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ESTATE PLANNING **REPORT**®

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PLANNING THOUGHTS

First, a clarification

In our last newsletter issue, we discussed the idea of giving low-basis property to an older relative, one whose estate was small enough to avoid death taxes, so as to take advantage of the tax-free basis step-up at death. An astute reader points out that this strategy only will work if the donee survives for at least a year after the gift, a caution that should have been included in our summary. Making a transfer to one who is near death will not achieve the hoped-for tax result.

Our thanks to this reader for bringing up this additional point. We hope to hear from more of our public as we all adjust to the changing environment for estate planning.

The decline and fall of state death taxes

The temporary doubling of the amount exempt from federal transfer taxes may be the most dramatic change facing the estate planning profession. A less sudden change, but one that actually will affect far more taxpayers, has been the steady erosion in the imposition of state death taxes.

The phrase "state death taxes" has been in the tax code for many decades—it was not invented by Republicans, as some have argued, though they certainly did popularize its use. The phrase encompasses the two distinct kinds of taxes imposed at death by the various states:

• *Inheritance taxes* are imposed upon the right to receive property. The amount of any exemption, as well as the rate of taxation, typically depends upon the relationship of the recipient to the decedent.

• *Estate taxes* are imposed upon the right to give property away at death. An exemption applies to the estate as a whole, as does the tax rate. Typically, amounts passing to charity and surviving spouses are exempt.

The federal government imposes only an estate tax, with an exemption this year of $11.18 million and a tax rate of 40%.

The 2001 sea change

In the last century, all states imposed one or the other kind of death tax, and a few states levied both. The IRS allowed a credit against the federal estate tax for any state death taxes paid, dollar for dollar, up to stated limits. Many states keyed their estate taxes to the maximum allowable credit, no more or less. Repealing such a state death tax would have been pointless, because it would not have changed the total tax liability of an estate; it would only have meant more money for the IRS.

However, the format changed in 2001, when the credit was converted to a deduction for state death taxes. That was the year that the amount exempt from federal transfer taxes began to grow, thanks to the Economic Growth and Tax Relief Reconciliation Act of 2001. As a revenue offset to the taxes lost to the higher exempt amount, Congress converted the credit for state death taxes to a deduction. The stated intention was to protect federal revenue, but the result was the undermining of state death taxes altogether.

Making state death taxes deductible, rather than creditable against federal taxes, meant that if any state repealed its death taxes the benefit would accrue to the estates, not to the IRS. States rapidly began to repeal their estate and inheritance taxes, as well as increase the amounts exempt from tax. Today 12 states and the District of Columbia continue to have an estate tax; five have an inheritance tax; and one—Maryland—has both. (See table on next page.)

State Death taxes in 2018

Estate tax	Inheritance tax
Maryland	Maryland
Oregon	Nebraska
Minnesota	Iowa
Illinois	Kentucky
New York	Pennsylvania
Connecticut	New Jersey
Rhode Island	
Massachusetts	
Vermont	
Maine	
Hawaii	
District of Columbia	
Washington	

Source: Tax Foundation, April 5, 2018

Most of these states have decoupled from the federal transfer tax regime; only Hawaii and the District of Columbia match the federal exempt amount. Oregon and Massachusetts impose death taxes when estates exceed just $1 million. Top tax rates range from 12% in Maine to 20% in Washington. The most common tax rate is 16%, because that was the cap when a credit was allowed instead of a deduction.

The future

The doubling of the amount exempt from federal estate tax last December is temporary, and the smaller exemption is scheduled to return in 2026. Nevertheless, the increase in the federally exempt amount increases the pressure on the remaining states with death taxes to increase their exemptions or drop these taxes altogether.

Given the decline in taxes at death, tax planning is receding in importance in the drafting of wills and trusts. Affluent benefactors have greater room for creativity in determining their testamentary plans, as they won't be constrained "for tax reasons."

CASES AND RULINGS

No gimmicks allowed.

Notice 2018-54; 2018-24 IRB 1

At least three high-tax states, California, New York, and Connecticut, are trying to establish a legislative work-around to the new $10,000 cap on the deduction for state and local taxes. The cap will only affect the highest-income taxpayers, who have long been the target for tax increases. Nevertheless, these states apparently fear that the loss of the deduction will increase the competitive disadvantage that results from their tax policies. The work-arounds involve the creation of quasi-charitable funds controlled by the government and the allowance of a state tax credit for donations to such funds. The theory seems to be that the SALT cap won't apply to such "donations."

The IRS is not likely to agree, and it signaled disapproval in this Notice. New Regulations on the subject are coming. Federal law controls the proper characterization of payments for federal income tax purposes, regardless of what the states may hope. The IRS will use substance over form, which suggests that if a purported charitable gift relieves a taxpayer of a legal obligation to pay a tax, it is not a charitable gift at all.

Still, the affected states may take the matter to court. On the other hand, the IRS position may prove chilling enough that tax advisors will not recommend the strategy to their clients.

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Interpretation of a trust clause does not trigger tax consequences in an irrevocable trust.

Private Letter Ruling 201814002

Parent, who is still living, created an irrevocable trust before 1985 for his lineal descendants. The creation date is before the effective date of the current generation-skipping transfer tax (GSTT), and so the trust is protected from that tax by the "grandfather" rule for pre-existing trusts. The trust will divide into three portions upon Parent's death, one for each of three children. When the trusts terminate, the remainder will pass to the issue of the children, if any.

Child 1 has three children, and Child 3 has none. Child 2 has a child and grandchild, both of whom were adopted as adults.

Evidently, Parent does not approve of Child 2's actions or lifestyle. Parent petitioned in state court to have the phrase "lineal descendant" exclude adoptees. At the time the trust was created, the state law presumption was that adoptees were not lineal descendants, a presumption that since has been reversed. Parent argues that when the trust was created, he understood lineal descendant to be limited to blood relations.

The state court granted the petition. The tax question is: Does this new interpretation have any effect on the status of the trust for generation-skipping transfer tax purposes?

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It does not, the IRS holds. The interpretation of the ambiguous term in a manner consistent with what the state's highest court would rule does not change the trust so as to cost it the "grandfather" status under the GSTT. What is more, although the hopes of Child 2's adoptees for trust beneficiary status have been terminated, the interpretation of the trust clause does not trigger a taxable termination, distribution, or gift to any other person.

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Decanting a trust to eliminate a beneficial interest is held void.

Hodges v. Johnson, 177 A.3d 86 (N.H. 2017)

Hodges created two irrevocable trusts in 2004, one that would be exempt from the generation-skipping transfer tax and one that would not be. Hodges owned a successful real estate development and holding company, HDC. The trusts were funded with all of the nonvoting shares of HDC, representing 98% of the firm's equity. The 2% retained by Hodges had all the voting power. Apparently, at that time the transfer of that much equity into an irrevocable trust made transfer tax sense. Hodges named his attorney and a business associate as the trustees.

The beneficiaries of the trusts were Hodge's wife and his five children. Some of the children had worked for HDC, but apparently not very well. There was a falling out with some of the children, and Hodge's marriage fell apart as well. Hodges prevailed upon the trustees to decant the irrevocable trusts into new trusts, and after three decantings the interests of the wife and three of the children were extinguished. The children sued.

The trial court found that the trustees had failed to take into account the beneficial interests of the excluded children, and had failed in their duty of impartiality. What's more, because they abused their discretionary powers in the decanting, two of the trustees were removed.

The New Hampshire Supreme Court now affirms.

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Division of a trust into separate trusts does not trigger adverse tax consequences.

Private Letter Ruling 201817016

Donor created an irrevocable trust before the effective date of today's generation-skipping transfer tax. The trust has many beneficiaries. Class one consists of Donor's grandchildren, class two of their spouses, class three of their issue. There are currently 17 grandchildren, six spouses, and eight great-grandchildren.

The trust is to be divided into 17 separate trusts, one for each grandchild. The spouses and descendants of each grandchild would become beneficiaries of the grandchild's trust. In the event additional grandchildren are born, an additional separate trust will be created for that grandchild, with a proportionate amount taken from the earlier trusts to create the new one. The trusts are all funded with shares of a closely held company.

The IRS finds that;

1. the new trusts will continue to be GSTT-exempt;
2. the division will not trigger any gift tax;
3. the division will not cause any trust to be included in any grandchild's estate;
4. the allocation of assets will not cause income or capital gain or loss to any trust or family member;
5. the adjusted basis and holding periods for the assets will be unchanged.

This was exactly the result for which the family was hoping.

WASHINGTON TALK

TCJA 2.0? House Ways and Means Committee Chair Kevin Brady (R-Texas) told reporters on May 21 that high-level discussions have been held with White House staffers about a "phase two" tax bill. Earlier in the month, Brady told reporters that one element of any new tax bill will be simplifying the 14 different tax provisions affecting education savings. Retirement savings is another area of concern, though what that means remains vague. More concrete, there may be an attempt to make permanent the individual tax cuts of the Tax Cuts and Jobs Act of 2017. Brady is pushing for a vote before the midterm elections.

Toward the end of the legislative journey of the Tax Cuts and Jobs Act, Senator Robert Menendez (D-N.J.) offered an amendment that would bar any corporate tax deductions for settlement payments for sexual harassment lawsuits if the settlement were subject to a nondisclosure agreement. The amendment was accepted, but unfortunately the final wording was not quite what the Senator wanted. Because of overly broad language, the new provision might prove applicable to victims as well, disallowing any deduction for attorney fees, for example.

Senator Menendez has now introduced the "Repeal the Trump Tax Hike on Victims of Sexual Harassment Act of 2018" to correct the problem.

Although the estate planning community still is adjusting to the temporary doubling of the amount exempt from the federal estate tax, a new bill has been introduced to repeal the estate and generation-skipping transfer tax entirely. H.R. 5422, the "Death Tax Repeal Act," was introduced by House Ways and Means Committee member Jason Smith (R-Mo.) with two co-sponsors, Sanford Bishop (D-Ga.) and Kristi Noem (R-S.D.). The federal gift tax would be retained, apparently as a check upon income-shifting within families.

A strong letter of support for the measure was sent to the three legislators, signed by 150 different organizations, ranging from Americans for Tax Reform and the National Small Business Association to the Log Cabin Republicans and the Hispanic Leadership Fund. The groups pointed to four reasons for complete repeal of death taxes:

- *Repealing the death tax would spur job creation and grow the economy.* Last year the Tax Foundation found that the U.S. could create over 150,000 jobs by repealing the estate tax. A 2012 study by the House Joint Economic Committee found that the death tax has destroyed over $1.1 trillion of capital in the US economy—loss of small business capital means fewer jobs and lower wages.
- *The death tax contributes a very small portion of federal revenues.* In fact, eliminating the death tax actually might increase income tax revenue.
- *A super-majority of likely voters supports eliminating the death tax.* Recent polls show that two-thirds of voters support permanent repeal.
- *The death tax is unfair.* Too often family farms and businesses have to be sold to pay the tax, or payrolls have to be slashed and jobs eliminated.

Nevertheless, estate tax repeal is not expected any time soon.

One of the early actions taken by President Trump was the issuance of Executive Order 13777, "Enforcing the Regulatory Reform Agenda," on February 24, 2017, with the purpose of reviewing and reducing the federal regulatory burden on the economy. In April the Treasury Department reported on the successes that it has had to date in complying with this order:

- 305 Treasury Regulations have been eliminated or proposed to be eliminated or modified;
- 94 net reduction in regulations on Treasury's regulatory agenda; and
- more than 250 specific recommendations for reform and burden reduction.

For the estate planning community, the most significant action under this program was the revocation of proposed regulations under IRC §2704, concerning the valuation effects of certain restrictions on interests in family businesses. The proposal was strongly criticized in a December 2016 hearing, and it was revoked on October 20, 2017.

The Service is combing through the regulations for deadwood, regulations for statutory provisions also that have been repealed or substantially altered. To date some 298 regulations have been identified as obsolete under this initiative.

The IRS has announced that guidance is on the way for alimony trusts, and it is seeking comments on the issue [Notice 2018-37; 2018-18 IRB 521].

Beginning next year, as a result of the Tax Cuts and Jobs Act of 2017, alimony payments will no longer be deductible by the payor and taxable income to the payee, a rule intended to allow rough income splitting for divorced couples. Apparently, the Congress believed that the payors were claiming their deductions, but some significant fraction of payees was not reporting the income. To avoid the possibility of using a trust as a workaround of the new rule, IRC §682 governing alimony trusts was repealed.

The new guidance will grandfather alimony trusts created for the rest of this year. The Treasury Department and IRS are looking for comments on whether guidance also is needed regarding the grantor trust rules of §§672(e)(1)(A), 674(d), and 677 following a divorce or separation in light of the repeal of former §682.

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