Fiscal Cliff Redux

PG Calc Featured Article, May 2024 eRate

By Bill Laskin, PG Calc Vice President, Product Management

Fifteen years ago, articles about the "fiscal cliff" were all over the news. The "fiscal cliff" referred to the looming expiration of a basket of tax reductions that had been included in the Economic Growth and Tax Relief Reconciliation Act of 2001. To pass muster with Congressional budget rules that limited the cost of that legislation, the tax reductions were set to expire on December 31, 2010. As the sunset date grew nearer, the big question was would Congress act to extend the tax reductions or allow them to expire and revert the U.S. to a higher tax regime?

Well, here we are again.

The Tax Cuts and Jobs Act of 2017 (TCJA) included a variety of changes designed to reduce federal taxes. The most dramatic of these were a doubling of the gift, estate, and generation skipping tax exemptions and of the standard deduction. The TCJA also eliminated or limited several popular itemized deductions, such as for mortgage interest (reduced from interest on the first $1 million to interest on the first $750,000) and state and local taxes (limited to $10,000 instead of unlimited). In addition, it reduced somewhat federal income tax rates and raised the income brackets at which they kicked in. In the wake of these changes, the fraction of estates that pay federal estate tax declined from an already very low 1% to a miniscule 0.1%, and the fraction of taxpayers who itemize their deductions declined from about 30% to about 10%.

Unless Congress acts, these tax reductions will expire on December 31, 2025. Donors and their advisors are beginning to plan for this possibility.

Transfer Tax Planning

The lifetime exemption for federal gift, estate, and generation skipping taxes in 2024 is $13,610,000. If the TCJA provisions are allowed to expire, this amount will decrease to about $7 million in 2026. Advisors are beginning to urge clients with taxable estates greater than $7 million to consider taking advantage of the current generous transfer tax exemptions before they may be cut in half.

When the person dies, taxable gifts they have made during their lifetime are included in their estate when determining the estate tax. However, Treasury Regulation 20.2010-1(c) makes clear that lifetime taxable gifts are not subject to a "clawback" when the lifetime exemptions used to shelter those gifts from tax are greater than the lifetime exemption allowed when the taxpayer dies.

For example, a taxpayer who has not made taxable gifts before and gives $10 million to her children in 2024 has more than enough lifetime exemption to eliminate all gift tax. If the lifetime exemption has been reset to $7 million by the time the taxpayer dies, her estate won't owe tax on the $3 million by which her lifetime transfers exceed the lifetime exemption in place when she died. Waiting could be expensive. If she waits until 2026 or later to transfer the $10 million to her children and the lifetime exemption has been reset to $7 million in the meantime, she will need to pay a 40% gift tax on the $3 million excess, or $1.2 million (the top transfer tax bracket will remain 40% if the TCJA provisions sunset).

With respect to gift planning, a charitable lead trust may be attractive to wealthy donors who wish to lock in today's high gift tax exemption and make a generous charitable gift. For example, a donor could fund a 15-year 5% charitable lead annuity trust (CLAT) with $25 million and earn a $12,974,575 gift tax deduction (using March's IRS discount rate of 5.0%). The taxable gift would be $12,025,425, which is less than the current federal lifetime gift tax exemption, so no gift tax would be due in the year of gift, nor when the trust terminates. For this donor, the CLAT presents a tax efficient way to pass assets to loved ones and make generous contributions to one or more charities: $18.75 million over 15 years! If the donor made the same gift when the lifetime exemption was $7 million, they would owe more than $2 million in gift tax in the year of the gift.

Thinking more broadly, any time a person is discussing estate plans with their advisors is an opportunity for charity to be included in those plans.

Income Tax Planning

If the TCJA provisions expire at the end of 2025, many more donors will benefit thereafter by itemizing their deductions, including their charitable deductions. In addition, more deductions may be eligible for itemizing, including more mortgage interest and state and local taxes (SALT) over $10,000. If the SALT limitation expires at the end of 2025, donors who expect to itemize in 2026 may benefit by delaying payment of their state estimated tax payment for Q4 2025 until early 2026. Doing so could allow them to itemize that payment on their 2026 federal tax return, which could save them thousands of dollars in income tax.

While the expiration of TCJA would increase the number of itemizers, it would also resurrect a limitation on itemized deductions that may encourage donors to accelerate their charitable giving into 2025. The so-called "Pease limitation," which was eliminated by the TCJA, reduces itemized deductions for SALT, mortgage interest, charitable gifts, and certain miscellaneous deductions by 3% of the amount by which a taxpayer's adjusted gross income (AGI) exceeds a threshold amount. The Pease limitation can eliminate up to 80% of these deductions, greatly reducing their tax benefit.

An example may help. In 2017, the Pease limitation threshold was $261,500 for a single person and $313,800 for a married couple who files jointly. The threshold amounts are adjusted for inflation. If the Pease limitation is restored, the threshold for a married couple filing jointly could be $350,000 in 2026, which would cause a donor with $1 million of taxable income to lose $19,500 of their itemized deductions. If those deductions are primarily for charitable gifts, the tax benefit from making those gifts will be reduced.

From a planning perspective, when to pay one's estimated state and local taxes for Q4 2025 and whether to accelerate charitable gifts into 2025 are decisions that can be made very late in that year. Donors should be able to delay making these decisions until new tax legislation is in place for 2026 or it is clear the TCJA provisions are going to be allowed to expire.

Will History Repeat Itself?

Two weeks before the U.S. was due to go over the fiscal cliff at the end of 2010, Congress extended and expanded the tax reductions that were about to expire (see the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010). In subsequent tax acts, Congress has largely preserved or enhanced these tax reductions.

Will Congress do the same in 2025? On the one hand, it is hard for politicians to agree to raise taxes. On the other hand, the federal government is running a substantial annual deficit, which will continue unabated if the TCJA provisions are extended. Whether taxes go up, stay the same, or go down further in 2026 may largely depend on which party controls the House, the Senate, and the White House in 2025. And that is anybody's guess.

In the meantime, donors and their advisors are starting to plan for the possible expiration of some favorable tax provisions. Encourage your donors to revisit their estate plans this year to see if any changes are needed in the event transfer tax exemptions are cut in half. Of course, this is also an opportunity to encourage your donors to consider including your charity in their plans as part of their review. Take advantage of it!