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IRS on “SALT” work-arounds: not so fast!

Readers will recall that the Tax Cuts and Jobs Act is the informal name for the major tax legislation enacted on December 22, 2017 (P.L. 115-97). Among the law’s many changes are reduced individual income tax rates, from 2018 through 2025, which are partly paid for by reducing (or eliminating) various tax benefits for individuals, including what’s known as the “SALT” deduction. Thus, taxpayers who previously could deduct what was basically an unlimited amount of, say, state and local income and real property taxes, will now find the deduction capped at $10,000 (single taxpayers and married filing jointly) or $5,000 (married filing separately). (Note that taxpayers subject to the alternative minimum tax (AMT) lose the deduction since it is an “add-back” in the AMT computation.)

High-tax states, such as New York, New Jersey, Connecticut and California, are worried that the SALT limitation may prompt high-income taxpayers to head for lower-tax jurisdictions, such as Florida. To stem that feared exodus, affected states have been crafting legislative “work-arounds” for the SALT cap. Last month’s *Tax Topics* (2018-04, 04/30/18) discussed New York’s recent measures, which include a new charitable fund, to which contributions will be deductible for both federal and state purposes (according to a state summary of the law) and will generate an 85% credit against the contributor’s New York state income tax liability in the year following the contribution.

Given that capping the SALT deduction is a clear policy decision on the part of Congress *and* represents an important source of federal tax revenue, the question was not if, but when, the IRS would object to these work-arounds.

On May 23rd, the IRS made its views known, by issuing **Notice 2018-54**, which can best be described as a shot across the bow – or taxpayer, beware! The Notice states that the Treasury Department and the IRS "intend to propose regulations addressing the federal income tax treatment of certain payments made by taxpayers for which taxpayers receive a credit against their state and local taxes." The Notice describes how some state legislatures "are considering or have adopted" legislative proposals that would let taxpayers contribute to state-controlled funds (or similar structures), claim a charitable income tax deduction for the contribution, and use the resulting tax credits to reduce state or local tax liabilities.

"Despite these state efforts to circumvent the new statutory limitation on state and local tax deductions," the Notice states, "taxpayers should be mindful that federal law controls the proper characterization of payments for federal income tax purposes." The new proposed regulations "will make clear that the requirements of the Internal Revenue Code, informed by substance-over-form principles, govern the federal income tax treatment of such transfers…and will assist taxpayers in understanding the relationship between the federal charitable contribution deduction and the new statutory limitation" on the SALT deduction.

Comment. Undaunted by this Notice, the governors of New York and New Jersey promptly stated that they would continue fighting the new SALT limitation. Be that as it may, the Notice puts a damper on things, even though the new proposed regulations may not be out for some time. The point is that taxpayers are on notice: the IRS will challenge state SALT work-arounds. (Most people aren't interested in being a test case.)

"Portability" and the $10+ million exclusion

The Tax Cuts and Jobs Act doubled the gift and estate tax exclusion from $5 million, indexed for inflation, to $10 million, indexed for inflation, from 2018 through 2025. In 2018, that means that individuals can protect $11.18 million from gift and estate tax, or $22.36 million per married couple – up from the 2017 numbers of $5.49 million per individual or $10.98 million per married couple. Yet barring Congressional action, in 2026, the exclusion will revert to $5 million, indexed for inflation, or $10 million, indexed for inflation, per married couple. This larger exclusion, coupled with its uncertain longevity, complicates the decision of whether "smaller" estates should elect portability so that the predeceased spouse's unused exclusion carries over to the surviving spouse.

To explain, **"portability"** is what allows spouses to leave each other everything, and not waste any of the predeceased spouse's exclusion; to elect portability, the predeceased spouse's executor must file a "timely" estate tax return, even if a return is not otherwise required because the spouse's estate is under the "filing threshold."

Before getting into details, here's what these terms mean:

— A **"timely"** estate tax return is due within nine months of the decedent's death (or within 15 months if the executor requests a filing extension); returns filed in June 2018, for example, typically relate to people who died in September 2017.

— The **"filing threshold"** is $11.18 million in 2018 and $5.49 million in 2017. If a decedent's **"gross estate"** plus **"adjusted taxable gifts"** exceed that threshold, the decedent's executor must file an estate tax return; if the gross estate and adjusted taxable gifts don't exceed the filing threshold, the executor must file an estate tax return *only if* electing portability (merely filing the return is enough to make the election).

- The **"gross estate"** refers to everything in which the decedent had an "interest" at death, such as bank and brokerage accounts, real estate, retirement accounts, life insurance, etc.

- **"Adjusted taxable gifts"** refer to the decedent's lifetime gifts that used up some of the decedent's exclusion amount; these are usually gifts other than: a) annual exclusion gifts (in 2018, $15,000 per donee, or $30,000 if the donor's spouse agrees to split the gift), and b) direct payments of tuition, medical expenses and health insurance premiums.

The initial $5+ million exclusion ($10+ million per married couple) shielded many married couples from gift and estate tax; the doubled exclusion ($10+ million/$20+ million) shields even more couples. Accordingly, when the first spouse dies, the executor of one of these "smaller" estates may wonder if portability is really worth it. In other words, why pay for a "pure portability" estate tax return when the couple's current asset level doesn't begin to approach, say, $20+ million?

What's "right" in a given situation depends on the circumstances, of course. Yet if portability is viewed as insurance – as in, maybe you'll never need it, but if you do, you'll be glad it's there – the potential benefits could far outweigh any upfront costs.

Admittedly, it's hard to make a case for portability if Mom and Dad are both in their late 80s, with collective assets of, say, $6 million, and Dad dies this year, leaving everything to Mom. Assuming that neither of them had used any of their respective exclusions by making taxable lifetime gifts, Mom doesn't even need her $11.18 million exclusion, let alone the $22.36 million exclusion that portability would give her.

But suppose, instead, that Mom and Dad are in their early 60s or 70s, with collective assets of $8 million, including valuable real estate and an enviable portfolio – both of which could appreciate even more than they already have. If Dad dies unexpectedly this year, never having used any exclusion and leaving everything to Mom, is there really any downside to electing portability, particularly since Mom is healthy and may live a long time?

Although Mom's current $11.18 million exclusion more than covers her current assets, and a $22.36 million exclusion is well over what she needs right now, the extra gift and estate tax protection may later prove useful. What if in 2026, for example, the exclusion really does revert to $5 million, indexed for inflation? Although no one knows whether that will happen and what that $5+ million number might be, Mom (and her children) might be very happy to have Dad's unused exclusion.

The bottom line: although portability may seem unnecessary with the current $11.18 million exclusion, it still may offer (welcome) future protection.

p.s. about "basis reporting." A side benefit of the larger estate tax return filing threshold – again, $11.18 million in 2018 and $5.49 million in 2017 – has to do with mandatory "basis reporting." That is, executors of estates *over* the filing threshold must file an estate tax return (see above); within 30 days of filing that return, they also must file Form 8971 with the IRS to report the basis of most estate assets *and* give estate beneficiaries the related Schedule A, showing the basis of property they will (or may) receive from the estate. Preparing these materials can be onerous. But with fewer estates now exceeding the filing threshold (especially the 2018 threshold of $11.18 million), fewer executors will be subject to this additional reporting – which is NOT required if the estate is *under* the filing threshold and the executor is merely filing an estate tax return to elect portability. Hooray!

June 7520 rate

The June 2018 7520 rate is 3.4%, an increase of 0.20% (20 basis points) from the April 7520 rate of 3.2%. The June mid-term AFRs are also up: 2.86% (annual), 2.84% (semiannual), and 2.83% (quarterly) and 2.82% (monthly). The May mid-term AFRs were: 2.69% (annual), 2.67% (semiannual), and 2.66% (quarterly and monthly).

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