Tax Reform's Impact on Family Office Trusts & Estate Planning Strategies

TRUSTS AND ESTATE PLANNING is an essential part of any family office's wealth preservation and transfer objectives. While many of the headlines about tax reform have focused on corporate tax breaks and lost deductions, it is important for family offices to pay close attention to how the new tax law has affected their trusts and estate tax planning strategies.

Prior to the Tax Cuts and Jobs Act of 2017 (TCJA), taxpayers were able to give away roughly $5 million from their estates free from estate tax. The Act doubled this lifetime exclusion amount and adjusted it for inflation through the year 2025. Currently, the amounts are $11.4 million (individual) and $22.8 million (married couple). Family offices that take advantage of this change will not be penalized with a "claw back" trigger once the exclusion amount reverts back to $5 million in 2026.

TCJA had several changes that affect the income taxation of trusts and estates. The law limited or repealed the deduction of certain expenses by trusts and estates through 2025. For example, state and local income taxes and property taxes are maxed out for trusts and estates at $10,000.

TCJA also suspended the deduction of miscellaneous itemized deductions. While the law does not specify which expenses trusts can deduct, the IRS has indicated that future regulation guidance will clarify that costs unique to trust or estate administration are deductible, but expenses that could have been incurred by an individual are considered miscellaneous itemized deductions and not deductible. Examples of deductible costs would include tax preparation fees for trust and estate services, probate costs, appraisal fees, and certain fiduciary fees, while property insurance and maintenance, tax preparation fees for final Form 1040 or Form 709 gift tax, and other regular fees would be disallowed.

Investment advisory fees and management fees charged under the normal course of asset management are considered miscellaneous itemized deductions and are no longer deductible. Since clients often pay one bundled fee when multiple fees are billed together, tracing must be done to carve out any deductible amounts from the bundle or else allocate using a reasonable method provided by IRS regulations.

Although TCJA nixed an individual's personal and dependency exemptions for the time being, it retained the exemption for trusts of $100/$300, and $600 for estates. This is a small consolation given that the tax brackets for trusts and estates are still very compressed as compared to individual rate brackets. Trusts and estates reach the top tax rate of 37 percent (down from 39 percent) once taxable income exceeds $12,500.

Family offices that use trusts and estates to distribute income can now take advantage of one of the most significant TCJA provisions – the Section 199A deduction. Section 199A grants a deduction equal to 20% of qualified business income (QBI) to pass-through entities that are engaged in a qualified trade or business. In order to calculate this complex deduction, trusts and estates must determine a QBI limitation at the level of either the trust or estate or the beneficiary, depending on the allocation of overall income and QBI between the trust or estate and the beneficiaries. Therefore, there is interplay between the QBI calculation and taxable income of both the individual and the trust/estate. Family offices should work closely with their tax advisor to calculate QBI and determine if it would be beneficial to distribute a portion or all of income (and hence the QBI) to a beneficiary in exchange for less compressed tax brackets.

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For non-grantor trusts and estates, the QBI limitation in 2018 applies at taxable income starting at $157,500 and gets fully phased in when taxable income exceeds $207,500. For grantor trusts, Section 199A has no impact at the trust level since the individual is treated as the owner of the assets and all calculations are done at the individual level.

Now that the 2018 tax filing season is over and family offices have seen how complicated the implementation of these changes can be, it's never too early to start re-evaluating tax planning strategies to minimize tax liability and get the most benefit out of the new provisions.

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