Assumptions You Should Not Make After the Tax Cuts and Jobs Act of 2017

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Last year held a lot of uncertainty for our clients after passage of the Tax Cuts and Jobs Act of 2017, (the "Act") which provided for the most comprehensive tax reform in over thirty years. Such sweeping changes meant that most taxpayers were uncertain of the impact the Act would have on their personal income tax situation until they were able to actually file their tax returns. For many, the final results did not come in until just this quarter when their federal income tax returns were due after extension. Clients should be much more comfortable making year-end charitable giving decisions as we approach the end of 2019 than they were this same time last year, given the certainty of their tax situation for this year. Additionally, now that planners have had time to digest the significance of the changes the Act made to the estate and gift tax arena, we are better able to advise our clients—not just those who are living, but also the beneficiaries of estates of our recently deceased clients. Many of the assumptions that were made after the initial passage of the Act have been incorrect; those are addressed in this article as well as some year-end items to consider when advising our clients in light of what we have learned over the past two years.

ASSUMPTION: The charitable deduction was reduced and/or eliminated by the Act.

Although most of us know this assumption is completely incorrect, many planners do not realize that the Act actually increased the charitable contribution deduction allowance from 50% to 60% of a taxpayer's adjusted gross income. This will benefit high net worth individuals making large donations, allowing them to utilize more of their charitable contribution deduction. The Act kept in place the ability for an individual to carry forward a charitable contribution deduction that cannot be fully deducted in the year of contribution for up to five years. The ability to carry forward the deduction in combination with the increased allowance should be attractive to donors who want to make very large donations in a single year. This increase, when combined with charitable split interest gift planning techniques, creates significant planning opportunities for these high net worth, high earning individuals. Some lower income earners will also benefit:

> Ex: A single individual who is retired and receives a large portion of tax exempt income but who can still itemize due to expenditures for SALT (State and local tax deduction), medical (10% floor reduced to 7.5% by the Act) and charitable donations will likely be able to deduct more of their charitable donations each year.

The Act left intact the charitable IRA rollover, which means that clients at all income levels can utilize this option without worrying about whether or not they can still itemize deductions. Individuals over 70 ½ can use this distribution to satisfy part or all of their required minimum distributions and any qualifying distribution will bypass the donor's income for federal tax purpose resulting in an effective 100% charitable income tax deduction regardless of whether or not the individual could otherwise itemize.

ASSUMPTION: Individuals will stop making charitable donations if they can't take advantage of a charitable deduction.

Many early critics of the Act cited that charitable donations will reduce dramatically beginning in 2018, with many projections stating there would be more than a 5% decrease, resulting in a $20-billion reduction in charitable giving. What was their reasoning? The largest basis for this claim was that due to the Act increasing the standard deduction so dramatically, fewer individuals would itemize their deductions. Because you claim a charitable contribution deduction on your Schedule A (itemized deductions schedule), those who do not itemize will no longer receive a direct tax benefit from making a charitable donation. As such, critics surmised that individuals would not make charitable donations to the same extent as they did when they believed they were getting a tax benefit.

So, how did charitable giving shake out in 2018? Analysis from the main think tanks that compile this type of data each year, namely Giving USA™, the Fundraising Effectiveness Project and the Blackbaud Institute, shows that overall giving increased from between 0.7% to 1.6% before adjustments for inflation. In dollars, Giving USA 2019 reports that total giving increased from $410.02 billion donated in 2017 to $427.71 billion donated in 2018, with giving by individuals making up a total of $292.09 billion of the total. Bequests from decedent's estates totaled $39.71 billion and giving by corporations increased by $20.05 billion in 2018. Because the highest reported increase in charitable giving of 1.6% didn't keep up with the 2.44% inflation pace for 2018, we end up with somewhere between a 0.8 and 1.7% decrease in overall giving when adjusted for inflation.[i] Considering the uncertainly of most taxpayers at the end of last year as to tax liability as well as the very large and unexpected downturn in the market in December of last year (when nearly 30% of all charitable giving takes place each year), the outcome for charitable giving was remarkably positive in 2018.

If we assume that historical trends will continue, then as gross domestic product and disposable personal income increase, so too will charitable donations.

ASSUMPTION: My clients without taxable estates will never need to fund a marital trust.

Now that we have extremely large exemptions plus portability, we no longer have to separate assets for most married couples for purposes of funding credit shelter trusts as we did in the past to absorb the exemption of the first spouse to die. For many clients we can recommend keeping assets held jointly, or if kept separate, then to rely on a simple plan of leaving everything outright to the survivor with the option to disclaim to a trust at the first death if needed.

In the past, we would always provide for the funding of a credit shelter trust first, because before portability, if you did not use up the first spouse's exemption by funding such a trust, you would lose it. Because portability looks like it is here to stay and will not sunset with the Act at the end of 2025, we no longer have to use up the first spouse's exemption in many situations. The big downside to funding credit shelter trusts was that the cost basis in those assets was set at the fair market value of those assets as of the first spouse's date of death. When the survivor later died, those assets could have substantially appreciated causing significant capital gains taxes to be imposed on the couple's children when the assets were later sold. When the exemptions were smaller, this wasn't a bad result because those inheriting the assets would rather pay 20% capital gains taxes on appreciated property than the much higher estate tax that would have been due if the credit shelter trust had not been utilized.

In this new landscape, however, most of our clients will not have taxable estates and so we want to ensure that their children will not have to pay capital gains taxes when they later inherit and then sell property. In order to maximize capital gains tax savings, we will now recommend that assets either pass directly to the surviving spouse OR to a marital trust that qualifies for a marital deduction under IRC Section 2056. In both of these scenarios, all such assets will be included in the surviving spouse's estate at their death and so will receive a full step up in basis at such time. If the couple's children sell any highly appreciated assets soon after the death of the surviving spouse, the capital gains tax will be completely eliminated. For many blended families, a marital trust is going to be the best option to ensure that the surviving spouse is taken care of while the children from the deceased spouse's first marriage are still the ultimate recipients of the assets. Now, this can be achieved with beneficial income tax savings for those children.

ASSUMPTION: I will never have to worry about filing an estate tax return again.

Although the Act nearly doubled the federal estate and gift tax exemptions for individuals, even before the Act only a very few estates were required to file estate tax returns and even fewer were actually paying any estate tax. According to the Tax Policy Center, for decedents who died in 2018, there is estimated to be only 4,000 estate tax returns filed (in contrast to the 11,300 estimated for 2017) with only 1,900 of those being taxable (compared with 5,500 taxable in 2017). Of the 2.7 million people projected to have died in 2018, estate tax returns will be filed for 0.15%, with only 0.7% owing any estate tax.

Despite the statistics, please don't assume that just because your client has an estate valued below the current federal exemption of $11.4 million that an estate tax return should not be filed at their death. The projections above are likely based upon estates required to file returns, and they do not take into account estates with values below the exemption amount but which should be advised to file returns regardless of whether or not a return is technically required. Below are two very important scenarios where an estate tax return should still be filed, even if the value of the decedent's estate is well below the current exemptions:

1. Portability. Portability has been around for nearly a decade now, created in the Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010 and made "permanent" in the American Taxpayer Relief Act of 2013. Portability is, in general, a rule that allows the surviving spouse of a decedent to utilize the deceased spouse's unused applicable exclusion amount (DSUE) for making future lifetime transfers and for use at the death of the surviving spouse.

   Ex: John and Mary are married and have a combined estate (everything owned jointly) of $6 million. John dies in 2019, and as a result Mary, automatically inherits his share of their assets by operation of law, as all assets were titled jointly. Mary later dies in 2026 after the sunset of the current tax laws (set to expire December 31, 2025), and as such, Mary's exemption from federal estate taxes is $5 million (adjusted for inflation).
   Assume that her assets appreciated and now are valued at $7 million.

If Mary failed to timely file an estate tax return at John's death, her estate could be facing an estate tax on the value that exceeds the federal exemption in place at her death, which potentially on over $1 million of assets at a 40% tax rate. If, however, she had timely filed an estate tax return for John's estate, then portability would have allowed her to add the federal estate tax exemption in place at John's death ($11.4 million) to her available exemption at her death, such that she would have over $16.4 million of available exemption at her death.

By filing estate tax returns to elect portability, we can ensure that most of our clients will never have an estate tax concern at their death. On the flipside, not filing a return in a scenario similar to that described above could lead to malpractice on the part of the attorney handling the estate.

2. QTIP Elections. Before this new age of very high estate and gift tax exemptions, a marital trust was seldom funded until after a credit shelter trust was fully funded, as discussed earlier in this article. In fact, when exemptions initially increased so substantially in 2011 to $5 million per individual, or $10 million per married couple, estate planners began utilizing the strategy of bypassing the credit shelter trust altogether and funding the marital trust exclusively for estates that were safely under the exemption amounts. However, even though an estate may not be taxable, the only way to ensure that a marital trust is treated as qualified terminable interest property (QTIP) for federal estate and income tax purposes is to make the QTIP election on a timely filed Form 706.

   Why is the QTIP election so important? Because this is the only way to treat the assets passing to a traditional marital trust as QTIP property such that it will be included in the surviving spouse's estate at the second death. The property must be included in the surviving spouse's estate for estate tax purposes in order to receive a step up in basis to the fair market value of the asset to achieve maximum capital gains tax savings if the asset is later sold by the couple's children.

The assumption that a non-taxable estate would never fund a marital trust was even embedded into the tax laws prior to 2010, with the IRS automatically assuming that any QTIP election made on an estate tax return which was not necessary to avoid or reduce an estate tax, was inadvertently made and so it was considered a mistake by the IRS and treated as NOT having been made by the estate. Revenue Procedure 2001-38 specifically provided that a QTIP election which was not necessary to reduce tax to zero will be disregarded by the IRS. Fortunately, the Treasury issued Revenue Procedure 2016-49, which supersedes the prior procedure and provides that a QTIP election made by an executor who has also made a portability election will not be disregarded. Because this technique will almost always be paired with a portability election, this clarification is what estate planners needed to safely proceed with exclusively utilizing marital trusts in non-taxable estates for capital gains planning.

CHARITABLE AND ESTATE PLANNING CONSIDERATIONS FOR YEAR END

Based on all of these assumptions that we shouldn't make, what should advisors focus on as we round out 2019 and get started in 2020?

- Educate your clients on the Act's enhancement of the charitable contribution deduction allowance as well as the continuation of the charitable IRA rollover for those clients over 70 ½. Our clients are now aware of whether or not they can still utilize the charitable contribution deduction based on their particular tax situation, so encourage those gifts to be made before December 31 so they can take advantage of the deduction on their 2019 tax return.

- For your clients who may have passed away in 2019, don't assume that an estate tax return is not needed. Evaluate the estate for the potential benefit of a portability and/or QTIP election for a marital trust, both of which elections must be made on a timely filed estate tax return.

- The end of the year or the beginning of a new year are both great times to encourage clients to update their beneficiary designations. Don't assume that just because they have an estate plan in place that their beneficiary designations were updated to work with that plan. Educate your clients that in order to properly fund a marital or other trust, their accounts must provide that either the trust is named the beneficiary OR that the client's estate is named as beneficiary so that the particular account will flow through the client's estate and fund any trust created in their Last Will and Testament.

i Giving USA 2018/Annual report on philanthropy for the year 2018, a publication of Giving USA Foundation, 2019, researched and written by the Indiana University Lilly Family School of Philanthropy.