Estate Planning Alert: Tax Cuts and Jobs Act of 2017

January 23, 2018

On Dec. 22, 2017, President Trump signed H.R. 1, also known as the Tax Cuts and Jobs Act, into law. The Act makes significant changes to individual income tax rates and deductions, business income tax rates and deductions, the Alternative Minimum Tax, and much more. This Estate Planning Alert focuses on the estate planning-related changes in the Act.

Key Tax Numbers for 2018

- $11,180,000: the increased federal gift and estate tax basic exclusion amount and generation-skipping transfer (GST) exemption amount
- $15,000: the increased federal gift tax annual exclusion amount
- 37%: the decreased rate of the top income tax bracket for individuals, estates, and trusts
- 60%: the increased charitable contribution limit for cash contributions to public charities
- $10,000: the new amount that annually can be paid per student from a § 529 plan for tuition at an elementary or secondary school

Federal Gift, Estate, and GST Tax Law Changes

Congress may have changed your estate plan. The Act significantly increases the amount that can pass free of federal estate tax and free of GST tax. Some wills and revocable trusts use formulas to transfer the portion of property that can pass free of federal estate or GST tax. For example, your will may be written using a formula that distributes the portion of your property that can pass free of federal estate tax to your children and distributes the balance of your property to a list of charitable organizations. Because the Act more than doubles the amount that can pass free of federal estate tax for tax year 2018 compared to tax year 2017, the Act may have changed your estate plan. You should contact your Gray Plant Mooty estate planning attorney if your will or revocable trust uses a formula based on the portion of your property that can pass free of federal estate or GST tax to divide property between your surviving spouse and your children, to divide property between your family members and charitable organizations, or to divide property in a similar manner.

Increase to federal gift and estate tax basic exclusion amount. For tax years 2018 through 2025, the Act increases the federal gift and estate tax basic exclusion amount from $5 million (plus an inflation adjustment) to $10 million (plus an inflation adjustment). At the time of publishing this Alert, the IRS has not yet determined the 2018 inflation-adjusted basic exclusion amount, but we expect that it will be $11,180,000 (up from $5,490,000 in tax year 2017). That's a 104% increase for 2018 compared to 2017, and that's why it's important to review your estate plan in light of these changes. In other words, an individual can shelter the first $11,180,000 of cumulative taxable transfers made during lifetime or at death from federal gift or estate taxes in 2018, and a married couple acting together can shelter the first $22,360,000 of cumulative taxable transfers made during lifetime or at death from federal gift or estate taxes in 2018. Absent any further action from Congress and the President, the federal transfer tax basic exclusion amount is scheduled to revert back to $5 million (plus an inflation adjustment) in tax year 2026. The Act directs the Secretary of the Treasury to issue regulations appropriate to address the situation that occurs if an individual makes taxable gifts using the larger gift tax basic exclusion amount available in tax years 2018 through 2025 and dies after the estate tax basic exclusion amount reverts back to $5 million (plus an inflation adjustment). No regulations have been issued at the time of publishing this Alert, but it appears that Congress intends that the regulations would not impose a transfer tax at death on lifetime gifts made using the larger gift tax basic exclusion amount.

Increase to Minnesota's estate tax exclusion amount. Minnesota's state-level estate tax was not changed by the Act, but Minnesota's legislature separately made tax law changes in 2017. Minnesota has a state-level estate tax that applies to Minnesota residents and to nonresidents of Minnesota who own property with a situs in Minnesota. Minnesota's new estate tax exclusion amounts are $2.4 million for tax year 2018, $2.7 million for tax year 2019, and $3.0 million for tax years 2020 and after.

Increase to federal gift tax annual exclusion amount. For tax year 2018, the inflation-adjusted gift tax annual exclusion amount is expected to increase to $15,000. So, an individual can make transfers of up to $15,000 per beneficiary in 2018 that are not treated as taxable gifts, and these transfers do not reduce the donor's $11,180,000 basic exclusion amount. A couple acting together can make transfers of up to $30,000 per beneficiary using their gift tax annual exclusions. The Act changes the way the inflation adjustment is calculated for the gift tax annual exclusion amount. At the time of publishing this Alert, the IRS has not yet determined the 2018 inflation-adjusted gift tax annual exclusion amount, but we expect that it will be $15,000 (up from $14,000 in tax year 2017).

Increase to federal GST exemption. For tax years 2018 through 2025, the Act increases the federal exemption from GST tax to $10 million (plus an inflation adjustment). At the time of publishing this Alert, the IRS has not yet determined the 2018 inflation-adjusted GST exemption, but we expect that it will be $11,180,000 (up from $5,490,000 in tax year 2017). The GST tax is an additional tax on transfers (made during lifetime or at death) that skip a generation.

Federal gift, estate, and GST tax provisions that were not changed. Significantly, the Act makes no changes to: (1) the top federal estate tax, gift tax, and GST tax rates, which remain at 40%; (2) the federal income tax basis adjustment for property acquired from a decedent, which changes the basis to the fair market value of that property at the date of the decedent's death (sometimes called a basis "step-up"); (3) the ability to transfer an individual's unused basic exclusion amount at death to the individual's surviving spouse by filing a federal estate tax return (also known as "portability"); and (4) valuation discounts for lack of control or lack of marketability that can apply to transfers of closely held business interests.

Federal Income Tax Law Changes

Lower top federal income tax rate bracket. The Act makes significant changes to federal income tax brackets and rates for individuals, estates, and trusts. For tax years 2018 through 2025, the Act reduces the top federal income tax rate bracket from 39.6% to 37% for single individuals with taxable income over $500,000, for married individuals filing jointly with taxable income over $600,000, and for estates and trusts with taxable income over $12,500.

No changes to qualified dividend or capital gains tax rates. The Act does not change the 0%, 15%, or 20% income tax rates for qualified dividends or capital gains, but it does change the breakpoints for when these tax rates apply. The 15% income tax rate applies between $38,600 and $425,800 for single individuals, between $77,200 and $452,400 for married individuals filing jointly, and between $2,600 and $12,700 for estates and trusts.

No changes to 3.8% net investment income tax. The Act also does not change the 3.8% tax on net investment income, which applies if a taxpayer's adjusted gross income exceeds $200,000 for single individuals, $250,000 for married individuals filing jointly, and $12,500 for estates and trusts.

Kiddie tax changes. The Act changes the "kiddie tax" rules so that the net unearned income of a child subject to the rules will be taxed using the brackets and rates applicable to estates and trusts. Before the Act, the net unearned income of a child was taxed at the greater of the child's tax rate or the parents' tax rate. The kiddie tax generally applies to children under age 19 and full-time students under age 24 at the close of the tax year.

Elementary or secondary school tuition payments permitted from § 529 plans. Starting in 2018, the Act permits tax-free distributions from a § 529 plan to pay expenses for tuition in connection with enrollment or attendance at an elementary or secondary public, private, or religious school, with a $10,000 per student aggregate limit per tax year. In tax year 2017, these distributions would not have qualified for tax-free treatment.

Fewer taxpayers will be subject to Alternative Minimum Tax. The Act does not eliminate the Alternative Minimum Tax (AMT). But, the Act increases the AMT exemption amount by 29.5% for tax year 2018 compared to tax year 2017, and the Act significantly increases the AMT exemption amount phaseout threshold for tax year 2018. As a result, fewer taxpayers will be subject to AMT in tax year 2018 compared to tax year 2017. The tax year 2018 amounts shown in the table below will be indexed for inflation for tax years 2019 through 2025.

Personal exemption eliminated. The Act eliminates the personal exemption for tax years 2018 through 2025. In tax year 2017, a taxpayer could reduce his or her adjusted gross income by a personal exemption of $4,050 for each of the taxpayer, the taxpayer's spouse, and any dependents. For a married couple with two dependent children, that's a $16,200 tax exemption in tax year 2017 that is eliminated for tax years 2018 through 2025.

Increase to standard deduction. Fewer individual taxpayers will itemize their deductions in 2018 because the standard deduction is increased and several significant deductions are reduced or eliminated for tax years 2018 through 2025. For tax year 2017, the standard deduction was $6,500 for single individuals and $13,000 for married individuals filing jointly. For tax year 2018, the standard deduction is $12,000 for single individuals and $24,000 for married individuals filing jointly.

New qualified business income tax deduction. One of the most significant changes in the Act is a new deduction that reduces taxable income by 20% of the "qualified business income" from a partnership, S corporation, or sole proprietorship and by 20% of certain qualified real estate investment trust (REIT) dividends, qualified cooperative dividends, and qualified publicly traded partnership income. This new deduction is available to individuals, estates, and trusts. This in an important new deduction for owners of pass-through entities, and some business owners may decide to make changes to their business structure or operations to meet the qualified business income requirements. At this time, there are many unanswered questions in the Act about the rules and requirements for this complex new deduction, and the IRS is likely to issue guidance in the coming months to clarify their interpretation of this new deduction.

Reduction of and elimination of many itemized deductions. The Act reduces or eliminates several individual income tax itemized deductions, some of which are described below, for tax years 2018 through 2025 unless otherwise specified.

- **Reduction of state and local income tax deduction.** The Act limits the itemized deduction for state and local income taxes and property taxes to a total of $10,000 ($5,000 for married taxpayers filing separately). That has a significant impact on Minnesota residents and residents of other states with high state income tax rates.

- **Changes to mortgage interest and home equity interest deductions.** The Act limits the itemized deduction for mortgage interest on acquisition indebtedness for a qualified residence so that: (1) interest on acquisition indebtedness incurred on or before Dec. 15, 2017 is only deductible on debt up to $1,000,000 ($500,000 for married taxpayers filing separately) and (2) interest on acquisition indebtedness incurred after Dec. 15, 2017 is only deductible on debt up to $750,000 ($375,000 for married taxpayers filing separately). The Act also eliminates the itemized deduction for interest on home equity indebtedness.

- **Increase to charitable deduction for cash contributions to public charities.** The Act increases the itemized deduction limit for charitable contributions to 60% (up from 50% in tax year 2017) of the donor's contribution base but only for cash contributions made to charitable organizations described in § 170(b)(1)(A) of the tax code. Generally, this includes public charities and most supporting organizations, but it excludes private foundations. A donor's contribution base is the donor's adjusted gross income computed without regard to any net operating loss carryback. If a donor's aggregate cash contributions to public charities in a tax year exceed 60% of the donor's contribution base, the excess portion can be carried forward and deducted in each of the five succeeding tax years in order of time, subject to the applicable percentage limitation in each of those years.

- **Elimination of miscellaneous itemized deductions.** The Act eliminates the miscellaneous itemized deductions that previously were deductible to the extent that they exceeded 2% of a taxpayer's adjusted gross income. These miscellaneous itemized deductions included, among other things, tax preparation costs, legal fees for tax advice, investment expenses, union dues, unreimbursed employee expenses, appraisal fees for charitable contributions, excess deductions (including administrative expenses) allowed by a beneficiary on termination of an estate or trust, and indirect miscellaneous deductions from pass-through entities.

- **Temporary reduction to threshold for medical expense deduction.** For tax years 2017 and 2018 only, unreimbursed medical expenses are an itemized deduction to the extent that they exceed 7.5% of adjusted gross income for all taxpayers. Prior to the Act, the limitation was 10% of adjusted gross income for most taxpayers.

Contact Your Gray Plant Mooty Estate Planning Attorney for More Information

The new $11,180,000 federal estate tax basic exclusion amount and the new $11,180,000 GST exemption for tax year 2018 may impact your current will or revocable trust. While many distribution formulas in wills and revocable trusts will continue to operate under the new federal transfer tax laws exactly as they were intended before the Act, it is important to contact your Gray Plant Mooty estate planning attorney to make sure that the Act does not negatively impact your estate plan, especially if your estate plan has not been updated in the past 10 years.

The new $11,180,000 federal gift tax basic exclusion amount and the new $15,000 federal gift tax annual exclusion amount for tax year 2018 create new estate planning opportunities. In general, making a gift today saves transfer taxes on future income and appreciation that may otherwise occur in your taxable estate. Lifetime gifts have an additional benefit for Minnesota residents, because Minnesota has a state-level estate tax but no state-level gift tax. But, Minnesota's estate tax does include gifts made within three years of death. Contact your Gray Plant Mooty estate planning attorney if you would like to discuss the benefits of making gifts as part of your estate plan.

For more information, contact any member of the Gray Plant Mooty Trust, Estate and Charitable Planning team.