federal estate tax revenue comes from estates larger than $50 million, and that revenue stream has been preserved.

Large estates also may want to take action to capture the larger gift tax exemption, subject to the cautions noted above. Dynasty trusts may increase in popularity for this purpose. A variety of strategies may be explored to apply some leverage to the exemption, such as asset sales to irrevocable trusts.

The coming year should be a good one for estate planners. They will have much to discuss with their clients, who should be especially receptive to reviewing their plans.

Power of appointment may be amended to clarify that it is a special power, not a general one.

Grantor created an irrevocable trust for his spouse and their descendants. The trust granted the spouse a testamentary power of appointment over the trust assets, to be exercised in favor of any person or charity the spouse may desire. However, the power did not include the required words of limitation, excluding from the exercise “Spouse, the estate of Spouse, the creditors of Spouse or the creditors of Spouse’s estate.” As such, it could be construed as a general power of appointment, taxable in Spouse’s estate under IRC §2041. That would not be the result that Grantor hoped for.

Grantor contended that the failure to include the words of limitation was a scrivener’s error, and petitioned the local court to reform the trust. The court entered the order, retroactively reforming the trust. Now the question becomes, will the IRS respect the reformation? Or will it instead consider the change in the trust to be a taxable exercise or release of the power of appointment, triggering a taxable gift?

Good news for this taxpayer—no taxable gift, and the trust will be excluded from the spouse’s estate [Private Letter Ruling 201737001].
Briefly noted

Expect more tax legislation in 2018, according to Ways and Means Committee Chair Kevin Brady (R-Texas). An “extenders bill” that was introduced in the Senate on December 20 will have to wait until next year, and some lawmakers are not convinced that additional temporary tax provisions make sense any more. The extenders include items that were overlooked in 2015, such as tax credits for geothermal heat pumps, fuel cell property, combined heat and power system property, and small wind turbines. Deductions for specific tuition expenses, film and TV industry incentives, tribal tax credits, empowerment zone incentives, some cost recovery provisions for horse racing, and more are also in the bill.

A technical corrections bill also would be expected after so large a tax reform bill, especially given the speed with which this tax bill sailed through the Congress. However, the Democrats may not be in a mood to cooperate on such a bill. Connecticut Representative John Larson, who is a member of the House Ways and Means Committee, stated that Democrats would seek a full year of committee and subcommittee hearings, with hundreds of expert witnesses, before they would agree to a technical corrections bill.

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