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# IMPACT OF THE TAX CUTS AND JOBS ACT ON ESTATE PLANNING

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A. 2017 Law (Prior to the Act)

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2. $5 million estate, gift and GST tax exemptions, indexed for inflation after 2011 ($5.49 million in 2017). Estate and gift tax exemptions are unified.

3. $14,000 gift tax annual exclusion.

4. Exemptions and tax brackets are indexed for inflation using the standard CPI.

5. Income tax rates for estates and trusts of 15%, 25%, 28%, 33% and 39.6%, with the top rate of 39.6% applying to taxable income in excess of $12,500.

6. Miscellaneous itemized deductions under Section 67 are deductible to the extent they exceed 2% of taxpayer's adjusted gross income (AGI).

7. Top rate of 20% for long term capital gains and qualified dividends for taxpayers in the 39.6% income tax bracket.

8. Transfer tax provisions and certain income tax provisions are permanent (unless changed by future legislation).

B. What 2018 Law Would Have Been Without the Act

1. 40% top rate for estate, gift and GST taxes.

2. $5 million estate, gift and GST tax exemptions, indexed for inflation after 2011 ($5.6 million in 2018). Estate and gift tax exemptions are unified.

3. $15,000 gift tax annual exclusion.

4. Exemptions and tax brackets are indexed for inflation using the standard CPI.

5. Income tax rates for estates and trusts of 15%, 25%, 28%, 33% and 39.6%, with the top rate of 39.6% applying to taxable income in excess of $12,700.

6. Miscellaneous itemized deductions under Section 67 are deductible to the extent they exceed 2% of taxpayer's adjusted gross income (AGI).

7. Top rate of 20% for long term capital gains and qualified dividends for taxpayers in the 39.6% income tax bracket.

8. Transfer tax provisions and certain income tax provisions are permanent (unless changed by future legislation).

## II. Key Estate Planning Provisions of the Act

A. Transfer Tax Provisions

1. Maintains a 40% top rate for estate, gift and GST taxes.

2. $10 million estate, gift and GST tax exemptions, indexed for inflation after 2011 (projected to be $11.18 million in 2018) for estates of decedents dying, and gifts made, after 2017 and before 2026. Estate and gift tax exemptions are unified.

3. Gift tax annual exclusion amount is yet to be determined, but projected to be $15,000.

4. Exemptions and tax brackets are indexed for inflation using the Chained CPI instead of the standard CPI, which results in slightly slower growth in exemptions and rate brackets.

5. Maintains the portability of unused estate tax exemption between spouses. Unused GST tax exemptions still are not portable.

6. The increased exemptions "sunset" after 2025. Therefore, estate, gift and GST tax exemptions in 2026 would revert to an amount equal to $5 million indexed for inflation after 2011. Some have estimated that, assuming the sunset occurs, the exemptions in 2026 would be about $6.75 million per person.

7. “Clawback” becomes an issue because exemptions will be lower in 2026 (and subsequent years) than they were in 2018-2025. The phrase “clawback” refers to the possibility that taxpayers who make gifts between 2018-2025 to utilize their increased gift tax exemption may have to pay additional estate tax when they die if the estate tax exemption amount in effect at the time of their death (after 2025) is less than at the time the gift was made. In other words, there may be a “clawback” of the prior gift. As part of the Act, Congress amended Code § 2001(g) and directed Treasury to issue regulations addressing the effect of a reduction in exemptions.

8. Similar to the clawback issue is what happens with unused deceased spousal unused exemption (“DSUE”) if the surviving spouse has not used it by 2026 when the increased exemptions sunset.

B. Relevant Income Tax Provisions

1. Income tax rates for estates and trusts of 10%, 24%, 35% and 37%, with the top rate of 37% applying to taxable income in excess of $12,500 for 2018.

2. Top rate of 20% for long term capital gains and qualified dividends for taxpayers applies to income in excess of $12,700 in 2018. It is unclear why the top capital gains rate applies at $12,700 of taxable income, but the top income tax rate applies at $12,500 of taxable income.

3. Miscellaneous itemized deductions under Section 67 are disallowed for 2018-2025.

4. $10,000 limitation on deducting state and local taxes applies to estates and trusts, except to the extent such taxes consist of property taxes that are paid or accrued in carrying on a trade or business.

5. For life settlements of life insurance policies, the selling taxpayer’s basis in the policy is not reduced by the cost of insurance component, which reverses the IRS position in Rev. Rul. 2009-13. However, reporting requirements were added for “reportable policy sales” which is defined as the sale of a policy to someone who has no substantial family, business or financial relation with the insured apart from the acquisition of the policy. Further, none of the transfer for value exceptions under Code § 101 apply to reportable policy sales, thus resulting in ordinary income treatment for insurance proceeds paid out on death.

6. Electing Small Business Trusts (ESBTs)

   a. Nonresident aliens now qualify as “potential current beneficiaries.”

b. Charitable deduction for ESBTs is now determined under Code § 170 limitations rather than Code § 642(c) requirements. Previously under Code § 642(c), a charitable contribution was only deductible to the extent it was paid from gross income and required by the terms of the trust. Further, excess charitable contributions could not be carried over under prior law.

c. Sunset does not apply to ESBT changes.

7. Roth Recharacterizations

a. Under the Act, an individual may still make a contribution to a traditional IRA and convert the traditional IRA to a Roth IRA. An individual may also make a contribution for a year to a Roth IRA and, before the due date for the individual's income tax return for that year, recharacterize it as a contribution to a traditional IRA (e.g., if an individual exceeded the $118,000 AGI threshold for a contribution to a Roth IRA, the individual would be permitted to recharacterize the contribution as having been made to a traditional IRA). However, under the Act, recharacterizations cannot be used to unwind a Roth conversion. In other words, once a traditional IRA is converted to a Roth IRA, the funds cannot be re-characterized back to a traditional IRA if the Roth IRA declines in value.

8. Alimony Payments are No Longer Deductible

a. Alimony payments made pursuant to a divorce or separation instrument *executed after December 31, 2018* will no longer be deductible by the payor spouse, nor will they be includible in the income of the payee spouse.

(1) This new rule of non-deductibility will also apply to a divorce or separation instrument executed on or before December 31, 2018 *if the instrument is modified or amended after such date to expressly provide that the new law shall apply.*

(2) In addition, Code § 682 is repealed for any divorce or separation instrument executed after December 31, 2018. Section 682 provided a mechanism for alimony to be satisfied through a trust arrangement. Specifically, Code § 682 provided that if one spouse created a grantor trust for the benefit of the other spouse, then following the divorce, the trust income would not be taxed to the grantor-spouse under the grantor trust rules to the extent of any fiduciary

accounting income that the donee-spouse is entitled to receive.

C. “Hot topics” in estate planning that were not included in the Act

1. Estate and gift tax repeal.

2. Modification of rules on valuation discounts

a. Revise Code § 2704 to add additional category of applicable restrictions that would be disregarded in valuing transferred assets.

b. In 2017, the IRS withdrew the proposed regulations that were issued in August 2016.

3. Limitations on Grantor Retained Annuity Trusts (GRATs)

a. 10 year minimum term; maximum term of grantor’s life expectancy plus 10 years.

b. Value of remainder interest must be greater than zero.

c. Annuity amount cannot decrease during GRAT term.

4. 90 year limitation on GST exemption

a. On the 90th anniversary of the creation of the trust, the inclusion ratio would be increased to 1, effectively making all generation-skipping transfers from the trust thereafter subject to GST tax.

5. 5 year mandatory payout period for designated beneficiaries on retirement accounts.

6. Inclusion of grantor trusts in grantor’s gross estate

a. If a trust is a grantor trust, then (i) assets would be includible in grantor’s gross estate for estate tax purposes, (ii) distributions from the trust would be treated as gifts and (iii) conversion to non-grantor trust status would be treated as a gift.

b. Same rules would apply to 678 trusts if the deemed owner sells assets to the trust (which could be intended to limit the use of Beneficiary Defective Trusts (BDITs)).

## III. Changes Affecting the Taxation of Estates and Trusts

### A. Change in Income Tax Brackets and Rates of Estates and Trusts[1]

| **Bracket** | **2017 Rate** | **2018 Rate** |
|---|---|---|
| Not over $2,550 | 15% | 10% |
| $2,550 - $6,000<br><br>$6,000 - $9,150 | $382.50 + 25%<br><br>$1,245 + 28% | $255 + 24% |
| $9,150 - $12,500 | $2,127 + 33% | $1,839 + 35% |
| Over $12,500 | $3,232.50 + 39.6% | $3,011.50 + 37% |

### B. Suspension of Miscellaneous Itemized Deductions for Taxable Years Beginning in 2018 Through 2025[2]

1. The Act adds new Code § 67(g).

   (g) SUSPENSION FOR TAXABLE YEARS 2018 THROUGH 2025. – Notwithstanding subsection [67](a), no miscellaneous itemized deduction shall be allowed for any taxable year beginning after December 31, 2017, and before January 1, 2026.

   Section 67(a) provides that "miscellaneous itemized deductions" may be deducted only to the extent they exceed 2% of a taxpayer's adjusted gross income (AGI). Miscellaneous itemized deductions are all itemized deductions other than those specifically listed in Code § 67(b).

2. Itemized Deductions.

   63(d) ITEMIZED DEDUCTIONS.— For purposes of this subtitle, the term "itemized deductions" means the *<u>deductions</u>* allowable under this chapter *<u>other than</u>*—

   **(1)** *<u>the deductions allowable in arriving at adjusted gross income [i.e. above the line deductions]</u>*,
   **(2)** the deduction for personal exemptions provided by section 151, and
   **(3)** the deduction provided in section 199A.

3. *Exclusions From Miscellaneous Itemized Deductions.* The items listed in Code § 67(b) that often apply to estates and trust include deductions for

[1] Code § 1(j)(2)(E); Sec. 11001 of the Act.
[2] Sec. 11045 of the Act added new Code § 67(g).

payment of interest, taxes, charitable contributions, and estate tax attributable to income in respect of a decedent (under Code § 691(c)). While the items listed in Code § 67(b) still are deductible, the deductions for certain items are subject to limitations, some of which existed under prior law and some of which were added by the Act.

67(b) MISCELLANEOUS ITEMIZED DEDUCTIONS. — For purposes of this section, the term "*miscellaneous itemized deductions*" means the *itemized deductions other than*—
**(1)** the deduction under section 163 (relating to *interest*),
**(2)** the deduction under section 164 (relating to *taxes*),
**(3)** the deduction under section 165(a) for casualty or theft losses described in paragraph (2) or (3) of section 165(c) or for losses described in section 165(d),
**(4)** the deductions under section 170 (relating to charitable, etc., contributions and gifts) and section 642(c) (*relating to deduction for amounts paid or permanently set aside for a charitable purpose*),
**(5)** the deduction under section 213 (relating to medical, dental, etc., expenses),
**(6)** any deduction allowable for impairment-related work expenses,
**(7)** the deduction under section 691(c) (*relating to deduction for estate tax in case of income in respect of the decedent*),
**(8)** any deduction allowable in connection with personal property used in a short sale,
**(9)** the deduction under section 1341 (relating to computation of tax where taxpayer restores substantial amount held under claim of right),
**(10)** the deduction under section 72(b)(3) (relating to deduction where annuity payments cease before investment recovered),
**(11)** the deduction under section 171 (relating to deduction for amortizable bond premium), and
**(12)** the deduction under section 216 (relating to deductions in connection with cooperative housing corporations).

4. *Examples of Miscellaneous Itemized Deductions.* The Joint Explanatory Statement of the House and Senate Conference Committee provides the following list of items subject to the aggregate 2% floor under Code § 67(a) that may not be deducted for taxable years beginning in 2018-2025:

**Expenses for the production or collection of income**

-Appraisal fees for a casualty loss or charitable contribution;
-Casualty and theft losses from property used in performing services as an employee;
-Clerical help and office rent in caring for investments;
-Depreciation on home computers used for investments;
-*Excess deductions (including administrative expenses) allowed a beneficiary on termination of an estate or trust [642(h)(2)];*
-Fees to collect interest and dividends;
-Hobby expenses, but generally not more than hobby income;
-Indirect miscellaneous deductions from pass-through entities;

-Investment fees and expenses;
-Loss on deposits in an insolvent or bankrupt financial institution;
-Loss on traditional IRAs or Roth IRAs, when all amounts have been distributed;
-Repayments of income;
-Safe deposit box rental fees, except for storing jewelry and other personal effects;
-Service charges on dividend reinvestment plans; and
-Trustee's fees for an IRA, if separately billed and paid.

**Tax preparation expenses**

**Other miscellaneous itemized deductions subject to the two-percent floor**

-Repayments of income received under a claim of right (only subject to the two percent floor if less than $3,000);
-Repayments of Social Security benefits; and
-The share of deductible investment expenses from pass-through entities.

C. Income Taxation of Estates and Trusts

1. *Tax Provisions for Individuals Generally Apply to Trusts.* Code § 641(b) provides, in part, that "[t]he taxable income of an estate or trust shall be computed in the same manner as in the case of an individual, except as otherwise provided in this part.

2. Deduction in Lieu of Personal Exemption

a. *Estates and Most Trusts.* In lieu of the deduction for personal exemption, under Code § 642(b) an estate is allowed a deduction of $600, a complex trust is allowed a deduction of $100, and a simple trust (required to distribute all of its income currently) is allowed a deduction of $300. These deductions in lieu of the personal exemption are not affected and are not indexed for inflation.

b. *Qualified Disability Trusts.* A "qualified disability trust" is allowed a deduction equal to the personal exemption of an individual. During the period the personal exemption for individuals is suspended (i.e., 2018-2025), Section 11041 of the Act adds new Code § 642(b)(2)(C)(iii) to allow a deduction of $4,150, indexed for inflation, for qualified disability trusts.

3. *Determination of Adjusted Gross Income of Estates and Trusts.* The adjusted gross income of the estate or trust is computed in the same manner as an individual, with two exceptions under Code § 67(e).

67(e) DETERMINATION OF ADJUSTED GROSS INCOME IN CASE OF ESTATES AND TRUSTS.—For purposes of this section, the *adjusted gross income* of an estate or trust shall be *computed in the same manner as in the case of an individual, except that*—

**(1)** the deductions for costs which are paid or incurred in connection with the administration of the estate or trust and which would not have been incurred if the property were not held in such trust or estate, and
**(2)** the deductions allowable under sections 642(b), 651, and 661,

*shall be treated as allowable in arriving at adjusted gross income [i.e., above the line deductions]*. Under regulations, appropriate adjustments shall be made in the application of part I of subchapter J of this chapter to take into account the provisions of this section.

*Are deductions under Code § 67(e) suspended by Code § 67(g)?* The argument is that new Code § 67(g) states that "[n]otwithstanding subsection [67](a), no miscellaneous itemized deduction shall be allowed for any taxable year beginning after December 31,2017, and before January 1, 2026." Miscellaneous itemized deductions are all itemized deductions other than those specifically listed in Code § 67(b), and executor and trustee fees and most other estate and trust administration expenses are not listed in Code § 67(b).

a. *Costs Incurred in Connection with the Administration of the Estate or Trust*. The deductions for costs paid or incurred in connection with the administration of the estate or trust and which would not have been incurred if the property were not held in such trust or estate are not itemized deductions, because they are specifically allowed in arriving at adjusted gross income under Code § 67(e)(1), therefore, they are not itemized deductions and cannot be miscellaneous itemized deductions.

Executor and trustee fees and other estate and trust administration expenses are deductible under Code § 67(e) to the extent that they satisfy the requirement of being expenses that "would not have been incurred if the property were not held in such trust or estate." Deductions for administrations costs still must meet the existing requirements under *Knight v. Comm'r.*, 128 S.Ct. (2008) and Treas. Reg. § 1.67-4.

(1) The *Knight* Case. In *Knight*, a case involving investment advisory fees, the Supreme Court interpreted Code § 67(e)(1) to mean that fees incurred in connection with the administration of a trust were not miscellaneous itemized deductions subject to the 2% floor only to the extent they are not commonly or customarily incurred by individuals.

(2) *Treas. Reg. § 1.67-4.* Subsequent to the *Knight* case, the IRS promulgated regulations, which provide as follows:

**(a)** ***In general*.—** Section 67(e) provides an exception to the 2-percent floor on miscellaneous itemized deductions for costs that are paid or incurred in connection with the administration of an estate or a trust not described in § 1.67-2T(g)(1)(i) (a non-grantor trust) and that would not have been incurred if the property were not held in such estate or trust. A cost is subject to the 2-percent floor to the extent that it is included in the definition of miscellaneous itemized deductions under section 67(b), is incurred by an estate or non-grantor trust, and commonly or customarily would be incurred by a hypothetical individual holding the same property.
**(b)** ***"Commonly" or "Customarily" Incurred***
**(1)** ***In general*.—** In analyzing a cost to determine whether it commonly or customarily would be incurred by a hypothetical individual owning the same property, it is the type of product or service rendered to the estate or non-grantor trust in exchange for the cost, rather than the description of the cost of that product or service, that is determinative. In addition to the types of costs described as commonly or customarily incurred by individuals in paragraphs (b)(2), (3), (4), and (5) of this section, costs that are incurred commonly or customarily by individuals also include, for example, costs incurred in defense of a claim against the estate, the decedent, or the non-grantor trust that are unrelated to the existence, validity, or administration of the estate or trust.
**(2)** ***Ownership costs*. —** Ownership costs are costs that are chargeable to or incurred by an owner of property simply by reason of being the owner of the property. Thus, for purposes of section 67(e), ownership costs are commonly or customarily incurred by a hypothetical individual owner of such property. Such ownership costs include, but are not limited to, partnership costs deemed to be passed through to and reportable by a partner if these costs are defined as miscellaneous itemized deductions pursuant to section 67(b), condominium fees, insurance premiums, maintenance and lawn services, and automobile registration and insurance costs. Other expenses incurred merely by reason of the ownership of property may be fully deductible under other provisions of the Code, such as sections 62(a)(4), 162 [trade or business expenses], or 164(a) [taxes], which would not be miscellaneous itemized deductions subject to section 67(e).
**(3)** ***Tax preparation fees*. —** *<u>Costs relating to all estate and generation-skipping transfer tax returns, fiduciary income tax returns, and the decedent's final individual income tax returns are not subject to the 2-percent floor</u>*. The costs of preparing all other tax returns (for example, gift tax returns) are costs commonly and customarily incurred by individuals and thus are subject to the 2-percent floor.
**(4)** ***Investment advisory fees*. —** Fees for investment advice (including any related services that would be provided to any individual investor as part of an investment advisory fee) are incurred commonly or customarily by a hypothetical individual investor and therefore are subject to the 2-percent floor. However, *<u>certain incremental costs of investment advice beyond the amount that normally would be charged to an individual investor are not subject to the 2-percent floor</u>*. For this purpose, such an incremental cost is a special, additional charge that is added solely because the investment advice is rendered to a trust or estate rather than to an individual or attributable to an unusual investment objective or

the need for a specialized balancing of the interests of various parties (beyond the usual balancing of the varying interests of current beneficiaries and remaindermen) such that a reasonable comparison with individual investors would be improper. *The portion of the investment advisory fees not subject to the 2-percent floor by reason of the preceding sentence is limited to the amount of those fees, if any, that exceeds the fees normally charged to an individual investor*.

**(5) *Appraisal fees*. —** *Appraisal fees incurred by an estate or a non-grantor trust to determine the fair market value of assets as of the decedent's date of death (or the alternate valuation date), to determine value for purposes of making distributions, or as otherwise required to properly prepare the estate's or trust's tax returns, or a generation-skipping transfer tax return, are not incurred commonly or customarily by an individual and thus are not subject to the 2-percent floor*. The cost of appraisals for other purposes (for example, insurance) is commonly or customarily incurred by individuals and is subject to the 2-percent floor.

**(6) *Certain Fiduciary Expenses*. —** *Certain other fiduciary expenses are not commonly or customarily incurred by individuals, and thus are not subject to the 2-percent floor. Such expenses include without limitation the following: probate court fees and costs; fiduciary bond premiums; legal publication costs of notices to creditors or heirs; the cost of certified copies of the decedent's death certificate; and costs related to fiduciary accounts*.

**(c) *Bundled fees***

**(1) *In general*.—** If an estate or a non-grantor trust pays a single fee, commission, or other expense (such as a fiduciary's commission, attorney's fee, or accountant's fee) for both costs that are subject to the 2-percent floor and costs (in more than a de minimis amount) that are not, then, except to the extent provided otherwise by guidance published in the Internal Revenue Bulletin, the single fee, commission, or other expense (bundled fee) must be allocated, for purposes of computing the adjusted gross income of the estate or non-grantor trust in compliance with section 67(e), between the costs that are subject to the 2-percent floor and those that are not.

**(2) *Exception*. —** If a bundled fee is not computed on an hourly basis, only the portion of that fee that is attributable to investment advice is subject to the 2-percent floor; the remaining portion is not subject to that floor.

**(3) *Expenses Not Subject to Allocation*. —** Out-of-pocket expenses billed to the estate or non-grantor trust are treated as separate from the bundled fee. In addition, payments made from the bundled fee to third parties that would have been subject to the 2-percent floor if they had been paid directly by the estate or non-grantor trust are subject to the 2-percent floor, as are any fees or expenses separately assessed by the fiduciary or other payee of the bundled fee (in addition to the usual or basic bundled fee) for services rendered to the estate or non-grantor trust that are commonly or customarily incurred by an individual.

**(4) *Reasonable Method*. —** Any reasonable method may be used to allocate a bundled fee between those costs that are subject to the 2-percent floor and those costs that are not, including without limitation the allocation of a portion of a fiduciary commission that is a bundled fee to investment advice. Facts that may be considered in determining whether an allocation is reasonable include, but are not limited to, the percentage of the value of the corpus subject to investment advice, whether a third party advisor would have charged a comparable fee for similar advisory services, and the amount of the fiduciary's attention to the trust

or estate that is devoted to investment advice as compared to dealings with beneficiaries and distribution decisions and other fiduciary functions. The reasonable method standard does not apply to determine the portion of the bundled fee attributable to payments made to third parties for expenses subject to the 2-percent floor or to any other separately assessed expense commonly or customarily incurred by an individual, because those payments and expenses are readily identifiable without any discretion on the part of the fiduciary or return preparer.
**(d)** ***Effective/applicability date*****. —** This section applies to taxable years beginning after December 31, 2014.

b. *Deductions Allowable Under Code Sections 642(b), 651, and 661.* To say that new Code § 67(g) suspends deductions Code § 67(e) would suggest that it suspends not only Code § 67(e)(1), but also Code § 67(e)(2), which addresses Code § 642(b) (the deduction in lieu of personal exemption), Code § 651 (distribution deduction for simple trusts), and Code § 661 (distribution deduction for complex trusts). If the argument is true, then it would result in the illogical conclusion that Code § 642(b) is overridden although another provision of the Act provide expanded relief under Code § 642(b)(2)(C) by increasing the deduction in lieu of a personal exemption for qualified disability trusts. It also would mean that trusts and estates would not be entitled to distribution deductions (which would completely overturn the basic premise of the income taxation of trusts and estates since 1954).

Moreover, Code § 67(e) states that the deductions described therein are deductible in arriving at adjusted gross income (i.e., above the line deductions) and, therefore are not itemized deductions under Code § 63(d)(1).

D. Excess Deductions or Losses at Termination of Estate or Trust. Code § 642(h) provides that on the termination of an estate or trust (1) a net operating loss or capital loss carryover and (2) deductions in excess of gross income shall be allowed as a deduction to the beneficiaries succeeding to the property of the estate or trust.

642(h) UNUSED LOSS CARRYOVERS AND EXCESS DEDUCTIONS ON TERMINATION AVAILABLE TO BENEFICIARIES. — If on the termination of an estate or trust, the estate or trust has—

**(1)** a net operating loss carryover under section 172 or a capital loss carryover under section 1212, or
**(2)** for the last taxable year of the estate or trust deductions (other than the deductions allowed under subsections (b) [deduction in lieu of personal exemption] or (c) [charitable deduction]) in excess of gross income for such year,

then such carryover or such excess shall be allowed as a deduction, in accordance with regulations prescribed by the Secretary, to the beneficiaries succeeding to the property of the estate or trust.

A trust generally will be considered as having terminated when it has distributed all of the property it holds to the persons entitled to succeed to the property, except that the trust may retain a reasonable amount for the payment of unascertained or contingent liabilities and expenses. Treas. Reg. § 1.641(b)-3.

1. *Net operating Losses and Capital Loss Carryovers*. Net operating losses carryovers under Code § 172 and capital loss carryovers under Code § 1212 are not itemized deductions, rather they are reductions in arriving at the total income of the estate or trust before any deductions are taken. Beneficiaries succeeding to the property of the estate or trust will continue to be able to take these items into account in computing their income.

2. *Deductions in Excess of Gross Income in the Final Taxable Year*. Deductions in excess of gross income in the final taxable year of an estate or trust are itemized deductions because they are not deductible by the beneficiaries in arriving at their adjusted gross income. They are miscellaneous itemized deduction, because they are not listed as exceptions in Code § 67(b). Thus, Code § 67(g) prevents their deduction for taxable years beginning in 2018-2025.

   The Joint Explanatory Statement specifically includes "[e]xcess deductions (including administrative expenses) allowed a beneficiary on termination of an estate or trust" in the list of deductions suspended by Code § 67(g).

3. Planning Considerations.

   a. *Timing of Termination.* Fiduciaries need to be cognizant of whether an estate or trust might have deductions in excess of gross income in determining the timing of payment of certain deductible expenses and termination of the estate or trust.

   b. *Professional Fees.* Attorneys and other professionals representing fiduciaries should bill separately for services rendered in respect to estates and related trusts and give careful consideration to which fees are property allocable to a terminating estate or trust and a continuing trust.

   c. *Decanting.* Fiduciaries need to be cognizant of whether an estate or trust might have deductions in excess of gross income in determining the timing of decanting a trust in situations in which the second trust will be a separate taxpayer and the decanting treated as a distribution from the first trust to the second trust; e.g., situations in which the first trust is decanted to a second trust funded by someone other than the settlor of the first trust.

E. Deduction for Estate Tax Attributable to Income In Respect of a Decedent. The deduction under Code § 691(c) for estate tax attributable to an item of income in respect of a decedent included in gross income by a taxpayer is not a miscellaneous itemized deduction and continues to be deductible, because it is listed as an exception in Code § 67(b)(7).

F. $10,000 Limitation on State and Local Taxes Applies to Estates and Trusts[3]

1. *SALT Deductions*. New Code § 164(b)(6) suspends the deduction for foreign real property taxes not incurred in a trade or business and limits the deduction for the aggregate amount of the following taxes not incurred in a trade or business to $10,000: (1) state and local real property taxes; (2) state and local personal property taxes; (3) state and local, and foreign, income, war profits and excess profits taxes; and (4) state and local sales tax. The taxes other than the foreign real property taxes are referred to as the state and local tax (SALT) deductions.

   The Joint Explanatory Statement confirms that the $10,000 SALT limitation applies to estates and trusts by virtue of Code § 641(b) (which provides that the taxable income of an estate or trust is computed in the same manner as an individual, except as otherwise provided) in footnote 171 on page 80.

2. *Planning Considerations.* There may be a benefit to creating multiple trusts, each of which would be subject to a separate $10,000 SALT deduction limit (as well as, a separate deduction in lieu of personal exemption and separate run up the income tax brackets). Care must be taken, however, to avoid the anti-abuse provisions for multiple trusts under Code § 643(f).

   643(f) TREATMENT OF MULTIPLE TRUSTS. — For purposes of this subchapter, under regulations prescribed by the Secretary, 2 or more trusts shall be treated as 1 trust if—

   **(1)** such trusts have substantially the same grantor or grantors and substantially the same primary beneficiary or beneficiaries, *<u>and</u>*
   ***<u>(2)</u>*** *<u>a principal purpose of such trusts is the avoidance of the tax imposed by this chapter.</u>*
   For purposes of the preceding sentence, a husband and wife shall be treated as 1 person.

   It is necessary for separate trusts to have different settlors, beneficiaries or terms, or not be established for income tax avoidance, in order to avoid Code § 643(f). *Boyce v. U.S.*, 190 F.Supp. 950 (5th Cir. 1961); PLR

[3] Sec. 11042 of the Act added new Code § 164(b)(6).

199912034. Although the provision regarding multiple trusts was added to the Code in 1984, no Regulations have been issued.

G. Alternative Minimum Tax Exemption and Phase-out Thresholds.[4] The Act increases the AMT exemptions and phase-out thresholds for individuals, but not for trusts and estates. Due to the change in the method of computing inflation adjustments, the AMT exemption amount and phase-out threshold for trusts and estates likely will be slightly lower than the amounts previously announced for 2018; i.e., $24,600 and $82,050, respectively.

H. Electing Small Business Trusts ("ESBT")

1. Non-*resident Alien can be a Potential Current Beneficiary of an ESBT.*[5] The Act amends the provision that provides that each potential current beneficiary of an ESBT shall be treated as a shareholder of an S Corporation to provide that it shall not apply in determining whether an S Corporation has a non-resident alien as a shareholder.

2. *Charitable Deduction of an ESBT Determined Under Code § 170 and No Longer Under Code § 642(c).*[6] The charitable contributions deduction for trusts is governed by Code § 642(c) rather than Code § 170, which governs the charitable deduction for individuals. Some restrictions that are imposed by Code § 642(c), but not by Code § 170 include: (1) distribution must be made from gross income (*Green v. U.S.*, 2018-1 U.S.T.C. ¶50,126 (10th Cir. 2018)) and pursuant to the terms of the governing instrument (CCA 201747005, August 14, 2017) and (2) no carryover of excess contributions is allowed for trusts. The Act provides that the charitable contribution deduction of the portion of an ESBT holding S Corporation stock is determined by the rules applicable to individuals under Code § 170, not the rules applicable to trusts under Code § 642(c), effective for taxable years beginning after 2017.

a. *Potential Benefits.* Elimination of the requirement that charitable gifts must be made from gross income will allow charitable deductions for gifts of property, the same as for individuals. The governing instrument requirement will no longer apply. Excess charitable deductions can be carried forward for five years.

b. *Potential Detriments.* The percentage limitations applicable to individuals will apply to charitable contributions made by the portion of an ESBT holding S Corporation stock. The substantiation requirements that apply to individuals under Code § 170 also will be applicable to charitable contributions from an ESBT.

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[4] Sec. 12003 of the Act left Code § 55(d)(1)(D) unchanged and added new Code § 55(d)(4)(A)(ii)(III).
[5] Section 13541 of the Act amended Code § 1361(c)(2)(B)(v).
[6] Sec.13542 of the Act added new Code § 641(c)(2)(E).

c. *No Sunset.* The changes described for ESBTs are permanent and do not sunset after 2025.

## IV. Impact of the Act on Existing Estates and Trusts: What You Should Be Doing Now.

A. Review Structure of Revocable Trusts and Wills

1. Does the formula clause for estate and/or GST tax exemptions used in the Will or Trust of an individual or individual's spouse need to be revised?

a. Revocable trusts and wills often contain formula clauses that divide assets based upon the remaining estate or GST tax exemptions of the taxpayer at death. Given the drastic increase in exemptions, consider whether the formula clause still accomplishes the taxpayer's intent.

b. Example: Assume the settlor's revocable trust provides for an amount equal to the settlor's remaining estate tax exemption to pass to a family trust for the benefit of the settlor's surviving spouse and descendants, with the balance passing to a marital trust that is solely for the benefit of the surviving spouse. As a result of the Act, the amount passing to the marital trust just decreased by up to $5.6 million in 2018, which may eliminate a large portion or all of the marital trust that was intended to be left for the sole benefit of the surviving spouse. While the surviving spouse is still a beneficiary of the family trust, he or she may not like the idea of the children having an opinion on the distribution of funds that the spouse was planning to have sole authority over.

c. Example: Assume the settlor's revocable trust provides for a gift of the settlor's remaining GST exemption to trusts for grandchildren, with the balance distributable to the settlor's children in trust. As a result of the Act, the amount of the gift made in trust for grandchildren increases by approximately $5.6 million. This may or may not be consistent with the settlor's intent, especially if either (i) the settlor had used up most of his or her GST exemption during life and was only anticipating a small amount of remaining GST exemption to pass to his grandchildren, or (ii) the increased amount passing GST exempt to the grandchildren consumes most or all of the inheritance that was intended to pass as the non-exempt share to the children.

B. Review Existing Irrevocable Trusts

1. As a result of the increased estate tax exemptions under the Act, consider whether assets held in trust should be distributed to a beneficiary or the trust should be modified to cause inclusion in the beneficiary's gross

estate to obtain a basis step-up for appreciated assets (e.g., add a testamentary general power of appointment).

2. As a result of the increased GST tax exemptions under the Act, consider whether assets held in trust should be distributed to a beneficiary or the trust should be modified to cause inclusion in the beneficiary's gross estate so that the beneficiary can allocate additional GST tax exemption to assets transferring upon his or her death. It is possible that assets held in trust will incur a GST tax upon the death of a beneficiary which could have been avoided if the trust was modified to instead have the assets includible in the beneficiary's gross estate.

   a. Example: Assume $5 million of assets are held in a GST non-exempt irrevocable trust that provides for distributions to be made to or for the benefit of the settlor's child, C, and at C's death, the remaining assets shall be distributed outright to C's issue. Assume further that C dies having $6 million of his own assets.

      (1) At C's death, a generation-skipping transfer (i.e., a taxable termination) will occur.

      (2) Prior to the Act, if the trust was left "as is" then a GST tax at the rate of 40% would be due at C's death on the trust assets, but no estate tax would be due. Alternatively, if the trust was modified prior to C's death to be includible in C's gross estate then an estate tax at the rate of 40% would be due, but no GST tax would be due. Thus, the transfer tax liability upon C's death would be the same regardless of whether the irrevocable trust was left as is or modified.

      (3) Under the Act, a GST tax at the rate of 40% will still be due on the trust assets if the trust is left as is because C's increased GST exemption cannot be applied to the transfer since C was not the transferor of the assets. However, all estate and GST tax can be avoided by modifying the trust terms to have the assets includible in C's gross estate for estate tax purposes (thereby taking advantage of C's extra $5.6+ million of estate tax exemption). Further, once the assets are includible in C's gross estate, C becomes the transferor for GST purposes and can allocate his extra $5.6± million GST exemption to them.

3. Caution: When making the decision to modify trusts to cause inclusion of trust assets at the beneficiary's death for estate or GST purposes, consider that the exemptions are currently scheduled to decreased in 2026. Thus, this planning will not work if the beneficiary survives until the date that the exemptions decrease. For beneficiaries who are likely to survive the

sunset, it may be prudent to adopt a wait and see approach before implementing trust modifications to see if the sunset is likely to occur or if the increased exemptions are likely to be extended by future legislation. However, for trusts with aging or ailing beneficiaries who are unlikely to survive until the sunset (or possible earlier repeal) of the increased exemptions, it may not be prudent to wait to implement changes. The decision to distribute assets or modify a trust for the tax reasons described in 1 and 2 above becomes much easier if the beneficiary is virtually certain to die before the exemptions decrease.

4. Consider converting a grantor trust to a non-grantor trust

   a. Grantor trusts are trusts that are structured to shift the liability for the payment of tax on the trust income to the grantor rather than the trust. This is often used when the grantor's estate is large enough that the grantor will be subject to estate tax and the grantor wants to spend down his or her taxable assets for the benefit of the trust beneficiaries. With an additional estate tax exemption of approximately $11.18 million for a couple, it may no longer be necessary to spend the grantor's assets on the tax liability for trust income as a means to reduce estate tax. The grantor may prefer to turn off the grantor trust status of the trust (in order to shift the liability for the tax to the trust), at least until the increased exemptions sunset.

   b. Further, converting to a non-grantor trust will create a separate taxpayer that may expand the available deductions. For example, assume an individual pays $10,000 of property taxes on his or her personal residence and an irrevocable trust created by the individual pays $10,000 of state income taxes. If the trust is a grantor trust as to the individual, then the individual may only deduct $10,000 of $20,000 total taxes paid. If, however, the trust is a non-grantor trust, then each of the individual and the trust should be able to deduct $10,000 on their respective returns.

   c. Caution: Converting a grantor trust to a non-grantor trust may not be as simple as releasing a power of substitution or other Code § 675 power. Code § 674 can be difficult to overcome depending on the terms of the trust and who is serving as trustee.

   d. Caution: Converting a grantor trust to a non-grantor trust can also have income tax consequences because the conversion is effectively treated *for income tax purposes* as the grantor transferring assets to the trust at the moment of conversion. Rev. Rul. 77-402; Treas. Reg. § 1.1001-2(c), ex. 5.

C. Analyze the Tax Year Options for Current Estate Administrations

1. Estates have the option to elect a fiscal tax year in lieu of a calendar year.

2. The first tax year of an estate may be less than 12 months.

3. Fiscal year election is made on the first filed return, even if it's a late return. Tax years indicated on a Form SS-4 are not binding. Further, the filing for an automatic extension of time to file does not establish a tax year. Treas. Reg. § 1.441-1(c).

4. An election can be made pursuant to Code § 645 to treat a decedent's revocable trust as part of the estate for income tax purposes for a limited period of time following the decedent's death. This results in the trust having the same fiscal tax year as the estate instead of a calendar year. The election must be made by filing Form 8855 no later than the due date (including any extensions) for filing the Form 1041 for the estate for its first taxable year. There is no relief for a missed Code § 645 election.

5. Why is the selection of a tax year important?

    a. The new income tax rates under the Act apply only to taxable years *beginning after* December 31, 2017 *and before* January 1, 2026. Thus, the tax year selected will determine how long the pre-Act tax rules will continue to apply for decedents dying in 2017.

        (1) Example: Assume decedent dies on November 1, 2017 and the estate expects to receive a considerable amount of income beginning in January, such as from the sale of a business interest or receipt of taxable retirement account proceeds. If the personal representative selects the longest fiscal year possible, which means the first tax year ends October 31, 2018, then the income received by the estate from January 1, 2018 to October 31, 2018 will be subject to the pre-Act rates, including a top rate of 39.6%. However, if the personal representative instead elects to have the first tax year end December 31, 2017, then all of the income from January 1, 2018 through October 31, 2018 will instead be subject to the Act rates, which means a top rate of 37%.

        (2) NOTE: An estate or qualified revocable trust seeking to make an election to have a fiscal year ending 12/31/17 must file a return or extension of time to file a return by April 17, 2018. If a timely return is not filed, the fiscal year election can be made on the first filed return for the estate (even though the return is late), but a Code § 645 election cannot be made for the qualified revocable trust.

(3) Caution: Rate brackets are not the only consideration. One must also consider the potential impact of the other income tax changes under Act, such as the suspension of miscellaneous itemized deductions under Code § 67. If an estate is expected to have significant itemized deductions (e.g., investment advisory fees) then it may be better to elect a November 30, 2017 year-end for the first tax year in order to have the estate taxed under the pre-Act rules for December 2017 through November 2018.

D. Move Irrevocable Trusts to Florida (or another Jurisdiction without a State Fiduciary Income Tax)

1. With the new limitations imposed on deductions for state and local taxes, it just became more expensive to administer a trust in a state that imposes income tax on trusts.

2. States impose income tax on irrevocable trusts on a variety of bases, such as the residence of a trustee, the principal place of administration, and whether the trust was created by a resident. These strings often can be severed to eliminate the application of the state income tax, resulting in an immediate savings to the trust.

E. Higher Transfer Tax Exemptions Does Not Mean that Planning for Clients Has Become Less Important

1. Non-estate tax reasons for planning

a. Asset protection planning;

b. Planning for disability and incompetency of recipients;

c. Business succession planning;

d. Protection from divorce;

e. Charitable giving;

f. Avoidance of litigation (enhanced when there is more to fight over);

g. Planning to minimize state income or estate taxes (in many states);

h. Income tax basis planning;

i. Controlling/restricting the disposition of assets post-death;

j. Planning for spendthrift children; and

k. Planning for clients with real estate in multiple states, including ownership, asset protection, state income taxation, spousal rights, and probate issues.

2. At the recent Heckerling Institute on Estate Planning, it was reported that in a recent survey by Trusts and Estates Magazine, respondents said the top planning concerns of those surveyed were as follows:

   a. 43% avoiding chaos and family discord;

   b. 41% avoiding estate tax;

   c. 36% protecting children from mismanagement;

   d. 35% business succession planning; and

   e. 22% asset protection.

## V. Planning for 2018 and Beyond

### A. Refresher on Portability

1. "Portability" means that the personal representative of a deceased spouse's estate may elect to transfer any unused estate tax exemption at the deceased spouse's death to the surviving spouse. The unused exemption is known as the "Deceased Spousal Unused Exclusion" amount or the "DSUE" amount.

2. Portability is intended to provide a married couple the opportunity to utilize the exemptions of both spouses even if the couple failed to plan prior to the death of the first spouse. For example, assume H has $22.36 million of assets in 2018 and W has $0. Without portability, if W died in 2018 (without any assets), W's $11.18 million exemption would be lost. When H later dies in 2018, estate tax would be due on the $11.18 million of assets in excess of H's $11.18 million estate tax exemption. With portability, no estate tax would be due upon H's death because H could add W's unused $11.18 million exemption to H's exemption, thus giving H a total exemption of $22.36 million.

3. Surviving spouse can use the DSUE of the deceased spouse to make gifts during the lifetime of the surviving spouse. Gifts by the surviving spouse use the DSUE amount first before using the surviving spouse's exclusion amount.

4. GST exemption is not portable. First spouse must use it or lose it.

5. The DSUE amount is not indexed for inflation (even though the surviving spouse's exemption is indexed for inflation).

6. The DSUE amount "ported" to a surviving spouse includes the DSUE amount the deceased spouse acquired upon the death of his or her prior spouse.

   a. Example −Assume Wife survives Husband 1 and Wife's applicable exclusion amount is $12 million (her $10 million basic exclusion amount plus $2 million DSUE from Husband 1). Wife remarries and then predeceases Husband 2. Wife made no taxable transfers and has a taxable estate of $3 million, which she leaves to children from her first marriage. An election is made on Wife's estate tax return to permit Husband 2 to use Wife's DSUE, which is $9 million (Wife's $12 million applicable exclusion amount less her $3 million taxable estate). Accordingly, Husband 2's applicable exclusion amount is increased by $9 million, i.e., the amount of Wife's DSUE.

7. *Addressing the Portability Election in your Documents.* Regardless of a client's wealth, it is important to draft provisions into your Wills, Trusts, Prenuptial Agreements and Postnuptial Agreements that address whether the portability election will be made, who will have the authority to decide whether to make a portability election, who will bear the costs associated with filing the portability election, etc.

   a. A will could designate whether the personal representative would be required or have the discretion to make or not make the portability election. An alternative is to require the executor to make the election if the spouse so requests, or perhaps to require that the executor make the election unless the spouse directs that the election not be made.

   b. The expense of preparing an estate tax return to make the portability election must be borne by someone. Even with the simplifications allowed by the temporary and proposed regulations of not having to list the values of each asset passing to the surviving spouse or charity, the expense in preparing the estate tax return to make the election still could be significant. The will can address whether the estate or surviving spouse would pay the expenses of making the election.

   c. If the expense, which is an estate transmission expense, is allocated to the share of the surviving spouse, it will reduce the marital deduction. As long as the expense is claimed as a deduction on the estate tax return, it will not affect the DSUE amount. If, however, the expense instead is claimed on the fiduciary income tax return, then to avoid the imposition of estate tax at the first death, the expense would have to be offset by the use of a portion of the deceased spouse's applicable exclusion amount, reducing the DSUE amount passing to the surviving spouse.

d. Providing for portability in a prenuptia1 / postnuptial agreement is important as well. The surviving spouse may not be the person responsible for making the portability decision. If portability is addressed in the prenuptia1 / postnuptial agreement, consider whether these provisions will permit the terms of a spouse's will or trust to override the terms of the prenuptia1 / postnuptial agreement with respect to portability.

B. Use of Portability vs. Credit Shelter Trust

1. *Portability Decision Is Complex* – The portability provisions may cause married clients to proceed with fairly simple "all to spouse" will planning, relying on portability to take advantage of both spouses' estate exemptions, rather than using more complicated trust planning. From the planner's perspective, this is a more complex decision involving a variety of factors.

a. Caution: The overarching concern with relying on portability under the new Act is that it is unclear what will happen to the DSUE when the Act sunsets and the increased exemptions revert to pre-Act levels. For example, if an individual dies in 2018 and his entire $11.18 million estate tax exemption is ported to the surviving spouse, what is the DSUE amount available to the surviving spouse if the surviving spouse dies in 2026? Will it be $11.18 million or will it be reduced in conjunction with the sunset? This is one area the IRS should be issuing guidance to clarify.

2. *Situations Favoring Portability* - Situations favoring an approach leaving all of the assets to the surviving spouse and relying on portability include:

a. A competent spouse who can manage assets;

b. Client's desire for simplicity and to avoid using trusts;

c. First marriage or no children existing from prior marriage of either spouse;

d. Clients who are more interested in obtaining a basis step up at death of surviving spouse rather than getting future appreciation out of their estate (although basis step up may still be available through trust planning described in Section C below);

e. Situations in which it is undesirable to retitle assets among spouses prior to death;

f. There is a residence or other assets (such as large retirement accounts) that would be difficult to administer in a trust;

g. Consumption of surviving spouse is expected to exceed growth rate of assets; and

h. Desirability of the surviving spouse to be able to use the DSUE to create a trust following the first spouse's death that would be a grantor trust as to the surviving spouse.

3. *Reasons for Using Trusts even with Portability* – There are various reasons for continuing to use credit shelter trusts at the first spouse's death and not rely on portability, including:

a. The DSUE is not indexed for inflation;

b. The DSUE from a predeceased spouse will be lost if the surviving spouse remarries and survives his or her next spouse;

c. Growth in the assets of a credit shelter trust are excluded from the gross estate of the surviving spouse;

(1) Example: Assume Wife dies in 2018 with a $11.18 million estate and that Husband has a $0 estate. If all assets are transferred from Wife for the benefit of Husband, what is the impact of relying on portability vs. using a credit shelter trust if the assets grow by 6% per year until Husband's death 7 years later in 2025? Assume Husband's exemption grows by 2.45% per year due to inflation. The DSUE is not indexed for inflation.

| | Portability | Credit Shelter Trust |
|---|---|---|
| Starting Balance | $11,180,000 (W) +<br><u>$11,180,000</u> (H)<br>$22,360,000 | $11,180,000 |
| Balance at end of 7 years | $ 11,180,000 (DSUE) +<br><u>$ 13,244,194</u> (H)<br>$24,107,471 | $16,810,586 |
| Amount subject to estate tax | $16,810,586 gross estate<br><u>-$24,107,471</u> exemption<br>$0 | $0 |
| Estate tax (40%) | $0 | $0 |

(2) Example: Same facts as example 1 above except Husband dies in 2038 and his estate tax exemption reverts back to the 2017 exemption level of $5,490,000. Assume Husband's exemption grows by 2.45% per year due to inflation. The DSUE is not indexed for inflation.

| | Portability | Credit Shelter Trust |
|---|---|---|
| Starting Balance | $11,180,000 (W) +<br>$11,180,000 (H)<br>$22,360,000 | $11,180,000 |
| Balance at end of 20 years | $ 11,180,000 (DSUE) +<br>$ 8,908,644 (H)<br>$ 20,088,644 | $35,855,755 |
| Amount subject to estate tax | $35,855,755 gross estate<br>-$20,088,644 exemption<br>$ 15,767,131 | $0 |
| Estate tax (40%) | $6,306,852 | $0 |

(3) Same facts as example 2 above except that the DSUE also reverts back to 2017 exemption levels. Assume Husband's exemption grows by 2.45% per year due to inflation. The DSUE is not indexed for inflation.

| | Portability | Credit Shelter Trust |
|---|---|---|
| Starting Balance | $ 11,180,000 (W) +<br>$ 5,490,000 (H)<br>$ 16,670,000 | $11,180,000 |
| Balance at end of 20 years | $ 11,180,000 (DSUE) +<br><$ 5,490,000><br>$ 8,908,644 (H)<br>$ 14,598,644 | $35,855,755 |
| Amount subject to estate tax | $35,855,755 gross estate<br>-$14,598,644 exemption<br>$ 21,257,111 | $0 |

| | | |
|---|---|---|
| Estate tax (40%) | $8,502,844 | $0 |

d. There is no portability of the GST exemption;

e. There is no statute of limitations on values for purposes of determining the DSUE that begins to run from the time the first deceased spouse's estate tax return is filed whereas the statute of limitations runs on values if a credit shelter trust is funded at the first spouse's death. See *Estate of Sower v. C.I.R.*, 149 T.C. No. 11;

f. Credit shelter trust could be funded with discounted / hard-to-value assets when there may be a low audit risk at the first spouse's death;

g. Credit shelter trust assets are protected from creditors, predators and divorce;

h. Credit shelter trust provides a mechanism for the management of assets if the surviving spouse is incompetent or otherwise unable to properly manage assets;

i. Individuals other than the surviving spouse can be included as beneficiaries of the credit shelter trust, which allows assets to be distributed to beneficiaries other than the spouse without the surviving spouse using exemption to make gifts; and

j. Predeceased spouse can control the disposition of the credit shelter trust assets during the surviving spouse's lifetime and upon the death of the surviving spouse. This is extremely important for blended families / second marriages.

4. *Planning for Blended Families is Critical*. In a blended family situation, substantial inequities may result if the credit shelter approach is not used.

a. If the assets are left outright to the surviving spouse, the spouse may give or bequeath the assets to persons other than the first deceased spouse's descendants (or may favor some over others of those descendants in ways that the deceased spouse would not have wanted).

b. If even a QTIP trust is used, the surviving spouse may be able to take steps that would significantly disadvantage the deceased spouse's descendants even though the assets are "protected" in a QTIP trust.

(1) For example, if the executor makes a QTIP election and elects portability, the surviving spouse will have the DSUE amount from the deceased spouse and could make gifts of the surviving spouse's assets to his or her own descendants utilizing all of the DSUE amount and his or her gift exemption amount. (Alternatively, the surviving spouse could make a gift using just the DSUE amount, and at death might leave all assets owned by the surviving spouse to his or her descendants.) At the surviving spouse's death, the QTIP trust is required to reimburse the surviving spouse's estate for taxes attributable to the QTIP trust assets pursuant to Code § 2207A. In effect, the first deceased spouse's descendants would not have benefitted at all from the first deceased spouse's exemption amount.

(2) This could be addressed in a prenuptial agreement or other marital agreement, to provide that the portability election would be made if the surviving spouse agreed to waive reimbursement rights from the QTIP trust. For example, the decedent's will could direct the executor not to make the portability election unless the surviving spouse agrees to waive the right to be reimbursed for estate taxes from the QTIP trust at the surviving spouse's subsequent death.

c. Use of credit shelter trust to assure that the first deceased spouse's descendants are treated fairly avoids these complexities.

C. Structuring Revocable Trusts and Wills for Clients Across the Wealth Spectrum

1. Clients with less than $11.18 million net worth

a. The major focus for estate planning for clients having assets under $11.18 million will be (i) core dispositive planning, (ii) income tax planning and (iii) preservation and management of assets.

b. *Transfer Taxes Generally Irrelevant.* Transfer taxes will generally be irrelevant for clients in this range. One issue clients will face is whether to make the portability election at the death of the first spouse. Filing an estate tax return and making the election will be preferable in most cases. The assets must be valued in any event for basis purposes, and the portability regulations allow a relaxed reporting procedure to merely list assets qualifying for the marital deduction rather than listing values of each of the assets. Filling out the estate tax return will not be overly onerous. If an estate tax return is not filed to make the portability election, the planner will want a written waiver letter signed by the personal representative (and perhaps the surviving spouse and other beneficiaries).

c. *Core Dispositive Planning.* Clients will continue to need estate planning documents disposing of their assets among their desired beneficiaries and coordinating beneficiary designations to achieve the desired result.

d. *Income Tax Planning.* While transfer taxes may be irrelevant, income tax issues will remain. A key issue for clients in this range will be preserving a step-up in basis at the death of each spouse. There are several ways to accomplish this which are discussed in Section V.C.2 and V.C.3 below.

e. *Preservation and Management of Assets; Trust Planning.* A key decision will be whether to use trusts as part of the estate plan for non-tax reasons. Non-tax reasons that a trust may be appropriate include:

(1) The surviving spouse is not capable of managing assets;

(2) There is a second marriage / blended family and each deceased spouse wants to control where his or her assets will pass;

(3) The parties have a concern about the spouse's remarriage or undue influence; or

(4) There is a need for asset protection or divorce protection.

If a trust is used, consider allowing discretionary income and principal distributions for health, education, support and maintenance – not for tax reasons but to ensure that distributions are made when needed. Consider making distributions to children or others subject to the consent of the spouse. Give the spouse a lifetime or testamentary general power of appointment in order to achieve a step up in basis at the surviving spouse's death. Be aware, however, that if asset protection is a concern, creating an enforceable right in the spouse to a "HEMS" distribution or granting a general power of appointment is not desirable.

f. *Rethinking Traditional Planning Concepts.* In light of the fact the transfer taxes are largely irrelevant (absent "winning the lottery" or a change in future transfer tax laws), planners will need to rethink traditional planning concepts. For example, steps that are taken to assure qualification for the annual exclusion, to avoid retained interests in trusts, etc. may no longer be necessary. Clients may opt for owning life insurance outright instead of creating irrevocable life insurance trusts.

g. *Focus on Maintaining Standard of Living.* Rather than focusing on strategies for wealth transfer, these clients may focus more on having sufficient assets to maintain the spouses during their retirement years.

h. *Qualified Retirement Plans.* A large part of planning for retirement will be to structure withdrawals from qualified retirement plans so that they can last for the lifetimes of the spouses.

i. *Elder Law/Medicaid Planning.* For clients with modest means, planning for long-term and nursing home care is important.

j. Asset Protection Planning.

(1) *Tenancy by the Entireties.* Florida law provides that assets held as tenants by the entireties are protected from the creditors of an individual spouse. However, a creditor of both spouses could reach assets owned as tenants by the entireties. Additionally, these assets will become subject to the creditors of the surviving spouse upon the death of the first spouse to die.

(2) *Qualified Retirement Plans.* Florida law generally protects assets held in qualified retirement plans (including inherited IRAs) from creditors' claims.

(3) *Life Insurance and Annuities*. Florida law generally protects the cash surrender value of life insurance policies issued upon the lives of residents of Florida and annuity contracts issued to residents (Fla. Stat. § 222.14).

k. *State Transfer Taxes.* About half of the states have state estate taxes with exemptions considerably lower than the $10 million indexed federal exemption. Planning to avoid state transfer taxes is important for clients who have property in those states.

2. Clients with $11.18 million - $22.36 million net worth

a. In addition to the planning issues discussed above, a primary estate planning decision for clients in this range will be whether to use a credit shelter trust or rely on portability at the first spouse's death. The key to planning for these clients is <u>flexibility</u>.

b. Possible Planning Approaches

(1) *All to spouse with optional disclaimer to credit shelter trust* -This structure permits the surviving spouse to determine upon the death of the predeceased spouse whether to have

any assets pass to a credit shelter trust or whether it would be preferable to transfer the assets outright and rely on portability.

**(a)** Disclaimed assets in credit shelter trust do not get a basis adjustment at death of surviving spouse.

**(b)** Disclaimer must be made within 9 months of decedent's death even if due date of estate tax return is extended.

**(c)** Caution: Surviving spouse cannot hold a power over the disclaimed property in the credit shelter trust as trustee or otherwise to make distributions or appoint assets unless limited by an ascertainable standard. Otherwise, the disclaimer will not be a qualified disclaimer for tax purposes.

(2) *All to QTIPable trust for spouse (including possibility of a Clayton QTIP)* – This plan has the potential to provide an optimal approach because it would (i) provide asset protection for trust assets, (ii) permit a basis adjustment for income tax purposes for trust assets at the death of the surviving spouse, (iii) permit the GST exemption of the predeceased spouse to be used for QTIP assets by virtue of a "reverse QTIP election" under Code § 2652(a)(3) or for assets passing to the non-QTIP trust and (iv) permit the DSUE amount of the predeceased spouse to be ported to the surviving spouse.

**(a)** All assets could pass to a single trust that is QTIPable. If the QTIP election were made in respect to all of the assets, then the deceased spouse's applicable exclusion amount would not be used and the DSUE amount could pass to the surviving spouse. If the QTIP election were made in respect to only a fraction or percentage of the assets, then a portion or all of the deceased spouse's applicable exclusion amount would be used, reducing or eliminating the DSUE amount that could pass to the surviving spouse. If a partial QTIP election is made, the trust should be divided into two separate trusts. The drawback to this planning is that all of the assets would be held under the same terms regardless of whether the QTIP election were made – including mandatory income to the surviving spouse.

(b) A variation of this planning, and perhaps even more beneficial, would be to use a "Clayton" provision, providing that any portion of the assets that otherwise would pass to the QTIPable marital trust over which the QTIP election was not made instead would pass to a credit shelter trust. The credit shelter trust could include beneficiaries other than the surviving spouse and allow discretionary, rather than mandatory, distributions. The surviving spouse also could have preference in distributions of the credit shelter trust.

(c) Personal representative has up to 15 months after death (assuming an election is filed to extend the due date of the estate tax return) to decide whether to make a QTIP election. This is 6 months longer than disclaimer planning.

(d) Rev. Proc. 2016-49 provides procedures under which the IRS will continue to disregard unnecessary QTIP elections and treat them as null and void. However, it will treat a QTIP election as valid in certain situations, including where an executor of an estate makes a portability election under Sec. 2010(c)(5)(A) to transfer the decedent's unused applicable exclusion amount (DSUE).

(3) Exemption gift to Credit Shelter Trust with a power in an independent person to (i) make distributions for any purpose and/or (ii) grant a general power of appointment in the surviving spouse.

(a) Authorizing an independent person to make distributions for any purpose will permit assets to be distributed to the surviving spouse if it is determined that it will be more beneficial to have these assets included in the surviving spouse's gross estate, and, thus, receive a basis adjustment.

(b) Authorizing an independent person to grant the surviving spouse a general power of appointment provides flexibility to cause the assets in the credit shelter trust to be includible in the surviving spouse's gross estate, and, therefore, receive a stepped-up basis, if the trust assets would not incur estate tax or it would be more beneficial to pay estate tax and get the income tax basis step up than avoid subjecting the trust assets to estate tax.

3. Clients with more than $22.36 million net worth

a. Traditional planning strategies for large estates will generally continue to apply in addition to many of the planning issues discussed above.

(1) Formula division of assets between marital and credit shelter trusts.

(2) Retitling assets to ensure each spouse has sufficient assets to fund a credit shelter trust at the death of the first spouse.

b. *Using Portability and the DSUE to Create a Grantor Trust.* One planning technique for large estates instead of using a credit shelter trust that was not available prior to portability may be to transfer assets outright to the surviving spouse at the first spouse's death (together with the deceased spouse's exemption via portability) and then have the surviving spouse make a gift to a grantor trust shortly after receiving the assets to utilize the DSUE amount.

(1) Gift by surviving spouse uses DSUE prior to using the surviving spouse's exemption.

(2) Payment of income tax by the surviving spouse effectively means that the trust assets will grow income tax free to the trust beneficiaries.

(3) Grantor trust status could be terminated at any time, including if the income taxes on the trust assets become too burdensome for the surviving spouse.

(4) Although assets will generally acquire a date of death basis at the death of the first spouse, this technique means that the assets will not obtain a date of death basis at the death of the surviving spouse unless further planning is done. For example, the surviving spouse could repurchase the assets prior to death, which would not have any income tax consequences because the trust is a grantor trust. See Rev. Rul. 85-13. The surviving spouse could also substitute high basis assets owned by the surviving spouse for low basis assets held in the trust prior to death if the surviving spouse has a power of substitution.

(5) Grantor trust can own S corp. stock without having to make an ESBT or QSST election.

(6) Surviving spouse can sell assets to or borrow assets from the grantor trust without creating income tax.

## VI. Benefits of 2018 Gifts

A. Considerations in Determining Whether to Make Gifts and How Much

1. Maintain sufficient cash flow for donor(s)

a. Gift property that will not impact or reduce the donors' cash flow below an amount they are comfortable with, such as 2nd or 3rd homes, art, vacant land, life insurance or other non-income producing property.

b. Cancel debts that donor does not expect repayment for. Potential may be available to take a discount on the face value of the obligation if the obligor appears financially unable to repay debt.

2. Basis issues

a. Gifted assets take a carryover basis. Therefore, advisors must analyze whether it is more important for the donor to hold the asset at death to obtain a step-up. If a grantor trust is used, then it is still possible to retain a power of substitution over the assets, which can be used to require the assets prior to death to get a step-up. A grantor can have limited right of substitution without estate tax problems. See Rev. Rul. 2011-28. Alternatively, a donor can always buy assets back from the grantor trust if there is no power of substitution.

3. Use of credit comes off the bottom, not the top

a. Gift needs to be in excess of the future exemption to get the benefit of the 2018-2025 exemptions. For example, a donor who has not made any gifts prior to 2018 will not specifically benefit from the higher exemptions in 2018 by making a gift of $5 million if the exemption amounts in subsequent years is $5 million or more.

4. Exemptions are as high as they have ever been and applicable federal rates and Code § 7520 rates are still low.

5. Donors are better off making lifetime gifts than transferring property at death, even if the tax rates are identical, because gifts are tax exclusive while transfers at death are tax inclusive.

a. Example: D has assets of $1,400,000. If D makes a gift of $1 million, D will incur $400,000 in gift tax and the donee will receive $1 million. If, however, D holds $1,400,000 until his death, then D's estate will pay estate tax of $560,000 (40% x $1,400,000). The beneficiary of D's estate will only receive $840,000 ($1,400,000 - $560,000).

6. With exemptions scheduled to revert to $5+ million in 2026, there is currently another opportunity to give away a significant amount of property transfer tax free. Even if exemptions return to these levels at some point in the future, making gifts now allows the appreciation and income on transferred assets to grow in the hands of the donee, not the donor. The growth can even be compounded income tax free to the donee if transfers are made to a grantor trust.

7. Estate planning in 2018-2025 is still estate planning, just with a twist

   a. $10+ million may be very difficult for clients to give away during their lifetime. Clients may be very apprehensive about giving away such a large amount out of fear that they may need the money at some point in the future.

   b. The twist is figuring out how to protect those clients who are apprehensive and want to retain an interest in the property so that they will be able to access the value that was gifted if necessary at some point in the future with minimal or no adverse tax consequences.

B. What is the "clawback" and will it apply?

1. If a gift is made in 2018 which uses exemption in excess of the estate tax exemption in the year of the decedent's death, will estate tax have to be paid on the difference?

2. Example: Assume taxpayer who made gifts (not covered by the annual gift exclusion) of $10,000,000 in 2018 dies with $5 million of assets in 2026 when the exemption is $5 million and top rate is 40%.

<u>2018 Gift Tax Computation</u>

| | |
|---|---|
| Taxable Gifts | $10,000,000 |
| Prior Taxable Gifts | $ 0 |
| Total Taxable Gifts | $10,000,000 |
| Tax of Total Taxable Gifts | $ 3,945,800 |
| Maximum Unified Credit | <$ 3,945,800> |
| Gift Tax Due | $ 0 |

No Gift vs. Clawback vs. No Clawback at Death

| | No Gift | Clawback | No Clawback |
|---|---|---|---|
| Tentative Taxable Estate | $15,000,000 | $5,000,000 | $5,000,000 |
| Adjusted Taxable Gifts | $ 0 | $10,000,000 | $10,000,000 |
| Augmented Amount | $15,000,000 | $15,000,000 | $15,000,000 |
| Tax on Augmented Amount | $5,945,800 | $5,945,800 | $5,945,800 |
| Gift Tax on Adjusted Taxable Gifts | $ 0 | $ 0* | ($3,945,800)* |
| Gross Estate Tax | $5,945,800 | $5,945,800 | $2,000,000 |
| Unified Credit | ($1,945,800) | ($1,945,800) | ($1,945,800) |
| Net Estate Tax | $4,000,000 | $4,000,000 | $2,000,000** |

| | |
|---|---|
| * Gift tax on gifts at 2018 rates | $3,945,800 |
| Unified Credit computed using applicable credit amount in 2026 not indexed for inflation | ($3,945,800) |
| Total | $ 0 |

** $5,000,000 @ 40% = $2,000,000

3. Section 2001(g)(2) addresses the clawback by providing: "[t]he Secretary shall prescribe such regulations as may be necessary or appropriate to carry out this section with respect to any difference between --

> (A) the basic exclusion amount under section 2010(c)(3) applicable at the time of the decedent's death, and
>
> (B) the basic exclusion amount under such section applicable with respect to any gifts made by the decedent."

4. The Regulations to be issued pursuant to Code § 2001(g) will hopefully clarify that clawback will not occur. Practitioners should nonetheless caution clients making new exemption gifts of this possible risk.

C. Even if the clawback applies, is it still a good idea to make gifts in 2018-2025?

1. The donor should not be worse off than if the assets were held until death, unless (a) the assets depreciate in value between the date of gift and date of death or (b) low basis assets are gifted and the income tax cost of losing a stepped-up basis is greater than the estate taxes saved on the appreciation in the assets since the date of transfer (which always have been caveats in making lifetime gifts).

2. The clawback would impose tax only on the value of the gift on the original date of transfer. The income and appreciation of the gifted property would still avoid estate tax.

## VII. Planning Ideas for 2018-2025 to use Lifetime Gift/GST Exemption without the Grantor or the Grantor's Spouse Retaining any Interest in the Transferred Property

*Before undertaking any transactions to fully utilize gift or GST exemptions, it is important to determine exactly how much of each exemption you or your client have used. This includes carefully reviewing prior gifts to trusts. Even if the gift tax return does not report an allocation of GST exemption to a gift to a trust, it is possible that GST exemption could have been automatically allocated to the transfer pursuant to Code § 2632, even if the current beneficiaries are only one generation below the transferor.*

A. Gifts to grantor dynasty trusts for the benefit of children and descendants

1. Use gift and GST exemption to transfer assets to dynasty trusts for the benefit of children and descendants, thereby getting income and appreciation out of transfer tax system for generations to come.

2. Can supercharge the benefit of the exemptions by making the trust a grantor trust. Because grantor is legally responsible for the payment of all income tax on income and gains of trust assets, the payment of such tax is not treated as an additional gift to the trust or its beneficiaries. Rev. Rul. 2004-64. This effectively allows the income and appreciation to grow inside the trust income tax free.

3. The benefits can be supercharged even more by gifting assets which are subject to valuation discounts, such as business interests or fractional interests in real property (see *Defined Value Formula Gifts* below for ways to protect against valuation adjustments).

   a. For gifts of real property (or interests in entities holding real property), the grantor could lease the transferred property back from the trust and pay fair market rent if the grantor has a desire to use the transferred property after making the gift. This permits the grantor to transfer additional funds into the trust gift tax free.

Additionally, no income tax should be due on the rent. This is an especially good idea for vacation homes.

b. On October 20, 2017, the IRS withdrew the controversial 2704 proposed regulations that would have significantly curtailed valuation discounts applicable to transfers of interests in closely-held family businesses for tax purposes. The 2704 proposed regulations will not be revised and republished while the current administration is in office. It is possible that these rules could be revived under a different administration, but for now and the foreseeable future, they should not be of concern to taxpayers and tax practitioners.

4. Cash is a great asset to gift as well for multiple reasons because it provides the trustee flexibility to purchase assets from the grantor on an installment basis (see *Sales to Grantor Trusts* below) and there is no potential IRS dispute over the value of a cash gift. There is also no problem with the loss of basis step-up (see below).

B. Trusts for grandchildren (and more remote generations)

1. Clients may have exemptions remaining, but not want to make more gifts for the benefit of children because they have already taken care of them and do not want to waste GST exemption on possible distributions to children.

2. Create dynasty trusts that are grantor trusts for the benefit of grandchildren and more remote descendants and allocate GST exemption.

a. Trusts can last up to 360 years in Florida.

b. A trust protector can be included in the trust with the power to add to the class of beneficiaries, which could be exercised to add the children if a need ever arose. However, distributions to children would waste GST exemption that was allocated to the trust.

c. Caution: Crummey powers may be given to trust beneficiaries to get annual exclusions for gifts to a grandchildren's trust. However, the crummey annual exclusion is only for gift tax purposes. GST exemption still needs to be allocated to a transfer subject to a crummey right of withdrawal unless (a) the trust is for the sole benefit of the powerholder and (b) the assets of the trust will be includible in the gross estate of the powerholder at his or her death. Code § 2642(c).

3. Consider "generation-jumping", especially if the donor does not have any GST exemption remaining, but has gift tax exemption remaining.

a. Only one GST tax applies regardless of how many generations are skipped. Code § 2653. Therefore, a donor can create a trust for the benefit of great-grandchildren and pay only one GST tax.

b. Since GST exemption would not be allocated to the trust, the assets will not be subject to estate tax until the death of great-grandchildren. This would avoid two levels of estate tax (children and grandchildren).

C. Cancellation of existing debt obligations

1. The value of the gift is presumed to be the amount of unpaid principal of the obligation, plus accrued interest to the date of the gift. Treas. Reg. § 25.2512-4. However, the donor may assert a lower value for a promissory note if there is satisfactory evidence that the note is worth less than the unpaid principal plus accrued interest because of factors such as the interest rate, date of maturity, insolvency of the obligor and insufficency of the collateral. Treas. Reg. § 25.2512-4.

2. The cancellation of a debt owed by a grantor trust to the grantor will be disregarded for income tax purposes. Rev. Rul. 85-13.

3. Cancellation of indebtedness income under Code § 108 should not arise to the obligor if the cancellation is intended to be a gift. Rev. Rul. 2004-37.

4. Consider gifting cash to a trust that will be used to repay a note instead of simply cancelling the note.

a. It is more conservative for the donor to gift cash to the trust if the donor is attempting to claim crummey annual exclusion gifts.

b. Generally, it's a great idea to repay promissory notes in full during the grantor's life because it gives more credibility that the initial transaction creating the obligation was bona fide and not a disguised gift. Additionally, the satisfaction of a note by a grantor trust during the grantor's life avoids the potential that the IRS will treat the death of the grantor as a disposition triggering gain. See *Madorin v. Commissioner*, 84 T.C. 667 (1985).

5. If the debt originated from an installment sale to someone other than a grantor trust, then the cancellation of the debt will accelerate the deferred gain or loss, potentially creating income tax for the donor. Code § 453B(f). Effectively, the cancellation is treated for income tax purposes as if the obligor paid off the remaining balance of the note.

6. Before cancelling a debt obligation, the donor should consider the history of the loan and the payments thereunder. The IRS has successfully argued that a transfer of funds was actually a gift, and not a loan, where the donor

did not have an expectation of repayment at the time the initial transfer was made (notwithstanding any loan documentation to the contrary at the time of the transfer), and there was no history of repayment.

a. This could result in substantial tax consequences to the donor because the transfer will be treated as a gift in the year it was initially made, not in the year that the loan was cancelled, thus triggering possible interest and penalties.

b. The substantial changes and window in the 2018-2025 gift tax laws should provide strong support for a donor to defend against this argument by the IRS. A donor could argue that he or she decided to forgive the loan to take advantage of $11.18 million worth of gifts.

D. Life Insurance Planning

1. Existing ILITs

a. Make lump sum cash gift into ILITs to pay for future premiums or purchase assets that will generate the income necessary to pay premiums. This is especially a good idea if (1) the trust does not contain crummey withdrawal powers, (2) the donor already makes or intends to make annual exclusion gifts to the trust beneficiaries outside of the trust or (3) the annual premiums exceed the amount of available annual exclusions.

b. If the terms of the existing ILIT are not great, decant the policy into a new ILIT with more favorable terms, and then make the gift to the new ILIT.

2. New ILITs

a. Make lump sum cash gift into a new ILIT to purchase a new policy (e.g., single premium policy) or to purchase a policy owned by an existing ILIT whose terms are not as favorable as the new ILIT.

(1) Sale between trusts will be disregarded for income tax purposes if each trust is treated as having the same grantor.

3. Existing policies owned by the insured

a. Gifting cash to a trust to purchase the policy from the owner is better than gifting the policy to the trust.

(1) If the policy is gifted, the insurance proceeds will be included in the estate of the insured if the insured dies within 3 years of the date of the transfer. Code § 2035.

However, a policy that is sold for fair market value can be removed from the insured's estate even if the insured dies with 3 years of the sale. Code § 2035(d).

(2) The purchase and sale of the policy may have income tax consequences unless the seller is treated as the grantor of the purchasing trust for income tax purposes. See Rev. Ruls. 2009-13 and 2009-14.

(3) Structure the transaction to avoid the "transfer-for-value" rule of Code § 101. The failure to meet one of the exceptions may cause at least a portion of the proceeds to be taxed as ordinary income (note: a sale from the grantor to his or her grantor trust avoids the transfer for value rule because the policy is treated as being transferred to the insured. PLR 200636086).

(4) Avoid the step transaction doctrine. Upon the receipt of cash by the trust, it is best for some time to pass before the purchase. Additionally, the trustee may want to explore other investment opportunities before deciding if the policy is a good investment.

(5) The gift tax return for the donor will reflect a cash gift rather than a gift of the policy, which may or may not reduce the chances of an audit. The donor should consider disclosing the sale of the policy by attaching a statement to the return pursuant to Treas. Reg. § 301.6501(c)-1(f)(4) to commence the statute of limitations for the IRS to challenge the transaction.

4. Valuing policies for gift tax purposes

a. Treasury regulations *do not* sanction the use of cash surrender value as an adequate measure of fair market value.

b. Generally, interpolated terminal reserve value is an accepted measure of value for policies on which additional premiums will be due. If the policy is a single premium or paid-up, then replacement cost may be used. Treas. Reg. § 25.2512-6(a).

c. It may even be necessary to explore the secondary market to determine fair market value if the insured is older or in declining health.

5. Life insurance is a great way to leverage the GST exemption of the donor by structuring the donee trust as a dynasty trust. In addition, ILITs can

provide liquidity for the payment of estate tax by purchasing assets from, or loaning cash to, the estate after a decedent's death.

E. Exercising Powers of Appointment

1. A general power of appointment over existing trust assets may be exercised to appoint the property into a new trust and avoid estate tax at the death of the power holder. The power holder will be treated as the transferor of the property for gift and GST tax purposes, thus using the power holder's exemptions and starting a new measuring period for the maximum duration of the trust. Code § 2514(b).

2. The exercise of a limited power of appointment will be treated as a general power if the limited power is exercised by creating another power of appointment which can be used to postpone the vesting period of the trust property (the "Delaware tax trap"). Code § 2514(d). Therefore, the power holder can appoint the property into a new trust and create another limited power of appointment in a beneficiary of the new trust. The original power holder will be treated as the transferor of the appointed property for gift and GST tax purposes, thus using the power holder's exemptions and starting a new measuring period for the maximum duration of the trust.

F. Late allocations of GST exemption to existing trusts

1. Even if a client has already exhausted his or her gift tax exemption through lifetime gifts, they may have GST exemption remaining.

2. Existing trusts should be analyzed to determine whether a late allocation of GST exemption can be made to avoid GST or estate tax that will be incurred in the future. See Code § 2642(b)(3).

3. If existing trusts are not currently structured as GST trusts, consider modifying these trusts (either judicially or nonjudicially) or decanting into new GST trusts in order to use the donor's GST exemption.

## VIII. Planning Ideas for 2018 to Use Lifetime Gift/GST Exemption Where the Grantor or the Grantor's Spouse Desires to Retain an Interest in or from the Transferred Property

A. Sales to Grantor Trusts

1. One of the best ways to leverage transfers to trusts is to sell an asset to the trust, have the trust pay for it in installments and use the income from the asset to make the note payments. This allows the grantor to get back the value of the asset on the date of sale, but all appreciation in the asset will stay in the trust to pass outside of the grantor's estate.

a. Example: Donor sells an asset worth $10,000,000 to a grantor trust in exchange for a promissory note. Donor receives payments of principal and interest at the current low rates. If the asset is worth $15,000,000 when grantor dies, then $5 million has escaped estate tax.

2. The sale is disregarded for income tax purposes so no gain or loss will be recognized on the transfer. Rev. Rul. 85-13. The trust will have a carryover basis in the purchased assets. Additionally, no income tax is due on the interest payments back to the grantor.

3. Although there is no bright-line rule, practitioners generally agree that a trust should own assets equal to at least 10% of the purchase price. The remainder of the purchase price can be paid by the issuance of a promissory note. Income generated from the purchased assets (or any other assets of the trust) can be used to make note payments.

4. Economically, this is a low risk transaction for the grantor, but has substantial tax savings and can significantly benefit the donee.

   a. Cash can be returned to the donor almost immediately in the form of a down payment by the trust.

   b. The grantor is obligated to pay the income tax on the income generated by the trust assets, which further reduces the gross estate of the grantor and allows the trust assets to grow income tax free to the trust.

   c. The income and appreciation of all purchased assets in excess of the interest rate due under the note increases the value of the trust, not the grantor's estate. Only the value of the note, which has a fixed growth rate equal to the interest, should remain in the grantor's estate.

   d. The grantor receives a consistent income stream back from the trust pursuant to the note terms. Payments under the note can be structured in an amount to meet the grantor's cash needs. Alternatively, note payments can be interest only and prepayments of principal can be made as necessary to meet the grantor's cash needs.

   e. If the note payments cannot be satisfied in cash, then the trust can retransfer assets back to the grantor as payment.

   f. Grantor can retain a secured interest in the assets sold to the trust.

5. A gift tax return would report a gift of the initial "seed" assets to the trust if the trust does not have sufficient equity. The seed gift is often in the

form of cash, which may or may not reduce the risk of an audit. The donor should still consider attaching a statement to his or her gift tax return pursuant to Treas. Reg. § 301.6501(c)-1(f)(4) disclosing the sale to get the statute of limitations running. Additionally, the donor should not be required to answer "yes" to the question on the gift tax return asking whether any item on Schedule A reflects a valuation discount because Schedule A will only reflect a gift of cash.

6. The purchased assets should still be appraised if market values are not readily ascertainable. However, it is advisable for the assets to be sold for a price negotiated between the parties at arm's length after giving due consideration to the appraisal rather than simply relying on the appraised value without further negotiation.

   a. If the IRS argues that the assets were sold for less than fair market value, then the donor can still argue that the transfer was made in the ordinary course of business (i.e., bona fide, at arm's length and free from donative intent). If a transfer is made in the ordinary course of business, then it is considered to be made for adequate and full consideration, regardless of whether the purchase price is less than fair market value. See Treas. Reg. § 25.2512-8.

   b. An appraisal may include a combined discount that is substantially higher than anything that the IRS is willing to accept. The negotiation of a sales price permits the donor to report on the disclosure statement that the assets were sold for greater than its appraised value.

7. Gifted assets retain a carryover basis in the hands of the grantor trust. However, this does not mean the assets cannot later receive a step up in basis at the donor's death. The grantor can retain a power to substitute assets of the trust (other than Code § 2036(b) stock) during his lifetime under Code § 675(4), which can be exercised near his or her death to substitute high basis assets into the trust for lower basis assets, or substitute cash into the trust for the low basis assets. If a trust does not contain a power of substitution, the grantor can purchase the assets from the trust shortly before his or her death for cash. The sale will be disregarded for income tax purposes because the trust is a grantor trust. It may even be a good idea to borrow money, if necessary, to repurchase the assets. After death, cash can be generated to repay the loan by reselling assets. See Rev. Rul. 2011-28.

B. Long-term Grantor Retained Annuity Trusts (GRATs)

1. Grantor transfers assets to a trust, but retains the right to receive an annuity from the trust at least annually. The value of the gift is equal to the value of the remainder interest in the trust calculated at the time of the

gift and is based, in part, on the Code § 7520 rate. The lower the Code § 7520 rate, the smaller the value of the remainder interest.

2. The purpose of a long-term GRAT is to lock in the Code § 7520 rate, which is currently near historical lows, for an extended period of time and transfer the appreciation in the asset without transfer tax to the remainder beneficiaries of the trust.

3. Although the assets of the GRAT will be included in the grantor's gross estate if the grantor dies during the annuity term, Treasury released final regulations under Code § 2036 in November 2011 which provide that the amount to be included in the grantor's gross estate for estate tax purposes is that portion of the trust corpus necessary to generate sufficient income to satisfy the retained annuity using the Code § 7520 rate in effect at the time of the decedent's death.

    a. The appreciation of the trust assets in excess of the Code § 7520 rate (currently 2.6%) is not included in the decedent's gross estate.

    b. The decedent will realize a benefit as well if the Code § 7520 rate is higher at date of death than date of funding because a higher rate at death will result in a lower amount of principal necessary to produce the decedent's retained income interest.

4. Some practitioners have even suggested doing a 99 year GRAT to maximize the potential benefits. However, a 99 year GRAT has not been the subject of a court case or PLR. It is possible the IRS may consider it to be abusive.

C. Domestic Asset Protection Trusts (DAPTs)

1. Donor creates an irrevocable trust in one of the jurisdictions that permits DAPTs and retains an interest in the trust as a discretionary beneficiary. An independent person is typically designated to serve as trustee so that the donor does not have any control over distributions.

2. DAPTs are intended to shield assets of the settlor from the settlor's future creditors.

3. Gifts to these trusts can be completed gifts for gift tax purposes even if the donor retains an interest in the trust as a discretionary beneficiary, which means exemption will be used.

4. The retention of an interest in the trust as a discretionary beneficiary does not, by itself, cause the assets to be included in the estate of the grantor under Code § 2036. However, assets of the trust will be included in the estate of the settlor under Code § 2036 if (i) there was an implied agreement or understanding between the settlor and trustee that

distributions would be made for the benefit of the settlor or (ii) creditors would be able to reach the assets of the trust under state law. PLR 200944002.

5. Florida law does not provide creditor protection for assets held in a self-settled trust created under Florida law. It is unsettled under existing caselaw whether assets held in a self-settled asset protection trust created by a Florida debtor in a jurisdiction that permits such trusts (such as Alaska, Delaware, Nevada etc.) will be protected from the creditors of the Florida debtor.

6. Caution: the Florida Uniform Fraudulent Transfer Act (F.S. Chapter 726) can be invoked to recover assets (or equivalent value) transferred to third parties (including trusts) if the transfer is made with the actual intent to hinder, delay or defraud a creditor, or without receiving reasonably equivalent value.

D. Family/Credit Trusts

1. Donor creates an irrevocable trust for the benefit of spouse and descendants during the spouse's lifetime. The assets of the trust will not be included in the spouse's estate for estate tax purposes.

2. Donor will typically be treated as the grantor of this trust for income tax purposes since spouse is a beneficiary, unless certain limitations are drafted into the trust. Code § 677(a).

3. Spouse may have a limited power of appointment, but it should not be exercisable in favor of the donor spouse.

   a. If the beneficiary spouse can appoint the trust property for the benefit of the donor spouse, then this could arguably be viewed as a retained interest subjecting the trust assets to the donor's creditors under state law and thus causing estate tax inclusion under Code § 2036.

   b. Alternatively, the IRS may argue that there was an implied agreement or understanding that the spouse would appoint the property back into trust for the donor spouse, thus causing inclusion under Code § 2036 or potentially Code § 2038.

   c. Several steps can be taken to minimize the inclusion risk if the spouse wants to be able to appoint the property back to the donor spouse, such as waiting as long as possible (several years) to exercise the power appointing property back to the donor spouse.

   d. Consider granting authority to the Trust Protector to give property back to the donor in trust.

4. Trustee(s) should be mindful of making distributions to the spouse because the gift exemption (and GST exemption if allocated to the trust) of the donor spouse would be wasted. Trust assets should be considered as a last resort for the spouse since the donor can make unlimited gifts directly to spouse outside of the trust tax free.

5. The trust should contain a clear definition of the term "spouse" to define what interest, if any, the spouse will have as a beneficiary in the event the donor and donor's spouse get divorced after the creation of the trust.

6. Gifts to a trust of which the spouse is a beneficiary generally cannot be split for gift tax purposes under Code § 2513 unless the value of the spouse's beneficial interest is capable of being valued so that it can be severed from the rest of the gift. Treas. Reg. Code § 25.2513-(1)(b)(4). However, see *Robertson v. Commissioner*, 26 T.C. 246 (1956) (spouse was permitted to split gifts made to a trust of which she was a discretionary beneficiary because the trustee was required to consider other assets and resources available to such spouse in making distributions, and the sufficient personal assets available to the spouse showed that there as no likelihood that any distributions would be made.)

7. A beneficiary cannot have a right to receive a distribution from the trust that would satisfy the legal obligations of the donor to support that beneficiary.

    a. For example, the trust should not permit distributions to be made for the support and maintenance of the donor's spouse or minor children because the donor has a legal obligation under state law to support his or her spouse and minor children. The failure to prohibit such distributions may cause the assets of the trust to be included in the donor's estate for estate tax purposes under Code § 2036.

    b. Trusts should include a savings clause that provides a blanket prohibition on distributions in satisfaction of a legal obligation, such as "none of the principal and none of the income therefrom shall ever be payable to me or to discharge any obligation of me to my creditors, to my estate or to the creditors of my estate. The authorization to distribute income or principal for a beneficiary's support does not include authority to make distributions that would discharge or substitute for any obligation of mine to support the beneficiary. I intend that no distribution from a trust hereunder shall be deemed to discharge or substitute for my obligation to support a beneficiary of a trust hereunder, and I direct that no distribution shall be made that would have that effect."

E. Non-reciprocal Trusts (e.g., Spousal Lifetime Access Trusts (SLATs))

1. Each spouse creates an irrevocable trust for the benefit of the other spouse.

2. How to avoid the "reciprocal trust doctrine".

    a. *Estate of Levy v. Commissioner*, T.C. Memo 1983-453 held that the reciprocal trust doctrine did not apply to trusts created by spouses for the benefit of each other because wife had a broad lifetime limited power to appoint assets of the trust created for her benefit to anyone other than herself, her creditors, her estate and the creditors of her estate, while husband did not have a power of appointment in the trust created for his benefit.

    b. Notwithstanding *Estate of Levy*, it is advisable to take precautions in addition to creating different powers of appointment to avoid the reciprocal trust doctrine, such as:

        (1) Create trusts at different times;

        (2) Fund trusts with different assets and different values;

        (3) Have different distribution standards (HEMS vs. any purpose);

        (4) Require trustee to consider other assets of one spouse, but not in the other trust;

        (5) Permit one trust to be converted to a unitrust; and

        (6) Have different trustees and removal powers.

3. Non-reciprocal trusts can also be created between persons who are not married (e.g., siblings, partners, etc.). Additional caution should be used when trusts are created outside immediate family members because the IRS may be more likely to use substance over form arguments.

4. Potential consequences if trusts are treated as reciprocal.

    a. Trust assets will be included in the donor spouse's estate for estate tax purposes under Code § 2036 to the extent mutual value was contributed to the reciprocal trust. Drafter should build in a contingent marital trust where any assets included in the donor spouse's estate would be transferred to defer estate tax at the death of the donor spouse.

    b. Although the reciprocal trust doctrine is a tax law concept, state courts may invoke a similar concept to treat each donor as if he or she created the trust for himself or herself. This would result in self-settled trusts for each donor, which are not valid under Florida law to protect trust assets from the creditors of the settlor.

F. Terminate QTIP Trusts

1. Many use QTIP trusts to (1) delay taxation on the trust property until his or her spouse's death; (2) provide income for his or her spouse's life; (3) control the disposition of the remainder interest on his or her spouse's death; (4) protect assets from creditors; and (5) balance the taxable estates of spouses to assist a less wealthy spouse in using his or her estate tax unified credit.

2. An individual can use gift tax exemption by terminating a QTIP trust.

   a. Termination of a QTIP Trust may result in the surviving spouse making two separate gifts: (1) a gift under Code section 2511 of the present value of spouse's life income interest determined under Code section 7520 (unless spouse is compensated for such interest); and (2) a gift under Code section 2519 of the remainder interest (if distributed to the remainder beneficiaries) equal to the fair market value of the trust less the present value of spouse's life income interest.

      (1) Code § 2519 gift is not eligible for the annual exclusion.

      (2) When a Code § 2519 gift (as opposed to a Code § 2511 gift) results in actual gift taxes, spouse has a right to recover from the trust the gift tax under Code § 2207A. This results in a "net gift" whereby the gift tax is calculated based upon the amount of property actually received by the remainder beneficiaries. However, spouse must use his or her gift tax exemption against the gift since the right of recovery under Code § 2207A applies only to actual taxes incurred, not the use of exemption. If a tax results from the QTIP termination and spouse chooses not to exercise his or her right of recovery under Code § 2207A, spouse will be treated as making an additional taxable gift equal to the amount of taxes spouse could have collected. See Treas. Reg. § 25.2207A-1(b).

3. *Estate Tax Consequences*. Code § 2035(b) adds to the gross estate for federal estate purposes the amount of any gift taxes paid on gifts made by the decedent within three years of death. In *Estate of Anne Morgens v. Commissioner*, No. 10-73698, 9th Cir. (May 3, 2012), Aff'g 133 T.C. No. 17 (December 21, 2009), the U.S Court of Appeals for the Ninth Circuit affirmed the Tax Court's holding that gift tax paid on a Code § 2519 is includible in the spouse's estate under Code § 2035(b) when the spouse

dies within three years of the trust termination notwithstanding the spouse's exercise of the right of recovery from the trust under Code § 2207A. The Court held that Code § 2035(b) applies based upon its finding that the spouse was legally responsible for the tax notwithstanding her right to recover the taxes from the trusts.

4. *Income Tax Consequences*. There are also income tax consequences to consider in deciding whether to terminate a QTIP trust. Code § 1001(e) provides that, for purposes of determining gain or loss on the disposition of the income interest in the QTIP trust, the adjusted basis of the life income interest should be disregarded. Therefore, when spouse "sells" his or her income interest when a QTIP trust is terminated, the entire value of the property received in exchange for the right to receive income is treated as gain.

5. *Divide the QTIP Trust First*. It may be possible to divide a QTIP trust into two separate trusts prior to termination so that the above tax implications can be minimized to the separate trust that is subsequently terminated. *See* PLRs 200723014 and 199926019.

## IX. Using Defined Value Formula Gifts to Protect Against Unanticipated Gift Tax

A. This is a formula transfer structured to define the specific value of a certain asset being transferred to a donee. If given full effect, the clause should operate to avoid any unanticipated gift tax for the donor.

1. Example: Donor makes a gift of $500,000 worth of XYZ stock. If the value of one share of XYZ stock is determined to be $1,000 pursuant to an appraisal obtained by the donor, then the books of XYZ are adjusted to reflect 500 shares being transferred for the benefit of the donee. If the IRS audits the transaction and determines that the per share value is actually $2,000, then donor has still only made a gift of "$500,000 worth of XYZ stock." Therefore, donee only has a legal right (which has not changed despite the IRS audit) to 250 shares, not 500 shares. Accordingly, the donor has transferred only 250 shares and retained the remaining 250 shares.

B. Generally, this type of transfer will only be necessary when the donor intends to make a gift of a specific dollar amount of property, and no more than that amount, such as when a donor is using up the remaining amount of his or her gift tax exemption.

C. Defined value clauses should not be confused with "savings clauses", which the IRS has successfully attacked for decades. On their face, savings clause appear to be essentially the same as defined value formula clauses. From a technical standpoint, the two clauses operate differently. Courts have upheld defined value formula clauses while rejecting savings clauses because of these technical differences. Careful drafting is a must.

1. Defined value formula clause: "I hereby gift $100,000 worth of XYZ stock to Trust A." Here, the value of the gift is fixed at $100,000 regardless of the shares of stock necessary to satisfy that amount.

2. Savings clause: "I hereby gift 10 shares of XYZ stock worth $100,000, but if such shares are finally determined to be worth more than $100,000, then the amount of shares gifted shall be reduced." Here, the donor made a gift of 10 shares, but has the right to recover some portion of the shares if their value is later determined to exceed $100,000.

* The distinction lies in determining what property right is created in the donee at the time of the gift.

D. Several cases in recent years have upheld the use of defined value formula clauses. See *Hendrix v. Commissioner,* T.C. Memo 2011-133; *Petter v. Commissioner*, 653 F. 3d 1012 (9th Cir. 2011); *Christiansen v. Commissioner*, 586 F. 3d 1061 (8th Cir. 2009); *McCord v. Commissioner*, 461 F.3d 614 (5th Cir. 2006). However, each case involved the use of a charity to receive any amount of the transfer that would have otherwise caused a gift tax if transferred to the non-charitable donee.

E. Enter *Wandry v. Commissioner*, T.C. Memo 2012-88 (March 26, 2012), which is the first court opinion upholding the use of a defined value formula gift where a charity was not involved. The IRS issued a notice of NonAcquiescense in regard to the *Wandry* decision. See *IRS Announcement Relating to: Joanne M. Wandry, Albert D. Wandry, A.K.A. A. Dean Wandry,* 2012-46 I.R.B. 543 (IRS ACQ 2012)

F. If the donor desires to transfer multiple assets pursuant to formula, consider contributing these assets first to an entity and then transferring an interest in the entity. This would permit a single asset to be transferred pursuant to the formula.

G. Planning points when using defined value formula gifts:

1. Include an adjustment clause that will automatically adjust the property between the donor and donee to the appropriate allocation under the formula clause once the value is finally determined.

2. Use a grantor trust as the donee. There will be a period of time where the IRS has the opportunity to challenge the gift. This will create uncertainty as to the appropriate allocation of the gifted asset between the donor and donee. Using a grantor trust alleviates the need to file amended income tax returns if the initial allocation is improper because all tax items will have been reported on the grantor's individual return.

3. Prepare the gift tax return consistent with the formula gift by reporting the formula and the value.

4. The grantor should not be the trustee of the donee trust. It is advisable to have an independent trustee acting on behalf of the trust beneficiaries to ensure that the trust receives the proper amount of the gifted asset pursuant to the formula.

H. One alternative is gifting cash and doing a defined value formula sale.

1. Gift tax return reports cash gift and no valuation discounts.

2. It is advisable to disclose the sale by filing a disclosure statement to start the statute of limitations. Treas. Reg. § 301.6501(c)-1(f)(4).