Patterson Belknap Webb & Tyler LLP

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Federal Tax Reform May Affect Estate Planning

On November 2, the House Ways and Means Committee released a draft tax reform bill known as the Tax Cuts and Jobs Act. The Senate Finance Committee followed on November 9 with its own outline for tax reform legislation. Both proposals contemplate significant changes to the gift, estate, and generation-skipping transfer (GST) tax laws. It is unclear how the two proposals will be reconciled, and if and when final legislation will be introduced. We have summarized below certain of the key provisions of these two proposals:

Current law. As you may know, under current law, U.S. federal gift and estate taxes may apply at a rate of up to 40%. Each individual who is a citizen or resident of the U.S. is allowed a $5.49 million lifetime exclusion amount, which may be used to shelter transfers made during life or at death from gift and estate taxes. That exclusion amount is indexed for inflation and is scheduled under current law to increase to $5.6 million on January 1, 2018. In certain cases, a surviving spouse may use a deceased spouse's unused exclusion amount. While transfers between spouses generally are not taxable, a transfer at death to a noncitizen surviving spouse will be taxed unless it is made to a special "qualified domestic trust".

The GST tax also applies to so-called generation-skipping transfers at a rate of up to 40%. A separate GST exemption amount, which is equal to the gift and estate tax exclusion amount, may be applied to shelter transfers from the GST tax. The GST exemption is not transferable between spouses.

The income tax basis of inherited property is typically adjusted to its value as of the original owner's death. The effect is that appreciated property can generally pass to heirs at death with a "stepped-up" income tax basis, and can later be sold without recognizing capital gain on the appreciation that occurred during the previous owner's life.

House proposal. The draft House bill would fully repeal the federal estate and GST taxes after a six-year period. During that transition period – that is, for estates of individuals dying and transfers made on or after January 1, 2018 but on or before December 31, 2023 – the gift and estate tax exclusion would be doubled to $11.2 million per person (as adjusted each year for inflation). The GST exemption would similarly be doubled. Other aspects of the current law would remain in effect during the transition period.

Under the House proposal, the federal estate and GST tax would be fully repealed for individuals dying and transfers made on or after January 1, 2024. The federal gift tax, however, would remain in effect with the doubled exclusion amount ($11.2 million, as adjusted for inflation) and a maximum rate of 35%. In connection with the repeal of the federal estate and GST tax, the tax imposed on the assets of qualified domestic trusts would be eliminated over time as well.

Prior estate tax repeal efforts, when eliminating the estate tax, typically also proposed substantially eliminating the basis adjustment for inherited property. The House proposal would instead preserve the basis adjustment that exists under current law – even for deaths occurring after January 1, 2024 – so that heirs could inherit appreciated property free of federal estate tax and with a "stepped-up" income tax basis.

Senate proposal. Unlike the House bill, the Senate's proposal does not contain a repeal of federal estate and GST taxes. Instead, the proposal would make permanent the changes proposed by the House to take effect during the six-year transition period beginning January 1, 2018. That is, for estates of individuals dying and transfers made on or after January 1, 2018, the gift and estate tax exclusion would be doubled to $11.2 million per person. The GST exemption similarly would be doubled. Other aspects of current law – including the 40% rate, annual inflationary adjustments to the exclusion amounts, and the basis adjustment for inherited property – would remain in effect.

The following provides a summary of these proposals as they would take effect on January 1, 2018:

	Current Law (as of January 1, 2018)	**House Proposal**	**Senate Proposal**
Gift and estate tax exclusion	$5.6 million (with inflation adjustments)	$11.2 million (with inflation adjustments) until January 1, 2024, when the estate tax is repealed; gift tax remains in effect	$11.2 million (with inflation adjustments)
GST exemption	$5.6 million (with inflation adjustments)	$11.2 million (with inflation adjustments) until January 1, 2024, when the GST tax is repealed	$11.2 million (with inflation adjustments)
Gift, estate and GST tax rate	40%	40% until January 1, 2024, when the estate and GST tax are repealed; gift tax rate is then lowered to 35%	40%
Income tax basis for inherited property	Generally adjusted to date-of-death value	Generally adjusted to date-of-death value, even after repeal of the estate tax	Generally adjusted to date-of-death value

State estate taxes. As you may know, many states, including New York, apply a separate estate tax. State estate taxes may continue to be imposed notwithstanding changes to federal tax laws. The New York estate tax exemption is currently $5,250,000 and is scheduled to increase so that it matches the federal estate tax exclusion amount for individuals dying on or after January 1, 2019. However, the New York exemption amount would not automatically increase to match any increases in the federal exclusion amount that would result from the adoption of either of these proposals.

Other tax reforms. The breadth of the proposed tax reforms goes beyond gift, estate and GST taxes. Certain income tax provisions may affect individuals and families, closely-held businesses, family trusts, foundations, and private art museums. We have not summarized those provisions here, although they too may have significant implications for estate planning and the administration of family entities.

We will continue to monitor the status of these federal tax reform efforts. If you have any questions about how these proposals could impact your family or your estate plan, please contact us.

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