Katten
Katten Muchin Rosenman LLP

Trusts and Estates Advisory

November 20, 2017

2017 Year-End Estate Planning Advisory

Overview

The fourth quarter of 2017 concludes a unique year in the planning arena. With the new administration and a Republican-led Congress in power, both taxpayers and tax professionals have kept a close eye on the potential for tax reform that may impact individual, corporate, estate, gift and generation-skipping transfer (GST) taxes. As the year draws to a close, much uncertainty remains about whether tax reform will be enacted and what the details of any new legislation might be.

The Republican leadership and the administration have published several high-level proposals on tax reform during the year, culminating with the House GOP Tax Cuts and Jobs Act (H.R.1) released on November 2 and the Senate's version released on November 9. Whether, and if so in what form, legislation will be enacted remains unknown at the publication of this advisory, but the reduction in the number of individual tax brackets, a sharp reduction in the maximum corporate tax rate, and some form of an estate tax repeal/reduction remain key points for the administration.

However, due to the political climate and to the steep cost of the pending proposals, many changes to what is described in this advisory will likely occur before any legislation is enacted; furthermore, it is uncertain how any enacted legislation would impact the estate, gift or generation-skipping transfer tax regime in the long-term. Our firm continues to monitor the legislative proposals closely and to analyze their impact on our clients.

In addition to the overarching issue of tax reform, there has been significant legislation, rulings and case law during 2017. Some of the legislation and decisions have beneficial consequences for taxpayers and practitioners. For example, in October, the Treasury officially withdrew the proposed Regulations under Internal Revenue Code (Code) Section 2704 that could have negatively impacted valuation discounts applicable to closely held business interests. Additionally, the IRS published guidance on simplified methods for making late portability elections, as well as guidance on how same-sex couples can reclaim applicable exclusion and GST exemption amounts for transfers made before same-sex marriages were recognized for federal tax purposes.

However, there have also been taxpayer defeats in the judicial system. *Estate of Powell vs. Comm'r* (148 T.C. No. 18 (May 18, 2017)) represents the first time in which the Tax Court included limited partnership interests (rather than general partnership interests) in a decedent's estate under Code Section 2036(a)(2), as well as the first case in which the Tax Court introduced the risk of "double inclusion" of both partnership assets and the partnership interest in a decedent's estate. These legislative enactments and judicial decisions are discussed in detail in this advisory.

While future tax reform may be uncertain, the current environment provides a great deal of opportunity for new planning, and also highlights the many non-tax reasons that proper planning remains important—including asset protection, privacy protection and protection of security. Families will—and should—continue to provide for their children and descendants during their lifetime, both for purposes of business succession planning, to move wealth to younger generations who may greatly benefit from the access to transferred assets and to protect the family's wealth. It is probable that any estate tax repeal, if implemented, would not be permanent. Our firm is encouraging clients to build flexibility into their estate plans and to take this opportunity to review how their estate plan would operate regardless of whether the federal estate tax applies.

The following are some key income and transfer tax exemption and rate changes absent legislative change:

Federal Estate, GST and Gift Tax Rates

For 2017, the estate, gift and GST applicable exclusion amounts are $5.49 million. For 2018, the estate, gift and GST applicable exclusion amounts will be $5.6 million. The maximum rate for estate, gift and GST taxes will remain at 40 percent.

Annual Gift Tax Exemption

Each year individuals are entitled to make gifts using the "Annual Exclusion Amount" without incurring gift tax or using any of their lifetime applicable exclusion amount against estate and gift tax. The Annual Exclusion Amount is $14,000 per donee in 2017. Thus, this year a married couple together can gift $28,000 to each donee without gift tax consequences. In 2018, the annual exclusion for gifts will increase to $15,000, enabling a married couple to gift $30,000 per donee. The limitation on annual gifts made to noncitizen spouses will increase from $149,000 to $152,000 in 2018.

Federal Income Tax Rates

- Individual ordinary income tax rates will remain the same in 2018, with a maximum rate of 39.6 percent. The 39.6 percent tax rate will affect single taxpayers whose income exceeds $426,700 and married taxpayers filing jointly whose income exceeds $480,050. Estates and trusts will reach the maximum rate with taxable income over $12,700.
- For taxpayers whose ordinary income is taxed at the maximum 39.6 percent level, long-term capital gains will continue to be taxed at 20 percent. Long-term capital gains for taxpayers in lower ordinary income tax brackets will continue to be taxed at 15 percent, or if the taxpayer's ordinary income is taxed at 10 percent, at 0 percent. Qualified dividends are taxed at the long-term capital gains rate.
- The threshold for the imposition of the 3.8 percent Medicare surtax on investment income and 0.9 percent Medicare surtax on earned income will remain the same in 2018 for individuals ($200,000 for single filers, $250,000 for married filers filing jointly, $125,000 for married filers filing separately), and trusts and estates ($12,500).

Potential Republican Tax Reform

President Trump has maintained several central tenets of his tax reform proposal during the campaign and since his election. The key points of his tax reform proposal have been business tax reform, such as lower corporate tax rates and a standard rate for pass-through business income to stimulate economic growth, and individual tax reform that would include a repeal of the estate tax.

White House Tax Reform Proposal

On April 23, President Trump's administration released a one-page handout that broadly outlines the administration's tax proposal. The proposal, entitled "2017 Tax Reform for Economic Growth and American Jobs,"stated that the administration's goals included growing the economy and creating millions of jobs, simplifying the tax code, providing tax relief to American families (especially middle-income families) and lowering the business tax rate. With respect to the individual income tax, the handout proposed reducing the seven existing tax brackets to three tax brackets of 10 percent, 25 percent and 35 percent. The proposal also calls for doubling the standard deduction, repealing the Alternative Minimum Tax (AMT), and repealing of the 3.8 percent tax on net investment income. The administration also seeks to provide tax relief for families with child and dependent care expenses, protect home ownership and charitable gift deductions, and eliminate "targeted tax breaks that mainly benefit the wealthiest taxpayers." With respect to business taxation, the proposed reform would reduce the top tax rate for all businesses to 15 percent. The handout also notes the goals of "leveling the playing field" for domestic companies, eliminating tax breaks for "special interests," and a one-time tax on funds held overseas. Finally, the only mention of estate or transfer taxes is the statement of the administration's desire to "[r]epeal the death tax."

With respect to the process for tax reform, the plan noted that the Trump administration would hold "listening sessions with stakeholders" to receive their input and would continue working with the House and Senate to develop the details of a plan that can pass both chambers of Congress that "provides massive tax relief, creates jobs, and makes America more competitive."

Trump Administration Budget Proposal

On May 23, the Trump administration issued a budget proposal entitled "Budget of the US Government—A New Foundation for American Greatness" for the 2018 fiscal year (Budget Proposal). The Budget Proposal contains few specific details about tax reform. The Budget Proposal calls for "deficit neutral tax reform," and includes a repeal of the AMT and the 3.8 percent tax on net investment income, reduction of individual and business tax rates, and expansion of the standard deduction. The Budget Proposal's sole reference to the estate tax is a statement that the administration desires to "abolish the death tax, which penalizes farmers and small business owners who want to pass their family enterprises onto their children." This administration's proposal is unlike those issued by past administrations, which have typically published a more comprehensive Greenbook with tax proposals for each fiscal year. Because a Greenbook has not been issued by the administration for fiscal year 2018, there is uncertainty on President Trump's position regarding transfer tax reform proposals made during prior administrations and on the specific details about a potential estate tax repeal.

House Republican Budget Resolution

On July 17, the House GOP issued a budget resolution entitled "Building a Better America—A Plan for Fiscal Responsibility" (Budget Resolution). Similar to the President's Budget Proposal, the Budget Resolution seeks budget neutral tax reform, but contains few details. The Budget Resolution calls for consideration of tax reform legislation that simplifies the tax code, lowers and consolidates individual income tax rates, repeals the AMT, reduces the corporate tax rate, and transitions the tax code to "a more competitive system of international taxation." The Budget Resolution does not reference the federal estate tax.

Joint Statement on Tax Reform

On July 27, six members of the Republican leadership issued a Joint Statement on Tax Reform (Joint Statement). Similar to the other proposals, the Joint Statement contains few specifics about tax reform. It does state a desire for "simpler, fairer, and lower [taxes] for hard-working American families," lower tax rates for businesses, and "permanence" of the tax laws.

Republican Framework for Tax Reform

On September 27, President Trump unveiled a Republican framework for tax reform that provides some details on the proposed reform. The nine-page proposal, entitled "Unified Framework For Fixing Our Broken Tax Code" (Framework), calls for a reduction in personal income tax brackets from seven to three (12 percent, 25 percent and 35 percent). The Framework also states that an "additional top rate may apply to the highest-income taxpayers to ensure that the reformed tax code is at least as progressive as the existing tax code and does not shift the tax burden from high-income to lower- and middle-income taxpayers."

The Framework proposes an increase in the standard deduction to $24,000 for married filers and $12,000 for single filers, an increase in the Child Tax Credit to an unspecified amount, and an elimination of most itemized deductions. Similar to other proposals, the Framework provides for a repeal of the AMT. Finally, the Framework calls for a repeal of "the death tax and the generation-skipping transfer tax," but provides no further detail on the specifics of this repeal, the impact on the gift tax or the impact on basis of inherited property.

With respect to corporate taxes, the Framework calls for a reduction in the corporate tax rate from 35 percent to 20 percent. A 25 percent tax rate would apply to pass-through businesses. The Framework also allows businesses to deduct the cost of new investments in depreciable assets (other than structures) made after September 27 for at least five years, and with respect to C corporations, contains unspecified limits on deductions of net interest expense.

House GOP Tax Cuts and Jobs Act (H.R.1)

On November 2, the House Republicans released their plan for tax reform entitled The Tax Cuts and Jobs Act (H.R.1). H.R.1 was primarily authored by the House Ways and Means Committee. H.R.1 calls for individual income tax brackets of 12 percent, 25 percent, 35 percent and 39.6 percent. The threshold for the maximum 39.6 percent would be increased to $1 million for married couples filing jointly. Similar to President Trump's Framework, H.R.1 also calls for an increase in the standard deduction to $12,000 for single filers ($24,000 for married couples filing jointly), an expansion of the Child Tax Credit and a repeal of the Alternative Minimum Tax.

Many itemized deductions, such as for medical expenses, alimony and student loan interest, would be eliminated, while a reduced mortgage interest deduction (applicable to home loans up to $500,000, rather than $1 million under current law) would be retained. The charitable deduction would be retained, and the limitation on current deductibility would increase from 50 percent of a donor's adjusted gross income (AGI) to 60 percent of a donor's AGI. Additionally, the deduction for most state and local taxes would be repealed, but the property tax deduction would remain with a cap of $10,000.

H.R.1 would also make changes to the capital gain exclusion on the sale of a principal residence. The exclusion would only be available if the residence was occupied for five out of the eight years prior to the sale, and only allow the exclusion to be used once every five years. The exclusion would also begin to phase out at AGI of $500,000, with a full phase out at AGI of $1 million. H.R.1 would also limit like-kind exchanges under Code Section 1031 to real property, eliminating like-kind exchange treatment for other assets such as artwork.

For the first time, H.R.1 provides some details on the repeal of the federal estate tax. The bill calls for the estate tax exemption to be doubled, from $5 million (adjusted for inflation; $5.6 million in 2018) to $10 million (adjusted for inflation; $11.2 million—or possibly $11.21 million—in 2018). The estate tax and generation-skipping transfer tax would be repealed effective January 1, 2024. The step-up in basis at death would be maintained, allowing the tax basis of an asset owned at death to be stepped up (or down) to fair market value. The higher exemption amounts would also apply to gifts, and the top gift tax rate effective January 1, 2024 would decrease from 40 percent to 35 percent.

Similar to President Trump's Framework, the corporate income tax rate would be reduced from 35 percent to 20 percent under H.R.1, and a new 25 percent tax rate would apply to pass-through businesses. "Anti-abuse" rules would distinguish between individual wage income and "pass-through" business income, based on a rebuttable presumption that 70 percent of income derived from a business is compensation and 30 percent is income subject to the 25 percent rate. Business could also deduct short-lived capital investments for a period of five years.

Senate GOP Tax Cuts and Jobs Act

On November 9, as this advisory was preparing to go to press, the Senate Finance Committee released its version of The Tax Cut and Jobs Act (Senate Bill). The Senate Bill calls for seven tax brackets, with a lowest rate of 10 percent and a highest marginal rate of 38.5 percent. Similar to H.R.1, the Senate Bill calls for an increase in the standard deduction to $12,000 for single filers ($24,000 for married couples filing jointly), an increase in the Child Tax Credit, and a repeal of the AMT.

The Senate Bill would eliminate all state and local tax deductions, which could adversely impact taxpayers living in jurisdictions with high state and local taxes. However, the Senate Bill does not eliminate the deduction for medical expenses, and does not reduce the mortgage interest deduction; taxpayers could still deduct interest paid on the first $1 million of mortgage debt. It would also retain the deduction for alimony.

As in H.R.1, the capital gain exclusion on the sale of a principal residence would only be available if the residence was occupied for five out of the eight years prior to the sale. The exclusion could only be used once every five years. Also, as in H.R.1, like-kind exchanges under Code Section 1031 would be limited to real property.

In a shift from H.R.1, the Senate Bill does not call for a repeal of the estate tax. Instead, it calls for a doubling of the estate tax exemption from $5 million (adjusted for inflation; $5.6 million in 2018) to $10 million (adjusted for inflation; $11.2 million in 2018). The current tax rate of 40 percent would remain unchanged, as would the step-up in basis at death available under current law.

As in H.R.1., the corporate tax rate would be reduced from 35 percent to 20 percent. However, in the Senate Bill, the new lower 20 percent tax rate would not be effective until 2019. Additionally, the tax rate for pass-through entities would remain unchanged (rather than the 25 percent rate proposed in H.R.1). Instead, the bill generally calls for a 17.4 percent deduction for pass-through income.

Important Rulings in 2017

Use of an Account Transcript as a Substitute for an Estate Tax Closing Letter

In Notice 2017-12, the IRS provided that an IRS transcript of an estate account can be used in lieu of an estate tax closing letter to confirm that an examination of the estate tax return (Form 706) has been closed. An estate tax closing letter confirms that a federal estate tax return has either been accepted by the IRS as filed, or has been accepted after an adjustment by the IRS to which the estate has agreed. Prior to June 1, 2015, the IRS generally issued an estate tax closing letter for every filed federal estate tax return. However, for estate tax returns filed on or after June 1, 2015, the IRS now only issues an estate tax closing letter at the request of an estate, which request may be made at least four months after the estate tax return is filed. This Notice confirms that an account transcript may be used as a substitute for an estate tax closing letter. An account transcript that includes transaction code "421" and the explanation "Closed examination of tax return" indicates that the IRS's examination of the estate tax return has been completed and that the IRS examination is closed. Therefore, an account transcript showing a transaction code of "421" can now serve as the functional equivalent of an estate tax closing letter.

Simplified Method for Making Late Portability Elections

In Rev. Proc. 2017-34, the IRS adopted a simplified procedure for an estate not otherwise required to file an estate tax return to make a late portability election under Section 2010(c)(5)(A) of the Code. A portability election would allow a surviving spouse to preserve a deceased spouse's unused estate tax exclusion. Under this method, an estate tax return to elect portability must be filed within the later of January 2, 2018 or two years after the decedent's date of death. The return must note that it is being filed under Rev. Prov. 2017-34 to elect portability under Code Section 2010(c)(5)(A), and no user fee is required for submissions under this Revenue Procedure. Executors of estates who do not fall within the simplified method may request an extension of time to make the portability election by requesting a letter ruling under the provisions of Treas. Reg. Section 301.9100–3.

Regulations Updating Due Dates for Filing of Certain Returns

On July 18, the US Treasury Department and the IRS issued regulations (T.D. 9821 and REG-128483-15) updating the due dates and extensions for filing certain tax returns and information returns to comply with the Surface Transportation and Veterans Health Care Choice Improvement Act of 2015 and the Protecting Americans from Tax Hikes Act of 2015. The regulatory updates provide as follows:

- Partnerships and S Corporations. Partnership tax returns (Form 1065) will be due on March 15 for calendar year partnerships (or the 15th day of the third month for fiscal year partnerships), with a maximum six-month extension until September 15. The due date and extended due date for S corporation returns will remain unchanged (March 15 deadline with an extension until September 15).
- Trusts. Income tax returns for trusts and estates (Form 1041) will remain due on April 15, but the maximum extension for these filings has been extended from September 15 to September 30 for calendar-year taxpayers.
- Tax-Exempt Organization Filings. Form 990 series returns will be eligible for an automatic six-month extension, providing an extension until November 15 for organizations operating on a calendar year.

Code Section 2704 Regulations Withdrawn

On August 2, 2016, the Treasury Department issued proposed Regulations under Code Section 2704(b), which sought to curtail or negate valuation discounts that may apply in intra-family transactions of closely held business interests. There was a great deal of public outcry by practitioners and estate planning professionals on the overreaching scope of the proposed Regulations and the potential impacts on valuation discounts for family owned businesses.

President Trump issued an Executive Order on April 21 instructing the US Treasury to examine "significant tax regulations" issued on or after January 1, 2016 and take specific actions to mitigate the burden imposed by regulations identified as being unduly burdensome or adding excessive complexity. In response, in Notice 2017-38, the IRS identified eight tax regulations that either impose an undue financial burden or add excessive complexity to the tax system. Among the proposed regulations that were identified as burdensome were the proposed Regulations under Code Section 2704(b). The Notice specifically cites commetators'

concern that the proposed Regulations would effectively eliminate such common discounts as minority discounts and discounts for lack of marketability, which would result in increased transfer tax liability and a greater financial burden on taxpayers.

In response, on October 2, the Treasury finally withdrew the proposed Regulations under Code Section 2704. Treasury Secretary Steven M. Mnuchin issued a report titled "Identifying and Reducing Tax Regulatory Burdens," stating that the Treasury agreed with commentators and that the approach in the proposed Regulations was unworkable.

Recovery of Applicable Exclusion Amount and GST Exemption for Same-Sex Marriages

In 2013, Rev. Rul. 2013-17 provided that terms relating to marriage include same-sex couples for federal tax purposes. The ruling applied as of September 16, 2013, but allowed a refund claim for tax years in which the statute of limitations had not expired. However, it did not address tax years for which the statute of limitations has expired, or whether prior use of unified credit can be recovered. Notice 2017-15 lays out special administrative procedures under which certain taxpayers (and the executors of certain taxpayers' estates) may reclaim applicable exclusion and GST exemption amounts for transfers between same-sex spouses made before same-sex marriages were recognized for federal tax purposes. Under the Notice, taxpayers who were married under state law at the time a gift was made to a same-sex spouse that should have qualified for marital deduction may recalculate the remaining applicable exclusion amount as a result of recognizing the individual's marriage to his or her spouse, even if the statute of limitations on claiming a refund has expired. The Notice also clarifies that the allocation of any GST exemption to transfers that resulted from the failure to recognize the marriage of a same-sex couple for tax purposes will be voided: the exemption remaining to the taxpayer will be recalculated, regardless of whether the statute of limitations has run. However, the Notice specifies that taxpayers will not be eligible for a refund of taxes already paid if such claims are filed after the expiration of the limitations period under Code Section 6511.

Importance of Adequate Disclosure in Gift Tax Returns

In FAA 2017807F (July 14, 2017), the IRS chief counsel held that the three-year statute of limitations for the assessment of gift tax remained open indefinitely when a donor made gifts and (1) failed to file a gift tax return (Form 709) and, subsequently, (2) filed a Form 709 for a later year that did not adequately disclose the gifts. Under the fact pattern addressed in this memorandum, the donor had made gifts in years one through six, but did not file Forms 709 for any of those years. The donor then made gifts in year seven, and filed a Form 709; however, the filed Form 709 failed to describe the property transferred or provide a description of the method used to determine the value of that property. While Code Section 6501 states the general rule that gift tax shall be assessed within three years after a gift tax return is filed, an exception applies if a gift is not adequately disclosed. A gift will not be considered "adequately disclosed" unless it is "reported in a manner adequate to apprise the Internal Revenue Service of the nature of the gift and the basis for the value so reported." (Treas. Reg. Section 301.6501(c)-1(f)(2)). Therefore, a donor's gift tax return must include a description of property transferred during the reporting period, any consideration received by the transferor in exchange and a detailed description of the method used to calculate the value of the transferred property. In this fact pattern, the statute of limitations on the donor's gifts will remain open for the gifts made in all seven years until the donor files complete and accurate gift tax returns for each year. This memorandum highlights the importance of properly filing gift tax returns for (and adequately disclosing) all gifts in order to begin the statute of limitations for assessments.

Release of Automatic Estate Tax Lien

Upon a decedent's death, an estate tax lien attaches under Code Section 6324(a) to all property includible in the decedent's estate. The lien lasts for a period of 10 years. If property subject to the estate tax lien is to be sold, the estate may make a request for discharge of the estate tax lien by filing Form 4422 (Application for Certificate Discharging Property Subject to Estate Tax Lien).

Under prior procedures, a lien could be released within 10 days of submitting Form 4422. However, under new procedures beginning June 1, 2016, after the IRS accepts the Form 4422, the net sales proceeds must be either paid to the IRS or placed in escrow. The funds may be released upon the issuance of an estate tax closing letter.

In April 2017, the IRS issued guidance on requests for the discharge of an estate tax lien by an internal memorandum titled "Memorandum for Director Specialty Collection, Offers, Liens & Advisory—Director Special Examination Estate & Gift Tax." Under this guidance, IRS advisory personnel are to review the Form 4422 and substantiating documents to determine how much (if

any) of the sales proceeds must be held in escrow or paid to the IRS in exchange for a certificate of discharge. The memorandum provides greater flexibility for the discharge of a lien, and lists several situations in which a certificate of discharge may be issued because the liability secured by the lien has been fully satisfied or provided for:

- The estate is not required to file an estate tax return. Instead of a discharge certificate, the IRS will then issue a Letter 1352 evidencing no estate tax return filing requirement.
- The Form 4422 indicates that the estate is non-taxable, based on the estimated gross estate and estimated deductions. However, if the collection officer has a question regarding the effect of any deductions on the tax computation, the officer should submit the application to the Examination Estate & Gift group before making a decision on the application.
- The Form 4422 shows an estimated estate tax liabilty, and that the estate filed an extension request and paid the full estimated estate tax liability. However, if the collection officer has a question regarding the effect of any deductions on the tax computation, the officer should submit the application to the Examination Estate & Gift group before making a decision on the application.
- A Form 706 has been filed by the estate, and the reported tax has been paid. However, the officer should submit the application to the Examination Estate & Gift group regarding the estate tax computation or questions regarding the effect of any deductions on the tax computation.
- The remaining property of the estate subject to the estate tax lien has a fair market value that is at least double the amount of the unsatisfied tax liability secured by the estate tax lien and the amount of all other liens upon such property which have priority over the estate tax lien.
- An adequate amount (an amount not less that the value of the IRS's interest in the property being discharged) has been paid in partial satisfaction of the estate tax liability secured by the lien.
- The IRS's interest in the property subject to the lien has no value.
- Property subject to the estate tax lien is sold and the IRS determines that the proceeds of sale should be held in escrow as a fund subject to the estate tax lien in the same manner and with the same priority as the estate tax lien had with respect to the discharged property. Reasonable and necessary expenses incurred in connection with the sale of the property or administration of the sale proceeds will be paid from the proceeds of the sale before the satisfaction of any claims.
- The property owner deposits an amount equal to the value of the IRS's interest in the property or furnishes an acceptable bond in that amount.

Charitable Deduction for Distribution to Foreign Charity

In PLR 201702004, the IRS allowed a charitable deduction for a distribution to a foreign charity. In this PLR, the decedent's will devised property to a certain foreign charity on the condition that such donation qualified as a charitable distribution under Code Section 2055. The charity's purpose was to improve the quality of life of the handicapped and the elderly, particularly those who are underprivileged or affected by conflict. The charity was prohibited from using any part of its net earnings for the benefit of private stockholders, and was not permitted to use its assets for lobbying or any other political activities. Finally, the organization had not engaged in any "prohibited transactions." The Service therefore concluded that the foreign charity qualified as a charitable organization under Code Section 2055(a)(2), entitling the estate to a deduction equal to the fair market value of the donated property.

Conversion of Non-Grantor CLAT to Grantor Trust

In a series of three private letter rulings (PLR 201730012, 201730017 and 201730018), the IRS addressed the conversion of a non-grantor charitable lead annuity trust (CLAT) to a grantor CLAT. In PLR 201730012, a CLAT was converted from a non-grantor trust to a grantor trust by amending the trust to give a substitution power under Code Section 675(4) to the grantor's brother. The IRS ruled that the conversion of the CLAT from a non-grantor trust to a grantor trust would not be a taxable transfer of property held by the CLAT to the grantor for income tax purposes (assuming the substitution power was held in a non-fiduciary capacity). Additionally, the conversion was ruled not to be an act of self-dealing under the private foundation rules (specifically, Code Section 4941) because the holder of the substitution power was not a "disqualified person" under Code Section 4946(a). Finally,

because a grantor transferring property to a grantor CLAT would be eligible for a charitable deduction, the grantor sought an income tax charitable deduction under Code Section 170 based on the conversion of the CLAT to a grantor trust. The IRS held that the grantor could not claim an income tax charitable deduction because the conversion was not recognized for income tax purposes.

Important Cases Decided in 2017

Estate Inclusion Under 2036(a)(2) (and Possible Double Taxation) for Limited Partnership Interests

In *Estate of Powell vs. Comm'r* (148 T.C. No. 18 (May 18, 2017)), the Tax Court held that family limited partnership (FLP) assets were included in a decedent's taxable estate. This case highlights the risks of "deathbed planning," as well as the fact that the IRS continues to closely scrutinize FLP planning, especially when incorrectly formed and administered, or if not undertaken for a legitimate non-tax purpose. Notably, this case was the first case in which the Tax Court included limited partnership interests (rather than general partnership interests) in a decedent's estate under Code Section 2036(a)(2), as well as the first case in which the Tax Court introduced the risk of "double inclusion" of both partnership assets and the partnership interest in the decedent's estate.

In *Estate of Powell*, Ms. Powell's son, as her agent under a power of attorney (POA), formed a FLP. The General Partner (GP) was given unilateral control over partnership decisions. Two days later, $10 million in cash and securities were transferred from Ms. Powell's revocable trust to the FLP in exchange for a 99 percent limited partner interest. Ms. Powell's two sons acquired the GP interest in exchange for unsecured notes. Ms. Powell's son, acting as her agent under her POA, then assigned Ms. Powell's 99 percent limited partner interest to a CLAT that would pay an annuity to Ms. Powell's foundation during her lifetime, followed by a distribution of the remainder to her descendants at her death. Ms. Powell's POA allowed for gifting by the agent, but limited gifts made by the attorney-in-fact to the annual federal gift tax exclusion. Ms. Powell died one week after the funding of the FLP, and the transfer to the CLAT. Ms. Powell's son, as executor of her estate, filed a gift tax return for his mother for the value of the CLAT's remainder interest, which applied a 25 percent discount for lack of control and lack of marketability of the limited partner interest.

The Tax Court first held that the gift of limited partnership interests to the CLAT was not valid because the actions of Ms. Powell's son exceeded his authority as agent under her POA. The Tax Court concluded that the limited partnership interests were included in Ms. Powell's estate under Code Section 2036(a)(2). Section 2036(a)(2) provides that if the decedent has made a transfer of property (other than a bona fide sale for adequate and full consideration), the property is included in the decedent's gross estate if the decedent controlled "the right, either alone or in conjunction with any other person, to designate the persons who shall possess or enjoy the property or the income therefrom." Estate inclusion resulted from Ms. Powell's retained right to designate who could enjoy the FLP property. The Tax Court held that a limited partner's right to vote (in conjunction with other partners) on a FLP's dissolution was a power to designate the enjoyment of the FLP's assets. Additionally, the Tax Court imputed the GP's rights to Ms. Powell, finding that the GP's fiduciary duty to the FLP was illusory due to his relationship as both family member and attorney-in-fact of the limited partner.

Additionally, the majority opinion of the Tax Court introduced the possibility of "double inclusion" in a decedent's taxable estate: inclusion of both the value of the FLP interests as of the date of death and the value of the FLP's underlying assets as of the date of death (but offset by the consideration the limited partner received in return for the contribution to the FLP). Double inclusion would not apply if the FLP assets did not appreciate before the decedent's death (as in the Powell case). However, if the assets have appreciated, this opinion notes that a "duplicative transfer tax" may apply because the date of death value of the assets included in the gross estate under Code Section 2036 is only offset by the discounted value of the FLP interest received on the date of the contribution. As a result, all appreciation of the FLP assets after the contribution to the FLP would be included in the decedent's gross estate.

Substantiation Requirements for Charitable Deduction

In *RERI Holdings I LLC vs. Commissioner* (149 T.C. No. 1, July 3, 2017), the Tax Court held that a partnership was not entitled to a $33 million charitable contribution deduction for a charitable contribution of a remainder interest in real property. In this decision, the Tax Court held that the partnership failed to substantiate the value of the property on the return, and was also liable for a gross valuation misstatement penalty.

In March 2002, a partnership (RERI) purchased a remainder interest in land for $2.95 million. In August 2003, RERI assigned the remainder interest to the University of Michigan. RERI had an appraisal of the remainder interest conducted in September 2003. Based on this appraisal, which valued the property at $55 million and applied an actuarial factor under Code Section 7520 for the value of the remainder interest, RERI claimed a deduction of approximately $33,019,000 on its 2003 tax return. RERI attached a Form 8283, non-cash charitable contributions, to its return, along with an appraisal summary. The Form 8283 claimed the deduction, but the space for RERI's cost or other adjusted basis was left blank. The IRS audited RERI and issued a final partnership administrative adjustment in 2008. Upon audit, the IRS found that the value of the remainder interest in the contributed property was $3.9 million, and applied a substantial valuation misstatement penalty under Code Section 6662(e)(1).

The Tax Court held that RERI did not meet the substantiation requirements provided in Treas. Reg. Section 1.170A-13(c)(2); as a result, the Tax Court denied any charitable deduction under Code Section 170 for the contribution to the university. Furthermore, the Tax Court applied a gross valuation misstatement penalty under Code Section 6662(h). The Tax Court determined that the value of the remainder interest was $3,462,886. It also determined that Code Section 7520 was not applicable for the valuation of the remainder interest in this case, as the underlying agreements governing the property did not provide adequate protection to the holder of the remainder interest. Because the deduction RERI originally claimed was more than 400 percent of the determined value of the property interest, it was deemed a "gross valuation misstatement," The Tax Court then applied the 40 percent gross valuation misstatement penalty to the excess of the claimed deduction ($33,019,000) over the determined fair market value ($3,462,886).

Important Planning Considerations for 2017 and 2018

Review and Revise Your Estate Plan To Ensure It Remains Appropriate

We are currently planning in an environment of legislative uncertainty with a potential estate tax repeal or reduction of some form. There remains great uncertainty regarding whether the estate tax will be repealed, and if so, whether the repeal will be permanent.

You should review your estate planning documents to make sure that those documents still make sense in light of your current life circumstances, level of assets and/or recent gifting you may have done. For example, your estate planning documents may assume that you will have a high applicable exclusion amount remaining to be used at the time of your death. If you made large lifetime gifts, that assumption may no longer be true. As another example, the birth or death of a descendant or ancestor may prompt changes to beneficiaries of or trust provisions in your estate plan.

You should consider whether property held in an irrevocable trust should be distributed prior to death so that it may obtain a step-up in basis upon the death of the beneficiary to whom it was distributed. Whether such a distribution is advisable depends on a careful analysis of the basis of the assets held in trust, the beneficiary's assets and applicable exclusion amounts, as well as the possibility that the stepped-up basis may be eliminated by the new administration's tax reform. Though H.R.1 and the Senate Bill would retain the step up in basis at death, prior tax reform proposals have called for an elimination of the stepped up basis if the estate tax is repealed. If basis step up under Code Section 1014 remains in place if the estate tax is repealed, there is uncertainty on what assets passing to a beneficiary in the future may be eligible for a stepped-up basis.

You should continue to be cautious in relying on portability for your estate planning, as portability may not be the most beneficial strategy based on your personal situation. In addition, a deceased spouse's unused exemption (DSUE) may not be available upon remarriage of the surviving spouse. Furthermore, it is unknown whether portability will continue to apply under any tax reform.

You also should review any provisions in your will and trust agreements that distribute assets according to tax formulas and/or your applicable exclusion amounts to ensure that the provisions continue to accurately reflect your wishes when taking into account the higher applicable exclusion amounts and the potential repeal of the federal estate tax. For example, funding formulas that bequeath the maximum amount possible without incurring estate tax to a credit shelter trust may result in the entire estate passing to the credit shelter trust if the estate tax is repealed. You should consider whether your will and trust agreements should include funding formulas that would apply if the federal estate tax does not apply at your death.

Your allocation of your GST applicable exclusion amount should be reviewed to ensure that it is utilized most effectively if you wish to plan for grandchildren or more remote descendants.

Now that same-sex marriages must be recognized by every state, as well as the federal government, same-sex couples should continue to review and revise their estate planning documents and beneficiary designations to ensure that the amount and structure of any bequests to the spouse are appropriate, as well as consider the benefits of split-gifting for gift tax purposes. Same-sex couples should also consider amending previously filed federal estate, gift and income tax returns and state income tax returns, as well as reclaiming applicable exclusion and GST exemption amounts for transfers between the spouses made before same-sex marriages were recognized for federal tax purposes.

Finally, in view of the uncertainty of the current environment, your plan should be reviewed to ensure it provides for as much flexibility as possible. As discussed above, you should consider whether your formula bequests are appropriate under current law or if the federal estate tax is repealed. You may also wish to give limited powers of appointment to the beneficiaries of your trust instruments to provide post-mortem flexibility to beneficiaries. You may also wish to appoint a Trust Protector (or Trust Protector committee) in your trust instruments to give a third party the ability to modify or amend the document based on changes in the tax laws or unforeseen future circumstances, or to grant certain powers to trust beneficiaries that may have tax advantages under a new tax regime.

Avoid the Medicare Surtax With Trust Income Tax Planning

A complex, non-grantor trust with undistributed annual income over $12,500 will be subject to the 3.8 percent Medicare surtax. However, some or all of the Medicare surtax may be avoided by distributing such income directly to beneficiaries who are below the individual net investment income threshold amount for the Medicare surtax ($200,000 for single filers, $250,000 for married couples filing jointly and $125,000 for married individuals filing separately).

Careful evaluation of beneficiaries' circumstances and tax calculations should be made to determine whether trusts should distribute or retain their income.

Make Gifts To Take Advantage of the Increased Applicable Exclusion Amount

This year you now have a total of $5.49 million ($10.98 million for a married couple) that you can gift in the aggregate during your lifetime, subject to reduction for any gifts in excess of the Annual Exclusion Amount you previously have made. Gifts in excess of these amounts are subject to a maximum federal gift tax rate of 40 percent. If you are a surviving spouse and your deceased spouse left you with any DSUE, you may add such unused applicable exclusion amount to your own applicable exclusion amount from gift tax. It is less expensive to make lifetime gifts rather than making gifts at death, because you do not pay a tax on the dollars used to pay gift tax, but you do pay estate tax on the dollars used to pay estate tax. In addition, you will benefit by removing any income and appreciation on the gift from your estate. However, we encourage you to seek advice if you have used all of your applicable exclusion amount and would pay federal gift tax on any gifts. Due to the uncertainty of the federal estate tax, making gifts that result in significant gift tax payments may not always be advisable in the current environment.

A countervailing consideration of lifetime gifting is that the gifted assets will not get a step-up in basis upon your death (as will assets you hold at your death) and will thus generate capital gains tax if they are subsequently sold for an amount higher than their basis. Accordingly, the decision of whether and how to embark on a lifetime gifting strategy depends on a number of factors, including the bases of your various assets, their projected income and appreciation, the total amount of your assets, and your remaining applicable exclusion amount. For individuals with assets far exceeding their applicable exclusion amounts, lifetime gifting of high-basis assets generally will be recommended. However, individuals with total assets close to or below their applicable exclusion amounts should exercise caution before making gifts of low-basis assets. Instead, those individuals should consider holding their assets until death in order to achieve a step-up in basis upon death, while minimizing estate taxes. Of course, maintaining a comfortable standard of living is a factor that also must be considered. We are available to discuss this analysis with you in more detail.

Note that absent legislative reform, your applicable exclusion amount will increase by $110,000 ($220,000 for a married couple) in 2018. Therefore, even if you use some or even all of the applicable exclusion amount available to you before the end of 2017, you may still make additional gifts in 2018 without paying any gift tax. Based on current law, your applicable exclusion amount also will be adjusted for inflation in future years.

Transfer Techniques

Due to the uncertainties of the current tax environment, you may wish to consider techniques that minimize the risk of paying current gift taxes, but still allow you to shift assets and appreciation from your estate in case the federal estate tax remains in place. Lifetime gifting remains very important in providing asset protection benefits for beneficiaries of trusts that you establish, shifting income to beneficiaries in lower tax brackets, and providing funds for your children or others whose inheritance may be delayed by your longer life expectancy.

Grantor Retained Annuity Trusts (GRATs)

GRATs remain one of our most valuable planning tools, particularly in this time of continuing low interest rates. Due to rising interest rates and the fact that prior administrations' presidential budget proposals frequently call for adverse changes in how GRATs may be structured, GRATs should be created as soon as possible. Under current law, GRATs may be structured without making a taxable gift. Therefore, even if you have used all of your applicable exclusion amount, GRATs may be used without incurring any gift tax. Because GRATs may be created without a gift upon funding, they are an increasingly attractive technique for clients who want to continue planning to pass assets to their descendants without payment of gift tax in the uncertain tax environment.

A GRAT provides you with a fixed annual amount (the annuity) from the trust for a term of years (which may be as short as two years). The annuity you retain may be equal to 100 percent of the amount you use to fund the GRAT, plus the IRS-assumed rate of return applicable to GRATs (which for transfers made in November 2017 is 2.4 percent). As long as the GRAT assets outperform the applicable rate, at the end of the annuity term you will be able to achieve a transfer tax-free gift of the spread between the actual growth of the assets and the IRS assumed rate of return. Although you will retain the full value of the GRAT assets, if you survive the annuity term, the value of the GRAT assets in excess of your retained annuity amount will then pass to whomever you have named, either outright or in further trust, with no gift or estate tax.

Sales to Intentionally Defective Grantor Trusts (IDGTs)

As with GRATs, the current administration has not specifically addressed sales to IDGTs. However, because prior presidential budget proposals frequently called for elimination of the benefit of IDGTs, we recommend implementing these trusts as part of immediate planning.

In utilizing a sale to an IDGT, you would sell assets likely to appreciate in value to the IDGT in exchange for a commercially reasonable down payment and a promissory note from the trust for the balance. From an income tax perspective, no taxable gain would be recognized on the sale of the property to the IDGT because it is a grantor trust, which makes this essentially a sale to yourself. For the same reason, the interest payments on the note would not be taxable to you or deductible by the trust.

If the value of the assets grows at a greater pace than the prevailing applicable federal rate (which for sales in November 2017 is as low as 1.38 percent for a short-term sale), as with a GRAT, the appreciation beyond the federal rate will pass free of gift and estate tax. While interest rates are projected to rise, they are still relatively low; this make sales to IDGTs most opportune to structure now.

Consider Planning Using Valuation Discounts

In 2016, the United States Treasury Department issued long-awaited proposed regulations under Code Section 2704, which would have the effect of limiting valuation discounts that apply to some or possibly all family-owned businesses, such as family limited partnerships and limited liability companies. Under current law, the value of non-managing, non-controlling interests in these entities, regardless of whether or not they own operating assets, may be subject to discounts based on the lack of marketability and lack of control associated with these minority interests. The proposed regulations sought to curtail the use of minority discounts when valuing these interests. These Regulations prompted criticism and backlash from estate planning practitioners and legislators, in part because they would impact active (rather than just passive) business entities. In addition, in Notice 2017-38, the IRS identified these Regulations as having the potential to impose an undue financial burden on taxpayers or add undue complexity to the tax laws. Finally, the Treasury withdrew these proposed Regulations on October 2. Therefore, you should consider taking advantage of existing estate planning techniques with closely held businesses that utilize valuation discounts.

Consider a Swap or Buy-Back of Appreciated Low-Basis Assets From Grantor Trusts

If you sold or gave (through a GRAT or other grantor trust) an asset with a low basis, when that asset is sold, the gain will trigger capital gains tax. However, if you purchase the asset back from the grantor trust for fair market value, no gain or loss is recognized. The trust would then hold cash or other assets equal to the value of the asset that was repurchased. Alternatively, many grantor trust instruments give the grantor the power to substitute the trust's assets with other assets, which would allow the low-basis assets to be removed from the trust in exchange for assets of equal value that have a higher basis. Then on your death, the purchased or reacquired asset will be included in your taxable estate and will receive a step-up in basis equal to fair market value, eliminating the income tax cost to your beneficiaries. Clients whose estates may not be subject to estate taxes due to the current high exemption amounts may utilize swaps or buy-backs to "undo" prior planning strategies that are no longer needed in today's environment.

Consider the Use of Life Insurance

Life insurance presents significant opportunities to defer and/or avoid income taxes, as well as provide assets to pay estate tax or replace assets used to pay estate tax. Generally speaking, appreciation and/or income earned on a life insurance policy accumulates free of income taxes until the policy owner makes a withdrawal or surrenders or sells the policy. Thus, properly structured life insurance may be used as an effective tax-deferred retirement planning vehicle. Proceeds distributed upon the death of the insured are completely free of income taxes. You may want to consider paying off any outstanding loans against existing policies in order to maximize the proceeds available tax-free at your death, although potential gift tax consequences must be examined. Note that the decision to pay off such loans requires a comparison of the alternative investments that may be available to you with the assets you would use to repay the loans and the interest rate on the loans.

Use Intra-Family Loans and Consider Re-Financing Existing Intra-Family Loans

Because interest rates are so low, many techniques involving use of intra-family loans should be considered, including:

- The purchase of life insurance on the life of one family member by an irrevocable life insurance trust, with premium payments funded by loans from other family members.
- The creation of trusts by older generation members for the benefit of younger family members, to which the older generation members loan funds. The spread between the investment return earned by the trust and the interest owed will create a transfer tax-free gift.
- Forgiving loans previously made to family members. The amount that is forgiven in excess of the annual gift tax exclusion amount will be a gift, and thus will use a portion of your applicable gift tax and/or GST tax exclusion amount.

Consider Charitable Planning

A planning tool that is very effective in a low-interest-rate environment is a CLAT, which combines philanthropy with tax planning. A CLAT is an irrevocable trust that pays one or more named charities a specified annuity payment for a fixed term. At the end of the charitable term, any remaining assets in the CLAT pass to the remainder, noncharitable beneficiaries. As with a GRAT, to the extent the assets outperform the IRS assumed rate of return (2.4 percent for November 2017), those assets can pass transfer tax free to the beneficiaries you choose.

The Qualified Charitable Distribution rules were made permanent by the Tax Hikes (PATH) Act of 2015 on December 18, 2015. The PATH Act permanently extended the ability to make IRA charitable rollover gifts, which allow an individual who is 70½ or older to make a charitable rollover of up to $100,000 to a public charity without having to treat the distribution as taxable income. Other types of charitable organizations, such as supporting organizations, donor-advised funds or private foundations, are not eligible to receive the charitable rollover. Therefore, if you need to take your required minimum distribution for 2017, you may arrange for the distribution of up to $100,000 to be directly contributed to your favorite public charity and receive the income tax benefits of these newly permanent rules.

Plan for Deferred Compensation

Previously deferred compensation from services performed for offshore funds generally must be paid to the fund manager and included in the fund manager's income before 2018. There are steps which may be taken now to begin planning for the associated tax burden.

Year-End Checklist for 2017

In addition to the above planning ideas, consider the following before 2017 is over:

- Make year-end annual exclusion gifts of $14,000 ($28,000 for married couples).
- Make year-end IRA contributions.
- Create 529 Plan accounts before year-end for children and grandchildren, and consider front-loading the accounts with five years' worth of annual exclusion gifts, taking into account any gifts made during the year to children and grandchildren and bearing in mind the increase in annual exclusion amount to $15,000 in 2018.
- Pay tuition and non-reimbursable medical expenses directly to the school or medical provider.
- Consider making charitable gifts (including charitable IRA rollovers) before year-end to use the deduction on your 2017 income tax return.

Below is an overview of national, international and local developments that occurred in 2017.

International Developments in 2017

Global tax transparency has been marching on in 2017, which no doubt will continue. Many jurisdictions have signed onto the Common Reporting Standard (or CRS), discussed below, and more and more jurisdictions are implementing trust registries and ultimate beneficial owner (or UBO) registries for companies as well, if they have not done so already. In addition, on June 7, over 70 ministers and other high-level representatives participated in the signing ceremony of the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting. The United States has not yet signed onto to this Convention.

While local tax amnesties continue in many jurisdictions, concern for privacy and security is driving ultra high net worth families to restructure their entities in the United States. Of paramount importance to many international high net worth famillies is that even information reported directly to governments may not be protected. Of course, for how long the United States remains a holdout to CRS is anyone's guess, but certainly it does not seem likely to be addressed by our current government soon.

Common Reporting Standard (CRS)

CRS is part of an initiative introduced by the Organisation for Economic Co-operation and Development (OECD) aimed at facilitating the exchange of financial information on a global scale. Introduced in 2014, the new standard was implemented by 49 countries who have committed themselves to the initial exchange of information by September 2017, with an additional 53 countries committed to the initial exchange by September 2018. Under the new standard, the financial institutions of the subscribing jurisdictions will be required automatically to exchange information such as the identity and nationality of the ultimate beneficial owners of accounts in the country and the account balances at the end of the relevant fiscal year. Noticeably absent from the long list of countries that have signed on to the CRS is the United States. According to the OECD, the United States has indicated that it intends to create a similar free flow of financial information by supplementing the provisions of the Fair and Accurate Credit Transactions Act (FACTA) with intergovernmental agreements (IGAs) requiring reciprocal automatic exchange with partner jurisdictions, but whether or not, and if so how soon, the United States does so remains to be seen. For the moment, the Trump administration seems unlikely to sign on to CRS in the near future.

Revenue Ruling 91-32 and the Grecian Mining Case

In *Grecian Magnesite Mining, Co. vs. Comm'r*, 149 T.C. 3 (July 13, 2017), the US Tax Court held that a foreign corporation (Grecian Magnesite Mining) was not subject to US federal income tax on the gain realized upon the redemption of its interest in Premier Chemicals, LLC (PC), other than the portion of the gain that was attributable to US real property. PC was a domestic entity treated as a partnership for US federal income tax purposes that was engaged in the conduct of a US mining business. Notably, this case is the first time that a court has directly addressed the IRS' position in Rev. Rul. 91-32, 1991-1 C.B. 107. In Rev. Rul. 91-32, the IRS took the position that gain realized by a foreign person with respect to a disposition of a partnership interest should be treated as effectively connected income to the extent that partnership assets were used or held for use in a US trade or business. The holding of Rev. Rul. 91-32 has been criticized by many tax practitioners since its issuance. While the Tax Court's opinion remains subject to appeal, it opens up the possibility of attracting more foreign investors to inbound US non-real estate investment because of more favorable treatment upon a sale of a partnership interest. The Senate Bill proposes to take away the benefits for NRA taxpayers of this case, however. Due to proposed changes in US federal income tax law concerning the taxation of domestic corporations and pass-through entities, it is a good time for foreign families with existing or prospective investments in the United States to review their holding structures.

UK Tax Reform

The UK government will likely enact legislation that will affect the imposition of inheritance tax (IHT) on UK residential property. Formerly, UK non-domiciliaries could shelter UK assets from IHT by holding them through foreign entities. As a result, the property was "excluded property" outside the scope of IHT. The new legislation will bring shares of foreign companies and similar entities within the scope of IHT if the value of any interest in the entity is derived from residential property in the UK. In certain situations, however, it seems that a properly structured trust owning UK real property may not be subject to UK IHT.

Additionally, the UK government has proposed legislation shortening the amount of time after which an individual may become deemed domiciled in the UK. The proposed legislation would treat any individual who has been resident in the UK for at least 15 of the past 20 tax years as deemed domiciled in the UK for tax purposes. Once deemed UK domiciled, an individual would no longer be able to use the remittance basis of taxation, and his or her foreign and UK assets would be subject to UK tax. Based upon further new proposed legislation, the income of certain offshore trusts that are "protected" settlements and created by a non-domiciled individual may not immediately be subject to UK income tax even if the settlor does not claim the remittance basis. There are many nuances involved in this proposed legislation, however, and protected settlements may easily lose their preferred status.

French Tax Reform

The French government's draft Finance Bill for 2018 proposes to replace the French wealth tax with a tax on real estate assets. The tax would be imposed on all real estate assets owned directly by the taxpayer that are not related to business activities as of January 1, 2018.

Local Developments in 2017: State-Specific Considerations

California

Doing Business in California for Purposes of the California Franchise Tax

In *Swart Enterprises, Inc. vs. FTB*, the California Court of Appeal found that merely holding a passive, non-managing investment interest in a California limited liability company is not considered "doing business" in California for franchise tax purposes. California's franchise tax is imposed on every corporation that is "doing business" in California, whether or not it is incorporated, organized, qualified or registered under California law. The California Franchise Tax Board (FTB) has taken a very broad view of what constitutes doing business in California, and the *Swart* case is a prime example. Swart Enterprises, Inc. was a small family-owned, Iowa-based business that invested $50,000 for a 0.2 percent interest in Cypress Equipment Fund XII, LLC (Cypress), a California limited liability company acting as an investment and equipment leasing company.

Cypress was manager-managed (as opposed to member-managed), which meant that Cypress investors had no operational control over the company. The FTB determined that this investment constituted doing business in California and sent Swart a bill for the $800 minimum franchise tax, plus interest and penalties. Swart paid the tax and sued for a refund, and won both at trial and on appeal. The California Court of Appeal found that Swart's 0.2 percent passive investment closely resembled that of a limited, rather than general, partnership interest, as evidenced by the fact that Swart had no interest in the specific property of Cypress, was not personally liable for the obligations of Cypress, had no right to act on behalf of or to bind Cypress, and, most importantly, it had no ability to participate in the management and control of Cypress. As a result, the court held that Swart is not "doing business" in California and is, therefore, not subject to the California franchise tax.

California Adopts New Fiduciary Access to Digital Rights Act

California adopted a new law providing guidelines for a fiduciary's ability to access a decedent's digital records, such as e-mail, social media accounts and online storage sites for photos and music. California's law was based on the Uniform Fiduciary Access to Digital Assets Act and provides a sequence of rules that will govern disclosure of a user's digital assets after his or her death. The priority order is as follows: first, instructions provided through the use of the service provider's online tool will control; second, if the service provider does not provide an online tool, or if the user has not made use of the online tool, the instructions of a written record, such as a will or other estate planning document, will control; and finally, in the absence of an online tool, or instructions in a written record, the service provider's terms of service will govern.

Attorney-Client Privilege Limited for Former Trustees

In *Fiduciary Trust International of California vs. Klein*, former trustees sought to withhold from the successor trustee and the trust beneficiary documents relating to their two prior trust accountings on the basis of attorney-client privilege. The successor trustee demanded that the former trustees produce documents that included communications between the former trustees and their legal counsel. The trial court permitted the former trustees to withhold only 45 of the 234 documents identified in their supplemental privilege log, based on the fact that the successor trustee now held the attorney-client privilege. Both parties appealed, and the appellate court held that the appropriate inquiry to determine whether a document is privileged in this circumstance is whether, at the time the legal advice was sought, the purpose of obtaining such advice was for protection against liability. To assert the attorney-client privilege as the basis for withholding documents from the successor trustee, the predecessor trustee must have taken steps to preserve the confidentiality of the communication, such as hiring a separate lawyer or paying for the advice out of the trustee's personal funds. The party claiming the privilege has the burden to establish the preliminary facts necessary to support its claims of privilege by distinguishing his own interests from those of the beneficiaries. The appellate court remanded the case to determine the privilege status of the documents using this standard.

Federal Government Lien May Attach to a Discretionary Trust

After being convicted of theft from an employee benefit plan, Michael Harris was sentenced to jail and ordered to pay $646,000 in restitution. Harris was the beneficiary of two irrevocable trusts. One of the trusts provided that the trustee shall pay income in the trustee's absolute discretion for Harris' support, and the other trust provided that the trustee may distribute income and principal in the trustee's absolute discretion for his support. In *United States vs. Harris*, the district court granted the government's application for a writ of continuing garnishment for any property distributed from the trusts to Harris. The Ninth Circuit affirmed, finding that present and future interests in trust distributions fall within the definition of property under federal law, and are subject to garnishment. Importantly, despite the trustee's discretion with respect to both trusts, California law allows Harris to compel distributions from the trusts. Accordingly, the court found that a federal government lien may attach to Harris' right to receive the trust distributions, and that disclaimers and spendthrift clauses do not prevent attachment of federal liens.

Bankruptcy Trustee May Reach Assets in a Spendthrift Trust

In *Carmack vs. Reynolds*, the California Supreme Court held that a bankruptcy trustee, standing as a hypothetical judgment creditor, and under the exception to spendthrift provisions provided in California Probate Code Section 15306.5, can reach a beneficiary's interest in a trust that pays entirely out of principal in two ways. First, the creditor may reach up to the full amount of any distributions of principal that are currently due and payable to the beneficiary, even though they are still in the trustee's

hands, unless the trust instrument specifies that those distributions are for the beneficiary's support or education, and the beneficiary needs those distributions for either purpose. Separately, the bankruptcy trustee can reach up to 25 percent of any anticipated payments made to, or for the benefit of, the beneficiary, reduced to the extent necessary by the support needs of the beneficiary and any dependents.

Reverse Corporate Veil Piercing Now Exists in California

In *Curci Investments LLC vs. James Baldwin*, for the first time in California, the California Court of Appeal held that reverse veil piercing may be an available remedy to a creditor. A prominent real estate developer, James Baldwin, created a Delaware limited liability company (LLC) for the purpose of investing his and his wife's cash balances. Baldwin held a 99 percent membership interest and his wife held a 1 percent membership interest, and Baldwin served as the manager and CEO of the LLC. Two years after forming the LLC, Baldwin personally borrowed $5.5 million from Curci Investments LLC (Curci). Baldwin defaulted on the loan, and Curci obtained an entry of judgment against him. After Baldwin failed to make any payments and continued to claim he had no personal assets subject to the judgment, Curci sought to add the LLC as a judgment debtor, under a reverse veil piercing theory. The court found that the facts of this case warranted reverse veil piercing, including the fact that Baldwin and his wife were the sole shareholders and were both liable for the debt, that Baldwin completely controlled the LLC and controlled when distributions would be made, and that Baldwin and his wife had received $178 million in distributions prior to the judgment on the Curci note, but had not received a single distribution since the judgment. The court contrasted this case with prior precedent in California that refused to apply the reverse veil piercing theory, in cases involving a corporation rather than an LLC, and where the corporation had innocent shareholders who might be harmed by the judgment.

Illinois

The Illinois legislature, with about one-fifth of House Republicans joining, overrode the veto of Governor Rauner and enacted a budget, which included a significant income tax increase, effective as of July 1. The income tax rate for individuals, trusts and estates will rise from 3.75 percent to 5.25 percent. The income tax rate for corporations (other than S corporations) will rise from 5.25 percent to 7 percent.

New York

2017 was not a particularly active year for legislative reform in this area, but there are still some items of note.

New York's version of the Prudent Investor Act was amended to provide that adjustments between income and principal are taken into account for the purposes of calculating fiduciary commissions.

The Not-for-Profit Corporation Law was amended to make the annual financial filing requirements, temporarily imposed in 2013 for charities having annual gross revenues in excess of $500,000, permanent.

The Mental Hygiene Law was amended to permit adult siblings access to a patient's clinical records.

The Domestic Relations Law was amended to raise the minimum age to marry from 14 to 17.

The Department of Taxation and Finance has clarified that if an interest in real estate is distributed gratuitously from a trust to a trust beneficiary, no real estate transfer tax will be due.

In 2018, the Basic Exclusion Amount from New York State estate tax will be $5.25 million (subject to reduction as the taxable estate begins to exceed that amount). Current law provides that in 2019, the New York exclusion will match the federal exclusion.

North Carolina

North Carolina Uniform Power of Attorney Act (S.L. 2017-153)

The North Carolina Uniform Power of Attorney Act will become effective January 1, 2018. The new legislation will be codified as Chapter 32C of the North Carolina General Statutes, and will repeal all of Chapter 32A with the exception of Articles 3 and 4, which cover Health Care Powers of Attorney and Consent to Health Care for Minors respectively. The Act establishes a

comprehensive legal framework for the creation and use of powers of attorney and provides specific guidance and protections for principals, agents and third parties. It also seeks to identify and remedy abuse of a power of attorney by an agent.

Among the most important changes under the new Act are (1) a presumption of durability, (2) requiring acknowledgement of a power of attorney and (3) new agent anti-abuse requirements. A power of attorney created pursuant to the new Act will be presumed to be durable. Therefore, the incapacity of the principal shall only cause the power of attorney to terminate if the instrument contains explicit language to that effect. The new Act also specifically requires that a power of attorney be acknowledged, which is not a requirement for validity under current North Carolina law. Finally, the Act creates a two-tiered grant of authority system meant to curb abuse by agents acting under a power of attorney. Under this system, agents are generally prevented from dissipating the principal's property or altering the principal's estate plan without "specific" authority, which can only be granted through express language in the power of attorney itself. The new Section 32C-2-201(a) contains a list of actions for which such specific authority is required in the document.

North Carolina Uniform Trust Decanting Act (S.L. 2017-121)

The North Carolina Uniform Trust Decanting Act, N.C. Gen. Stat. Section 36C-8B-1 et seq. became effective on July 18. The new Act repealed and replaced N.C. Gen. Stat. Section 36C-8-816.1. The Act is applicable to all trusts with a principal place of administration in North Carolina, along with trusts which provide that North Carolina law governs administration, construction or the determination of the meaning or effect of trust terms.

The new Act provides for increased notice requirements prior to a decanting. Prior law only required that notice be given to the qualified beneficiaries of the original trust from which property was being decanted. Under the new Act, prior written notice must also be given to any settlor as to whom the second trust would be a grantor trust, any person with the right to remove the fiduciary causing the decanting and each other fiduciary of the original trust. The new Act also prevents a fiduciary from using decanting in order to unilaterally increase his or her compensation. Under the new Act, when the original trust instrument specifies the fiduciary's compensation, the fiduciary may not use the decanting power to increase compensation above the specified level unless such increase is consented to by all qualified beneficiaries of the second trust or by the Clerk of Superior Court. Finally, the new Act provides for an exception to the otherwise applicable restrictions on a fiduciary's decanting power when being used to decant a special needs trust to enable a beneficiary to qualify for governmental benefits.

Reformation and Correction of Wills and Trusts (S.L. 2017-152)

Effective as of January 1, 2018, S.L. 2017-152 provides for judicial modification of wills and trusts under particular circumstances. The law first amends Chapter 31 by allowing courts to amend wills (1) to correct mistakes and (2) to achieve testator's tax objectives. Under the new provision, the court may reform the terms of a will to conform to the testator's contrary intent, but only if the original terms are ambiguous and such contrary intent is proved by clear and convincing evidence. The amended statute also gives the court the power to modify the terms of a will to achieve a testator's tax objectives, provided such modification is not contrary to the testator's probable intent.

The law also limits the situations in which a court may reform the terms of a trust, specifically amending Section 36C-4-415 of the N.C. Uniform Trust Code. Whereas the statute currently allows the court to reform trust terms to conform to the settlor's intent even if the original terms are unambiguous, the amended provision will only allow for judicial reformation when the original terms are ambiguous. Similar to the new requirements for judicial correction of mistakes in wills, reformation of a trust will require clear and convincing evidence of the settlor's actual intent, along with proof that the original terms were affected by a mistake of fact or law, whether in expression or inducement.

We Can Help

We hope that this advisory helps you with your year-end estate and gift tax planning, and also provides you with some interesting ideas to consider for the future. As always, the Trusts and Estates practice stands ready and able to assist you with these matters at any time.

CHARLOTTE

Diane B. Burks, Special Counsel	+1.704.344.3153	diane.burks@kattenlaw.com
Joseph R. Shealy, Associate	+1.704.344.3076	joseph.shealy@kattenlaw.com
A. Victor Wray, Of Counsel	+1.704.444.2020	victor.wray@kattenlaw.com

CHICAGO

Charles Harris, Chicago Practice Head	+1.312.902.5213	charles.harris@kattenlaw.com
Michael O. Hartz, Chicago Practice Head	+1.312.902.5279	michael.hartz@kattenlaw.com
David M. Allen, Partner	+1.312.902.5260	david.allen@kattenlaw.com
Victor H. Bezman, Of Counsel	+1.312.902.5204	victor.bezman@kattenlaw.com
Elizabeth D. Creasy, Associate	+1.312.902.5513	elizabeth.creasy@kattenlaw.com
Hadar R. Danieli, Special Counsel	+1.312.902.5581	hadar.danieli@kattenlaw.com
Stuart E. Grass, Of Counsel	+1.312.902.5276	stuart.grass@kattenlaw.com
Royelle M. Kashiwahara, Associate	+1.312.902.5335	royelle.kashiwahara@kattenlaw.com
Melvin L. Katten, Senior Counsel	+1.312.902.5226	melvin.katten@kattenlaw.com
Tye J. Klooster, Partner	+1.312.902.5449	tye.klooster@kattenlaw.com
Louis A. Laski, Associate	+1.312.902.5607	louis.laski@kattenlaw.com
Andrew L. McKay, Associate	+1.312.902.5315	andrew.mckay@kattenlaw.com
Allan B. Muchin, Of Counsel	+1.312.902.5238	allan.muchin@kattenlaw.com
Kelli Chase Plotz, Special Counsel	+1.312.902.5347	kelli.plotz@kattenlaw.com
Bonita L. Stone, Partner	+1.312.902.5262	bonita.stone@kattenlaw.com
Philip J. Tortorich, Partner	+1.312.902.5643	philip.tortorich@kattenlaw.com

LOS ANGELES – CENTURY CITY

Abby Feinman, Los Angeles Practice Head	+1.310.788.4722	abby.feinman@kattenlaw.com
Whitney M. Schwartz, Special Counsel	+1.310.788.4514	whitney.schwartz@kattenlaw.com
Carol A. Johnston, Partner	+1.310.788.4505	carol.johnston@kattenlaw.com
Casey C. Verst, Associate	+1.310.788.4612	casey.verst@kattenlaw.com

NEW YORK

Joshua S. Rubenstein, National Practice Head	+1.212.940.7150	joshua.rubenstein@kattenlaw.com
Ronni G. Davidowitz, New York Practice Head	+1.212.940.7197	ronni.davidowitz@kattenlaw.com
Mal L. Barasch, Of Counsel	+1.212.940.8801	mal.barasch@kattenlaw.com
Lawrence B. Buttenwieser, Of Counsel	+1.212.940.8560	lawrence.buttenwieser@kattenlaw.com

Jonathan C. Byer, Associate	+1.212.940.6532	jonathan.byer@kattenlaw.com
Neil V. Carbone, Partner	+1.212.940.6786	neil.carbone@kattenlaw.com
Alexandra Copell, Associate	+1.212.940.8588	alexandra.copell@kattenlaw.com
Lauren G. Dell, Associate	+1.212.940.6344	lauren.dell@kattenlaw.com
Marla G. Franzese, Of Counsel	+1.212.940.8865	marla.franzese@kattenlaw.com
Robert E. Friedman, Of Counsel	+1.212.940.8744	robert.friedman@kattenlaw.com
Milton J. Kain, Of Counsel	+1.212.940.8750	milton.kain@kattenlaw.com
Dana B. Levine, Special Counsel	+1.212.940.6668	dana.levine@kattenlaw.com
Rebecca H. Lomazow, Associate	+1.212.940.6497	rebecca.lomazow@kattenlaw.com
Cynthia C. Reed, Associate	+1.212.940.6710	cynthia.reed@kattenlaw.com
Kathryn von Matthiessen, Partner	+1.212.940.8517	kathryn.vonmatthiessen@kattenlaw.com

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Katten Muchin Rosenman LLP

www.kattenlaw.com

AUSTIN | CENTURY CITY | CHARLOTTE | CHICAGO | HOUSTON | IRVING | LONDON | LOS ANGELES | NEW YORK | ORANGE COUNTY | SAN FRANCISCO BAY AREA | SHANGHAI | WASHINGTON, DC

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