November 19, 2018

2018 Year-End Estate Planning Advisory

Overview

This year brought sweeping change to our country's tax system. On December 22, 2017, President Trump signed the law commonly known as the Tax Cuts and Jobs Act (the Act). The Act and its resulting tax reform have dominated the legislative and planning landscape for much of 2018. The Act made significant changes to the individual and corporate income taxes, restructured international tax rules, provided a deduction for pass-through income and eliminated many itemized deductions. Most significantly for estate planning purposes, the Act has temporarily doubled the estate, gift and generation-skipping transfer tax exemptions. Absent legislative action, many of the changes imposed under the Act—including the increased exemptions—will sunset after December 31, 2025, with the laws currently scheduled to revert back to those that existed prior to the Act. This temporary increase in exemption amounts has created an unprecedented opportunity for valuable estate planning.

There were also significant cases decided in the past year. In 2017, the case of *Estate of Powell vs. Comm'r* (148 T.C. No. 18 (May 18, 2017)) represented the first time in which the Tax Court included limited partnership interests (rather than general partnership interests) in a decedent's estate under Internal Revenue Code (the Code) Section 2036(a)(2), under the theory that the partners could unanimously agree to terminate the partnership. In 2018, the *Powell* case was cited as precedential authority in *Estate of Cahill vs. Commissioner* (T.C. Memo 2018-84), in which the Tax Court determined that a decedent's right, in conjunction with others, to terminate a split-dollar agreement was a retained right under Section 2036(a)(2) and 2038(a). Additionally, state courts have addressed the limits of the constitutionality of state taxation of trusts. The case of *Kaestner 1992 Family Trust vs. North Carolina Department of Revenue* (No. 307PA15-2 (N.C. S.Ct. June 8, 2018)), decided by the North Carolina Supreme Court, has the potential to impact trust taxation in states that tax trusts based solely on the residence of the trust beneficiaries.

While the permanency of the Act's provisions remains uncertain, the current environment provides a great deal of opportunity for new planning. We are encouraging clients to build flexibility into their estate plans and to use this window of opportunity to engage in planning to take advantage of the increased estate, gift and generation-skipping transfer (GST) tax exemptions.

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

Federal Estate, GST and Gift Tax Rates

For 2018, the estate, gift and GST applicable exclusion amounts are $11.18 million. For 2019, the estate, gift and GST applicable exclusion amounts are projected to be $11.4 million. The maximum rate for estate, gift and GST taxes is projected to 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 $15,000 per donee in 2018. Thus, this year a married couple together can gift $30,000 to each donee without gift tax consequences. In 2019, the annual exclusion for gifts is projected to remain at $15,000. The limitation on annual gifts made to noncitizen spouses is projected to increase from $152,000 in 2018 to $155,000 in 2019.

Federal Income Tax Rates

- The Act provides for seven (7) individual income tax brackets, with a maximum rate of 37 percent. The 37 percent tax rate will affect single taxpayers whose income exceeds $500,000 (indexed for inflation) and married taxpayers filing jointly whose income exceeds $600,000 (indexed for inflation). Estates and trusts will reach the maximum rate with taxable income over $12,500.
- Capital gains will be taxed at 20 percent for single taxpayers whose income exceeds $425,800, and married taxpayers filing jointly whose income exceeds $479,000. There is a zero (0) percent capital gains rate that applies for single filers with income up to $38,600 or married taxpayers filing jointly with income up to $77,200. There is also a 15 percent rate that applies for income above this threshold up to $425,800 (for single filers) or $479,000 (for married taxpayers filing jointly).
- The standard deduction was increased to $24,000 for married individuals.
- In 2018, the threshold for the imposition of the 3.8 percent Medicare surtax on investment income and 0.9 percent Medicare surtax on earned income is $200,000 for single filers, $250,000 for married filers filing jointly, and $12,500 for trusts and estates.

Tax Cuts and Jobs Act

The Act has many implications for domestic corporate and individual income tax, as well as federal gift, estate and GST tax, fiduciary income tax and international tax implications. In light of the changes discussed below, it is important to review existing estate plans, consider future planning to take advantage of the increased exemption amounts and maintain flexibility to allow for future strategic planning.

Gift, Estate, and GST Exemptions, Rates and Stepped-Up Basis

The Act retained the federal estate, gift and GST tax rates at a top rate of 40 percent, as well as the marked-to-market income tax basis for assets includable in a decedent's taxable estate at death.

While the federal gift, estate and GST taxes were not repealed by the Act, fewer taxpayers will be subject to these transfer taxes due to the Act's increase of the related exemption amounts. Under the Act, the base federal gift, estate and GST tax exemptions have doubled from $5 million per person to $10 million per person, indexed for inflation. As noted above, the relevant exemption amount for 2018 is $11.18 million per person, resulting in a married couple's ability to pass $22.36 million worth of assets free of federal estate, gift and GST taxes. These amounts will increase each year until the end of 2025, with inflation adjustments to be determined by the chained Consumer Price Index (CPI) (which will lead to smaller increases in the relevant exemption amounts in future years than would have resulted from the previously used traditional CPI). Without further legislative action, the increased exemption amounts will sunset, and the prior exemption amounts (indexed for inflation, using the chained CPI figure) will be restored, beginning in 2026.

While the federal estate tax exemption amount has increased, note that multiple US states impose a state level estate tax. The estate tax exemption amount in some of these states matches, or will match, the increased federal estate tax exemption amount. However, in other states, such as Illinois and New York, the state estate tax exemption amount will not increase with the federal estate tax exemption amount, absent a change in relevant state law. Additionally, states may have their own laws that impact planning in that state. For example, in New York, for decedents dying in 2018, gifts made from April 2014 until January 2019 will be included in the base amount for calculation of state estate tax.

It should also be noted that the federal estate tax exemption that applies to non-resident aliens was not increased under the Act. Under current law, the exemption for nonresident aliens remains at $60,000 (absent the application of an estate tax treaty).

There is uncertainty about whether future legislation will address the sunset, either by extending the new exemption amounts beyond 2025 or changing the exemption amounts further. There is also uncertainty on how the IRS will address differences between the exemption amounts at the date of a gift and exemption amounts at the date of a taxpayer's death (often referred to as a "clawback"). As of the date of this advisory, the IRS has not yet addressed how, or if, additional gift and/or estate taxes may be due on planning that takes advantage of the increased exemption. The IRS has also not addressed the impact of the increased exemption amounts on the portability election if one spouse dies before 2026, but the surviving spouse dies after the sunset of the increased exemption amounts. The Act directs the US Department of the Treasury to issue regulations addressing a difference in the basic exclusion amount at the time of a taxpayer's gift and the time of the taxpayer's death. While most believe that clawback is not the intent of the Act, the potential of clawback should be discussed with advisors as taxpayers entertain planning to take advantage of the increased federal exemptions.

Income Taxation of Trusts and Estates

The Act added new Code Section 67(g), which applies to trusts and estates as well as individuals, and provides that no miscellaneous itemized deductions (all deductions other than those specifically listed in Code Section 67(b)) are available until the Act sunsets after December 31, 2025. While the Act doubled the standard deduction for individuals, taxpayers that are trusts and estates are not provided a standard deduction. Under the Act, trust investment management fees will no longer be deductible. After the enactment of the Act, there was uncertainty about the deductibility of fees directly related to the administration of a trust or estate (e.g., fiduciary compensation, legal fees, appraisals, accountings, etc.). Historically, these fees had been deductible under Code Section 67(e) and without regard to whether they were miscellaneous itemized deductions or not. In Notice 2018-61, the Treasury issued guidance on whether new Code Section 67(g) eliminates these deductions. This Notice provides that expenses under Code Section 67(e) are not itemized deductions and, therefore, are not suspended under new Code Section 67(g). Note that only expenses incurred solely because the property is held in an estate or trust will be deductible. While the Notice went into effect July 13, estates and non-grantor trusts may rely on its guidance for the entire taxable year beginning after December 31, 2017.

New Code Section 67(g) may also impact a beneficiary's ability to deduct excess deductions or losses of an estate or trust upon termination. Prior to the Act, it was common tax planning to carry out unused deductions of a trust or estate to the beneficiary upon termination, so the deductions could be used on the beneficiary's personal income tax return. Under new Code Section 67(g), these deductions are miscellaneous itemized deductions and, therefore, would no longer be deductible by the beneficiary. Notice 2018-61 notes that the IRS and the Treasury recognize that Section 67(g) may impact a beneficiary's ability to deduct unused deductions upon the termination of a trust or an estate, and the IRS and Treasury intend to issue regulations in this area and request comments on this issue. In the interim, taxpayers should consult with their advisors about whether it would be prudent to engage in planning to utilize (to the extent permissible) these deductions at the trust or estate level.

Finally, the Act made a number of taxpayer-friendly changes to the taxation of electing small business trusts (ESBTs). Non-resident aliens are now permissible potential beneficiaries of ESBTs. Also, the charitable deduction rules for ESBTs are now governed by Code Section 170 instead of Code Section 642(c), which means that several restrictions imposed by Code Section 642(c) (e.g., that the charitable donation be paid out of income and pursuant to the terms of the trust) no longer apply. Additionally, an ESBT's excess charitable deductions can now be carried forward five years, but the percentage limitations and substantiation requirements will now apply.

Income Tax

The Act made significant changes to the federal income tax. While many federal income tax changes under the Act are beyond the scope of this advisory, some are particularly relevant to estate planning. The deduction for state and local taxes (the SALT deduction) was retained, but is now limited to $10,000 for jointly filing taxpayers or unmarried taxpayers. The $10,000 limit also applies to trusts. Almost immediately after the Act's passage, a number of states implemented workarounds to the SALT deduction limit by allowing residents to "contribute" to state-controlled charitable funds in exchange for SALT credits. The aim of these workarounds is to allow residents to characterize such contributions as fully deductible charitable contributions for federal income tax purposes, while simultaneously permitting a credit for state or local income, real estate or other taxes for the same contribution. In the proposed regulations released in August, the IRS responded to these workarounds by limiting federal income tax deductions that taxpayers, including trusts or estates, are able to take upon charitable contributions to such state-controlled charitable funds under Section 170 of the Code.

Under the proposed regulations, a taxpayer that makes payments or transfers property to an entity eligible to receive tax deductible contributions would have to reduce its charitable deduction by the amount of any state or local tax credit the taxpayer receives or expects to receive. Therefore, a tax credit received in return for the contribution is treated as a *quid pro* *quo* benefit for the contribution, reducing the amount of the charitable income tax deduction otherwise available dollar-for-dollar. However, there is a *de minimis* exception: if the amount of the SALT credit does not exceed 15 percent of the amount of the contribution, the taxpayer's charitable income tax deduction is not required to be reduced.

The proposed regulations state that they are to apply to contributions to all SALT credit programs made after August 27. While the proposed regulations target recently enacted state and local legislative efforts seeking to circumvent the new annual $10,000 SALT limitation, their application may also extend to long-standing programs across the country in which state and local tax credits have been provided for donations to certain community organizations and private schools where taxpayers have been claiming charitable contribution deductions notwithstanding the tax credits provided in return.

Additionally, the deduction for home mortgage interest for acquisition indebtedness of a residence has been reduced. For indebtedness incurred after December 15, 2017, the deduction is limited to the interest on $750,000 of debt (rather than $1,000,000 of debt, as under prior law). The Pease limitation—which reduced most itemized deductions by 3 percent of the amount by which a taxpayer's adjusted gross income exceeded a certain amount (in 2017, $313,800 for married taxpayers), with a maximum reduction of 80 percent—is also eliminated for years 2018–2025. The Act also eliminates many itemized deductions through 2025, while "above the line" deductions are generally not impacted.

The Act also has implications for married couples who are divorcing or contemplating a divorce. The Act changes prior law to provide that alimony payments will not be deductible by the payor and will not be deemed to be income to the recipient. The Act also repealed Code Section 682, which generally provided that if a spouse created a grantor trust for the benefit of his or her spouse, the trust income would not be taxed as a grantor trust as to the grantor-spouse after divorce to the extent of any fiduciary accounting income the recipient-spouse is entitled to receive. Due to the repeal of Section 682, a former spouse's beneficial interest in a trust may cause the trust to be taxed as a grantor trust as to the grantor-spouse even after divorce. These changes to the taxation of alimony and the repeal of Code Section 682 do not sunset after 2025; they apply to any divorce or separation instrument executed after December 31, or any divorce or separation instrument executed before year-end but later modified, if the modification expressly provides that changes made by the Act should apply to the modification.

Charitable Deduction

The Act increases the percentage limitation on cash contributions to public charities from 50 percent of the donor's contribution base (generally, the donor's adjusted gross income) to 60 percent. This 60 percent limitation applies if only cash gifts are made to public charities. The deduction limitations remain the same for donations of other assets, such as stock, real estate and tangible property.

Business Entities

The Act reduced the top corporate income tax rate to 21 percent. To decrease the discrepancy in the tax rates between C corporations and pass-through entities, the Act also addressed taxation of pass-through entities (partnerships, limited liability companies, S corporations or sole proprietorships) that would typically be taxed at the rate of the individual owners. Generally, new Section 199A provides a deduction for the individual owner of 20 percent of the owner's qualified business income (QBI). This deduction has the effect of reducing the effective income tax rate for an owner in the highest tax bracket from 37 percent to 29.6 percent. The deduction is subject to numerous limitations and exceptions. Notably, the deduction may be limited for taxpayers over a certain taxable income threshold ($315,000 for married taxpayers filing jointly and $157,500 for other taxpayers, to be adjusted for inflation in future years). For these taxpayers, the deduction may be subject to limitations based on whether the entity is a specified service business (an SSTB, which is generally a trade or business involving the performance of services in health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, investing and investment management, trading, or where the principal asset is the reputation or skill of one or more employees), the W-2 wages paid by the business entity, and the unadjusted basis immediately after acquisition (UBIA) of qualified property held by the trade or business. On August 8, the IRS issued 184 pages of Proposed Regulations on new Section 199A, as well as Notice 2018-64 that addresses issues on computations under these provisions. The rules surrounding the deduction, as well as the Proposed Regulations, are very complex, and taxpayers should consult with their tax advisors to determine the implications of the Section 199A deduction. Section 199A is effective until December 31, 2025.

Important Cases Decided in 2018

Estate of Cahill vs. Commissioner (T.C. Memo 2018-84)

In *Estate of Powell vs. Commissioner* (148 T.C. 18), decided in 2017, the Tax Court applied Code Section 2036(a)(2) to include a pro rata value of a limited partnership's assets in a decedent's estate because the partners could unanimously agree to terminate the partnership. Practitioners had expressed concern that *Powell* could be extended to other multi-party arrangements in which the parties could agree to terminate an arrangement or contractual agreement. The *Cahill* case is significant because the Tax Court used its reasoning in *Powell* in the context of a split-dollar arrangement to deny summary judgment to an estate on the issue of estate inclusion.

In *Cahill*, a split-dollar arrangement was established in 2010. The decedent's son, as agent under the decedent's power of attorney, created an irrevocable trust to acquire life insurance policies on the son and the son's wife. The decedent's son was also the Trustee of the decedent's revocable trust. In 2010, the decedent's revocable trust borrowed $10 million and used the loan proceeds to acquire the life insurance policies. The irrevocable trust was named as the owner of the policies. The two trusts entered into a split-dollar agreement to provide that the revocable trust would be reimbursed for the $10 million it had advanced for the premium payment. The decedent died in December 2012. On the estate's federal estate tax return, the estate valued the estate's reimbursement right at $183,700, based on the period of time that would elapse before the policies would mature at the death of the decedent's son and his wife. The IRS issued a notice of deficiency claiming that the reimbursement right should be valued at the cash surrender value of the policies on the date of the decedent's death ($9,611,624), pursuant in part to Code Sections 2036, 2038 and 2703. In addition, the IRS assessed penalties of over $2.2 million based on negligence and either a gross or substantial valuation misstatement.

In denying the estate's motion for summary judgment, the Tax Court held that Sections 2036(a)(2) and 2038(a)(1) could be applicable because the decedent, in conjunction with the irrevocable trust, could agree to terminate the split-dollar agreement at any time. The court applied the reasoning of the 2017 *Powell* decision, which held in part that a decedent's ability to dissolve a limited partnership with the cooperation of her sons constituted a right, in conjunction with others, to designate the persons who shall possess or enjoy the transferred property within the meaning of Code Section 2036(a)(2). Additionally, the court held that the exception for bona fide sales for full and adequate consideration did not apply, as the decedent's son stood on both sides of the transaction. The court found that the consideration the decedent received was not adequate based on the value of the reimbursement right that the estate claimed the decedent received ($183,700) as compared to the $10 million that was paid.

Additionally, the court broadly interpreted Section 2703(a) in finding that Section 2703(a) could be applicable to the intergenerational split-dollar plan. In *Cahill*, the court considered whether the restriction on the decedent's right to terminate the arrangement (the irrevocable trust's right to veto termination of the split-dollar agreement) should be ignored for the purposes of valuing the decedent's reimbursement right. The court held that the irrevocable trust's veto right should be disregarded for valuation purposes. It should be noted that the court denied the estate's motion for summary judgment on this issue, and did not rule Code Section 2703(a) to be applicable. However, the court's reasoning provides a strong argument for the application of Code Section 2703.

Finally, the estate argued that applying Code Sections 2036, 2038 and 2703 to include the cash surrender value of the policies subject to the split dollar agreements in the decedent's gross estate was inconsistent with Reg. Section 1.61-22. Generally, under Reg. Section 1.61-22, the only amount transferred each year under the economic benefit regime of the split-dollar regulations is the current cost of insurance protection for that year. The court determined that those regulations apply for income and gift tax purposes, but not for estate tax purposes.

Constitutionality of State Taxation of Trusts

States have varying requirements to determine whether, and to what extent, a trust can be subject to state income tax. Some states consider the residence of the grantor when the trust was established, some states look at the residence of the trustee, and some states impose tax liability on a trust if one or more trust beneficiaries are residents of that state. However, many attempts by states to impose state income taxation on trusts using existing statutes have been found to violate the US and state constitutions. In 2018, decisions in North Carolina and Minnesota show how courts are challenging the constitutionality of state taxation statutes.

Kaestner 1992 Family Trust vs. North Carolina Department of Revenue, No. 307PA15-2 (N.C. S.Ct. June 8, 2018)

On June 8, the North Carolina Supreme Court ruled that it was unconstitutional for North Carolina to impose income tax on the Kimberly Rice Kaestner 1992 Family Trust, when the trust's only connection to the state was the residence of a beneficiary.

The trust was created in New York and governed by New York law. When the trust was created, no beneficiaries lived in North Carolina. In 1997, Kimberly Rice Kaestner (the grantor's daughter and a primary beneficiary) became a North Carolina resident. The trust had no other connections to North Carolina: during the years at issue, the trustee was a Connecticut resident, the trust records, documents and books were kept in New York; all trust tax returns and accountings were prepared in New York; the custodians of the trust's assets were located in Massachusetts; and no trust income was generated from investments located in North Carolina. All trust distributions were made in the trustee's sole discretion, so the North Carolina resident beneficiary had no absolute right to the trust's assets or income. Additionally, no distributions were actually made to the North Carolina resident beneficiary during the years at issue. The trust instrument did instruct the trustee to distribute the assets to the North Carolina resident beneficiary when she reached a specified age, but this did not occur during the tax years at issue.

North Carolina imposes income tax on trusts based on the residence of the beneficiaries. Pursuant to N.C.G.S. Section 105-160.2, "[t]ax is computed on the amount of the taxable income of the estate or trust that is for the benefit of a resident of this State." For the tax years of 2005–2008, the trust paid in excess of $1.3 million in taxes on its accumulated income to the North Carolina Department of Revenue based on Ms. Kaestner's residence in North Carolina.

The trust sought a refund of tax previously paid for the tax years 2005–2008, arguing that the relevant portion of the North Carolina statute that imposed a tax on trust income was unconstitutional. When the refund claim was denied, the trust brought suit challenging the constitutionality of the statute, both on its face and as applied to the trust. The North Carolina Business Court and the North Carolina Court of Appeals found the statute to be unconstitutional as applied to the trust. The state appealed those rulings to the North Carolina Supreme Court.

The North Carolina Supreme Court held that the statute, as applied to the trust, violated both the Due Process Clause and Commerce Clauses because the trust did not have sufficient minimum contacts with the state of North Carolina to be constitutionally subject to tax in that state. The court found it significant that the trust did not have any connection to the state other than the fact that a primary beneficiary was a North Carolina resident. Because a trust has a separate legal existence from its beneficiaries, the beneficiary's contacts with the state of North Carolina could not be attributed to the Trust.

The North Carolina Supreme Court highlighted that it only considered whether the statute was constitutional as applied to the trust and not whether the statute was unconstitutional on its face (i.e., as applied to all trusts). However, this ruling—though limited—could have far-reaching consequences for other trusts. Based on this ruling, any trusts that have paid income tax in the state of North Carolina when the trust's *only* connection with North Carolina is the residence of a beneficiary should carefully consider whether to apply for refunds on any open years and whether North Carolina state income taxes may be due in future years. This case may also have implications for trusts paying income taxes in other states that impose income tax on trusts based solely on the residence of a beneficiary.

Fielding vs. Commissioner of Revenue, Minnesota Supreme Court, No. A17-1177, July 18, 2018

Under Minnesota law, a trust is taxed as a Minnesota resident if the grantor was a Minnesota resident when the trust became irrevocable. In *Fielding*, the Minnesota Supreme Court held that the state's trust taxation statute was unconstitutional as applied to the trusts at issue. In *Fielding*, four trusts were created by a Minnesota resident in 2009. The trusts became irrevocable in 2011, when the grantor was still a Minnesota resident; as a result, the trusts were classified as resident trusts under the Minnesota income tax statutes. In 2014, the trusts sold stock and were subject to Minnesota income tax on the full amount of the gain under the applicable taxation statute. During the year at issue, no trustee had been a Minnesota resident: the trusts were not administered in Minnesota: the records of the trust's assets and income were maintained out of state: and three out of four of the trusts' beneficiaries lived outside of Minnesota.

The Minnesota Supreme Court held that Minnesota's taxation of the trust's worldwide income of the trusts at issue would violate the Due Process Clause of the US Constitution and the Minnesota constitution. The court found that the trusts at issue had insufficient contacts with the state of Minnesota to permit the state to impose income taxation on the trust's non-Minnesota source income. Rather than considering only the residence of the grantor, the Minnesota Supreme Court held that all relevant contacts between a trust and the state should be considered, including the relationship between the income earned by the trusts and the benefits conferred upon it by the state of Minnesota. The court held that the residency of the grantor upon the creation of the trust was not, in itself, a sufficient contact in this case to justify imposition of Minnesota income tax on all trust income.

Important Planning Considerations for 2018 and 2019

Given the changes implemented by the Act, taxpayers should review their existing estate plans and consult with their tax advisors about how to best take advantage of the higher exemption amounts while they are available. The following is a summary of several items that should be considered.

Review Formula Bequests

Many estate plans utilize "formula clauses" that divide assets upon the death of the first spouse between a "credit shelter trust," which utilizes the client's remaining federal estate tax exemption amount, and a "marital trust", which qualifies for the federal estate tax marital deduction and postpones the payment of federal estate taxes on the assets held in the marital trust until the death of the surviving spouse. While the surviving spouse is the only permissible beneficiary of the marital trust, the credit shelter trust may have a different class of beneficiaries, such as children from a prior marriage. With the Act's increase in the exemption amounts, an existing formula clause could potentially fund the credit shelter trust with up to the full federal exemption amount of $11.18 million. This formula could potentially result in a smaller bequest to the marital trust for the benefit of the surviving spouse than was intended, or even no bequest for the surviving spouse at all. There are many other examples of plans that leave the exemption amount and the balance of the assets to different beneficiaries. Taxpayers should review any existing formula clauses in their current estate plans to ensure they are still appropriate given the increase in the federal exemption amounts and the implications of the potential sunset of these exemption amounts. In addition, taxpayers should consider alternative drafting strategies, such as disclaimers, to maintain flexibility in their plans.

Income Tax Basis Planning

Taxpayers should consider the potential tradeoffs of utilizing the increased exemption amounts during their lifetimes to gift assets to others, as opposed to retaining appreciated assets until their death so that those assets receive a stepped-up income tax basis. Taxpayers may want to consider retaining low basis assets, which would then be included in their taxable estates and receive a step-up in income tax basis, while prioritizing high income tax basis assets for potential lifetime gift transactions. In addition, if a trust beneficiary has unused federal estate tax exemption, consideration should be given to strategies that would lead to low income tax basis assets currently held in trust, and otherwise not includable in a beneficiary's taxable estate, being included in the beneficiary's taxable estate, such as:

- granting the beneficiary a general power of appointment over the trust assets;
- utilizing the trust's distribution provisions to distribute assets directly to the beneficiary, so the assets may obtain a step-up in basis upon the death of the beneficiary to whom it was distributed; or
- converting a beneficiary's limited power of appointment into a general power of appointment by a technique commonly known as "tripping the Delaware tax trap."

Consequently, the assets included in the beneficiary's estate would receive a step up in income tax basis at the beneficiary's death and would take advantage of the beneficiary's unused federal estate tax exemption amount. Whether these techniques should be implemented depends on a careful analysis of the basis of the assets held in trust and the beneficiary's assets and applicable exclusion amounts, and should be discussed with advisors.

529 Plan Changes

The Act expanded the benefits of 529 Plans for federal income tax purposes. Historically, withdrawals from 529 Plans have been free from federal income tax if the funds were used towards qualified higher education expenses. Under the Act, qualified withdrawals of up to $10,000 can now also be made from 529 Plans for tuition in K-12 schools. As a result, the owner of the 529 Plan can withdraw up to $10,000 per beneficiary each year to use towards K-12 education. The earnings on these withdrawals will be exempt from federal income tax under the Act. However, it should be noted that each state has its own specific laws addressing 529 Plan withdrawals, and not all states provide that withdrawals for K-12 tuition will be exempt from state income taxes. Taxpayers should consult with their advisors to confirm the rules in their respective states.

Planning To Utilize Increased Federal Exemptions

Given that the increased federal exemption amounts are currently set to sunset at the end of 2025, it may be prudent to make use of these increased amounts before they disappear (with a caveat that the law may, of course, change).

Gifting Techniques To Take Advantage of the Increased Applicable Exclusion Amount

Taxpayers may want to consider making gifts to utilize the increased federal exclusion amount. It is less expensive to make lifetime gifts rather than making gifts at death, because tax is not imposed on dollars used to pay gift tax, but estate tax is imposed on the dollars used to pay estate tax. In addition, taxpayers may benefit by removing any income and appreciation on the gift from their estate. However, taxpayers should seek advice if they have used all of their applicable exclusion amount and would pay federal gift tax on any gifts. 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 death (as would assets held at 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 the transferor's various assets, their projected income and appreciation, the total amount of the transferor's assets, and the transferor's remaining applicable exclusion amount. For individuals with assets far exceeding their applicable exclusion amounts, lifetime gifting of high-basis assets generally may 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.

If undertaking a gifting strategy, gifts to utilize the increased exemption may be made to existing or newly created trusts. For instance, a taxpayer could create a trust for the benefit of the taxpayer's spouse (spousal lifetime access trust or SLAT) and gift assets to the SLAT utilizing the taxpayer's increased Federal exemption amounts. The gifted assets held in the SLAT should not be includable in the taxpayer's or spouse's respective taxable estates and distributions could be made to the spouse from the SLAT to provide the spouse with access to the gifted funds, if needed, in the future. Additionally, gifts could be made by a taxpayer to dynasty trusts (to which GST exemption is allocated), which would allow the trust property to benefit future generations without the imposition of estate or GST tax.

Note that absent legislative reform, the federal applicable exclusion amount is projected to increase by $220,000 ($440,000 for a married couple) in 2019. Therefore, even if a taxpayer uses some or even all of the available applicable exclusion amount before the end of 2018, additional gifts may be made in 2019 without paying any federal gift tax. Those resident in Connecticut should be mindful that Connecticut is the only state with a state level gift tax. Based on current law, the applicable exclusion amount also will be adjusted for inflation in future years.

Other Techniques To Take Advantage of the Increased Applicable Exclusion Amount

In addition to making gifts to utilize the increased exemption, below is a summary of several other widely applicable recommendations:

- Sales to Trusts. Taxpayers should also consider utilizing the increased federal exemption amounts through sale transactions to grantor trusts. The increased federal exemption may provide a cushion against any asset valuation risk attendant with such sales. Taxpayers who enter into such sale transactions should consider taking advantage of the adequate disclosure rules to start the three-year statute of limitations running.
- Loan Forgiveness. If taxpayers are holding promissory notes from prior estate planning transactions, from loans to family members, or otherwise, they should consider utilizing some or all of the increased federal exemption amounts to forgive these notes.
- Allocation of GST Exemption to GST Non-Exempt Trusts. If a taxpayer's existing estate plan utilizes trusts that are subject to GST tax (GST non-exempt trusts), consideration should be given to allocating some or all of the taxpayer's increased GST exemption amount to such trusts.
- Balancing Spouses' Estates. For married taxpayers, if the value of the assets owned by one spouse is greater than the increased federal exemption amounts and greater than the value of the assets owned by the other spouse, consideration should be given to transferring assets to the less propertied spouse. Such a transfer would provide the less propertied spouse with more assets to take advantage of the increased federal exemption amounts, especially the increased GST exemption, which is not portable to the surviving spouse upon the first spouse's death. Taxpayers should be mindful, however, that transfers to non-US citizen spouses are not eligible for the unlimited marital deduction for federal gift tax purposes, and such transfers should stay within the annual exclusion for such gifts ($152,000 in 2018) to avoid federal gift tax. Note that the annual exclusion for gifts (to donees other than a spouse) is $15,000 in 2018.
- Life Insurance. Taxpayers may wish to review or reevaluate their life insurance coverage and needs with their insurance advisors.
- Other Planning Options. Taxpayers should also consider other means for utilizing the increased federal exemption amounts, such as triggering a transfer under Section 2519 of the Code of a surviving spouse's qualified terminal interest property in a marital trust or the formation and funding of an entity that purposely violates Code Section 2701, in each case utilizing the increased federal gift tax exemption amount.

Review and Revise Your Estate Plan to Ensure It Remains Appropriate

As noted above, any provisions in your will and trust agreements that distribute assets according to tax formulas and/or applicable exclusion amounts should be reviewed to ensure that the provisions continue to accurately reflect the testator's or grantor's wishes when taking into account the higher applicable exclusion amounts. Consideration should also be given to including alternate funding formulas in wills or trust agreements that would apply if the federal estate tax exemption amounts do sunset in 2026.

Additionally, in light of the increased exemption amounts, taxpayers should also consider whether certain prior planning is now unnecessary and should be unwound, such as certain qualified personal residence trusts (QPRTs), family limited partnerships (FLPs) and split-dollar arrangements.

Allocation of GST-applicable exclusion amounts should be reviewed to ensure that it is utilized most effectively, if one wishes to plan for grandchildren or more remote descendants. In addition, due to the increased GST exemption amounts available under the Act, allocation of some or all of one's increased GST exemption amounts to previously established irrevocable trusts that are not fully GST exempt may be advisable.

Taxpayers should continue to be cautious in relying on portability in estate planning, as portability may not be the most beneficial strategy based on your personal situation. In addition, a deceased spouse's unused exemption may not be available upon remarriage of the surviving spouse. However, portability may be a viable option for some couples with estates below the combined exemption amounts. Portability can be used to take advantage of the first spouse to die's estate tax exemption amount (which, for taxpayers dying before 2026, should be $10 million adjusted for inflation), as well as obtain a stepped up basis at each spouse's death. Portability can also be used in conjunction with a trust for the surviving spouse (a QTIP trust) in order to incorporate flexibility for post-mortem planning options. Factors such as the asset protection benefits of utilizing a trust, the possibility of appreciation of assets after the death of the first spouse to die, the effective use of both spouses' GST exemption, and state estate tax should be discussed with advisors in determining if relying on a portability election may be advisable.

Same-sex couples should continue to review and revise their estate planning documents and beneficiary designations now that same-sex marriages must be recognized by every state, as well as the federal government. Same-sex couples may want 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.

Unmarried couples should particularly continue to review and revise their estate planning documents and beneficiary designations, as since the advent of same sex marriage, it is now clear that domestic partners, even if registered as such, do not qualify for the federal (and in many cases state) tax and other benefits and presumptions that are accorded to married couples.

Finally, in view of the potential sunset of many pertinent provisions of the Act, estate plans should provide for as much flexibility as possible. As noted above, formula bequests should be reviewed to ensure they are appropriate under current law and consideration should be given to granting limited powers of appointment to trust beneficiaries to provide flexibility for post-mortem tax planning. A Trust Protector (or Trust Protector committee) may also be appointed to give a third party the ability to modify or amend a trust 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 (such as the granting of a general power of appointment to trust beneficiaries in order to obtain a stepped-up basis in trust assets at the beneficiary's death).

Mitigate Trust Income Tax and Avoid the Medicare Surtax With Trust Income Tax Planning

Non-grantor trusts should consider making income distributions to beneficiaries. Trust beneficiaries may be taxed at a lower taxed rate, especially due to the compressed income tax brackets applicable to non-grantor trusts. Additionally, 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.

Transfer Techniques

Many techniques that have been utilized in prior years continue to be advantageous planning techniques under the Act. Due to potential sunset of many applicable provisions of the Act, consideration should be given to planning that minimizes the risk of paying current gift taxes, but still allows taking advantage of the increased exemption amounts to shift assets and appreciation from the taxable estate. Additionally, consideration should be given to selling hard-to-value assets due to the increased exemption available to "shelter" any valuation adjustment of these assets upon audit. Lifetime gifting and sales transactions remain very important in providing asset protection benefits for trust beneficiaries, shifting income to beneficiaries in lower tax brackets, and providing funds for children or others whose inheritance may be delayed by the longer life expectancy of one's ancestors.

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 called 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 one has used all of his or her 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 the grantor 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 the grantor retains may be equal to 100 percent of the amount the grantor used to fund the GRAT, plus the IRS-assumed rate of return applicable to GRATs (which for transfers made in November 2018 is 3.6 percent). As long as the GRAT assets outperform the applicable rate, at the end of the annuity term the grantor 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 the grantor will retain the full value of the GRAT assets, if the grantor survives the annuity term, the value of the GRAT assets in excess of the grantor's retained annuity amount will then pass to whomever the grantor has named, either outright or in further trust, with no gift or estate tax.

Sales to Intentionally Defective Grantor Trusts (IDGTs)

Sales to IDGTs have become an increasingly popular planning strategy due to the increased exemption amounts under the Act.

In utilizing a sale to an IDGT, a taxpayer 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 one's self. For the same reason, the interest payments on the note would not be taxable to the seller 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 is as low as 2.7 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 makes sales to IDGTs most opportune to structure now.

The current environment creates a window of opportunity for sales to grantor trusts. The increased federal exemption amounts may provide a cushion against any asset valuation risk attendant to such sales. Additionally, the increased exemption amounts permit the sale of a substantially larger amount of assets to grantor trusts. Typically, grantor trusts should be funded with at least 10 percent of the value of the assets that will be sold to the trust. With the higher exemption amounts, those who have not used any of their exemptions could contribute up to $11,180,000 (or $22,360,000, if splitting assets with a spouse) to a grantor trust. This would permit the sale of up to $100,620,000 (or $201,240,000) of assets to the trust in exchange for a promissory note with interest at the appropriate applicable federal rate.

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

If a grantor trust has been funded with low-basis assets, the grantor should consider swapping or buying-back those low-basis assets in exchange for high-basis assets or cash. If the grantor 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 the grantor swaps or purchases 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 the grantor's death, the purchased or reacquired asset will be included in the grantor's taxable estate and will receive a step-up in basis equal to fair market value, eliminating the income tax cost to the beneficiaries. Those 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. Taxpayers should consider paying off any outstanding loans against existing policies in order to maximize the proceeds available tax-free at 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 with the assets that would be used 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 remain low (and the exemption amounts are so high), many techniques involving the 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. This may be a beneficial strategy considering the increased exemption amounts.

Installment Sale to Third-Party Settled GST Tax-Exempt Trust

Unique planning opportunities and transfer tax benefits may be available if a relative or friend of the taxpayer has an interest in creating and funding a trust for the benefit of the taxpayer and/or the taxpayer's family. For example, a third-party grantor (e.g., a relative or friend of the taxpayer) could contribute cash to a trust for the benefit of the taxpayer, allocate GST tax exemption to that gift, and then that trust could purchase assets from the taxpayer in exchange for such cash and a secured promissory note in the remaining principal amount of assets purchased. While this sale could result in payment of capital gain tax to the taxpayer (ideally at an earlier, lower value), this planning could present the following potential benefits:

- There should be no transfer tax concerns for the third party grantor if the grantor's other assets, even when added to the value of the foregoing gift, would not be sufficient to cause the estate tax to apply at the grantor's death (this depends on what the estate tax exemption amount is at the grantor's subsequent death);
- The taxpayer could receive a step-up in basis as of the date of the initial sale;
- The taxpayer could be a beneficiary, hold a limited power of appointment over, and control who serves as trustee of the trust;
- The appreciation in the value of the asset being sold from the date of the initial sale above the interest rate on the promissory note (e.g., 3.04 percent is the mid-term AFR in November) would accrue transfer tax free for the benefit of the taxpayer and/or the taxpayer's family; and
- The trust could be structured in such a way as to provide protection from the taxpayer's creditors and remove the trust assets from the taxpayer's and his/her family members' taxable estates.

In order to achieve the foregoing benefits, it is important that only the third-party grantor makes any gratuitous transfers to the trust and that the third-party grantor not be reimbursed for any such transfers.

Purposely Triggering Application of Section 2701

A taxpayer may desire to utilize the increased gift and estate tax exemption prior to the scheduled sunset, and may also desire to shift appreciation on this amount to a trust for the benefit of the taxpayer's children that is removed from the estate tax system. This desire may be met with hesitation to part with $11.18 million of assets. The taxpayer may also be concerned about losing cash flow from the transferred assets and not having the option of taking the property back if needed in the future. Finally, the taxpayer may also have concerns that assets available for transfer have a low-income tax basis, which will carry over if a traditional gift is made.

A planning alternative exists which can potentially address each of these concerns. The strategy is to create and fund a preferred partnership, which is structured to purposely violate Section 2701 of the Code.

Assume the taxpayer gifts $1.1 million to an irrevocable trust for the benefit of the taxpayer's children (the family trust). Taxpayer and family trust create a preferred partnership (PP). Taxpayer transfers to the PP $9.9 million of low-basis assets in exchange for a preferred interest entitling the taxpayer to a 5 percent non-cumulative preferred return and the right to put the preferred interest to the PP for an amount equal to its associated capital account. The family trust contributes $1.1 million to the PP in exchange for a common interest entitling the family trust to all cash flow above the 5 percent payment made to the preferred interest and all appreciation on the PP's assets.

Structuring the preferred interest in this manner violates Section 2701 of the Code. The result is a deemed gift of $9.9 million, which combined with the taxpayer's gift of $1.1 million to the family trust means the taxpayer has consumed $11 million of gift and estate tax exemption. Also, when the taxpayer dies, the preferred interest will be included in the taxpayer's estate under Section 2033 of the Code, resulting in an income tax basis step-up of the preferred interest. The estate tax calculation will include a reduction in the taxpayer's tentative taxable estate of $9.9 million, to account for the prior taxable gift and avoid double taxation.

This structure has addressed each of the taxpayer's concerns. The taxpayer has consumed the increased exemption amount, but has done so in a manner that preserves an income tax basis step up. The taxpayer has also retained a 5 percent return on the preferred interest and the right to put the interest back to the PP and take back the value of the taxpayer's capital account. Finally, cash flow above the 5 percent preferred return and appreciation on the PP's assets have been shifted to the family trust free of transfer taxes.

Consider Charitable Planning

As noted above, the Act increases the adjusted gross income percentage limit for cash contributions to public charities from 50 percent to 60 percent. Because of the increased percentage limitation, consideration should be given to accelerating charitable giving to possibly obtain a current income tax deduction and potentially reduce one's taxable estate (of both the contributed asset, as well as future appreciation).

A planning tool that is very effective in a low-interest-rate environment is a Charitable Lead Annuity Trust (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 (3.6 percent for November), those assets can pass transfer tax free to the chosen beneficiaries. Alternatively, a strategy that works better in a high-interest-rate environment is a Charitable Remainder Annuity Trust (a CRAT). A CRAT is an irrevocable trust that pays an annual payment to an individual (typically the grantor) during the term of the trust, with the remainder passing to one or more named charities. The grantor may receive an income tax deduction for the value of the interest passing to charity. Because the value of the grantor's retained interest is lower when interest rates are high, the value of the interest passing to charity (and, therefore, the income tax deduction) is higher. A CRAT may continue to become an attractive option, if interest rates continue to rise.

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 70-1/2 or over 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 one needs to take a required minimum distribution for 2018, he or she may arrange for the distribution of up to $100,000 to be directly contributed to a favorite public charity and receive the income tax benefits of these rules. Due to new limitations on itemized deductions (i.e., the cap on the state and local tax deduction), some taxpayers may no longer itemize deductions on their personal income tax returns. Without itemizing deductions, these taxpayers could not receive the income tax benefit of a charitable deduction for charitable contributions.

The Qualified Charitable Distribution rules allow taxpayers who are claiming a standard deduction to still obtain a financial benefit from charitable donations.

Attention to Rising Interest Rates

Certain planning techniques are more attractive in a higher interest rate environment. With interest rates rising, taxpayers should consider strategies that can take advantage of these higher rates. As noted above, a CRAT is an effective charitable planning strategy when interest rates are high, as it increases the value of the charitable portion of the trust and thereby increases the income tax deduction. As another example, QPRTs are also attractive when interest rates are higher. A QPRT is an irrevocable trust designed to pass a primary residence or vacation home to chosen beneficiaries, while the grantor retains the right to occupy the residence for a period of time. The creation of the QPRT "freezes" the value of the residence for the purposes of gift and estate tax. When interest rates are higher, the present value of the gift made by the grantor is lower.

Year-End Checklist for 2018

In addition to the above planning ideas, consider the following before 2018 is over:

- Make year-end annual exclusion gifts of $15,000 ($30,000 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;
- Pay tuition and non-reimbursable medical expenses directly to the school or medical provider; and
- Consider making charitable gifts (including charitable IRA rollovers) before year-end to use the deduction on your 2018 income tax return.

Below is an overview of national, international and local developments that occurred in 2018.

International Developments in 2018

Additional Implications of the Act Relevant to International Tax Planning

Under the Act, there were major implications for private client international tax planning. Specifically, with respect to US individuals who own interests in foreign corporations, those foreign corporations may be classified as controlled foreign corporations or CFCs pursuant to a new definition of CFC. A foreign corporation will be classified as a CFC if more than 50 percent by vote or value is owned by US "shareholders". US "shareholders" are now defined as U.S. persons owning 10 percent or more by vote or value of the foreign corporation. The prior definition of "shareholder" was 10 percent or more by vote only of the foreign corporation. In addition, previously, an individual was only taxed on problematic "Subpart F" income of a CFC if he or she owned the stock of the CFC for 30 days or more. The 30-day period has now been eliminated by the [Act]. This change may alter, for example, post-mortem planning for US beneficiaries of foreign grantor trusts with foreign holding companies upon the death of the foreign grantor.

In addition, a new tax on all shareholders of CFCs called Global Intangible Low-Taxed Income (GILTI) will disproportionately impact individual shareholders of CFCs. For US corporate shareholders of CFCs, there will be a deduction against GILTI that will apparently not be available to US individual shareholders of CFCs.

The categorization of a foreign company as a CFC is also more likely, as the definition of a CFC has been expanded to allow constructive attribution through foreign entities to US persons beginning in 2017.

Finally, due to the fact that the US corporate tax rate has been permanently reduced to 21 percent, foreign families purchasing US real estate interests may choose to protect themselves from US estate tax exposure through two-tiered corporate rather than partnership structures. Also, foreign clients with US corporations should check with home-country advisors to see if the US corporations may be re-characterized as CFCs under their local law rules.

The continuing global regulatory focus on anti-money laundering (AML) and countering the financing of terrorism (CFT) has led governments to strengthen regulatory regimes worldwide. In the European Union, the Fourth Anti-Money Laundering Directive 2015/849/EU (4th AMLD)—the UK implementation of which came into effect in June 2017—resulted in a number of changes to the way firms and regulators deal with AML/CFT issues.

In addition, in December of 2017, the EU reached an agreement to amend the 4th AMLD. As opposed to the 4th AMLD which gave countries the decision on whether to publish their beneficial owner (BO) registries or not, the amended Directive (5th AMLD) will require all EU member states to establish public BO registries for companies by 2020. EU countries will also have to establish BO registries for trusts managed by a local trustee, or with business relationships or that acquire real estate in the EU, but access to this information will be subject to a legitimate interest test. On May 1, the UK Parliament approved an amendment to the sanctions and anti-money laundering bill, which requires British Overseas Territories (e.g., Cayman Islands, British Virgin Islands, etc.) to establish public BO registries by 2020.

Ironically, the EU's General Data Protection Regulation (GDPR) is now in effect as well. The GDPR is a historically significant piece of data protection legislation and impacts any organization that processes personal data in connection with goods or services offered to an EU resident, or monitors the behavior of persons within the EU. The GDPR strengthens indviduals' privacy rights through tighter limits on processing of their personal data, significantly expanding their rights over their data and providing increased transparency into the nature, purpose, and use of it.

Not surprisingly, given the inherent tension between the BO registries, trends toward transparency and the GDPR, at least one lawsuit has been initiated, with more presumably to come. In May, an Italian-domiciled woman lodged an official complaint with the UK's Information Commissioner, alleging that the disclosure of her personal and financial information to other countries under the Organisation for Economic Co-operation and Development's Common Reporting Standard infringes the GDPR.

Local Developments in 2018: State-Specific Considerations

California

Communications Between Trustee and Attorney Not Always Shielded by Attorney-Client Privilege

In *Morgan vs. Superior Court*, the appellate court found that a trust may not permit a former trustee to withhold from a successor trustee communications between the former trustee and the former trustee's attorney, and any trust provision seeking to do so is in violation of public policy and is, therefore, unenforceable. Thomas Morgan acted as successor trustee of his mother, Beverly's, trust after her death. Beverly's daughter filed petitions to invalidate the trust and remove Thomas as trustee. In response, Thomas filed an inadequate accounting, which led to the court suspending him as trustee and ordering him to turn over all trust records to the interim trustee. Thomas refused to produce attorney-client communications by relying on a trust provision, which allowed the trustee to withhold privileged communications from a successor trustee.

The appellate court ruled against Thomas, requiring him to turn over to the interim trustee communications that were attorney-client privileged. The court reviewed the law applicable to a trustee's liability, confirming that the trustee may not be absolved in cases of intentional misconduct, gross negligence, or acts taken in bad faith or with reckless indifference to the interests of the trust beneficiaries. The court found that, as a matter of public policy, the trust agreement may not prevent the disclosure to the successor trustee of the records that might be used to establish such liability. Attorney-client communications between a trustee and the trustee's attorney will only be privileged to the extent the trustee retains separate counsel to differentiate personal advice from advice obtained in a fiduciary capacity. Because Thomas did not retain separate counsel for that purpose, he was ordered to produce all trust records, including attorney-client communications, to his successor.

Update Beneficiary Designations Upon Divorce

In *Estate of Post*, the California Court of Appeal found that if a decedent does not change his or her life insurance beneficiary designation to exclude his or her ex-spouse, then the decedent's ex-spouse will remain the rightful beneficiary of the insurance proceeds upon the decedent's death. Jerome Norman Post purchased a life insurance policy during his lifetime and named his then-wife, Angela Post, as the primary beneficiary of the policy. Jerome named his two sons from a prior marriage, Kenneth Post and Eric Post, as the secondary beneficiaries of the policy. Subsequently, Jerome and Angela were divorced and Jerome executed a codicil to his will stating that he intended that Angela receive nothing from his estate upon his death, including by beneficiary designation. Jerome did not, however, change the beneficiary on his life insurance policy.

Relying on the codicil to Jerome's will, after Jerome's death, Kenneth and Eric sought a court order designating them as the rightful beneficiaries of the insurance policy. The trial court found in their favor. The Court of Appeal reversed based on the finding that a beneficiary of an insurance policy takes under a contract and not under the probate laws of succession. Since the decedent's estate had no interest in the life insurance policy, the trial court had no jurisdiction over the life insurance proceeds and its order was void.

California Adopts New Decanting Laws

California's new Uniform Trust Decanting Act takes effect on January 1, 2019. The Act applies to all California trusts, whenever executed, unless the trust states otherwise. Decanting allows a trustee of an existing irrevocable trust to transfer, or decant, the trust assets into a new irrevocable trust, in order to incorporate different trust provisions, ranging from more useful administrative terms to modifying certain dispositive provisions. The terms of the new trust and whether a decanting is permissible depends on the terms of the existing/original trust and the purpose for the potential changes. That said, this procedure provides a significant opportunity for trusts to address needed changes in a streamlined manner.

A trustee of an existing trust with distributions limited to an ascertainable standard (e.g., where distributions may be made only for a beneficiary's health, education, maintenance and support) may not decant to a new trust that materially changes the dispositive provisions of the existing trust, but may decant only to a new trust that modifies the administrative provisions, such as the trustee powers. On the other hand, a trustee of an existing trust with the power to make unrestricted principal distributions to a beneficiary may decant to a new trust that changes certain dispositive provisions, including eliminating a beneficiary, changing the standard for distributions, granting powers of appointment and extending the duration of the trust. There are limitations on modifications related to trustee compensation, trustee liability, and the removal and replacement of a trustee in order to mitigate self-dealing. Further, there are extensive limitations regarding any modifications to charitable interests. Finally, tax benefits under an existing trust may not be jeopardized.

In order to decant, a sixty-day advance notice must be provided to various parties, including (a) the trust's settlor, if living: (b) each qualified beneficiary: (c) each holder of a currently exercisable power to appointment: (d) each holder of the current right to remove or replace the trustee; (e) all trustees of the existing trust other than the decanting trustee; (f) each trustee of the new trust; and (g) the California Attorney General, if the existing trust contains charitable interests. Qualified beneficiaries are current distributees and permissible distributees, those who would be current distributees or permissible distributees if the interests of the actual current distributees were terminated, and those who would be distributees of income or principal if the trust terminated immediately. Unless the existing trust provides otherwise, a court-appointed guardian *ad litem* is required to represent minor, unborn and unascertainable qualified beneficiaries.

The enactment of the Uniform Trust Decanting Act provides greater flexibility to trustees in California to meet the needs of beneficiaries and modernize outdated trusts.

Illinois

Uniform Powers of Appointment Act

On August 23, Illinois House Bill 4702 was signed into law as Public Act 100-1044 and is known as the Uniform Powers of Appointment Act. This law is effective January 1, 2019, and unless otherwise specifically stated in the legislation to the contrary, applies to all powers of appointment governed by Illinois law (whether such power was created before the effective date or after). Enacted in only eight other states thus far, the Uniform Powers of Appointment Act aims to streamline the creation and exercise of powers of appointment. A common problem throughout the United States was the patchwork common-law and statutory system of determining the legalities of the creation and exercise of powers of appointment; in an attempt to streamline and harmonize the creation and exercise of powers of appointment throughout the United States, the Uniform Powers of Appointment Act was created by the Uniform Law Commission. For example, in Illinois, powers of appointment were governed in part by common law, in part by the Probate Act (concerning the exercise of testamentary powers of appointment in 755 ILCS 5/4-2), in part by the Powers of Appointment Exercise Act (concerning the exercise of non-testamentary powers of appointment in 765 ICLS 320) and in part by the Termination of Powers Act (concerning the release of powers of appointment in 765 ILCS 325). In furtherance of the goal of harmonizing this field, all of those statutory provisions were repealed.

Frail Elderly Individual Family Visitation and Protection Act

On August 14, Illinois House Bill 4309 was signed into law as Public Act 100-0850 and is known as the Frail Elderly Individual Family Visitation and Protection Act (the Kasem/Baksys Visitation Law). This law is effective January 1, 2019. This Act provides certain family members with recourse in the event that a family caretaker of a frail elderly individual unreasonably withholds visitation from such family member. Importantly, the Act does not apply if the frail elderly individual is under guardianship or if the family caretaker is acting on behalf of the frail elderly individual under a power of attorney.

Amendment to Illinois Dissolution of Marriage Act

On August 14, Illinois Senate Bill 2437 was signed into law as Public Act 100-0871. This Public Act amends the Illinois Marriage and Dissolution of Marriage Act to provide that if a judgment of dissolution of marriage is entered into after an insured has designated his or her spouse as the beneficiary under a life insurance policy, then the designation in favor of the insured's spouse will be ineffective unless special enumerated circumstances apply. In the event that the designation of the insured's spouse is ineffective, the life insurance proceeds will flow to the alternate designee, or in the event there is none, then to the insured's estate. It is important to note that Illinois law remains somewhat inconsistent in determining when a testamentary transfer to a former spouse will be deemed ineffective (for example, transfers to a former spouse and fiduciary appointments of a former spouse in a will and revocable trust will be deemed ineffective after the divorce is finalized, but there may not be similar statutory provisions with respect to assets flowing outside of a decedent's will and/or revocable trust such as assets passing pursuant to beneficiary designation (like retirement accounts and irrevocable trusts). As a result, it is often a good idea to contact your estate planning attorney if contemplating a divorce or once a divorce is initiated to make sure that all consequences of the divorce from an estate planning perspective can be analyzed and dealt with.

Collins vs. Noltensmeier, 2018 IL App (4th) 170443 (April 5, 2018)

In *Collins*, Billy D. Collins named his longtime romantic partner as his power of attorney for property. The power of attorney specifically authorized Billy's agent to "change beneficiaries under any beneficiary form or contractual arrangement." Billy passed away on January 23, 2011, but prior to his passing, Billy's agent under the property power of attorney changed the beneficiary designation of Billy's IRA to herself. The court held that an agent under a property power of attorney is not authorized to self-deal (i.e., exercise the agency in favor of himself or herself) unless expressly authorized to do so in the power of attorney. Additionally, where no express authorization is given, the self-dealing creates a rebuttable presumption of fraud that the agent can overcome if the agent can show that the agent exercised good faith and did not betray the confidences placed in her. In *Collins,* the agent was unable to rebut the presumption of fraud as the record contained no suggestion that the agent acted under the direction of Billy, that Billy received separate counsel relating to the decision to change the beneficiary of his IRA, or even that Billy intended to change the beneficiary of his IRA. Therefore, summary judgment in favor of the plaintiffs was affirmed.

New York

2018 was not a particularly active year for legislative reform in this area, but there are still some items of note.

The existing prohibition against exonerating trustees of testamentary trusts from liability for failure to exercise reasonable care was extended to trustees of inter vivos trusts.

Standby guardianships are now available not only to parents who are terminally ill, but also to parents who are incarcerated.

The authority to execute "do not resuscitate" and similar orders has been extend to nurse practitioners.

For individuals dying on or after January 1, 2019, the basic exclusion amount will be equal to the federal basic exclusion amount indexed annually, but without regard to the passage of the Act (i.e., $5,740,00 in 2019).

New York source income of a nonresident individual has been expanded to include the gain or loss from the sale of co-ops.

There will be no gift add-back for individuals dying on or after January 1, 2019.

The law that eliminated the requirement to create a qualifying domestic trust, if no federal estate tax return was required, is set to sunset on July 1, 2019, absent further legislative action.

New York has decoupled from the federal treatment of alimony and itemized deductions, retaining the pre-Act treatment.

North Carolina

In addition to the *Kaestner* decision, discussed above, North Carolina has also implemented important legislative changes impacting estate planning:

<u>North Carolina Uniform Power of Attorney Act (S.L. 2017-153)</u>

The North Carolina Uniform Power of Attorney Act became effective January 1. The new legislation was codified as Chapter 32C of the North Carolina General Statutes. This 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.

<u>Reformation and Correction of Wills and Trusts (S.L. 2017-152)</u>

Effective as of January 1, S.L. 2017-152 provides for judicial modification of wills and trusts under particular circumstances. The law first amended 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 previously allowed 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.

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