

2018 Estate and Trust Tax Planning

Inflation Adjustments and Initial Observations on the 2017 Tax Act's Impacts

In late October, the Internal Revenue Service issued its inflation-adjusted exemptions, exclusions and tax brackets to be used for 2018 federal tax returns. *See generally*, Internal Revenue Notice 2017-178 and Revenue Procedure 2017-58 issued on October 19, 2017. In the estates and trusts area, the principal adjustments are as follows:

- An individual's federal estate, gift, and generation-skipping tax exemptions are increased after December 31, 2017 to \$5,600,000. Thus, for decedents dying after December 31st with a gross estate (i.e., a taxable estate at death plus prior adjusted taxable gifts) of less than \$5,600,000, there will be no federal estate tax due and no federal estate tax return is required to be filed. In addition, individuals may cumulatively make up to \$5,600,000 in taxable lifetime gifts before any federal gift tax is imposed.
- After years of remaining fixed at \$14,000 per year, the federal gift tax exclusion will increase to \$15,000. As a result, for calendar year 2018, individuals may make gifts that can be enjoyed immediately totaling \$15,000 or less to any number of individuals without those gifts counting as lifetime taxable gifts (and without those gifts requiring the use of the \$5,600,000 gift tax exemption mentioned above).
- Finally, for trusts receiving and retaining taxable income, the federal income tax brackets have changed such that trusts do not reach the 39.6% marginal rate until they have taxable income in excess of \$12,700. (Please recall that trusts get "distributable net income" deductions for amounts distributed to trust beneficiaries so that this maximum marginal rate will only be imposed on retained ordinary income above that amount. In turn, the beneficiaries receiving this distributable net income will pay tax on the income received at their personal marginal rates.) Note that the new bracket amount does not affect the Maryland income tax paid by the trust at Maryland rates on top of the federal tax.

Despite the IRS's October pronouncement, a real question exists as to whether any of these limits will apply in 2018. As I write this article, House of Representatives and Senate conferees in Congress have agreed upon a final version for a bill entitled H.R. 1, "the Tax Cuts

and Jobs Act of 2017” (referred to below as “the TCJA”). This “Conference Committee” version of the TCJA will now come before both houses of Congress for separate votes of approval. If, as expected, this Conference Committee report is approved by the House and Senate, the Conference Committee version of the TCJA will become law and generally apply with respect to tax years commencing after December 31, 2017. The Conference Committee approved version of the TCJA will substantially change the applicable 2018 estate and generation-skipping transfer tax exemption numbers already announced by the IRS and will change the income tax brackets for trusts:

- The Conference Committee version of the TCJA will double the basic federal estate, gift, and generation-skipping tax exemptions from \$5,000,000 to \$10,000,000. With inflation adjustments back to 2010, the actual exemptions per individual will increase to approximately \$11,200,000, and a married couple will be able to shelter over \$22,000,000 for their post-mortem beneficiaries before having to worry about paying federal estate tax.

On January 1, 2019, the Maryland estate tax exemption is scheduled to become “recoupled” with the federal exemption. As of now, were the TCJA to pass with the doubled estate tax exemption, that doubled estate tax exemption will apply for Maryland estate tax purposes as well. Time will tell how Maryland reacts to this substantial decrease in tax revenue.

- The original House of Representatives’ version of H.R. 1 would have repealed the federal estate and generation-skipping transfer taxes entirely as of January 1, 2025. This repeal, however, is **not** included in the Conference Committee’s approved final version of the TCJA, and for now such repeal is no longer on the agenda.

Since neither the House nor the Senate versions of the TCJA (nor the Conference Committee report) repeal or change the federal gift tax exclusion amount, it appears that the federal gift tax exclusion will in fact increase to \$15,000 for 2018 and succeeding years (until inflation again requires an adjustment in a \$1,000 increment).

- Under the Conference Committee version of the TCJA, the brackets for trust taxable income will be changed as follows:

Retained trust income up to \$2,550 would be taxed at 10% (a rate below the current 15% tax on such income);

From \$2,550 to \$9,150, retained trust income would be taxed at 24% (a rate also below that mandated by current law);

From \$9,150 to \$12,500, retained trust income would be taxed at 35% (a rate higher than that mandated by current law); and

Above \$12,500, retained trust income would be taxed at the maximum 37% (a rate that is 2.6% less than that mandated by current law).

Thus, under the Conference Committee's version of the TCJA, the maximum bracket for federal income tax on retained trust income will apply at an amount slightly below that projected by the IRS in October, but the rate itself would be 2.6% lower.

- Because estates and trusts are generally subject to the same rules for calculating taxable income as individuals and because the TCJA suspends most individual itemized deductions until December 31, 2025, estates and trusts will be subject to the same TCJA provisions as individuals with respect to the loss or limitation of itemized income tax deductions (e.g., a \$10,000 limit on the deductibility of state and local property and income taxes, limits on the deductibility of home mortgage interest, and loss of the deduction for preparation of tax returns). In particular, trusts and estates will no longer be able to claim as deductions expenses that previously were allowable if they exceeded 2% of taxpayer's adjusted gross income. However, trusts and estates will now be eligible for a new complicated deduction for certain "qualified business income" received for the taxable year with respect to pass-through business entities.
- Since individual beneficiaries will not be able to make itemized deductions for these pass-throughs (at least until after December 31, 2025), residuary beneficiaries of estates and trusts will no longer be eligible to benefit from unused excess deductions for estate and trust administration expenses after termination of an estate or trust.
- The TCJA does not change the "stepped-up" basis provisions of current law with respect to capital gains on inherited assets. As such, beneficiaries will continue to inherit capital assets with the date of death fair market value of the assets as their respective bases for capital gains purposes and without the potential of realizing income taxation on pre-mortem appreciation (or losses) in value.

All of this will make wonderful fun for the IRS's tax return designers over the Holidays. Here's hoping that your Holidays are merrier than theirs and that we all have a Happy New Year.