ESTATE AND TRUST PLANNING

AFTER THE TAX CUTS AND JOBS ACT OF 2017

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May 15, 2018

TABLE OF CONTENTS

I. SUMMARY OF THE ACT 1
- A. Effective Date and Increased Exemptions 1
- B. Change in Indexing 1
- C. Tax Rates and Brackets 1
- D. Trajectory of the Applicable Exclusion Amount 4
- E. Income Tax Rates for Estates and Trusts 4
- F. Kiddie Tax 4
- G. Step-Up In Basis Preserved 5
- H. Brief Summary of Other Important Changes Made By TCJA 5
  - 1. Standard Deduction and Personal Exemption 5
  - 2. Child Tax Credit 5
  - 3. Home Mortgage Interest 5
  - 4. Estate and Local Income Tax ("SALT") 5
  - 5. Charitable Deductions 6
  - 6. Elimination of Miscellaneous Itemized Deductions 6
  - 7. Qualified Business Income Deduction (§199A) 6
  - 8. Alimony 7
  - 9. Alternative Minimum Tax 7
  - 10. Elimination of Deduction for Tax Preparation and Tax Advice Expenses 7
  - 11. 529 Plans 7
  - 12. Charitable Gifts from Small Business Trusts 7
  - 13. Sales of Life Insurance 8
- I. Clawback and Potential "Off-the-Top" Gift Trap 8
  - 1. Clawback 8
  - 2. Importance of Understanding the First Out ("FIFO") Concept Applicable to Gifts after TCJA 9
  - 3. Anticipated "Off-the-Top" Regulations. 9
  - 4. The Portability Analogy to the FIFO Issue 9

II. PLANNING FUNDAMENTALS FOLLOWING TCJA 10
- A. ATRA Revisited 10
- B. TCJA Punctuates Pursuing Portability 10
  - 1. General Explanation of Portability 10
  - 2. Electing Portability 10
  - 3. First IRS Relief - Notice 2012-12. 11
  - 4. Second IRS Relief - Rev. Proc. 2014-18. 11
  - 5. Third IRS Relief - Rev. Proc. 2017-34. 11
  - 6. QTIP Election and Portability. 12
  - 7. Should Portability be Ignored in Estates Below the 706 Filing Threshold? 12
  - 8. Other Features of Portability 13
  - 9. Further Discussion of Portability in this Outline 15
- C. Other Planning Principles Following TCJA 15

D. A Few Risky Generalizations 18

III. EFFECTS OF TCJA ON ESTATE AND TRUST INCOME TAX PLANNING 18
A. Trust and Estate Tax Rates and Brackets 18
B. Trust and Estate Personal Exemptions 18
C. SALT Limitation 19
D. Miscellaneous Itemized Deductions Disallowed 19
E. Trade or Business Expenses Under §162 20
F. New §67(g) 20
G. Excess Deductions in the Final Year of an Estate or Trust 21
H. Section 691(c) Deduction for Estate Tax Paid on Income in Respect of a Decedent. 22
I. State Income Taxes on Estates and Trusts 22

IV. PLANNING FOR PERSONS WHOSE ASSETS ARE UNLIKELY EVER TO EXCEED THE EXCLUSION AMOUNT, WHETHER $11.18 MILLION OR $5.49 MILLION (UNINDEXED) 22
A. Generally 23
B. Existing Estate Planning Documents Should Be Reviewed 23
C. Joint Tenancy Ownership 23
D. Transfer on Death 23
E. Beneficiary Designations 23
F. Joint Revocable Trusts 24
G. Unwinding Unnecessary Separate Trusts for Spouses 24
H. Other Planning Considerations for Estates Unlikely to Be Exposed to Estate Tax25
I. Continuing Non-Tax Planning Remains Essential 26

V. PLANNING FOR PERSONS WITH ASSETS THAT COULD EXCEED THE EXCLUSION AMOUNT AND FOR MARRIED PERSONS WHOSE ASSETS COULD EXCEED THE COMBINED EXCLUSION AMOUNT AT THE SECOND DEATH . 27
A. Estate Tax Planning Continues 27
B. Drafting for Flexibility 27
C. The "Simple" Plan - All to the Surviving Spouse 28
D. Traditional Credit Shelter Trust Alternative 33
E. The QTIPable Trust - An Alternative to the Simple Plan and the Credit Shelter Plan 36
F. Disclaimer to QTIPable Trust 38
G. Single Marital Deduction Trust with Right to Withdraw or Disclaim 38
H. Other Planning Issues Applicable to Potentially Taxable Estates 39

VI. PLANNING FOR SPOUSES WHO HAVE POTENTIALLY TAXABLE ESTATES BUT WHO ARE UNWILLING TO RELINQUISH THE BENEFITS AND CONTROL OVER THEIR PROPERTY BY MAKING LIFETIME TRANSFERS TO DESCENDANTS. 41
A. Spousal Limited Access Trusts ("SLATs") 41

B. Other Benefits of SLATs . . . 42
C. Potential SLAT problems . . . 42
D. Kansas SLAT Caveat . . . 43
E. Domestic Asset Protection Trusts ("DAPTs") . . . 44
F. Spouses for Whom a Gift of the Total Exclusion Amount Would Create Estate Tax Benefits, But Who Do Not Wish to Make Such a Gift . . . 44
G. Other Planning Suggestions that Provide Potential Continued Benefits for Both Spouses After the Gift . . . 45

VII. PLANNING FOR ULTRA-HIGH NET WORTH CLIENTS . . . 45
A. FIFO or Off-the-Top Gift Issue . . . 45
B. Flexible Planning Tools . . . 45
C. Sales to IDGTs . . . 46
D. Additional Funding to ILITs . . . 46
E. Forgiveness of Indebetdness . . . 46
F. Using grantor trusts . . . 46
G. Planning to Minimize Use of Exclusion Amount . . . 46
H. Other Planning Arrangements for UHNW Clients . . . 47

VIII. BASIS PLANNING - MORE IMPORTANT THAN ESTATE TAX PLANNING? . . . 50
A. A Step-Up in Basis for All of the Spouse's Assets at the Time of the First Death50
B. Avoiding Loss of Basis Step-Up at the Time of Death of the Surviving Spouse or the Death of a Trust Beneficiary . . . 51
1. Use Powers of Appointment. . . . 51
2. Springing the Delaware Tax Trap. . . . 51
3. Distributions from Credit Shelter Trusts . . . 52
4. Upstream Basis Planning . . . 53
C. Additional Basis Planning Resource Material . . . 53
D. Life Insurance Acquired by Credit Shelter Trust . . . 53

IX. CHARITABLE PLANNING UNDER TCJA . . . 54
A. Charitable Income Tax Deduction . . . 54
B. Standard Deductions and Charitable Contributions . . . 54
C. Qualified Charitable Deductions from IRAs . . . 55
D. Charitable Deductions by Electing Small Business Trust ("ESBT") Realized Under TCJA . . . 55
E. Planning to Maximize Testamentary Charitable Contributions . . . 56
F. Important Development for Donor Advised Funds . . . 56

X. LIFE INSURANCE AND TCJA . . . 57
A. Statutory Changes under TCJA . . . 57
1. Reportable Policy Sales . . . 57
2. Rules for Determining the Basis of a Life Insurance Policy Acquired in a Life Settlement . . . 57
3. Exceptions to Transfer for Value Rules . . . 57

B. Insurance Planning Issues after TCJA Not Caused by the Statutory Changes Under TCJA 57
1. Life Insurance Acquired for Estate Tax Liquidity Purposes 58
2. Life Insurance Owned by an Irrevocable Life Insurance Trust (ILIT). . 58
3. Life Insurance Acquired for Non-Tax Liquidity Purposes 59
C. Important Recent Cases Involving in Life Insurance Planning 59
D. Additional Materials Pertaining to TCJA and Life Insurance. 60

XI. NEW CENTRALIZED PARTNERSHIP AUDIT RULES 60
A. General Description 60
B. Significance to Estate Planners 60

EXHIBIT A 1

ESTATE AND TRUST PLANNING AFTER THE TAX CUTS AND JOBS ACT OF 2017

I. SUMMARY OF THE ACT

The Tax Cuts and Jobs Act of 2017 created the most sweeping changes in federal tax law since 1986. The Act became effective for taxable years beginning on and after January 1, 2018, and sunsets for most individual tax provisions, including the estate, gift, and generation-skipping tax provisions, for years after 2025. The prominent features of TCJA, with emphasis on estate and trust tax provisions, are as follows:

A. **Effective Date and Increased Exemptions**. TCJA effectively doubles the estate and gift tax applicable exclusion amount for estates of decedents with gifts made after 2017 and before 2026. The basic exclusion amount is $10,000,000, adjusted for inflation annually for each taxable year after 2011. For 2018, the applicable exclusion amount is $11,180,000. For married couples, this means a combined exemption of $22,360,000. Because the GST exemption amount equals the basic exclusion amount, the increase in the GST generation-skipping transfer tax exemption will be the same as the increase in the basic exclusion amount for estate and gift taxes.

B. **Change in Indexing**. The TCJA amends §1(f) of the Internal Revenue Code ("Code") by introducing the Chained Consumer Price Index for All Urban Consumers ("CCPI-U") published by the Bureau of Labor Statistics, and which adjusts the applicable exclusion amount and the GST exemption for years beginning after 2017. The CCPI-U results in a smaller annual increase than the Consumer Price Index for All Urban Consumers as it will account for consumer substitution between item categories in the market basket of consumer goods and services that comprise the index, whereas the CPI-U accounts for only modest substitution within categories of different items. Contrary to many of the provisions in the TCJA, the changes to inflation indexing continue after 2025 and do not sunset.

C. **Tax Rates and Brackets**.

See tables on following pages.

1. **<u>Projected Estate, Gift, and Generation-Skipping Transfer Tax Rates and Exemptions.</u>**

Calendar Year	Estate Tax Exemption	Estate Tax Rate	Gift Tax Exemption	Gift Tax Rate	GST Exemption	GST Tax Rate
2017	$5,490,000	40%	$5,490,000	40%	$5,490,000	40%
2018	$11,180,000	40%	$11,180,000	40%	$11,180,000	40%
2019*	$11,400,000	40%	$11,400,000	40%	$11,400,000	40%
2020*	$11,630,000	40%	$11,630,000	40%	$11,630,000	40%
2021*	$11,860,000	40%	$11,860,000	40%	$11,860,000	40%
2022*	$12,100,000	40%	$12,100,000	40%	$12,100,000	40%
2023*	$12,340,000	40%	$12,340,000	40%	$12,340,000	40%
2024*	$12,590,000	40%	$12,590,000	40%	$12,590,000	40%
2025*	$12,840,000	40%	$12,840,000	40%	$12,840,000	40%
2026**	$6,560,000	40%	$6,560,000	40%	$6,560,000	40%

* The exemptions for 2019-2025 are estimated based on a 2% per year chained CPI.
** The exemption for 2026 is estimated based on a 2% per year chained CPI and the sunset provisions after 2025.

Projections made by Tom Overby, ACTEC Listserv Thread.

<u>Annual Exlusion Amounts Per Individual, Per Donee</u>

Calendar Year	Gift Tax Annual Exclusion	Gift Tax Rate	GST Annual Exclusion	GST Tax Rate
1966	$ 3,000*	58%	No GST tax	
2018	$15,000	40%	$15,000	40%

* Lifetime exemption $30,000.

2. Historical Estate Tax Exemptions and Rates.

Year	Federal Estate Tax Exclusion Amount per Individual	Federal Estate Tax Maximum Rate		Year	Federal Estate Tax Exclusion Amount per Individual	Federal Estate Tax Maximum Rate
1966	$60,000	77%		2010	Repealed	Repealed - carry over basis
2001	$675,000	55%		2011	$5,000,000	35%
2002	$1,000,000	50%		2012	$5,120,000	35%
2003	$1,000,000	49%		2013	$5,250,000	40%
2004	$1,500,000	48%		2014	$5,340,000	40%
2005	$2,000,000	47%		2015	$5,430,000	40%
2006	$2,000,000	46%		2016	$5,430,000	40%
2007	$2,000,000	45%		2017	$5,490,000	40%
2008	$3,500,000	45%		2018	$11,180,000	40%
2009	$5,000,000	45%				

3. Income Tax Brackets and Rates for Estates and Trusts.

Taxable Income	Old Marginal Rate	New Marginal Rate	Difference in Rates	Cumulative Tax Change
$0-$2,550	15%	10%	-5%	-$127.50
$2,550-$2,600	15%	24%	+9%	-$123.00
$2,600-$6,100	25%	24%	-1%	-$158.00
$6,100-$9,150	28%	24%	-4%	-$280.00
$9,150-$9,300	28%	35%	+7%	-$269.50
$9,300-$12,500	33%	35%	+2%	-$205.50
$12,500-$12,700	33%	37%	+4%	-$197.50
Over $12,700	39.6%	37%	-2.6%	

4. **Income Tax Brackets and Rates (Joint and Individual)**.

	CURRENT	CURRENT	NEW TAX LAW	NEW TAX LAW	Income Tax Rates	Income Tax Rates
	Married	Single	Married	Single	Current	New Law
Not over	$18,650	$9,325	$19,050	$9,525	10%	10%
Not over	$75,900	$37,950	$77,400	$38,700	15%	12%
Not over	$153,100	$91,900	$165,000	$82,500	25%	22%
Not over	$233,350	$191,650	$315,000	$157,500	28%	24%
Not over	$416,700	$416,700	$400,000	$200,000	33%	32%
Not over	$470,700	$418,400	$600,000	$500,000	35%	35%
Not over	$470,700	$418,400	$600,000	$500,000	39.6%	37%

D. **Trajectory of the Applicable Exclusion Amount**. The applicable exclusion amount, often called the exemption, has increased from $675,000 with a 55% maximum estate tax rate in 2001, to $11,180,000 with a 40% rate in 2018. Chart C.1 shows an estimate of the indexed applicable exclusion amount increasing to $12,840,000 in 2025. If the ever-increasing applicable exclusion amount in fact ends in 2025, the estimated indexed exclusion amount in 2026 will be $6,560,000. Chart C.2 illustrates how the applicable exclusion amount and maximum tax rate have increased since 2001, with the 2010 aberration of a one-year total repeal and carryover basis.

E. **Income Tax Rates for Estates and Trusts**. TCJA makes only modest changes to the income tax rates for trusts and estates. The top individual tax rate applies, almost punitively, to income levels over $12,700. As with many of the estate and trust related provisions under TCJA, the brackets and rates for trusts and estates revert in 2026 to the present schedule, adjusted for inflation.

F. **Kiddie Tax**. TCJA purports to "simplify" the kiddie tax by applying ordinary and capital gains rates applicable to trusts and estates to unearned income of a child under age eighteen. Prior to TCJA, such unearned income in excess of $2,100 was taxed at the parents' rates if those rates were higher than the child's rate. A child's unearned income below $2,100 was taxed at the child's single individual rates. TCJA causes a child's tax to be unaffected by the child's parents' tax brackets or rates. The kiddie tax change sunsets after December 31, 2025. The rate chart for trusts and estates, shown above, will apply to unearned income of a child subject to the kiddie tax.

Concern was initially expressed that the change to the kiddie tax would cause the net investment income tax ("NIIT") for a child subject to the kiddie tax to have a threshold amount of $12,700, which is the amount at which trusts reach the highest tax bracket. TCJA does not, however, change IRC §1411, pertaining to NIIT, with the result that a child subject to the kiddie tax will still appear to qualify for the $100,000 NIIT threshold amount.

G. **Step-Up In Basis Preserved**. Contrary to President Trump's campaign proposal, the step-up in basis was preserved under TCJA. Basis step-up planning therefore retains its significant role in estate planning, particularly because fewer estates will be subject to the estate tax under the increased exemptions. Various techniques to obtain a step-up in basis are discussed in more detail in Section III of this Outline.

H. **Brief Summary of Other Important Changes Made By TCJA**.

1. **Standard Deduction and Personal Exemption**. The standard deduction increases for married individuals to $24,000 ($26,600 if both spouses are over 65), and for single individuals to $12,000 ($13,300 if over 65). The standard deduction prior to 2018 was $12,700 for married taxpayers filing jointly and $6,350 for single taxpayers. The increase in the standard deduction is described in Section 11021 of the Senate Amendment to TCJA, and amends IRC §63. These increases, however, sunset on December 31, 2025. Although the standard deduction has been increased, the personal exemption is eliminated. Because many deductions for individuals have been eliminated by TCJA, the standard deduction will be used by more taxpayers, many of whom will not obtain any income tax benefit because of charitable contributions, home mortgage interest payments, state and local tax payments, or other payments that qualify as itemized deductions. The 20% deduction for qualified business income under §199A for certain business owners is allowed in addition to the standard deduction.

2. **Child Tax Credit**. The Act significantly increases the child tax credit from $1,000 for each qualifying child under age 17 to $2,000. Although the child tax credit is subject to phase-out rules, the phase-out would not start until income exceeds $400,000 for married taxpayers filing jointly or $200,000 for other taxpayers. The refundable portion of the child tax credit is also increased.

3. **Home Mortgage Interest**. Prior to 2018, interest incurred on up to $1,000,000 of mortgage debt was deductible. The TCJA reduces that amount to $750,000. The Act also provides that only interest on acquisition debt may be deducted, which negates the deduction on home equity lines of credit.

4. **Estate and Local Income Tax ("SALT")**. Although SALT taxes continue to be deductible when incurred in carrying on a trade or business or an activity described in Code §1212 (related expenses for the production of income), they are limited after 2017 to $10,000 ($5,000 per married taxpayers filing separate return).

5. **Charitable Deductions**. Charitable contributions continue to be deductible. TCJA increased deductible cash contributions to 60% of the contribution base, rather than 50%. All non-cash contributions continue to have the same percentage limitations as they had prior to TCJA. Importantly for Kansas University Athletic Corporation and similar organizations, the deduction for contributions made for priority seating at university athletic events is eliminated.

6. **Elimination of Miscellaneous Itemized Deductions**. Section 67(g) of the Act suspends, for the period 2018 through 2025, any miscellaneous itemized deductions. This change will have a significant impact on income tax planning for trusts and estates, as discussed in more detail in Section III of this Outline. Important to the estate and tax planning community, taxpayers will no longer be able to deduct the following:

a. that portion of estate planning fees allocable to tax planning or tax compliance related to estate planning. Non-tax estate planning continues to be nondeductible, unless it fits into one of the exceptions in §212.

b. appraisal fees for charitable contributions.

c. excess deductions on the termination of an estate or trust that are passed through to beneficiaries, including administrative expenses that would otherwise be deductible by the estate or trust if not incurred in the year of termination.

d. investment fees and expenses. Elimination of this deduction is extremely important to fiduciary income tax planning and is discussed in more detail in Section III.F of this Outline.

7. **Qualified Business Income Deduction (§199A)**. In an effort to provide some parity for pass-through businesses following the reduction of the top bracket for C-corporations to 21%, owners, including trusts and estates, of businesses operated as pass-through entities, including sole proprietorships, partnerships, limited liability companies, and S-corporations, are entitled to deduct 20% of qualified business income. Qualified business income is generally defined as income from a trade or business. The deduction under new §199A provides significant benefits to business owners, but comes with an extraordinary level of complexity. Although a discussion of the contours, limitations, and planning opportunities under §199A is beyond the scope of this Outline, its impact generally is unfavorable to attorneys, accountants, physicians, and many other professionals whose incomes are above $157,500 for single persons and $315,000 for married persons who file joint returns.

8. **Alimony**. Following December 31, 2018, alimony payments are no longer deductible by the payor or taxable to the recipient. This change is applicable to any divorce or separation agreement executed after December 31, 2018, and any divorce or separation agreement executed before December 31, 2018, but modified after that time if the modification states that the amendments made by TCJA apply to such modification. Unlike many of the changes pertaining to individuals and estates and trusts, this provision does not sunset after 2025.

9. **Alternative Minimum Tax**. The AMT exemption is increased to $109,400 for married taxpayers filing a joint return and half that amount for married taxpayers filing a separate return. For other taxpayers, the exemption is $70,300, other than for estates and trusts, the exemption for which remains at $24,100. The exemptions are phased out after $1,000,000 for married taxpayers filing a joint return and $500,000 for all other taxpayers, other than estates or trusts. These amounts are indexed under the new Chained CPI adjustment.

10. **Elimination of Deduction for Tax Preparation and Tax Advice Expenses**. Under the change introduced by §67(g), TCJA eliminated the deduction for tax preparation expenses. These expenses are miscellaneous itemized deductions and have been deductible only in excess of 2% of AGI. This change will be important for tax return preparers and planners and will require careful allocation of tax planning and preparation fees between the taxpayer individually and a taxpayer's trade or business.

11. **529 Plans**. Flexibility has been added to 529 account planning in that TCJA permits payments of up to $10,000 per student for each taxable year from §529 plans to elementary and secondary schools, which include public, private, and religious schools. Qualified expenses include tuition, books, fees, and related expenses. The Act initially contained a provision allowing 529 accounts to be used for home schooling, but that provision was deleted from the final Act.

12. **Charitable Gifts from Small Business Trusts**. An Electing Small Business Trust ("ESBT") is one of the eligible trusts that may be an S-corporation shareholder. The other is a Qualified Subchapter S Trust ("QSST"). Although all income from a QSST generally must be distributed to a single beneficiary of the QSST, the income of an ESBT may be accumulated. Generally the income from the S-corporation shares held by an ESBT is taxed at the highest rate for individual taxpayers. TCJA changes the rules regarding contribution deductions from an ESBT. Previously, charitable contribution deductions from an ESBT were determined by the rules generally applicable to trusts (§642(c)), which required distributions to be made from trust income. TCJA changes this rule to permit charitable deductions of an ESBT to be governed by the rules applicable to charitable contributions of individuals (§170), so that percentage limitations and

carry-forward provisions pertaining to individuals will apply to charitable contributions made by that portion of the ESBT holding stock in a Subchapter S corporation.

13. **Sales of Life Insurance**. TCJA mandates additional reporting requirements for the purchaser of an existing life insurance contract, referred to in the Act as a "reportable policy sale." Reportable policy sales include the purchase of a life insurance policy or an interest in such a policy, directly or indirectly, by a person who has no substantial family, business, or financial relationship with the insured. These reporting requirements are precise and also pertain to an insurance company that pays a death benefit under life insurance contract that has been transferred in a reportable policy sale. Significantly, the §102 Transfer for Value Rules do not apply to a transfer of a life insurance policy in a reportable policy sale. The relationship between reportable policy sales and exceptions to the transfer for value rules is murky and will require careful analysis to ensure a transfer subject to one of the exceptions will not become a reportable policy sale. The TCJA also changes how the tax basis of a life insurance contract is determined.

I. **Clawback and Potential "Off-the-Top" Gift Trap**.

1. **Clawback**. What happens if a person gifts his/her entire increased gift tax exemption of $11,180,000 during lifetime and dies after January 1, 2026 when the exemption has returned to pre-2018 exemption levels? Does the offset for gift taxes payable under IRC §2001(b) use the estate and gift tax exclusion amount applicable at the time of the gift or at the time of the taxpayer's death? In other words, does a prior gift covered by the gift tax exclusion at the time of the gift result in estate tax if the estate tax basic exclusion amount is lower at the time of death than at the time of the gift, thus causing a "clawback" of the gift for estate tax purposes.

a. Example. Donor makes an $11,180,000 gift in 2018, and dies in 2026 when the exclusion amount has been reduced to $6,000,000. Clawback would require the donor's estate to pay estate tax on $5,180,000, the difference between the exclusion amount at the date of the gift and the date of death. In the absence of clawback, the full $11,180,000 would be considered the exclusion amount and would not result in tax on the difference between the exclusion amount at the date of gift and the date of death.

b. Section 2001(g)(2) as added by the TCJA, requires the Treasury Department to prescribe regulations that are *"necessary or appropriate to carry out this Section with respect to any difference between*

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

Although Treasury regulations have not been issued under §2001(g)(2), commentators almost unanimously believe that those regulations will eliminate clawback.

2. **Importance of Understanding the First Out ("FIFO") Concept Applicable to Gifts after TCJA**. Clients should be advised to "use it or lose it" with respect to the increased $11,180,000 exclusion amount. Although this admonition probably is important only for ultra-high net worth clients who are considering making gifts utilizing the increased, and perhaps temporary, exclusion amount, gifts first use the existing $5.5 million (rounded) exclusion amount, and only gifts in excess of $5.5 million are allocated to the increased $5.5 million exclusion amount. In other words, a first-in/first-out, or FIFO, concept would apply, causing the increased exclusion amount to be considered as having been gifted only after the existing or prior exclusion amount has been used. For example, the taxpayer makes a gift of $5.5 million in 2018 and dies in 2026 when the unindexed exclusion amount reverts to $5.5 million. Because in 2026 the incremental of $5.5 million of new exclusion amount enacted by the TCJA disappears, the taxpayer is considered as having used his or her full exclusion amount (the exclusion amount before the increase under TCJA) and no exclusion amount would remain at the time of death. Therefore, using more of, if not the entirety of, the total exclusion amount is the only way to be certain that if sunset occurs, the increased exclusion amount has been used.

3. **Anticipated "Off-the-Top" Regulations**. The IRS is expected to issue regulations dealing with this FIFO issue, but uncertainty remains whether those regulations will state that a donor who makes a $5.5 million gift when the exclusion amount is $11 million (unindexed), will still have all of his or her pre-existing $5.5 million exclusion amount after the increased exclusion amount disappears after 2025. This uncertainty complicates estate planning, not only for the high-net-worth clients, but also clients who may ultimately be exposed to estate tax if the increased exclusion amount sunsets in 2026. Several planning suggestions pertaining to dealing with this uncertainty are discussed in later sections of this Outline.

4. **The Portability Analogy to the FIFO Issue**. If the current portability regulations are carried over to the FIFO gift situation, a gift of $5.5 million would be considered to have been made from the increased exclusion amount, thus protecting the existing $5.5 million exclusion amount when sunset occurs. Under Treas. Reg. §20.2010(2)(c)(1), pertaining to portability, the Deceased Spousal Unused Exemption ("DSUE") is based on the exclusion in

effect at the first spouse's death. Under this regulation, for example, if a surviving spouse makes a gift of the full DSUE amount (assume $5.5 million), the gift is considered to be the DSUE amount ported from the previously deceased spouse, rather than from the surviving spouse's exclusion amount.

II. PLANNING FUNDAMENTALS FOLLOWING TCJA

A. **ATRA Revisited**. Many of the planning fundamentals introduced after the American Taxpayer Relief Act of 2012 ("ATRA"), as generally described in the author's outline presented to the Douglas County Estate Planning Council in 2014, from which some of this Outline has been adapted, remain, but the boundaries of those fundamentals have expanded, and must be addressed both to avoid pitfalls and to exploit opportunities.

B. **TCJA Punctuates Pursuing Portability**.

1. **General Explanation of Portability**. The concept of portability, which is codified in IRC §2010(c)(4), ports, or carries over, to the surviving spouse the unused exclusion amount of the first spouse to die. The exclusion amount is ported for gift and estate tax purposes, but not for GST purposes. Consequently, the unused exclusion amount of the first spouse to die (the deceased spouse's unused exemption - "DSUE") is ported to be available for use by the surviving spouse for estate and gift tax purposes. Ensuring that assets transferred by the first spouse to die to the surviving spouse qualify for the marital deduction therefore remains important, because if the transfer to the surviving spouse does not qualify for the marital deduction, it uses a portion of the exclusion amount of the first spouse to die, which therefore cannot be ported to the surviving spouse. The exclusion amount that can be ported is reduced by (i) any taxable gifts made by the first spouse to die and (ii) the amount of the exemption used in the estate of the first spouse to die.

The importance of portability can be seen in the following example: If the first deceased spouse dies prior to 2026 when the indexed exclusion amount is, for example, $12 million, the portability election made in the first spouse's estate will port to the surviving spouse a DSUE of the full $12 million even if the exclusion amount decreases after 2025, or perhaps sooner. The computation of the DSUE amount is described in Treas. Reg. §20.2010-2(c).

2. **Electing Portability**. Although portability may conceptually have simplified estate planning for spouses, the implementation of portability is not so simple under IRC §2010(c)(5)(A). Portability must be elected on a timely filed estate tax return for the predeceased spouse. Treasury Regulations provide, however, special rules for reporting the value of property on an estate tax return that is filed solely to elect portability but would not otherwise be required, which would be the case if the decedent's estate were under the exclusion amount. See

Treas. Reg. §20.2010-2T et seq. This Regulation generally requires only an estimate of the fair market value of the gross estate, so long as the executor "exercises due diligence" in making such an estimate. A more precise valuation may, however, be needed if the decedent's will or trust uses a formula valuation for marital or charitable deduction purposes, including a partial or "Clayton" QTIP election, as explained in more detail later in this Outline.

3. **First IRS Relief - Notice 2012-12**. Because of the understandable but incorrect decision by many executors and their advisors not to file estate tax returns and elect portability because the decedent's estate was under the filing threshold, the IRS issued Notice 2012-21, 2012-10 IRB 450, that granted an automatic six-month extension for the time to file a portability-only return and make the portability election. This Notice was intended to provide relief to executors to estates of decedents who died in the first half of 2011 and were not otherwise required to file Form 706 because the value of the gross estate was under the threshold requirements and the executor was unaware of the requirement to file Form 706 in order to make the portability election. The relief granted by this Notice was, therefore, somewhat limited and executors of qualifying estates were granted a six-month extension of time to file Form 706 fifteen months after decedent's date of death, so long as the executor of the estate filed an application for a six-month extension on Form 4768 no later than fifteen months from the decedent's date of death.

4. **Second IRS Relief - Rev. Proc. 2014-18**. Because the relief granted by Notice 2012-21 was limited, the IRS issued Rev. Proc. 2014-18, in January, 2014. This Rev. Proc. provides a simplified relief procedure for those estates below the filing threshold that did not make the portability election on a timely filed return because the executor or person in possession of decedent's assets was not aware of the need to file the return because of the newness of the Treasury Regulations. This Rev. Proc. would also be available to same-sex couples who are retroactively recognized as spouses in Rev. Rul. 2013-17, 2013-38 IRB 2001. This relief provision was available through December 31, 2014, and granted an automatic extension for filing the estate tax return and making the portability election, subject to certain defined procedures.

5. **Third IRS Relief - Rev. Proc. 2017-34**. In 2017 a further important safety valve for making the portability election, or rescuing those who had failed to make the election, was provided in Rev. Proc. 2017-34, 2017-26 IRB 1282 (June 9, 2017). Under this important Rev. Proc., the IRS further extended the time to file portability-only returns to the later of January 2, 2018, or the second anniversary of the decedent's death. This Rev. Proc. therefore, in effect, means that the temporary relief granted by Notice 2012-21 and Rev. Proc. 2014-18 was further extended through January 2, 2018, for all decedents dying after December 31, 2010, and prior to January 3, 2016 and, significantly, provided permanent relief to the second anniversary of the decedent's death for all

decedents dying after January 2, 2016. Rev. Proc. 2017-34 should not be considered an excuse for not filing an estate tax return and making the portability election in those situations where there might possibly be estate tax exposure at the time of the second death. For example, if the death of the second spouse to die occurs more than two years after the date of death of the first spouse to die, and the executor of the estate of the second spouse to die could benefit from the DSUE of the first spouse to die, this Rev. Proc. provides no solution because the return for the first spouse to die was not filed prior to the second anniversary of that spouse's death.

6. **QTIP Election and Portability**. Rev. Proc. 2016-49 provided an answer to the question of whether a QTIP election could be made when the executor elected portability and the QTIP election was not necessary to reduce estate tax in the estate of the first spouse to die. Consequently, when an estate makes a portability election under IRC §210(c)(5)(A), to transfer the DSUE of the first spouse to die, Rev. Proc. 2016-49 permits a QTIP election to be made regardless of whether the election is necessary to reduce the estate tax in the first estate. If estate tax is not a concern, the assets of the first spouse to die could be left in a QTIP trust, thus obtaining a second basis step-up at the surviving spouse's death, while at the same time preserving many of the asset-protection benefits of a credit shelter trust. A variation on Rev. Proc. 2016-49 is pertinent for clients whose estates have become nontaxable because of the substantially increased exclusion amount, but who have failed to revise their existing trusts that include a marital deduction formula. If under the formula the entire estate of the first spouse to die passes to a credit shelter trust because the estate is less than the exclusion amount, so long as the nominal credit shelter trust meets the QTIP rules, in particular the rule requiring all of the trust's income to pass to the surviving spouse and the rule that no principal can pass to any other person during the surviving spouse's lifetime, the QTIP election can be made along with portability, thus providing a second step-up at the surviving spouse's death for what otherwise would have been a credit shelter trust without such a step-up.

7. **Should Portability be Ignored in Estates Below the 706 Filing Threshold?** Should the portability election be ignored by estates well below the $11,180,000 2018 §706 filing threshold?

a. Because of the cost of filing an estate tax return, many advisors may recommend that, for estates under the 706 filing threshold an estate tax return not be filed if the only purpose is to elect portability and little likelihood exists that the survivor's estate would ever exceed the survivor's exclusion amount, thus eliminating the need to use the DSUE of the first spouse to die.

b. Consider, however, the following:

(i) The spouses are in their mid-60's with the following assets: Residence, $450,000; financial assets, $1,500,000; insurance, $750,000; IRA and retirement plans, $2,000,000; other real estate, $500,000; total, $5,200,000. All of the spouse's assets are in joint tenancy or pass to the surviving spouse by beneficiary designation. Husband dies in 2018. $11,180,000 could be ported to the surviving spouse.

(ii) Reasons in example why an estate tax return to elect portability should be filed:

- The survivor may live over twenty years and his or her assets could easily grow, for example, to $12,000,000. Assume the exclusion amount has been reduced to $7,000,000 after indexing, thus causing $5,000,000 to be exposed to estate tax in the survivor's estate. If an estate tax return had been filed in the estate of the first spouse to die, a portability election would have ported DSUE of $11,180,000 to the surviving spouse and eliminated estate tax in that spouse's estate.

- The surviving spouse may inherit substantial assets from an elderly parent or relative, thus substantially increasing the size of the survivor's estate.

- The survivor may remarry, thus changing the planning dynamics that would otherwise be obtained if the surviving spouse did not remarry. For example, if the surviving spouse remarries a new wealthy spouse, the surviving spouse could gift the DSUE from the first deceased spouse and therefore preserve his or her own exclusion amount to be ported to the more wealthy second spouse. In the absence of the portability election, the gifts would reduce the surviving spouse's own exclusion amount, therefore leaving less to port to the surviving second spouse.

8. **<u>Other Features of Portability</u>**.

a. The surviving spouse's DSUE amount is not subject to reduction if Congress later reduces the exclusion amount or the exclusion amount reverts back to $5,490,000 (unindexed) in 2026.

b. The surviving spouse can use the DSUE amount any time after the death of the first spouse to die, assuming the portability election is made by the executor of the estate of the predeceased spouse.

c. Any gifts made by the surviving spouse are first covered by the DSUE amount, leaving the surviving spouse's own exclusion amount to cover later transfers or perhaps to be used by a second spouse. This feature of portability is to be contrasted with the FIFO possibility for gifting the increased exclusion amount, in that the use of DSUE is a last-in/first-out or "LIFO" concept and gifting of the exclusion amount is a FIFO concept under which the gift is considered to have been made from the pre-existing exclusion amount, not from the increased exclusion amount provided by TCJA.

d. Portability and the increased exclusion amount should eliminate the need to leave qualified retirement plan and IRA benefits in a credit shelter trust. Prior to portability, complications frequently occurred when substantially all of the spouses' assets were in qualified plans. The only way to avoid pyramiding all of the value of those plans into the survivor's estate was to use the awkward arrangement of a credit shelter trust as a beneficiary of qualified plans. After portability, particularly with the increased exclusion amount under TCJA, retirement accounts can instead be left outright to the surviving spouse to take advantage of spousal rollover and stretch payout provisions available to surviving spouses.

e. Interesting property questions exist as to whether a spouse's DSUE is an asset possessing value. Clearly value exists in certain situations, and may require consideration in premarital agreements and post-marital agreements. Consider for example, a second marriage situation in which one spouse who has assets of $4,000,000 develops terminal cancer at a time when the other spouse has assets of $12,000,000. Because the spouses are in their second marriage and each has children from prior marriages, an effort should be made to ensure that the executor of the dying spouse will elect portability, which would provide an additional DSUE of $7,180,000 ($11,180,000 less $4,000,000 to children of the deceased spouse) to the surviving spouse.

f. The Internal Revenue Service may re-examine the estate of the first spouse to die for purposes of determining whether the DSUE amount claimed by the surviving spouse is correct, even if the statute of limitations has run on the estate of the first spouse to die. Although the IRS cannot assess additional estate tax with respect to the first return, it can change the DSUE amount which was incorrectly determined in the estate of the first spouse to die. *Estate of Sower v. Commissioner, 149 T.C. No. 11 (September 11, 2017).*

g. The question of whether the personal representative of an estate is under a duty to elect portability was answered in the Oklahoma case of *In re Vose, 390 P.3rd 238 (Okla. January 17, 2017).* In *Vose* the Oklahoma Supreme Court held, in what appears to be a case of first impression, that an executor is under a duty to make the portability election and cannot refuse the request of the surviving spouse to make the election. The interesting facts of the case involved a prenuptial agreement in which the surviving spouse relinquished any interest in the estate of his wife, who was the first spouse to die. Consequently, although the surviving spouse took nothing from the estate of the first spouse to die, the Oklahoma Supreme Court held that the prenuptial agreement did not waive any rights of the surviving spouse to portability and that under IRC §2010 the surviving spouse has a pecuniary interest in the DSUE amount of the first spouse to die. This case is significant in that DSUE is considered to be a property interest different from the property interest relinquished by the surviving spouse in the prenuptial agreement, in that it was a property interest created by Congress, and could not have been anticipated at the time the prenuptial agreement was signed. Apparently the surviving spouse had agreed to pay all costs of preparing the estate tax return of the estate of the predeceased spouse, therefore making the election would not involve any expense to the estate of the predeceased spouse. The *Vose* case emphasizes the need to cover the portability election in prenuptial agreements and perhaps also in post-nuptial agreements, particularly in cases of a second marriage.

9. **Further Discussion of Portability in this Outline**. See Section V.D.1 of this Outline for a further discussion of portability in the context of the "simple plan."

C. **Other Planning Principles Following TCJA**. Although each of these principles will be discussed in more detail in subsequent parts of this Outline, the following items should be considered as important planning principles following the enactment of TCJA:

1. The traditional A-B formula arrangement, whether pecuniary or fractional, or whether pre-residuary or post-residuary, resulting in the exclusion amount passing to a credit shelter or bypass trust, should be used only sparingly and then with the recognition of alternatives. For large estates, perhaps exceeding $20 million, a formula credit shelter arrangement may continue to be advantageous.

2. All formula clauses, whether marital or formulas used to define a testamentary gift, must be reviewed. The following are examples of formula clauses that may create mischief and should be revised or eliminated.

a. In a second marriage, children of the first marriage are left with an amount equal to the exclusion amount, with the balance passing into a QTIP trust for the surviving spouse. Unless the estate exceeds $11,180,000, the surviving spouse receives nothing.

b. A grandparent leaves the credit share or exclusion amount to a trust for grandchildren, and the balance to children. Unless the estate exceeds $11,180,000, the children receive nothing.

c. Wife's estate is $11,180,000. The formula clause states that the husband, either outright or in trust, is to receive the minimum amount necessary to eliminate estate tax. The residue is to pass into trust for children and grandchildren. Husband receives nothing because the minimum amount necessary to reduce the estate tax to zero is zero. The entire estate passes to trust for children and grandchildren.

3. Income tax planning to ensure basis step-up in most instances may be more important than estate tax planning.

4. Planners should determine if irrevocable trusts, including irrevocable life insurance trusts, are still necessary, and if not necessary, consider methods to add flexibility to the trust. Trust modification under the Uniform Trust Code, decanting, adding further flexibility through powers of appointment, trust protectors, toggling grantor trust status on or off, and changing the trust situs should all be considered.

5. Carefully consider lifetime gifts. In all instances gifting must consider that only future appreciation of the gifted assets is removed from the donor's estate tax base. Because the donor's basis in the gifted asset becomes the donee's basis, substantial appreciation in the gifted assets is required to compensate for the loss of a basis step-up. For example, for a person who has used all of his or her available exclusion amount, the gift of a $1,000,000 zero-basis asset would have to appreciate to $2,469,135 (a 247% appreciation over the value at the date of gift) for the estate tax savings on the future appreciation ($2,469,135 x 40%) to begin offsetting the loss of basis step-up ($2,469,135 x 23.8% for high-bracket taxpayers). Greater appreciation will be required if the state in which the donee lives and ultimately sells the asset has state capital gains tax.

6. All existing credit shelter or bypass trusts should be reviewed to determine if the potential exists for appropriately moving assets out of the credit

shelter trust to the surviving spouse or giving the surviving spouse a power over the credit shelter trust which will cause the trust assets to be taxed in the surviving spouse's estate. This planning would be applicable only if the surviving spouse's estate would not be subject to estate tax at the time of his or her death. This issue is discussed in more depth in Section VII of this Outline.

7. If a death occurs before changes can be made in trust documents, and a credit shelter trust must be funded following the death of the first spouse, consider whether a QTIP election can be made with respect to the credit shelter trust. Such a QTIP election is permitted under Rev. Proc. 2016-49, discussed in Section II.B.6 of this Outline. If, however, the credit shelter trust provides for sprinkling distributions not only to the spouse but also descendants of the settlor, a QTIP election will not be permitted. The QTIP election causes the assets to be included in the surviving spouse's estate, but will provide a step-up in basis at the surviving spouse's death. As with several other techniques described in this Outline, this planning should only be utilized if there is little likelihood that the surviving spouse's estate would be subject to federal estate tax.

8. Review family limited partnerships and family limited liability companies to determine if the valuation formula should be changed to avoid discounts. IRC §2036(a)(2) inclusion using the recent *Powell* case, 148 T.C. (May 18, 2017), might be considered for basis step-up purposes. The Tax Court, in *Powell*, held that an FLP interest owned by a deceased senior family member was includable in his estate under §2036(a)(2) even though he owned only a limited partnership interest. Estate tax inclusion occurred, in the Tax Court's view, because the decedent, together with other family members, could dissolve the partnership and therefore obtain the undiscounted liquidation value of the decedent's LP interest. *Powell* could, therefore, be used to cause estate tax inclusion at the undiscounted value of the LP or LLC interest and obtain a step-up in basis by making an IRC §754 election. These planning arrangements should, however, be used only if the current exclusion amount or the reduced exclusion amount in 2026 will protect the senior family member's estate from estate tax.

9. Ignore the generation-skipping transfer tax at your peril. Use of the increased generation-skipping transfer tax exemption may allow existing trusts to be funded and GST exemption allocated to those trusts through a late GST exemption allocation. There is not total clarity as to whether a late allocation can be made to an existing GST trust by changing the inclusion ratio of the existing trust. Defining these arrangements is beyond the scope of this Outline, but there seems to be reasonable certainty that the additional GST exemption can be allocated to existing trusts and the inclusion ratio of those trusts changed by the additional allocation. Keep in mind that the GST exemption cannot be ported and is lost if not used at the time of the first death either directly or through a reverse QTIP trust.

D. **A Few Risky Generalizations**. Although generalizations are not only risky, but also probably impossible, the following are a few general guidelines:

- Avoid formula marital bequests, whether pecuniary or fractional and whether pre-residuary or residuary, although in extremely large estates of $20 million or more combined spousal assets, the credit shelter arrangement probably will be preferable with the understanding that no step-up in basis will occur at the second death.

- The use of a QTIPable arrangement (assuming that after careful legal and tax advice spouses determine to use a trust structure) will in almost all instances be the best planning arrangement, other than for estates that have little if any estate tax exposure at the time of the second death.

- For most estates having combined spousal assets of $10-20 million, a better result may occur by opting out of QTIP treatment at the time of the first death for all or a portion of the assets of the deceased spouse, thus causing those assets to be in a credit shelter-type trust (non-QTIP portion). This election will, however, result in the loss of a step-up in basis for the non-QTIP assets at the time of the second death.

- For estates of $10 million and under combined spousal assets, electing QTIP and portability for all of the assets of the first spouse to die may be preferable, by locking in the full $11,180,000 (unindexed) DSUE.

- The foregoing guidelines are essentially worthless without considering the following factors at the time of the first death: the health of the surviving spouse; the surviving spouse's age and life expectancy; the surviving spouse's consumption needs; the character of assets owned by the spouses; economic conditions at the time of the first death; tax laws at the time of the first death, including likelihood of change in the tax laws; and similar considerations. When the life expectancy of a surviving spouse is involved, consider the mortality tables used by the IRS under IRC §7520 and Treas. Reg. §1.401(a)(9), which show the life expectancy of a surviving spouse after the first spouse's death is 14.2 to 17 years at age 70, 8.4 to 10.2 years at age 80, and 4.4 to 5.5 years at age 90.

III. EFFECTS OF TCJA ON ESTATE AND TRUST INCOME TAX PLANNING

A. **Trust and Estate Tax Rates and Brackets**. See chart on page 3 of this Outline.

B. **Trust and Estate Personal Exemptions**. Although the personal exemptions for trusts and estates generally remain the same (estates $600, complex trusts $100, and simple trusts $300) new §642(b)(2)(c)(3) provides a reduction of $4,150 (indexed) for qualified disability trusts for years in which the personal exemption for individuals is $0 (2018-2025). A qualified disability trust is defined in IRC §642(b)(2)(C).

C. **SALT Limitation**. The $10,000 limitation for deducting state and local taxes applies to trusts. Multiple, nongrantor trusts may become a planning technique for a taxpayer with multiple homes. For example:

- The taxpayer's principal residence and second home should be transferred to separate limited liability companies.

- Husband and wife each own a 50% interest in each LLC through a nongrantor trust created by each spouse. The trusts must be nonreciprocal. A §761(a) election might be made to avoid filing partnership tax returns.

- The spouses will transfer by gift their LLC interests into the nongrantor trusts, so that each trust will qualify for the $10,000 real estate tax deduction.

- Loss of §121 Personal Residence Sale Exclusion should be considered.

- Multiple trusts rules under IRC §643(f) might be applied to collapse the separate trusts, although the breadth of this section is uncertain because final regulations were never issued by the IRS.

D. **Miscellaneous Itemized Deductions Disallowed**. New §67(g) disallows miscellaneous itemized deductions for tax years 2018 through 2025. Previously, miscellaneous itemized deductions could be deducted to the extent that they exceeded 2% of AGI. Miscellaneous itemized deductions are all itemized deductions other than those specifically listed in §67(b). IRC §67(e), however, provides an exception to the 2% floor on miscellaneous itemized deductions for deductions that are unique to an estate or trust. Other itemized deductions fall into one of two categories: (i) deductions that are not miscellaneous itemized deductions under §67(b), and (ii) all other deductions that are miscellaneous itemized deductions. New Section 67(g) pertains only to miscellaneous itemized deductions that otherwise have been subject to the 2% floor. Several conclusions appear to result from these changes:

1. Certain itemized deductions continue to be deductible under §67(b). All other itemized deductions are miscellaneous deductions and are no longer deductible. The §67(b) itemized deductions that continue to be deductible are the following:

- Interest, subject to limitations, §163;
- Taxes under §164, subject to the $10,000 annual SALT limitation;
- Charitable deductions under §170 and §642(c);

- Medical deduction under §213;
- Deduction for net federal estate tax paid on income with respect to decedent under §691(c);
- Several other deductions that are rarely used and are listed in §67(b).

2. IRC §67(e) allows the §651 or §661 distribution deduction and the §642(b) personal exemption in computing the adjusted gross income of an estate or trust. Section 67(a) therefore does not apply to these deductions.

3. The new §199A 20% pass-through deduction for qualified business income is not an itemized deduction and therefore will be permitted to a trust or an estate.

E. **Trade or Business Expenses Under §162**. These are not affected by the limitations under §67(a).

F. **New §67(g)**. Section 67(g), discussed generally in Section II.D above, increases the necessity and administrative burden on estate personal representatives and trustees of trusts to filter fiduciary expenses for those unique expenses which are expenses individuals normally do not incur and those expenses that are not unique to the estate or trust normally incurred by individuals. The filtering process involves the following:

1. Deductions that are considered unique to estates and trusts under Treasury Regulations and are therefore deductible under §67(e) and deemed adjustments to gross income in all tax years:

- Certain tax return preparation costs, including costs for preparation of estate tax, GST tax, fiduciary income tax, decedent's final return, and certain return costs under IRC §162, such as sole proprietor returns and retirement plan returns. Gift tax return preparation costs would appear not to be in this category.

- Fiduciary fees to the extent not attributable to investment advice. Fiduciary fees, therefore, must be unbundled and allocated between the portion of the fee that is subject to the §61(a) limitation and the portion that is not. To the extent that those fees are allocated to investment advisory services, they are nondeductible as miscellaneous itemized deductions. Treas. Reg. §1.67-4(b)(4) states however, that in certain limited circumstances the incremental cost of investment advice does not fall within the §67(a) limitation if that advice is given to an estate or trust rather than similar advice that might be given to an individual. For example, such additional advice might be pertinent to advice to comply with the Prudent Investor Rule to ensure diversification of assets, which might not ordinarily be applicable to an individual.

- Appraisal fees needed to file tax returns and administer an estate or trust.

- Administrative costs including probate fees, fiduciary bond premiums, legal notices, and accountings.

- The §642(b) personal exemption.

- Distribution deductions provided for in §651 and §661, generally measured by distributable net income of the estate or trust.

2. Specific expenses that previously were deductible subject to the 2% floor will no longer be deductible, including the following:

- Investment advisory fees, as described above.

- Appraisal fees that are commonly incurred by individuals, including appraisal fees to determine the amount of a charitable deduction unless such charitable deduction is unique to the estate or trust, such as a deduction on the federal estate tax return.

- Property ownership costs not deductible under §162 (trade or business) or §62(a)(4) as adjustment to gross income.

- Expenses pertaining to the determination, collection, or refund of a tax under IRC §212(3) unless such expenses are incurred in connection with estate, GST, or fiduciary tax return.

- Expenses pertaining to the production of income under IRC §212(1), if not connected with rents or royalties under §212(2).

- Deductions from a pass-through entity (partnership, LLC, or S-corporation) that would be miscellaneous itemized deductions to the recipient.

G. **<u>Excess Deductions in the Final Year of an Estate or Trust</u>**.

1. IRC §642(h) states that the deductions for the final taxable year of an estate or trust that are in excess of the gross income of the estate or trust will generally be allowed as deductions to the beneficiaries who receive property from the estate or trust. These excess deductions fall into two categories:

- net operating losses or capital loss carryovers of an estate or trust, which continue to be deductible by beneficiaries, and

- other deductions in the final year in excess of net income that are miscellaneous deductions and are disallowed for tax years after 2017 and before 2026.

Any excess deductions with respect to net operating loss carryover or capital loss carryover can be passed through to the estate or trust beneficiaries as net operating losses or capital losses under IRC §642(h)(1). All other final-year deductions of the estate or trust generally pass through to the beneficiaries in one amount, and under TCJA are considered disallowed miscellaneous itemized deductions, even if they would otherwise have been deductible by the estate or trust.

2. During the final year of the estate or trust, the fiduciary should endeavor to ensure that the income of the estate or trust and payment of expenses are timed, to the extent reasonably possible, to avoid excess deductions in the final year. If the estate or trust projections would indicate excess deductions will exist, the estate or trust may attempt to realize taxable income or gain in the final year to avoid losing such deductions all together. The estate or trust might consider selling appreciated assets to generate income or accelerate the receipt of income in respect of a decedent (IRD) by causing the IRD to be recognized in the final year. Examples would be creating an extra distribution from an IRA or retirement account, or funding a pecuniary gift with appreciated assets thus creating gain to the trust or estate. The §643(e) election might also be made so that the trust or estate recognizes gain on the distribution of appreciated property, thus causing a step-up in basis to the distributee with the result that an actual tax savings may occur.

H. **Section 691(c) Deduction for Estate Tax Paid on Income in Respect of a Decedent**. Although probably of limited use because few estates will actually incur estate tax, the §691(c) deduction for estate taxes attributable to income in respect of a decedent remains and is not suspended by §67(g).

I. **State Income Taxes on Estates and Trusts**. Although not affected by TCJA, state income taxes continue to be important in fiduciary income tax planning. Situs selection, through choice of law provisions in estate planning documents, change of situs when permitted by estate planning documents, decanting, either under common law (perhaps Kansas) or statutory law (Missouri) are possible approaches.

IV. PLANNING FOR PERSONS WHOSE ASSETS ARE UNLIKELY EVER TO EXCEED THE EXCLUSION AMOUNT, WHETHER $11.18 MILLION OR $5.49 MILLION (UNINDEXED)

A. **Generally**. Estate tax issues generally will not need to be considered for estates that could never exceed the exclusion amount, whether $11,180,000 or $5,490,000 (unindexed). In states such as Kansas that do not have a state estate or inheritance tax, state estate tax issues similarly will not need to be considered. If, however, the client owns real estate in a state that has an estate or inheritance tax, potential state death tax issues should be recognized.

1. The Congressional Joint Committee on Taxation estimates only about 1,800 estates for decedents who die in 2018 will be required to pay estate tax. In 2017 the number was approximately 5,000.

2. If, however, the estate is one of a nonresident alien, the exclusion amount remains at $60,000. Estate tax issues may, therefore, come into play for non-resident alien individuals.

B. **Existing Estate Planning Documents Should Be Reviewed**.

1. Formula clauses should be eliminated, particularly if the formula takes into account the exclusion amount. See Section II.C. of this Outline. If a trust for a surviving spouse is necessary because of a second marriage situation, the need for creditor protection, or because of the surviving spouse's inability to manage assets, a Qualified Terminable Interest Property (QTIP) trust should be considered. If there is any reasonable possibility that the assets in the survivor's estate may possibly become subject to estate tax if the exclusion amount is reduced, the portability election should be made for the QTIP trust.

C. **Joint Tenancy Ownership**. Spouses might consider holding most of their assets in joint tenancy with right of survivorship, with wills that would only be applicable at the time of the survivor's death. If probate avoidance is a goal, the surviving spouse could create a revocable trust following the first death. As previously discussed, joint tenancy results in a step-up in basis at the time of the first death for only one-half of the joint tenancy property. The age and health of the clients should also be considered, taking into account substantial difference in ages or health conditions that might cause low-basis property to be held outside of joint tenancy by the older spouse or the spouse whose health is precarious so that a basis step-up will occur for all of such property.

D. **Transfer on Death**. Simple, but many risks, including uncertainty regarding the result if one transfer-on-death beneficiary predeceases the person who created the transfer-on-death account. If the transfer of joint tenancy assets is to occur upon the death of the surviving spouse, steps should be taken to ensure that the TOD language is clear that the transfer is to occur only upon the death of the surviving joint tenant.

E. **Beneficiary Designations**. The disposition of many assets will pass through beneficiary designations, including the following:

- Life insurance. Beneficiary designations are critical, particularly ensuring that per stirpes designations are included in beneficiary language if per stirpes distribution is desired.

- Qualified retirement plans and IRA's. Beneficiary designations are essential and must be reviewed. Any beneficiary designation resulting in a transfer to a trust must be carefully considered to avoid a five-year payout requirement. Conduit and look-through trusts must be considered, analyzed, and carefully explained to the client.

- Retirement plan beneficiary designations and payout structures are extremely complex. The author recommends regularly consulting Natalie Choate's book entitled, "Life and Death Planning for Retirement Benefits - the Essential Handbook for Estate Planners." It is readily available, reasonably inexpensive, and comfortably authoritative.

F. **Joint Revocable Trusts**.

1. Joint revocable trusts should probably be the dispositive centerpiece of the client's estate plan, although for smaller estates the debate between revocable trusts and wills continues. If a joint revocable trust is used, basis step-up at the first death will be applicable only to one-half of the assets in the trust, but the same situation would obtain for joint tenancy property. Clients should be alerted to basis planning for joint revocable trusts so that assets can be arranged to increase the basis of low-basis assets at the time of the first death. A joint revocable trust makes such an arrangement difficult unless assets are removed from the trust prior to the first death and subsequently transferred back to the joint trust under a TOD arrangement. Such planning must, however, avoid IRC §1014(f), which requires a transferee to hold property for at least one year before the death of the transferee will allow a step-up in basis if the transferred property returns to the original transferor following the death of the transferee. Uncertain results occur, however, if the property is transferred into a trust for the benefit of the original transferor.

2. The drafting attorney must explain to the client the advantages and disadvantages of wills and trusts. The author's experience is that many benefits of revocable trusts are not understood or appreciated until the time of death, at which time the descendant's family understands and appreciates the speed and simplicity with which the decedent's assets can be distributed. Situations exist, however, for which court supervision may be needed or when family discord is likely. Even then, using an institutional trustee may avoid problems, while retaining speed and simplicity of prompt asset distribution.

G. **Unwinding Unnecessary Separate Trusts for Spouses**. If the clients previously had separate trusts with formula clauses, transferring assets out of the two existing trusts may be an unwelcome experience. For some older clients who have an existing formula arrangement with a credit shelter trust to which substantially all of the assets of the first spouse to die will be transferred because of the increased exclusion amount, the two-trust formula arrangement may be preferable if the credit shelter trust qualifies for the QTIP election, as discussed in more detail in this Outline. Another arrangement that would cure the need to revoke both trusts and transfer assets to a joint trust would be to amend the dispositive provisions of each separate trust so that at the time of the first death all of the assets held in that trust are distributed to the survivor's revocable trust. This arrangement would not, however, generally be appropriate for second marriages and would provide no credit protection for the surviving spouse.

H. **Other Planning Considerations for Estates Unlikely to Be Exposed to Estate Tax**.

1. Income tax planning, particularly planning to obtain a step-up in basis, has replaced estate tax planning for most estates. As previously indicated, low-basis assets should often be held in the name of the spouse with a significantly shorter life expectancy to obtain a step-up in basis at the time of that spouse's death. If those assets are held in joint tenancy or in a joint revocable trust, a step-up would only be available as to one-half of the assets.

2. Assets should usually be allocated to the spouse who has less creditor exposure.

3. Lifetime gifting for tax purposes should be infrequent because of loss of step-up in basis of the gifted assets. Powers of attorney should be reviewed to determine if gifting authority should be eliminated, or perhaps expanded, particularly if existing powers of attorney limit gifts to the gift tax annual exclusion ($15,000 in 2018). Powers of attorney should also be reviewed to determine if the client wishes an attorney-in-fact to have the authority to continue the client's pattern of charitable giving.

4. The need to prepare carefully drafted and well thought-out documents to achieve a family's estate planning objectives will continue to be essential.

5. The role of life insurance in the client's estate plan should be reconsidered. If an irrevocable life insurance trust was created for estate tax planning purposes, thought should be given to "unwinding" the trust. An irrevocable life insurance trust no longer needed for estate tax purposes may be particularly nettlesome if Crummy notices must be given annually. If the trust is a grantor trust, policies may be sold from one grantor trust to another grantor trust with different planning objectives. See Section X of this Outline for additional considerations regarding life insurance planning under TCJA.

6. The estate planning focus should be on achieving core family values through planning, in a goal-oriented estate plan. The tax tail should no longer wag the estate-planning dog.

I. **Continuing Non-Tax Planning Remains Essential**. Estate planning will continue to be a significant area of practice, even though transfer tax planning has become less important. Important areas of estate planning remain. Many such areas were suggested by former ACTEC President, Lou Mezzullo.

1. Identifying guardians for minor children, if and when needed.

2. Planning for the disposition of the client's assets upon death.

3. Asset protection planning.

4. Planning for marital and other dissolutions.

5. Planning for physical disability.

6. Planning for legal incapacity.

7. Business succession planning (without the estate tax to blame for failure of a business).

8. Using business entities to accomplish non-tax objectives.

9. Income tax planning.

10. Charitable giving (for its own sake, and also because income tax considerations are still relevant and techniques such as lifetime charitable remainder trusts should continue to be used).

11. Retirement planning.

12. Planning for life insurance protection.

13. Trust administration.

14. Fiduciary litigation (perhaps more so if there is more to fight over because of reduced estate tax exposure).

15. Planning to pay state death taxes (in many states).

16. Planning for clients with property in more than one state, including ownership, asset protection, state taxation, and probate issues (in addition to state estate tax).

17. Planning for children with disabilities.

18. Planning for spendthrift children.

19. Planning for clients who are U.S. citizens or resident aliens who own property in other countries.

20. Planning for nonresident aliens with assets in the United States or who plan to move to the United States.

21. Planning for clients who intend to change their citizenship.

22. Planning to live with non-tax regulatory regimes, including Sarbanes-Oxley Patriot Act, HIPAA, and charitable governance reform.

23. Planning for possible increases in the estate gift, and GST taxes.

24. Planning for same-sex marriages following *Windsor v. United States, 570 U.S. 133 S.Ct. 2675 (No. 12-307, June 26, 2013).*

V. PLANNING FOR PERSONS WITH ASSETS THAT COULD EXCEED THE EXCLUSION AMOUNT AND FOR MARRIED PERSONS WHOSE ASSETS COULD EXCEED THE COMBINED EXCLUSION AMOUNT AT THE SECOND DEATH

A. **Estate Tax Planning Continues**. Don't be lulled into complacency or permit your clients to be lulled into complacency because their assets currently are below the temporary exclusion amounts. As discussed in this Outline, the current $11,180,000 exclusion amount, or $22,360,000 per couple exclusion amount, continues only through 2025, and may be reduced earlier if political winds change. The reduction of the exclusion amount to $3,500,000 per person, as recommended by Hilary Clinton in the 2016 election, reveals the Emperor's New Clothes for those who are lulled into complacency by the temporary exclusion amount. On the other hand, planners must also recognize that the estate and gift taxes could disappear, although most commentators believe the estate and gift taxes will continue for many years.

B. **Drafting for Flexibility**. Drafting for flexibility is essential. Estate tax exposure or the lack of exposure must be considered, together with other variables, including the following: the clients' ages; the clients' health; the clients' consumption needs; the potential that one or both clients will receive a substantial inheritance; the clients' gifting patterns, including supporting disabled children or elderly parents; and the cost benefit to the client of a complex estate plan versus a "simple" plan relying on portability. TCJA, because of increased exemptions and portability, has increased the complexity of our planning responsibilities and requires that we spend more time discussing planning alternatives with clients. There is no "one size fits all."

C. **The "Simple" Plan - All to the Surviving Spouse**.

1. The "simple" plan that relies on portability and leaves the estate of the first spouse to die outright to the surviving spouse either by will, joint revocable trust, joint tenancy, transfer on death, beneficiary designation, or similar dispositive arrangements. Several issues regarding the simple plan and ignoring portability were discussed in Section II.B of this Outline. Other issues include the following:

a. Advantages of the simple plan:

(i) Apparent simplicity.

(ii) Achieves certain step-up in basis at the second death for all of the assets owned by spouses although the same result could obtain under a QTIP trust.

(iii) Convenience, particularly for IRA's and other retirement benefits for which trust ownership often is cumbersome and may be counterproductive.

(iv) Provides more control and therefore more perceived security for the surviving spouse.

(v) The ported amount ("DSUE") will not be reduced even if the exclusion amount is reduced in the future. For example, if the DSUE is $11,180,000 and the exclusion amount drops to $6,000,000 (indexed) the DSUE remains $11,180,000 for the surviving spouse.

b. Portability in the simple plan - also for the not-so-simple plan:

(i) DSUE will not be reduced even if the assets subject to DSUE in the first estate decline in value during the surviving spouse's over life. If, however, assets from the first spouse to die pass into a credit shelter trust, and the assets in the credit shelter trust decline in value, the amount protected from estate tax in the survivor's estate because of the credit shelter trust will similarly decline. The DSUE amount, on the other hand, is fixed at the time of the death of the first spouse to die.

(ii) As described by Jonathan Blattmachr and Diana Zeydel, in their creative plan called the "Supercharged Credit Shelter Trust," using portability by having the surviving spouse gift the DSUE amount, particularly by creating a grantor trust for descendants over which trust the survivor will be treated as the owner for income tax purposes but not for estate tax purposes, offers significant planning opportunities. Such a trust protects the DSUE amount by the gift from the surviving spouse to a trust for descendants, and because it is also a grantor trust, the surviving spouse pays income tax on the trust's actual income, thus creating an indirect gift to the survivor's descendants through income tax-free growth of the trust.

(iii) A simplified plan using portability eliminates the need to use more complex formula clauses, whether such clauses are of the fractional or pecuniary variety. Such formula clauses are seldom, if ever, fully understood by clients and add difficulty in the administration of a trust or estate following the first death.

(iv) Because the DSUE amount is available only with respect to the "last deceased spouse," questions may arise if the surviving spouse remarries or survives a second spouse. The DSUE amount is not adversely affected by remarriage, because remarriage alone does not change the identity of the last-deceased spouse. If a second spouse has not died, the spouse of the first-deceased spouse will have the full DSUE amount of a prior spouse available until the time the second spouse dies. At that time, only the DSUE amount from the second spouse, who has become the last-deceased spouse, is available. Consequently, if the last-deceased spouse is the second spouse and that spouse leaves no unused exemption or smaller exemption because a portion of the exemption previously has been used by the last-deceased spouse, the first-surviving spouse may have no or a significantly reduced DSUE.

c. <u>Disadvantages of the simple plan relying on portability</u>:

(i) The ported amount (DSUE) is not indexed for inflation and therefore does not increase after the first death and remains the same during the survivor's lifetime. For example, if the DSUE in 2018 is $11,180,000, and the survivor lives 20 years, the amount ported to the survivor remains $11,180,000, whereas a credit shelter trust would not be subject to estate tax at the time of the survivor's death even if it had grown to $20,000,000.

(ii) The generation-skipping transfer tax exemption is not ported to the survivor. Consequently, if allocating the GST exemption of the first spouse to die is important, it will need to be allocated to a credit shelter trust or to a reverse QTIP trust.

(iii) As previously discussed, the DSUE is lost if the surviving spouse remarries and the second spouse also predeceases the surviving spouse and has little unused exclusion, because the DSUE amount is based on the unused exclusion of the last predeceased spouse. Consequently, if the surviving spouse had received unused exclusion from a prior deceased spouse, at the surviving spouse's death the "inherited" DSUE cannot be ported to the surviving spouse to the extent the first surviving spouse's unused exclusion amount exceeds the basic exclusion amount at the time of death of the first surviving spouse.

(iv) The survivor will have complete control of the couple's total assets if all assets pass outright to the survivor. Consequently, the assets could be diverted from the couple's children or be left to a second spouse.

(v) Leaving all assets to the surviving spouse provides no creditor protection for the surviving spouse.

(vi) Leaving all assets to the surviving spouse usually is not appropriate in a second-marriage situation.

(vii) The first spouse to die may wish to have a portion of the couple's assets provide for lifetime benefits to persons other than the surviving spouse during the surviving spouse's lifetime. This objective cannot be assured if all assets are left to the survivor.

(viii) Portability requires filing an estate tax return for the estate of the first spouse to die, although, as previously discussed, Rev. Proc. 2014-18 relaxes the detail required for an estate tax return filed solely for the purpose of electing portability.

(ix) As previously discussed, the statute of limitations does not run on values that were used to establish the DSUE amount of the first spouse's estate, and can be reopened at the time of the surviving spouse's death to determine whether the DSUE amount claimed in the estate of the surviving spouse is correct, even if the statute of limitations has run on the estate tax return of the first spouse to die. This exposure should be contrasted with the fact that the statute of limitations runs on values used to fund a credit shelter at the first spouse's death.

(x) Portability requires an election by the executor of the estate of the first spouse to die. Although the *Vose* case, described above, requires the executor to elect portability if requested by the surviving spouse, at this time such a requirement is only clear in Oklahoma. The executor therefore has substantial authority to alter the beneficial interests of potential beneficiaries under the estate plan of the predeceasing spouse. Consider for example, the following: Husband (H) dies with an estate of $22,360,000. $11,180,000 of this amount passes outright to the surviving spouse (W) in joint tenancy, IRA's, life insurance, and similar assets. The remaining $11,180,000 passes into a single QTIP trust subject to the executor's right to elect QTIP or non-QTIP treatment. The non-QTIP portion, if elected, would in effect be a credit shelter trust.

(A) Assume the QTIP election is not made, and the full $11,180,000 in the QTIP trust is treated as a non-QTIP or credit shelter portion, and W dies in 2025 with an indexed exemption of $12,000,000. The following could then occur:

- W's individual assets have grown to $15,000,000.
- The credit shelter or non-elected portion of the QTIP trust has grown to $15,000,000.
- The $15,000,000 credit shelter or nonelected portion of the QTIP trust is not included in W's taxable estate.
- W's taxable estate is $3,000,000 ($15,000,000 less exclusion amount of $12,000,000).
- The estate tax at W's death is $1,200,000 ($3,000,000 x 40%).

- The $1,200,000 estate tax will be paid from W's estate and not from the nonelected portion of the trust because it did not contribute to the estate tax cost.

(B) Assume on the other hand, that H's executor elected the entire $11,180,000 to qualify for QTIP treatment and a DSUE of $11,180,000 is ported to W's estate. W dies in 2025, with an indexed exemption of $12,000,000. The following could then occur:

- The amount ported to W or DSUE is $11,180,000.
- Combined exclusion amount plus DSUE is $23,180,000.
- W's individual assets are $15,000,000.
- QTIP share, subject to tax in W's estate, is $15,000,000.
- W's gross estate is $30,000,000.
- W's taxable estate is $6,820,000.
- Estate tax is $2,728,000 ($6,820,000 x 40%).
- The share of estate tax paid by W's estate is zero.
- Estate tax paid from QTIP share is $2,728,000.

The reason for the QTIP share being responsible for the total estate tax is that W's estate (exclusive of the QTIP share) was within the combined DSUE amount and W's exclusion amount, and therefore could not contribute to the estate tax burden. Only the QTIP trust contributed to the total estate tax burden and therefore will be the source of payment of estate tax under usual allocation provisions in a QTIP trust, the Kansas Tax Apportionment Act and IRC §2207A. This example illustrates the significant differences between electing QTIP and not electing QTIP in a taxable estate. If, for example, H and W are in a second marriage and the beneficiaries of the QTIP trust are the children of H, the first spouse to die, and W's estate passes to her children, the full tax burden would fall on H's children. Similarly, even in a first marriage situation, if W, as the surviving spouse, leaves her separate assets to a companion who is not her spouse rather that to the children, the QTIP trust will still be responsible for the estate tax under either the tax allocation provisions in the QTIP trust, Kansas Tax Apportionment Act, or IRC §2207(A).

(xi) Elections under IRC Sections 303, 2032A and 6166 may be affected by the portability election because of the percentage ownership and other requirements to qualify under those provisions.

d. If portability is used in the first estate and the assets of the first spouse to die pass outright to the surviving spouse, and potential exists for the estate of the surviving spouse to exceed the surviving spouse's exemption and DSUE (keeping in mind that DSUE remains static following the first death), the following might be considered:

(i) The surviving spouse gifts the DSUE amount either in full or in part, shortly after the first spouse's death, thereby removing the appreciation from the survivor's estate and ensuring the use of the DSUE amount even if the surviving spouse remarries. The surviving spouse could gift assets that received a step-up in basis at the first spouse's death, avoiding the problem of gifting low-basis assets.

(ii) The survivor creates an intentionally defective grantor trust and either gifts or sells assets to the IDGT. The IDGT could contain a swap provision so that the survivor could substitute low-basis assets in the IDGT with high-basis assets he or she owns outside of the IDGT in order to obtain a step-up at death.

(iii) The survivor could create a GRAT or a series of cascading GRATs.

(iv) Some other technique might be used to reduce estate tax exposure to the survivor such as a CRUT or a CLAT or other charitable gift arrangements.

D. **Traditional Credit Shelter Trust Alternative**. The use of traditional A-B trust planning by which a marital trust and a credit shelter trust are created by formula generally should be avoided in estates where uncertainty exists as to whether the survivor's estate will ever be exposed to estate tax. As previously indicated in this

Outline, all estate plans should be reviewed and if a formula clause has been used, the will or trust should be restated or amended unless there is a specific and well-considered reason to use a formula. For estates other than ultra-high net worth estates, a formula arrangement resulting in a credit shelter trust may have benefits, and for estates of ultra-high net worth clients, should result in benefits.

1. The benefits, highly summarized, are as follows:

a. Creditor and second marriage protection.

b. Limited powers of appointment that can provide flexibility while ensuring creditor and second marriage protection.

c. Regardless of how much the credit shelter trust grows, its value will be excluded from the taxable estate of the surviving spouse.

d. The GST exemption may to be allocated to the credit shelter trust, whereas the GST exemption is not ported under portability.

e. Sprinkling provisions can be added to give income tax flexibility.

f. Asset management can be placed in the hands of a corporate trustee if the surviving spouse lacks financial skills.

g. Hard-to-value assets in the credit shelter trust will not be subject to valuation scrutiny at the time of the survivor's death.

h. Many of these same benefits can be achieved by using a QTIPable trust, either the more standard QTIP arrangement or the Clayton QTIP arrangement, both of which have greater flexibility than the traditional formula clause. Many of these benefits, however, could be compromised if the surviving spouse is the executor under a QTIP arrangement and can thus make an election determining ultimate estate tax consequences.

2. The disadvantages, highly summarized, are as follows:

a. If a traditional formula is used, so that an amount equal to the exclusion amount or exemption passes to the credit shelter trust, unless the estate of the first spouse to die exceeds the exclusion amount, the entire estate passing under the formula will pass into a credit shelter trust. For example, assume a death in 2018 in which the value of the assets of the first spouse to die under that spouse's will or trust are $10,000,000. The full $10,000,000 will pass to the credit shelter trust and unless that trust has substantial flexibility, perhaps in the form of a trust protector or an independent trustee, the surviving spouse's access to the trust principal may be significantly reduced, particularly if that access is limited to a health, maintenance, education, and support ("HMES") standard.

b. There will be no step-up in basis for the assets in the credit shelter trust at the time of the survivor's death.

c. The 3.8% Medicare tax on capital gains will apply after the trust's AGI exceeds approximately $12,700, whereas that tax would not apply if the gains were taxed to the surviving spouse unless his or her AGI exceeded $200,000, assuming he or she remains single.

d. The 3.8% tax on net investment income may also be triggered if a pecuniary formula is used and funded with appreciated assets.

e. The survivor lacks dispositive flexibility even with a limited power of appointment, although a five-and-five power could be added.

3. If a traditional credit shelter trust is used, consider the following:

a. Give an independent trustee or trust protector the power to give the surviving spouse a general power of appointment, perhaps established by formula, even if the power is limited only to the creditors of the survivor.

b. Include provisions in the trust that could trigger the Delaware Tax Trap under IRC §2041(a)(3), as discussed in more depth in Article VIII of this Outline.

c. Include sprinkling provisions or giving an independent trustee the power to make principal distributions to the surviving spouse for the "best interests" of the surviving spouse so that low-basis assets could be distributed out of the trust or capital gains could be distributed to avoid the 3.8% Medicare tax at the trust level.

d. If trust protection is needed for a surviving spouse, consider a discretionary trust for the survivor that might provide not only for the survivor but for other beneficiaries. If the primary objective is to ensure that the survivor will have adequate resources, total discretion on the part of an independent trustee or an HEMS standard might be used. If the trust does not qualify for the marital deduction in the estate of the first spouse to die, a method causing estate tax exclusion at the second spouse's death may be important to achieve a basis step-up for the trust assets when the spouse dies. Methods to obtain such a basis step-up are described in more depth in Section VIII of this Outline.

E. **The QTIPable Trust - An Alternative to the Simple Plan and the Credit Shelter Plan**.

1. All assets held by the first spouse to die pass either from a revocable trust or by will to a single QTIP trust and the trustee (executor) can elect QTIP for all or part of the assets depending on whether it is anticipated that the total estate of the survivor will exceed the spouses' combined exemptions.

a. Advantages of a single QTIPable trust include the following:

- A single QTIP approach generally provides substantial flexibility and can be adjusted to various asset levels and changing estate tax exclusion amounts. Although an estate tax return will be required for making the QTIP election, the return would also be necessary if portability is elected. As discussed in more detail below, a Clayton arrangement could be built into the QTIP trust structure for added flexibility. For smaller estates, however, that under no circumstances could have exposure to estate tax, other than perhaps winning the lottery, these planning arrangements are probably more complex than clients desire, or for which they would be willing to pay, although there are situations in smaller estates for which a trust for the surviving spouse is essential.

- A reverse QTIP election could be made if needed for GST purposes.

- The QTIP arrangement provides creditor protection and ensures that the assets will pass to intended beneficiaries, usually children.

b. There are several problems with the single QTIP approach, as follows:

- The survivor could use the DSUE during his or her lifetime, thus causing the QTIP trust potentially to be liable for estate tax at the time of the survivor's death;

- The QTIP rules prevent any income or principal of the QTIP trust being used for anyone other than the surviving spouse during the surviving spouse's lifetime unless the QTIP trust is a Clayton QTIP.

- The 3.8% Medicare tax may still be a problem, particularly on capital gains in the trust.

- Determining the portion of the QTIPable trust which should be elected for QTIP treatment and non-QTIP treatment is a complex and often tedious process of running the numbers based on various future and uncertain events, including unpredictable growth of assets following the first death, applicable estate tax exemptions and rates, applicable income tax rates, the surviving spouse's health, the surviving spouse's consumption needs, and the various issues pertaining to portability, as described in Section II.B of this Outline.

2. A Clayton QTIP should be considered.

a. A Clayton QTIP allows the executor to make a QTIP election for only a part of the trust with the remaining part passing into a credit shelter-type trust that could benefit not only the surviving spouse, but children or others. Ordinarily, the trust with respect to which a QTIP election can be made permits only the surviving spouse to have lifetime benefits from both the elected and nonelected portions of the share. The Clayton QTIP may provide additional flexibility by allowing the nonelected portion to benefit persons other than only the surviving spouse. Many of the problems associated with making a Clayton QTIP election following the first death are similar to those described in the immediately preceding Section of this Outline.

b. The decision whether to make the QTIP election under a Clayton arrangement can be postponed for fifteen months, rather than the nine months within which a disclaimer must be made if the disclaimer format is used. An independent trustee should be designated to make or not make the QTIP election. Otherwise, the surviving spouse may be considered to have made a gift to the extent of the nonelected portion, particularly if the non-QTIP share passes to the couple's children.

3. Consider using a QTIPable trust with a delayed power of withdrawal. This arrangement gives to the spouses the flexibility provided by using QTIPS, such as having 15 months to decide whether the QTIP election should be made or making the Clayton QTIP election while still giving the

surviving spouse an unlimited, but delayed, withdrawal power. The QTIPable arrangement would allow some estate tax to be paid in the estate of the first spouse to die to provide a full §2013 credit based on the income interest granted to the surviving spouse. This credit could be valuable if the surviving spouse is expected to die within a few years after the death of the first spouse to die. The withdrawal power gives to the surviving spouse the ability to make gifts, which may be important emotionally for the surviving spouse as well as providing an opportunity for the surviving spouse to make taxable gifts shortly after the first death if such gifts would save overall transfer taxes (the gift tax is a tax-exclusive tax and the estate tax is a tax-inclusive tax). If this arrangement is considered, a standard QTIP trust might be used with a delayed withdrawal power that avoids causing the trust to be a general power of appointment trust because the withdrawal power does not exist immediately following the death of the first spouse to die. Treas. Reg. §20.2056-5(a)(4)("must be exercisable in all events").

F. **Disclaimer to QTIPable Trust**. All assets of the first spouse to die could pass outright to the survivor with the survivor having the right to disclaim into a QTIP with a subsequent disclaimer right from the QTIP to a credit shelter. Disclaimers are easy to understand, but often fail because of the surviving spouse's unwillingness to disclaim. Moreover, assets cannot be disclaimed if the surviving spouse has accepted any benefits from the disclaimed property or if the surviving spouse has a power of appointment, even a limited power of appointment, over the credit shelter or non-QTIP trust into which the disclaimed property will pass.

G. **Single Marital Deduction Trust with Right to Withdraw or Disclaim**. All assets of the first spouse to die could pass to a marital deduction trust which gives to the survivor the right to withdraw all or part of the trust and the further right to disclaim into a credit shelter trust. This arrangement provides greater protection and flexibility than an outright gift to the survivor with the right to disclaim into a credit shelter trust, in that if the survivor is incapacitated at the time of the first death, a conservatorship is not needed. This arrangement seems to meet the QTIP rules. See Stephens, Maxfield, Lind, Calfee & Smith, *Federal Estate and Gift Taxation*, 9th Ed., 5.06(8)(d). See also IRC §2056(b)(7)(B)(ii)(II) and Treas. Regs. §20.2056(b)-5(j). This plan provides little creditor protection and the right to withdraw may be considered as a general power of appointment. If the survivor disclaims into a QTIP, the disclaimer may constitute a release of a power of appointment rather than a qualified disclaimer. If the surviving spouse does not disclaim and has not used the DSUE during his or her lifetime, the full DSUE should be available for the QTIP at the time of the survivor's death. Moreover, a question exists whether the estate tax at the time of the survivor's death would be under the QTIP rules (§2207) or under either §2041 (general power of appointment) or §2044 (QTIP inclusion at the survivor's death). This may create a difference in the source of paying estate tax at the time of the survivor's death. If the trust is a QTIP trust, §2207A would control, whereas if the trust is a life estate with a power of appointment §2207 would control. If a disclaimer is used, the survivor cannot have a power of appointment over the disclaimed property without causing the disclaimer to be unqualified, unless the survivor also disclaims the power of appointment.

H. **<u>Other Planning Issues Applicable to Potentially Taxable Estates</u>**. Other planning issues applicable to potentially taxable estates.

1. If a traditional credit shelter trust is used and not revised prior to the first death, and if the credit shelter trust, as is often the case, does not provide for sprinkling of income or principal, the QTIP election can be made following the first death if there is little or no possibility of the total assets of the spouses exceeding the combined exclusion amounts of both spouses at the time of the survivor's death. The QTIP election should enable portability to be used while at the same time including the assets in the QTIP trust in the estate of the surviving spouse and obtaining a step-up in basis at the time of the survivor's death. Rev. Proc. 2016-49 permits a QTIP election to be made in this situation even though unnecessary to reduce estate tax in the estate of the first spouse to die.

2. Balancing assets between the spouses is no longer necessary if the estate plan is to rely on portability. If, however, QTIP planning or use of a traditional credit shelter or bypass trust is to be used, some balancing may be necessary.

3. Creditor protection is important in the allocation of assets between spouses. Nonexempt assets should be transferred to the spouse with the least creditor exposure.

4. Basis planning is important in the allocation of assets between spouses. Asset transfers shortly before death to obtain a step-up in basis may be subject to the one-year rule of IRC 1014(f).

5. In most instances, portability and the increased exemption should eliminate the need to have retirement plan assets fund a credit shelter trust.

6. Certain planning situations may lend themselves to a joint revocable trust that gives to the first spouse to die a general power of appointment over the entire trust, thus giving a step-up at the first death to all of the assets in the trust. The author has used this arrangement and received a closing letter from the IRS. The CPA intends to treat all of the assets in this estate as being stepped up to their values at the time of the first death. The arrangement is sometimes referred to as a joint exempt step-up trust or 'JEST." See for example, Eassman, Denicolo and Hohnaded, "JEST" Offers "Superior Estate Planning for Spouses," Parts I and II, <u>Estate Planning</u> October, 2013, p. 3, and November, 2013, p. 14.

7. A spousal lifetime access trust ("SLAT") might be considered. A SLAT is essentially a credit shelter trust created during lifetime for spouses who

may need income or principal (through discretionary or HEMS standards) from an independent trustee. See discussion in Section VI.A of this Outline.

8. Jonathan Blattmachr's "Supercharged Credit Shelter Trust" might be considered. Gans, Blattmachr, Zeydel, Probate and Property (July/August, 2007). This arrangement involves a lifetime QTIP created by one of the spouses for the other spouse. Because the income from the trust, and perhaps principal, can be distributed to the beneficiary spouse, the trust is a grantor trust as to the donor spouse, but defective so that it will not be included in the donor spouse's estate. If the donee spouse predeceases the donor spouse (the donee spouse should be the spouse with the shorter life expectancy) the assets in the trust are included in the donee spouse's estate under IRC §2044. Pursuant to the terms of the trust or the exercise of a limited power of appointment by the donee spouse into another trust, the trust becomes a credit shelter trust after the death of the first spouse and the donor spouse can be a discretionary beneficiary of the trust so long as there is an independent trustee. Because the trust remains a grantor trust with respect to the donor spouse, he or she will be taxed on the trust income and if the income is not distributed, it will grow income tax-free inside the trust and, through compounding, may result in significantly more assets passing to the family at the time of the donor spouse's death than if the trust had paid income tax on the trust's income. Moreover, because the trust (now a credit shelter trust after the donee spouse's death) is a grantor trust to the donor, the donor spouse can swap high-basis assets owned by that spouse outside of the trust for low-basis assets inside the trust and thus have a step-up with respect to the low-basis assets. There are many practical problems with this structure, but Blattmachr believes it is one of the most powerful planning tools available. Caution, however, in Kansas because of K.S.A. 58a505(a)(2), as discussed in Section VI.D of this Outline.

9. Domestic Asset Protection Trusts ("DAPT's"). A DAPT might be considered if the client is willing to create a trust in a state that provides creditor protection to "self-settled trusts" and the client is willing to place assets in the hands of an independent trustee located in that state who is given discretionary powers of distribution to the settlor. The efficacy of such a trust was recently called into question in the Alaska case of *Toni 1 Trust v. Wacker, No. 7228,* Supreme Court of Alaska, March 2, 2018. See discussion of the *Wacker* case in Leimberg, Asset Protection Planning Newsletter No. 363, March 26, 2018.

10. As previously discussed in Section II.C.4 of this Outline, gifting needs carefully to be scrutinized. If there is no estate tax exposure, gifting can prevent basis step-up and lock the donee into the donor's low basis. If the estate tax rate remains 40%, the difference between the 40% estate tax rate and the 20% capital gains rate (perhaps 23.8% if the 3.8% tax on net investment income under §1411 is applicable) together with state income taxes, the gap between the estate tax rate and combined income tax rates shrinks considerably. Although gifts

remove appreciation in the gifted property from the donor's estate tax base, and may shift income tax liabilities (unless a grantor trust is used), there is no step-up in basis for the gifted asset at the time of the donor's death. Consequently, a substantial amount of appreciation may be needed in order for the 40% estate tax savings on the appreciation to offset the loss of basis step-up on the full value of the asset. Moreover, if the gifted assets decline in value, the donee may be in a worse position than if the gift had not been made in the first place.

VI. PLANNING FOR SPOUSES WHO HAVE POTENTIALLY TAXABLE ESTATES BUT WHO ARE UNWILLING TO RELINQUISH THE BENEFITS AND CONTROL OVER THEIR PROPERTY BY MAKING LIFETIME TRANSFERS TO DESCENDANTS.

A. Spousal Limited Access Trusts ("SLATs").

1. A SLAT is a trust generally created by each spouse in which the spouse (the "donor spouse") transfers assets equal to the exclusion amount into a trust for the benefit of the other spouse (the "donee spouse"). The trust uses the donor spouse's exclusion amount or exemption, but provides for the donee spouse to have all of the income from the trust and distributions of principal either pursuant to an HEMS standard or discretionary distributions made by an independent trustee. The donee spouse could then create a similar, but nonreciprocal trust, for the previous donor spouse who becomes the donee spouse of the trust created by the other spouse (a "bounce-back" SLAT). Consequently, the income from both trusts is available to the spousal unit and limited amounts, and in some instances all, of the principal may be available to the spousal unit by an independent trustee with the power to make discretionary distributions. The spouses have, therefore, used their exemptions, removed the appreciation in the value of the trusts' assets from both of their estates, and transferred the SLATs to their descendants free of estate tax.

2. SLATs may also be used in lieu of irrevocable life insurance trusts in that each trust may acquire life insurance subject to rules pertaining to retaining the incidents of ownership, on the life of the donee spouse thus sheltering additional assets from estate tax at the time of the donee spouse's death. For example, if high cash value life insurance were acquired by a SLAT, the SLAT would have access to the cash value in the life insurance policy to invest or otherwise leverage during the lifetime of the donee spouse. If, however, as discussed later in this Outline, the donor spouse is a beneficiary of the trust initially created for the donee spouse through the exercise by the donee spouse of a limited power of appointment or by a third party utilizing a power to designate the donor spouse as a continued beneficiary of the trust (the bounce-back SLAT), the donor spouse will have the benefit of at least the income from the life insurance proceeds through distributions made by the trust following the donee spouse's death.

B. **Other Benefits of SLATs**.

- Taxed as grantor trusts. SLATs generally are grantor trusts because the income from the trust may be used for the grantor's spouse. IRC §677(a)(1). Because the grantor, rather than the trust, pays tax on the trust's income, the trust grows income tax-free.

- A non-grantor SLAT could be created by having an adverse party approve any distribution to the spouse. This would, however, appear to defeat one of the purposes of a SLAT; that is, ensuring that the income from the trust property will be available to the donee spouse and therefore to the spousal unit.

- If the SLAT is a grantor trust, the donor spouse could swap assets out of the trust under a swap power by which the donor spouse (the grantor for income tax purposes) could swap assets of equivalent value for trust assets. If the assets transferred out of the SLAT to the donor spouse were low-basis assets, and the assets transferred by the donor spouse to the SLAT were high-basis assets, a step-up in basis would occur with respect to the low-basis assets being held by the donor spouse at the time of his or her death. Those assets would not receive a step-up in basis if they were held by the SLAT at the time of the donor spouse's death.

- Asset protection benefits may be obtained from SLATs, particularly if the SLAT acts as an ILIT in which cash values in life insurance policies held by the SLAT, as well as death benefit proceeds, may be protected from the creditors of both spouses. If, however, the initial donor spouse is a permissible beneficiary of the trust created for the donee spouse by the exercise of limited power of appointment by the donee spouse in a bounce-back SLAT, the donor's creditors, in non-self-settled trust states (Kansas), can reach the trust assets following the death of the donee spouse. If the donor spouse's creditors could reach those assets, those assets would similarly be exposed to federal estate tax under IRC §2036.

- SLATs, as with most irrevocable trusts, can be structured to provide for an institutional trustee or an institutional wealth manager, thus providing benefits to the donee spouse.

C. **Potential SLAT problems**. Although the use of SLATs in Kansas has its own problems, as described in Section D of this Article VI, SLATs present other planning issues that must be considered. Among those issues are the following:

- The reciprocal trust doctrine must be avoided.

- The spousal unit may disappear in the event of a divorce. The donor spouse therefore would receive no post-divorce benefits from the SLAT created for the donee spouse. Because of the possibility of divorce and loss of the marital unit's access to the SLAT, the trust could define "spouse" to be the person to whom the grantor is married at the time of trust creation, without causing estate tax inclusion in the donor's estate. If a divorce should occur, however, the donor spouse might not immediately remarry and therefore a question would exist as to the identity of the beneficiaries following the divorce.

- Unless both spouses create SLATs (bounce-back SLATs), and those SLATs are nonreciprocal, the death of one spouse prevents the donor spouse from benefitting from the assets transferred into the trust for the donee spouse unless the donee spouse is given a limited power of appointment back to the donor spouse or a third party holds such a power. In non-self-settled trust states, including Kansas, any benefit the donor spouse would receive from the trust after the death of the donee spouse would probably expose the trust to the donor spouse's creditors and therefore to estate tax under IRC §2036.

- The relation back doctrine, applicable to powers of appointment, might be viewed as causing the trust appointed back to the donor spouse by the donee spouse in a bounce-back SLAT to have been created by the donor spouse even if the donor spouse's interest in the trust is only due to the exercise of the limited power of appointment by the donee spouse. The United States Supreme Court Case of *Chanler v. Kelsey, 205 U.S.466(1907),* even though covered in dust, might be resurrected to prevent the application of the relationship back doctrine in the context of nonreciprocal SLATs created by the spouses.

D. **Kansas SLAT Caveat**.

1. A single SLAT probably would be effective in Kansas. Nonreciprocal SLATs, or bounce-back SLATs, in which both spouses create a SLAT for the other spouse would, however, present significant problems in Kansas if the donee spouse could exercise a limited power of appointment or if a third party could amend the trust by including the donor spouse as a trust beneficiary following the death of the donee spouse. In such situations, K.S.A. 58a-505(a)(2) would appear to cause the assets of the trust, following the death of the donee spouse, to be exposed to the donor spouse's creditors. K.S.A. 58a-505(a)(2) states in part, "...with respect to irrevocable trusts, a creditor or assignee of the settlor may reach the maximum amount that can be distributed to or for the settlor's benefit." Thus, whether the donee spouse exercises a limited power of appointment in favor of the donor spouse or the power is exercised by a third party, any amount that can be distributed to or for the donor spouse's benefit

would be subject to the donor spouse's creditors under K.S.A. 58a-505(a)(2). Some states have specifically provided by statute that a donor spouse's creditors cannot reach the trust property under this kind of planning. See, for example, Florida Statutes Ann. 736.0505(3)(a) and (b). No such statute, however, exists in Kansas, nor does Kansas have a statute protecting self-settled trusts from the settlor's creditors. To the contrary, K.S.A. 58a-505(a)(2) seems clearly to do just the opposite; that is, expose the trust to the settlor's, or in the case of a nonreciprocal, bounce-back SLAT, the donor spouse's creditors after the donee's spouse's death. If the trust is exposed to the settlor's creditors or the creditors of a donor spouse who is the beneficiary of a SLAT under which the donee spouse has exercised a limited power of appointment in trust back to the donor spouse, the trust is subject to estate tax inclusion under IRC §2036. The relation back doctrine applicable to powers of appointment might also cause estate tax inclusion.

2. K.S.A. 58a505(a)(2) is almost a verbatim adoption of §505(a)(2) of the Uniform Trust Code. However, the official comments to the UTC state that assets will be exposed to the settlor's creditors only to the extent the *trustee* can make the trust assets available to the settlor. The Kansas version states a creditor of the settlor may reach the maximum amount in the trust that can be distributed to the settlor, which is the same language as the UTC, but there is no Kansas comment to K.S.A. 58a505(a)(2) that would limit exposure only to assets that the *trustee* can make available to the settlor. Some commentators have argued that the use of "trustee" in the UTC 505(a)(2) comments would enable an independent third party to have a power to either add the donor spouse to the permissible beneficiaries of the SLAT created for the donee spouse or exercise a power causing the SLAT to be appointed back to the donor spouse for the donor spouse's remaining lifetime with an independent trustee having the right to make discretionary income and principal distributions to the donor spouse. This approach would not, however, appear to be permissible under K.S.A. 58a-505(a)(2) without causing the assets in the appointed-back SLAT to be exposed to the donor spouse's creditors and therefore to estate tax under IRC §2036.

E. **<u>Domestic Asset Protection Trusts ("DAPTs")</u>**. Approximately eighteen states have enacted statutes protecting domestic asset protection trusts although, as previously described with respect to the recent *Wacker* case in Alaska, the creditor protection offered by those trusts may be illusory. If one is seeking creditor protection and is willing to take the risk of creating a DAPT in a DAPT state, the assets placed in the DAPT may be available to the settlor but only by the exercise of discretion of an independent trustee, who is a resident of the state in which the DAPT was created.

F. **<u>Spouses for Whom a Gift of the Total Exclusion Amount Would Create Estate Tax Benefits, But Who Do Not Wish to Make Such a Gift</u>**. In this situation, consider one spouse making a gift of the full $11,180,000, or the balance of that spouse's unused exclusion amount, thus protecting against the FIFO consequence described in Section I.I.2 of this Outline with respect to the donor spouse. This arrangement would be preferable to each spouse making a gift, for example, of $5,490,000, because of the fact that if the exemption returns to $5,490,000 (unindexed), the FIFO effect of TCJA would be to eliminate the remaining exclusion amount for both spouses.

G. **Other Planning Suggestions that Provide Potential Continued Benefits for Both Spouses After the Gift**.

- Self-settled trusts in DAPT states which rather than allowing a Settlor to be a discretionary beneficiary, provide to a third party the power to appoint assets to the Settlor under a nonfiduciary power of appointment.

- Preferred partnership freezes.

- Gifts of interests in family limited partnerships or limited liability companies and payment of management fees to the donor.

- Seeding intentionally defective grantor trusts with the exclusion amount or a substantial amount and then selling assets having valuation discounts to the trust for a note. This arrangement ensures to the settlor that note payments will be made, thus providing an income stream to the settlor. There are many permutations of this arrangements and planning is necessary to ensure that full benefits are obtained.

- Other "leaky freeze" techniques.

VII. PLANNING FOR ULTRA-HIGH NET WORTH CLIENTS

TCJA creates little change for clients who will be subject to federal estate tax so long as there is a federal estate tax.

A. **FIFO or Off-the-Top Gift Issue**. One exception to the limited changes for ultra-high net worth ("UHNW") clients is the "use it or lose it" issue described in Section I of this Outline. Any incremental exemption in making gifts to existing or new multi-generational trusts, including generation-skipping trusts, life insurance trusts, or GRATs should be considered. A helpful checklist regarding the analysis to determine the suitability for making gifts was created by Barry A. Nelson, and can be found in "Leimberg Estate Planning Newsletter" No. 2631, March 22, 2018.

B. **Flexible Planning Tools**. Many of the flexible planning arrangements described in Section V of this Outline for clients who potentially may be exposed to federal estate tax at the time of the survivor's death, or at the time of a single person's death, are applicable to UHNW clients. QTIPable trusts should be considered even for high net worth clients if for no reason other than the QTIP election can be postponed for fifteen months after the date of death.

C. **Sales to IDGTs**. The UHNW client might consider making new sales to intentionally defective grantor trusts ("IDGTs") or when advantageous, making substantial gifts, including valuation discounted gifts, to existing IDGTs to enable notes to the grantor to be paid, thus eliminating the possibility of gain at the time of the grantor's death, although most commentators view the likelihood of such gain occurring as minimal. Even though some risk exists in sales to IDGTs due to the *Woelbing* cases, TCJA provides an impetus to continue such transactions. The increased exclusion amount under TCJA could be used to further leverage a sale to an IDGT. Many commentators suggest a 9:1 or 10:1 debt-to-equity ratio for the sale of assets to a grantor trust. Consequently, an additional $10,000,000 of exemption used to fund or add to an existing IDGT might support a sale of assets in the $100,000,000 discounted value range. A thirty percent valuation discount would allow assets having an underlying nondiscounted value of $130,000,000 being sold to the IDGT for a note of $100,000,000. While this example would be applicable to few estates, a scaled-down example sould be considered by UHNW clients, particularly after the withdrawal of the proposed §2704 Regulations.

D. **Additional Funding to ILITs**. Making cash gifts to existing irrevocable life insurance trusts to provide a fund for future premium payments, thus eliminating annual contributions to the trust with nettlesome Crummey notices.

E. **Forgiveness of Indebetdness**. Forgiveness of outstanding loans to children or grandchildren.

F. **Using grantor trusts**. Grantor trusts may contain swap provisions, or allow loans to the grantor so long as reasonable interest is charged on those loans, thus providing a safety valve for the grantor should funds be needed for other purposes.

G. **Planning to Minimize Use of Exclusion Amount**. The amount of the spouse's remaining exemption will influence what planning arrangements are available. If most of the exclusion amount has been used, further lifetime transfers may create a gift tax. As previously noted, exemption-consuming gifts should carefully be scrutinized. To the extent that exemption remains, it may be possible to accomplish desired lifetime transfers using planning techniques that minimize using the gift tax exclusion amount, such as multiple annual exclusion gifts, zeroed-out GRATs, or sales to grantor trusts. The goal should be to maximize the exclusion amount remaining at death if necessary to retain low-basis assets that will be stepped up at death. Swap provisions in a grantor trust may be a technique to accomplish this result. Gifts of interests in closely held entities may result in estate tax benefits because of valuation discounts, but if the donor's death occurs within a short time after the gift and no appreciation occurs, little may be gained, particularly if the assets of the entity are sold shortly after the donor's death.

H. **<u>Other Planning Arrangements for UHNW Clients</u>**. Although this Outline will not attempt to describe all, or even most of the available planning techniques for UHNW clients, planning arrangements that might be considered include the following:

- GRAT's, including leveraged GRATS.
- Charitable Lead Trusts.
- Charitable Remainder Trusts.
- Sales to intentionally defective grantor trusts, although such sales have been challenged by the IRS in the *<u>Woelbing</u>* cases.
- Preferred partnership freezes.
- Net gifts.
- Intra-family loans.
- Continued use of discounted gifts, but only if income tax (basis) issues are considered. The IRS's withdrawal of the proposed §2704 Regulations should re-ignite such planning.
- Private foundations.
- Gifts to donor-advised funds with the children ultimately responsible for designating the charities that will receive distributions.
- Using a "Remainder Purchase Marital Trust." This arrangement involves one spouse transferring assets to a trust in which the other spouse has an interest such as an annuity or income interest for a specified term or life, after which the assets pass to a separately created trust for the family. At the time the RPM trust is funded, the family trust purchases the remainder interest that would pass to it at the time of the donee spouse's death. The donee spouse's interest qualifies for the gift tax marital deduction and the interest acquired by the family trust is not a gift because it has been purchased for fair market value. Consequently, all of the appreciation in the assets attributable to the remainder will be removed from the donee spouse's estate. This is a complex arrangement, and this summary is only the beginning. See Handler, "Remainder Purchase Marital Trusts and Other Exotic Planning Techniques," 2013 N.Y.U. Tax Institute, 16-1.
- Private annuities. See the recent *Kite* case for an example of how private annuities could be structured. *Kite* involved a sale of assets from a QTIP

trust in exchange for a deferred private annuity. *Kite v. Commissioner*, 105 TCM,(CCH) 1277 (2013).

- Irrevocable life insurance trusts. ILITs may still produce benefits, but if there is no estate tax exposure for either of the spouses who created an ILIT, consideration should be given to unwinding it if the trust is incurring a trustee's fee and nettlesome annual Crummey withdrawal notices are required.

- Gifts of fractional interests that could be discounted. Avoid tenancy in common by use of a tenancy in common agreement or a limited liability company. Valuation of fractional interests may be difficult becuase of limited comparable sales data.

- Consider large inter-family loans, or cash gifts to enable grantor or other family members to repay existing loans from senior family members.

- Private split-dollar life insurance plans, including planning under the *Morisette* case, 146 T.C.11, April 13, 2016, as described in more detail in Section X of this Outline.

- Consider estate income tax planning and the use of DINGs (Delaware Incomplete Grantor Trust) and NINGs (Nevada Incomplete Grantor Trust). See Martin Shenkman's analysis of such state income tax saving techniques in "Leimberg's Estate Planning Message" No. 2628, February 20, 2018. Further information on DINGs and NINGs may also be found in the following articles: Stone, "Tax Planning Techniques for Client Selling a Business," October, 2016 Estate Planning, p. 3; Keebler "Family Tax Planning Forum," August, 2013 Taxes - The Tax Magazine, p.5.

- Although the continued use of family limited liability companies and family limited partnerships for valuation discount planning remains, the recent tax court case of *Powell*, 148 T.C. (May 18, 2017) requires a careful analysis of existing family partnership and family limited liability company operating agreements to determine if the §2036(a)(2) risks described in *Powell* are applicable. Agreements should be changed if risk exists under *Powell* and if valuation discounts are sought at the death of the senior family members. A thorough analysis of the *Powell* case by Steve Akers can be found at www.bessemer.com.

- QTIP trust planning for a surviving spouse. If a surviving spouse who is a beneficiary of a QTIP trust gifts or releases a small portion of the income or interest in that trust, for example 5%, the surviving spouse is treated as making a gift of the entire remainder interest under IRC §2519. The surviving spouse has therefore made a gift using his or her additional exclusion amount while retaining a 95% income interest. Because the surviving spouse in this example has retained a 95% income interest, 95% of the QTIP assets would be includable in the surviving spouse's estate under IRC §2036, but the §2519 gift of the remainder interest would be excluded as an adjustable taxable gift in the surviving spouse's estate tax return. See IRC §2001(b) and Treas. Reg. §20.2044-1(e), Example 5. As Steve Akers has pointed out, although the deemed gift of the remainder interest is not added back into the tentative estate tax base of the surviving spouse as an adjusted taxable gift, the amount of the gift tax that would have been payable using the date of death rates and the date-of-death exclusion amount (assuming clawback does not apply) remains as a subtraction from the estate tax calculation under §2001(b). The result is that the date of gift value portion of the amount of the remainder interest that is included in the gross estate under §2036 is offset by the gift tax payable subtraction with respect to that amount, so only the net appreciation is effectively subjected to estate tax, therefore making use of the gift exclusion amount which was available at the time of the gift. Steve Akers further points out that if the QTIP trust is larger than the gift that the surviving spouse wishes to make, the QTIP trust might be divided into two separate QTIP trusts under applicable state law and the §2519 deemed transfer could be made from only one of the separate trusts. Private Letter Ruling 2017106 seems to permit this result.

- Graegin loans to fund estate tax liability. See Price, "Funding Estate Tax Liabilities with Graegin Loans," <u>ALI-CLE Estate Planning Course Material Journal</u> p.3, October, 2013.

- Defined value clauses have lost some of their efficacy as a result of TCJA because the taxable gift potential for many transfers may now be cushioned by the larger exclusion amount. For UHNW clients, however, defined value clauses may still effectively be used. Although a detailed explanation of the use of defined value clauses is beyond the scope of this Outline, current planning often involves shifting the gift tax risk or perhaps the estate tax risk by formula allocation clauses and formula transfer clauses. A formula allocation clause may allocate the amount transferred among transferees; i.e., transfers all of the particular asset, and allocates that asset among taxable and nontaxable transferees by formula. Nontaxable transferees could include a charity, marital deduction transfers to spouses, including QTIP trusts, and zeroed out GRATs. In a formula allocation clause, the allocation could be based on values as determined for gift or estate tax purposes, or the allocation could be based on an agreement among the transferees as to value.

- The formula transfer clause is simpler and limits the amount transferred (i.e., transfer of a fractional portion of an asset, with a fraction described by formula). An example would be, "I give to my daughter that number of units in Acme LLC that has a fair market value of $200,000, as determined for federal gift tax purposes." This form of defined value clause has been analogized to the old days when a gas station customer would ask for "$5 worth of regular." This form of defined value clause was approved by the United States Tax Court in the much publicized case of *Wandry v. Commissioner*, T.C. Memo 2012-88. Although *Wandry* is a helpful development, many planners are still concerned with using a formula transfer clause without a gifting over the excess value to a charity or to another nontaxable transferee. When considering the use of defined value clauses, one should note that the case of *King v. United States*, 545 F.2d 700 (10th Cir. 1976) is a favorable case for using formula allocations within the 10th Circuit, in which Kansas is located.

- Several articles discussing formula transfer clauses are as follows: "Not Another Wandry Article: Real Issue with Wandry Formulas," Austin Bramwell and Brad Dillon, Estate Planning, May, 2014,p.3; Mulligan, "Defined Value Formula Transfers Get a Boost from the Tax Court in Wandry," 117 J. Taxation 244 (November, 2012); McNary, "The Wandry Way: A Better Approach to the Disclaimer of Hard-Value Assets?" 27 Prob & Prop. 44 (July/August, 2013).

VIII. BASIS PLANNING - MORE IMPORTANT THAN ESTATE TAX PLANNING?

Because of the increased exclusion amounts, albeit temporary under TCJA, planning for a step-up in basis in most situations is more important than planning for estate tax reduction.

A. **A Step-Up in Basis for All of the Spouse's Assets at the Time of the First Death**. Although a double step-up in basis at the time of the first spouse's death is applicable to community property in community property states, a step-up in basis is only applicable to the property owned by the deceased spouse in non-community property states. Only a few techniques, therefore, exist for a step-up with respect to all assets of the spouses at the time of first death. They include the following:

1. The joint exemption step-up trust ("JEST") as described in Section V.H.6 of this Outline. Although the IRS continues to assert that a step-up in basis at the time of the first death is limited to the assets contributed to the trust by the deceased spouse, arguments exist to the contrary, particularly if the general power of appointment given to the deceased spouse over all of the assets of the joint trust is recognized, as it perhaps should be, in IRC §2041.

2. If the spouses owned property in a community property state, for example, a vacation home in Arizona or California, an election may be made to cause the property to be considered community property. Each community property state has a different method for opting in to community property, but in

most community property states, real estate that is located in that state and owned by the spouses can be treated as community property. For example, a vacation home acquired by spouses in Arizona could be deeded to them as community property and in joint tenancy, so that a double step-up in basis would occur at the first spouse's death under IRC §1014(b)(6) without Arizona probate. This arrangement could be enhanced by adding a TOD beneficiary designation that would enable the home to pass to the survivor's (or joint) revocable trust at the time of the death of the second spouse.

3. Transferring low-basis assets to the spouse having a shorter life expectancy either due to age or ill health should be considered, subject, however, to the one-year rule in IRC §1014(e).

B. **Avoiding Loss of Basis Step-Up at the Time of Death of the Surviving Spouse or the Death of a Trust Beneficiary**. Techniques to ensure a step-up in basis of assets in a trust created for a surviving spouse or a beneficiary of a trust, include the following:

1. **Use Powers of Appointment**. Provide to an independent party the authority to grant a general power of appointment to the beneficiary to cause inclusion in the beneficiary's estate. The general power of appointment granted by the third party, either an independent trustee or a non-trustee acting in a nonfiduciary capacity, might be limited to a power in favor of creditors and then only if exercised with the approval of a nonadverse party, IRC §2041(b)(1)(C)(iii). If a trust is drafted to permit someone other than the grantor to grant a general power of appointment to a beneficiary, including a power exercisable by the beneficiary only with the consent of a nonadverse party, basis step-up may be obtained at the time of the beneficiary's death if the third party actually grants the general power of appointment. Any trust drafted with similar language should consider using a broad exculpatory clause for the person who can grant the power of appointment and including language stating that the power holder has no duty to monitor the consequences of granting a general power to a trust beneficiary. Similarly, the power holder could be limited to granting the general power only if requested by a member of the beneficiary's family. Contours of this kind of planning are expanding but remain uncertain. If a general power of appointment is granted for basis step-up purposes, caution must be used to avoid potential exposure to the beneficiary's creditors.

2. **Springing the Delaware Tax Trap**. IRC §2041(a)(3)(B) is often referred to as "the Delaware Tax Trap." The Delaware Tax Trap causes estate tax inclusion if a person holding a special or limited power of appointment can exercise that power by creating another power of appointment that under applicable local law can validly be exercised so as to postpone the vesting of any estate or interest in such property, or suspend the absolute ownership or power of alienation of such property, for a period ascertainable without regard to the date of

the creation of the first power. Applicable local law in Kansas is the Uniform Rule Against Perpetuities Act, K.S.A. 59-3401 et. seq., which seems to be a statute invalidating certain conveyances or interests in property that postpone the vesting of such an interest in property beyond certain designated time periods as set out in the statute. Under the Kansas Rule Against Perpetuities, an extension of the rule against remoteness of vesting appears to occur when the holder of a non-general power (first power), exercises that power to create a presently exercisable general power of appointment (the second power). An extension would appear to occur because a new perpetuities period begins at the time of the exercise of the second power rather than at the creation of the first power. Consequently, the Delaware Tax Trap appears springable in Kansas, either intentionally or unintentionally.

The benefit of springing the Delaware Tax Trap is to cause the assets of a trust over which a person holds a limited power of appointment to be taxed in that person's estate for federal estate tax purposes even though in the absence of triggering the trap the trust assets would not be includable in the holder's estate because the holder has only a limited power of appointment. Including the property in the estate of the limited power holder under §2041(a)(3)(B) will cause the assets in the trust to have new basis as of the date of the power holder's death. Because of the substantially increased exclusion amounts under TCJA, many persons holding limited powers of appointment will not be exposed to estate tax even if the property to which the power pertains would be includable in that person's estate. Therefore, intentionally triggering the Delaware Tax Trap to cause assets in a trust to be included in the estate of a holder of a limited power may be sound planning. Moreover, if the assets in the trust are includable in the estate of the power holder, what might previously have been a taxable generation-skipping transfer may no longer be subject to GST tax.

Further discussions of springing the Delaware Tax Trap can be found in the following articles: Nenno, "*Getting a Step-Up Income Tax Basis and More by Springing - or Not Springing - the Delaware Tax Trap the Old-Fashioned Way*," Tax Management Estates, Gifts, and Trusts Journal, July, 2015; Raatz, "*Delware Tax Trap Opens Door to Higher Basis for Trust Assets*," Estate Planning, February, 2014; Spica, "*A Practical Look at Springing the Delaware Tax Trap to Avert Generation Skipping Transfer Tax*," 41 Real Property, Probate and Trust Journal, pg. 166; Blattmachr and Pennell, "*Adventures in Generation-Skipping or How We Learned to Love the Delaware Tax Trap*," 24 Real Prop. Prob. & Tr. J. 75 (Spring, 1989).

3. **Distributions from Credit Shelter Trusts**. Distributions may be made outright to a surviving spouse from a credit shelter trust, thereby causing the assets to be includable in the surviving spouse's estate with a step-up in basis. Distributions may be possible through a trust modification, exercise of a broad standard to make distributions to a surviving spouse in order for the spouse to

maintain his or her accustomed standard of living, or under a trust drafted for the purpose of ensuring the possibility of basis step-up, that gives an independent trustee the power to make distributions to the surviving spouse for his or her best interests or to achieve income tax benefits. Trusts should be drafted to provide flexibility to help ensure basis step-up at the time of the beneficiary's death.

4. **Upstream Basis Planning**. Upstream planning involves a client (child) who has a taxable estate also having a surviving parent or parents who will not have a taxable estate. The child with estate tax exposure could transfer assets upstream, from the child to the parent, so that the assets are included in the parent's estate and obtain a step-up in basis at the time of the parent's death. The risk in this form of planning is, of course, that the child may be deprived of the assets if the parent fails to create a trust or some other dispositive arrangement that benefits the child following the parent's death. One approach to mitigate this risk is for the child to transfer the assets to a trust created for the parent, giving the parent a general power of appointment, the exercise of which is limited to the parent's creditors and can only be exercised with approval of a nonadverse person. The upstream transfer arrangement could be enhanced even more by limiting the amount subject to the general power of appointment to the amount which, when added to the power holder's other assets, is slightly less than the amount of the power holder's exclusion amount or that the general power of appointment only extends to assets that have a fair market value in excess of their income tax basis. See Berry, "Tips from the Pros: The 'Hook' of Increased Income Tax Basis," Wealth Planning Newsletter, Wealth Management, March 22, 2018. Any upstream planning should involve avoiding the IRC §1014(e) risk of assets returning to the donor if the donee dies within one year from the date of the gift. For example, the trust created for the parent might provide that following the parent's death (assuming the parent fails to exercise the general power of appointment, which is generally anticipated), the trust assets would pass into a discretionary trust for the original donor rather than passing outright to the original donor. Under PLR 90036036, this may avoid the §1014(e) hook.

C. **Additional Basis Planning Resource Material**. A thorough analysis of basis step-up planning can be found in Paul Lee's presentation, at the 2014 University of Miami Tax Institute, entitled "Estate and Income Tax Intersection - Basis Planning for Larger Estates." See also Lee, "Run the Basis and Catch Maximum Tax Savings - Part 1," Jan. 2015 Estate Planning, p.3; Lee "Run the Basis and Catch Maximum Tax Savings - Part 2," Feb. 2015 Estate Planning, p. 11. Several cutting-edge basis step-up planning techniques are presented in Bramwell, "Toggling Estate Tax Inclusion On or Off: A Powerful Strategy," Estate Planning Journal, March, 2017.1

D. **Life Insurance Acquired by Credit Shelter Trust**. While not directly related to basis step-up planning, in situations where a credit shelter trust is locked in to a low-basis asset that has substantial cash flow, the trustee might consider acquiring life insurance owned by the credit shelter trust on the life of the surviving spouse. The surviving spouse could not be a trustee of the trust, but at the time of the surviving spouse's death, the life insurance proceeds will be payable to the trust estate tax free and negate the consequence of no step-up in basis. If the life insurance has significant cash value, policy loans could be obtained for the benefit of the surviving spouse so long as the policy is not a "modified endowment contract," as defined in §7702A of the Code.

IX. CHARITABLE PLANNING UNDER TCJA

Although charitable planning generally is beyond the scope of this Outline, there are several changes made by TCJA pertaining to charitable planning for estates and trusts. The following discussion, although not comprehensive, describes some of the more important issues to be considered.

A. **Charitable Income Tax Deduction**. Though many deductions, including miscellaneous itemized deductions, were eliminated by TCJA, charitable contributions continue to be deductible with an increased percentage limitation for cash contributions to public charities. The increased percentage limitation is now 60% of the contribution base, which in most instances is adjusted gross income ("AGI") with a few modifications. The prior percentage limitation was 50% of AGI for cash contributions. Unfortunately, TCJA particularly conditions the new 60% limitation to only cash gifts to public charities. Consequently, if one dollar of noncash assets (securities) is donated with a cash gift, the 50% AGI limitation would appear to apply to the entire donation.

B. **Standard Deductions and Charitable Contributions**. Because the standard deduction has been increased through 2025 to $24,000 for a married couple filing jointly ($26,600 if both are over 65) and $12,000 for other individual taxpayers ($13,300 over 65), many taxpayers will no longer itemize. Those taxpayers therefore will receive no benefit from charitable contributions. For example, unless the combination of state and local taxes, limited to $10,000, and charitable contributions exceed $24,000 ($26,600 if over 65) per married couple no tax benefit results from the charitable contributions. Taxpayers might therefore consider the following:

1. Bunching charitable contributions. For example, a couple's charitable contributions in 2018 total $12,000, which together with the state and local tax limitation of $10,000, provide itemized deductions of $22,000, or $2,000 less than the standard deduction. The couple, therefore, receives no tax benefit from their charitable contributions. If, however, the couple made a $24,000 contribution to a donor advised fund ("DAF") in 2018, and had $12,000 of their 2018 contributions made from the DAF to designated charities, they could itemize in 2018, receive a tax advantage for $10,000 of their contributions ($24,000 + $10,000 - $24,000 = $10,000). In 2019, regardless of whether the couple made their contributions from the DAF or from other sources, they would still be entitled to use the $24,000 standard deduction. Over a period of time, the periodic bunching of charitable contributions could provide significant tax benefits.

2. Martin Shenkman has suggested forming a nongrantor trust with a noncompensated family member serving as a trustee. The client could continue using the standard deduction but the trustee of the nongrantor trust would have the discretionary authority to make distributions to the client's children or to charities, including specific charities if the client wishes to name specific charities. Under Shenkman's suggestion, if, for example, the client anticipates making charitable contributions of $10,000 per year, the trust might be funded with $200,000 which, if it produced 5% growth per year (ordinary income and capital gains), $10,000 ($200,000 x 5%) could be donated to charity and the trust would be entitled to an IRC §642(c) deduction for charitable distributions made from income. Because distributable net income ("DNI") is determined after the §642(c) deduction, any distributions to children would likely have little, if any, DNI carried out to the children. The trustee would have the discretion to allocate capital gains to income. The grantor taxpayer who established the trust would therefore have indirectly made his or her desired $10,000 annual charitable contributions with dollars that otherwise would have been taxable to the settlor, and still have the full $24,000 standard deduction. This arrangement has added flexibility because the children could be beneficiaries of the trust and if distributions to charities were not desired by the taxpayer, distributions could be made to the taxpayer's children or other descendants.

C. **Qualified Charitable Deductions from IRAs**. The opportunity for persons over age 70-1/2 to make charitable contributions from an IRA, up to $100,000 annually, is an important charitable planning tool. Natalie Choate, in a recent Leimberg Estate Planning Newsletter, suggested the following technique for utilizing the qualified charitable distribution:

> Barbara is single and over age 70-1/2. Barbara lives in a low-tax state and has no mortgage interest to deduct. She anticipates making a $13,000 charitable contribution in 2018. If Barbara donates $13,000 to charity from her non-retirement accounts, she gets no tax benefit from the contribution because she will be ahead to use her $13,300 standard deduction ($12,000 for single individual plus $1,300 for being over age 65). If, however, she makes the contribution directly from her IRA as a qualified charitable distribution, she obtains an income tax exclusion for the $13,000 IRA distribution which totally bypasses her income tax return, and she still has the full $13,300 standard deduction against her other income.

D. **Charitable Deductions by Electing Small Business Trust ("ESBT") Realized Under TCJA**. As previously described in this Outline, an ESBT is a trust qualified to hold Subchapter S-corporation stock. The S-corporation reports on Schedule K-1 each shareholder's pro rata share of certain separately stated items of income, loss, deduction and credit. Charitable contributions of an S-corporation are separately stated. Prior to TCJA, the deduction for charitable contributions from an S-corporation by an ESBT were determined under §642 of the Code. Under §642(c), a trust is allowed a charitable contribution deduction for amounts of gross income which under the terms of the governing instrument are paid for charitable purposes. No carryover of excess contributions was permitted. Now, as a result of TCJA, the charitable contribution deduction of an ESBT is determined under IRC §170, not the rules applicable to trusts under §642(c). This change will be helpful for an ESBT because no longer are gifts of property to charity limited to gifts from the trust's gross income. The rule causes the percentage of contribution base limitations and carry-forward provisions applicable to individuals under §170 to be applicable to charitable contributions made by the ESBT to the extent of its S-corporation stock ownership. The changes were made by §13542 of TCJA by amending §642(c) of the Code.

E. **Planning to Maximize Testamentary Charitable Contributions**. Although not a part of TCJA, estate planners should attempt to have clients prepay charitable contributions designated by a will or trust so that the charitable contribution deduction can be used during the client's lifetime for income tax purposes, assuming that the contributions are beneficial to the settlor and further assuming that the client's estate will not be exposed to estate tax. This may be possible by an attorney-in-fact acting under a durable power of attorney so long as the prepayment is accompanied by a recognition from the charity that it has received the gift as an advancement and waives any claim to payment under the trust or will. Similar planning in appropriate circumstances might involve a settlor or testator making a pecuniary gift to a child in an amount that the settlor or testator otherwise would wish to have paid to a charity following death. If the settlor's or testator's estate is not a taxable estate for federal estate tax purposes, there will be no tax benefit from the charitable gift. If, on the other hand the charitable gift is made by the child after the settlor's or testator's death, the child will have the benefit of the charitable contribution deduction for income tax purposes. The risk of course is that the child may not carry out the wishes of the settlor or testator.

F. **Important Development for Donor Advised Funds**. IRS Notice 2017-73, issued in December, 2017, contains several important IRS pronouncements pertaining to donor advised funds, including the following:

- How grants from a donor advised fund ("DAF") impact a charity's status as either a public charity or a private foundation;
- Clarification regarding what occurs when private foundations make grants to DAFs;
- Distributions from a DAF for the charitable portion of a grant (a bifurcated grant), when, for example, a grant is for a ticket to a charitable fund-raising event and there is a nondeductible portion of the ticket cost, for example, the value of the dinner.
- Satisfaction of a donor's pledge with a payment from a DAF.

Probably the most significant of the four items described above pertains to whether a charitable pledge can be paid from a DAF, when the pledge is made by a person creating the DAF. The Notice seems to permit pledges to be paid so long as the sponsoring organization (for example, Douglas County Community Foundation) makes no reference to the existence of a charitable pledge when making the DAF distribution and the donor/advisor does not receive, directly or indirectly, any other benefit that is more than incidental on account of the DAF distribution. Moreover, the donor/advisor cannot attempt to claim a charitable contribution deduction under IRC §170(a) with respect to the DAF distribution. The Notice therefore appears to establish guidelines for a DAF's payment of a donor's pledge without the payment constituting more than an incidental and impermissible benefit to the donor.

X. **LIFE INSURANCE AND TCJA**

A. **Statutory Changes under TCJA**.

1. **Reportable Policy Sales**. When a reportable policy sale, as defined in TCJA occurs, new reporting requirements are imposed upon the purchaser of an existing life insurance contract. Generally, a reportable policy sale involves the purchase of a life insurance contract or interest in a life insurance contract, directly or indirectly, if the buyer has no substantial family, business, or financial relationship with the insured. In addition, notice to the IRS must be given by an insurance company that pays a death benefit under a policy that was acquired in a reportable sale transaction.

2. **Rules for Determining the Basis of a Life Insurance Policy Acquired in a Life Settlement**. If a life insurance policy is acquired in a viatical sale arrangement, TCJA provides that the basis in the life insurance policy is not reduced by the "cost of insurance" charges. This would generally include mortality, and insurance company expenses (expense loading), and other charges under the life insurance contract. TCJA therefore reverses the IRS position taken in Rev. Rul. 2009-13. Significantly, this change in basis rule is applied retroactively to transactions entered into after August 25, 2009, and does not sunset after 2025.

3. **Exceptions to Transfer for Value Rules**. Section 13522(a) of the Act outlines the various exceptions to the transfer for value rules under IRC §101(a)(2) with respect to any life insurance contract or interest in a life insurance contract acquired in a reportable policy sale. Because most of the exceptions to the transfer for value rules pertain to transfers to or between parties who have a substantial family, business, or financial relationship with the insured, the scope of this change seems quite limited.

B. **Insurance Planning Issues after TCJA Not Caused by the Statutory Changes Under TCJA**. Although planning for life insurance is beyond the scope of this

Outline, the reach of TCJA may affect life insurance planning. The effect of TCJA falls into two categories. The first category is private life insurance acquired for estate liquidity purposes, perhaps in an irrevocable life insurance trust ("ILIT"). The second category pertains to life insurance acquired for non-tax and non-estate liquidity purposes.

1. **Life Insurance Acquired for Estate Tax Liquidity Purposes**. Most planning issues for life insurance acquired for estate tax liquidity purposes under TCJA pertain to the increased exclusion amount through 2025. In these situations, the increased exclusion amount reduces estate tax exposure and may cause many policy holders, or those paying policy premiums, to question why such insurance should be continued. While there are many possible answers, most thoughtful answers would recommend continuing the insurance, albeit with perhaps policy modifications and premium reduction arrangements. The "thoughtful" answer is premised on the fact that the federal estate tax has not been repealed, and that the current increased exclusion amount is expected to end on December 31, 2025, if not sooner.

2. **Life Insurance Owned by an Irrevocable Life Insurance Trust (ILIT)**. In addition to the question of whether life insurance held by an ILIT should be terminated because of the increased exclusion amount under TCJA, an ILIT trustee continues to be faced with several daunting issues:

a. Do the initial reasons for creating the ILIT still exist? If not, consider trust reformation, decanting if permitted by state law, and utilizing flexible trust arrangements if a trust protector or independent trustee has been named in the trust agreement.

b. Is the policy performing as anticipated? In this regard, one should always determine if the trustee has obtained current in-force ledger illustrations. For a thorough analysis of insurance design issues under ILITs, see Whitelaw, "The Insurance Policy Crisis," (2016).

c. ILIT Planning Opportunities:

(i) The insured or grantor of an ILIT could make a substantial gift to the ILIT using the increased exclusion amount. The substantial one-time gift could ease the burden of future premium payments and provide cash or liquid assets that the trustee can invest or use to acquire additional insurance.

(ii) The use of an ILIT combined with a GRAT can provide powerful results and create a means for future premium financing. For example, grantor establishes an ILIT with an initial gift. The trustee of the ILIT acquires life insurance on the life of the grantor. Grantor creates a GRAT funded by marketable securities, or perhaps a discountable interest in either an LLC or FLP, and the ILIT is named as the ultimate beneficiary of the GRAT. Substantial appreciation in a successful GRAT could then be transferred to the ILIT for the purposes of paying future insurance premiums, investing in other assets or additional insurance, all of which should be excludable from the grantor's estate and have a GST inclusion ratio of zero.

(iii) Acquire Life Insurance in a SLAT. Kansas SLATs, particularly "bounce-back" SLATs, may have adverse creditor and estate tax consequences, as discussed in more detail in Section VI.D of this Outline. If each of the spouses wishes to protect against assets in one of the SLATs disappearing from the spousal unit upon the death of the donee spouse, in a non-bounce-back SLAT, each of the SLATs could acquire life insurance on the life of the other spouse so that if the husband predeceases the wife, the SLAT created for the wife would receive life insurance proceeds. If the wife predeceases the husband, the SLAT created for the husband by the wife would receive life insurance proceeds following the wife's death. The life insurance proceeds would compensate for the loss of access to the assets in the deceased spouse's non-bounce-back SLAT.

3. **Life Insurance Acquired for Non-Tax Liquidity Purposes**. In most instances, life insurance acquired for purposes other than estate tax liquidity should not be affected by the increased exclusion amount. For example, life insurance acquired to ensure that a family business could survive the loss of a key person or a family farm kept in the family will continue to be needed to accomplish those non-tax objectives. Similarly, estate equalization, providing security for a surviving spouse, or eliminating the need for early withdrawals from qualified retirement plans in excess of required minimum distributions to support a surviving spouse and in some cases, the insured's children, remain as non-tax life insurance objectives.

C. **Important Recent Cases Involving in Life Insurance Planning**. Two significant inter-generational private split-dollar life insurance cases were decided by the U.S. Tax Court within the last few years. Private split-dollar arrangements involve, in the broadest terms, an agreement by which a grantor agrees to fund all policy premiums on one or more life insurance policies held in an ILIT in exchange for an interest in the policy or policies equal to the greater of the policy's cash value or the total premiums paid. For gift and GST tax purposes, the grantor's annual gift to the ILIT equals the "economic benefit" which generally is considered to be the value of the term cost for the current insurance protection. When the split-dollar agreement terminates, the grantor is entitled to be paid the greater of the policy's cash value at that time or the total premiums paid. Split-dollar life insurance is complex and this description is limited to a brief definition of the economic benefit arrangement rather than a loan arrangement, which involves different considerations and different tax consequences.

In the U.S. Tax Court case of *Estate of Morrissette v. Commissioner*, 46 T.C. No. 11 (April 13, 2016), the court held that the grantor's cash contribution to an ILIT enabling the ILIT to purchase large life insurance policies was not a gift and the split-dollar agreement should be considered a valid agreement. A side bar in the *Morrissette* case was the estate tax valuation of the note or receivable the ILIT owed Mrs. Morrissette at the time of her death. That issue is yet to be determined, and will remain a significant issue in all private, inter-generational split-dollar life insurance arrangements.

A second tax court case pertaining to private, inter-generational split-dollar life insurance arrangements was the *Estate of Marilyn Levine v. Commissioner*, T.C. Docket No. 9345-15 (Order issued July 13, 2016).

D. **Additional Materials Pertaining to TCJA and Life Insurance**. For a perceptive analysis of insurance planning under TCJA, see Ratner and Brody, "The Ways and Means of Tax Planning with Life Insurance after Tax Reform," April, 2018, Trusts and Estates.

XI. NEW CENTRALIZED PARTNERSHIP AUDIT RULES

A. **General Description**. Although well beyond the boundaries of this Outline, a brief discussion of an important 2017 development may be helpful. That development was the promulgation of Treasury regulations establishing centralized partnership audit rules ("Audit Rules") pursuant to the Bipartisan Budget Act of 2015, P.L. 114-74, P.L. 114-13. This development has generated surprisingly little publicity, although its breadth is substantial. For any practitioner creating or responsible for the management of partnerships or limited liability companies taxed as partnerships, familiarity with the intricacies of the Audit Rules is essential because all partnership agreements and limited liability company operating agreements should be reviewed, discussed with partners or LLC members, and revised during 2018. Any new partnership or limited liability company must take these new rules into account and governing documents drafted to reflect the consequences of the Audit Rules.

B. **Significance to Estate Planners**. The Audit Rules provide an opportunity to opt out of the centralized audit regime so that pre-TEFRA partnership audit rules would apply. There are significant limitations on opting out, including the inability of a partnership having more than 100 partners to opt out. For estate planners, the Audit Rules create a collision between familiar and in many instances desirable estate planning arrangements and limitations for opting out of the centralized audit regime. Those familiar arrangements include the use of trusts, including revocable or grantor trusts. Under Final Regulations recently issued by the IRS, any partnership or limited liability company having a partner or member who is one of the following cannot opt out of the centralized audit regime:

1. A partnership,

2. A trust, including a revocable trust,

3. A foreign entity that is not an eligible foreign entity described in Paragraph (b)(3)(iii) of Reg. §301.6221(b)-1(b)(3)(ii),

4. A disregarded entity described in §301.7701-2(c)(2)(1),

5. An estate of an individual other than a deceased partner, or

6. Any person who holds an interest in the partnership on behalf of another person.

Although C-corporations and S-corporations can be eligible partners for opting out purposes, the entities or persons described in Items 1 through 6 preclude opting out. Even if a partnership interest or limited liability company interest could be held in a transfer-on-death ("TOD") form, following the death of the partner or member, a TOD beneficiary would have to be an eligible person or the opt-out rules would be violated. The unwillingness of the IRS to relax its regulations, notwithstanding requests from many interested groups, creates a difficult planning environment when many entities, including many family entities established for estate planning purposes, wish to have membership interests held by a member's revocable trust. Although the IRS has indicated that it will review the regulations to determine hardship on taxpayers, because the purpose of the regulations is to reduce hardship on the IRS in partnership audits, any change appears unlikely, other than through corrective legislation.

For an example of a memorandum written to partnership and LLC clients, see the Memorandum attached as Exhibit A. The author's law firm is now actively developing and including language to be included in LLC and partnership agreements to address the issues presented by the centralized audit rules.

EXHIBIT A

MEMORANDUM

DATE: January 11, 2018

FROM: Barber Emerson, L.C.

RE: 2018 Partnership and LLC Tax Audit Rules Effective January 1, 2018

New tax rules pertaining to partnership tax audits became effective on January 1, 2018. These rules (the "BBA Rules") are part of the Bi-partisan Budget Act of 2015 and will govern IRS audits of entities classified as "partnerships" for federal income tax purposes. This includes both general and limited partnerships, as well as most limited liability companies. Single-member limited liability companies and corporations, including S corporations, are not affected by these rules. IRS regulations implementing the BBA Rules will significantly change how partnerships and LLC's ("entities") are audited and how these entities may negotiate tax matters with the IRS. For purposes of this Memorandum, all references to "partners" include LLC members.

This Memorandum does not offer any specific legal advice, but instead is for the purpose of providing a summary of the BBA Rules. This summary is not intended to be a complete analysis of the rules or a substitute for seeking further advice as to how the rules affect any particular entity, or whether necessary changes should be made to an entity's partnership or operating agreement.

Most partnerships and limited liability companies will need to revise their partnership or operating agreements to address the BBA Rules. We recommend that any entity taxed as a partnership consult with knowledgeable tax counsel or a certified public accounting firm within the next few months for advice regarding the effect of the new rules on the entity and its partners.

Under the current rules, partnership tax audits are conducted and assessed at the partner level, with the entity represented by a partner who is designated as the "tax matters partner." If any additional taxes result from adjustments to partnership income, deductions, or credits, they are imposed at the individual partner level, not the partnership level, and are assessed directly to those partners who were partners during the audit year in question. Most partners generally have the right to receive information from the IRS in the course of the audit, to elect out of settlements reached by the tax matters partner, and to contest any adjustments separately.

Under the new BBA Rules, additional taxes resulting from an IRS tax audit are assessed and collected at the partnership level. This means that the entity will bear the cost of a prior year's tax liability. As a result, current partners of the entity may indirectly bear the economic burden of an adjustment made for an audit year in which they were not a partner and for which they received no economic benefit. Certain entities may be entitled to elect out of these new rules and apply the prior rules, but the entities that are eligible to elect out are limited. Electing out of the BBA Rules may not be available to most closely held and family-structured entities unless the proposed regulations are changed.

We hope the following will be a helpful summary of the new BBA Rules:

- <u>Prior Year Adjustments and Liability</u>. If an entity-level tax audit occurs, and adjustments are made to the entity's tax return for a prior year (the "reviewed year"), the partnership must pay the deficiency and related interest and penalties during the current year in which the adjustment is made (the "adjustment year"). This means the current, adjustment year partners must effectively pay or bear the economic cost of the tax deficiency for the prior, reviewed year. An entity's partnership or operating agreement should, therefore, be reviewed and probably revised to ensure that profit and loss sharing ratios and reimbursement provisions are added. Former partners should remain liable for their tax burden arising in the reviewed year, even if the entity pays entity-level tax in the adjustment year, so that the economic burden of the additional tax borne by the current, adjustment year partners is based on their reviewed year profit and loss sharing ratios or in some other agreed upon manner.

- <u>Tax Adjustments at the Entity Level</u>. Any entity-level tax deficiency assessed as the result of an IRS tax audit will require the entity itself to pay the additional tax, interest, and perhaps penalties. An entity's partnership or operating agreement, therefore, should require the entity to maintain a reserve fund, or require capital contributions from its partners to cover any such deficiency.

- <u>Partnership Representative</u>. One of the most significant changes made by the new rules requires each entity to designate a Partnership Representative, who may or may not be the same as the tax matters partner. This designation must be made annually and should be coordinated with the entity's tax advisor. If the entity does not designate a Partnership Representative, the IRS may select any person to serve as the entity's Partnership Representative, with certain limitations. The proposed regulations restrict an entity's ability to change the designation of its Partnership Representative, and provide detailed guidelines as to how a Partnership Representative may resign. Consequently, all partnership or operating agreements should give the entity the power to require the Partnership Representative to resign, and should require the Partnership Representative to provide notice to each partner of all audit issues and to seek approval by the entity before binding the entity to any settlement with the IRS. While these provisions may not be binding on the IRS, they should be binding on the partners of the entity. Addressing the relationship of the Partnership Representative to the entity and its partners will be an important element of all partnership or operating agreements, because the IRS is no longer required to notify individual entity partners of audit matters, and because the entity and its partners are bound by agreements made by the Partnership Representative.

- <u>The Election-Out Procedures</u>.

    - To be eligible to elect out of the BBA Rules, the entity can only have individuals, corporations (including S-corporations), and estates of deceased individuals as partners. An entity seeking to elect out of the new rules may not, therefore, have as a partner any partnership, disregarded entity, or trust of any kind, including a revocable trust treated as a grantor trust for federal income tax purposes. If an entity is eligible to elect out of the new rules, or has successfully made the election, the partners should consider including a provision in the partnership or operating agreement restricting future transfers of partnership or LLC interests that would affect the entity's eligibility.

    - The election-out process is tedious and requires the entity to provide substantial information to the IRS. Whether an entity is eligible to make the election and whether the entity should make this election are matters that should be discussed with the entity's tax advisor before filing its 2018 federal income tax return.

    - The BBA Rules create a tension for individuals who are considering the benefits of electing out of the new rules and the benefits of owning interests in an entity through trusts and other partnerships or limited liability companies (i.e., "tiered" structures). Each entity and its partners should conduct a thorough analysis with their advisors to consider whether ownership arrangements for the entity, including trust ownership and ownership by other entities, are preferable for estate planning or other business purposes to re-structuring the entity to be eligible to elect out of the new rules.

- <u>"Pull-In" and "Push-Out" Elections</u>. There are two separate procedures available if a tax audit occurs and results in an adjustment to the entity's tax return. One procedure is the "pull-in" election by which the entity requires one or more of its partners to file amended returns, taking into account all adjustments properly allocable to such partner. This procedure effectively reduces the amount of additional tax payable at the entity level. This procedure is complex and requires knowledgeable advice by the entity's tax advisors, particularly certified public accountants. The second procedure is the so-called "push-out" election by which an entity may elect to include certain adjustments on the returns of the reviewed year partners in the adjustment year rather than amending returns previously filed in the reviewed year. The "push-out" election effectively shifts the economic burden of the entity's audit tax assessment from the entity level to the entity's partners. As with the "pull-in" election, the "push-out" election requirements are tedious and specific and must carefully be implemented with the advice of a knowledgeable tax advisor.

The issues described in this Memorandum should be discussed with each entity's tax advisors, and appropriate amendments or modifications should be made to partnership or operating agreements. At a minimum, each entity should strongly consider designating a Partnership Representative in the event the entity is not eligible to elect of out the new rules. In addition, the partnership or operating agreements of any entity to be formed following the implementation of these rules should consider these issues and the partners must determine how the new audit rules, particularly those pertaining to the Partnership Representative, are to be reflected in their agreements.

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