2018 Year-End Estate Planning: Part 2

By **Joshua Rubenstein and Diane Burks** December 5, 2018, 11:53 AM EST

The Tax Cuts and Jobs Act has dominated the legislative and estate planning landscape for much of 2018. The act made significant changes to the individual and corporate income taxes, restructured international tax rules, provided a deduction for pass-through income and eliminated many itemized deductions. In the **first part of this four-part article**, we focused on key income and transfer tax exemption and rate changes. Below, we continue the discussion by highlighting important estate tax cases and planning considerations for 2018 and 2019.

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Important Cases Decided in 2018

Estate of Cahill v. Commissioner

In Estate of Powell v. Commissioner,[1] decided in 2017, the U.S. Tax Court applied Code Section 2036(a)(2) to include a pro rata value of a limited partnership's assets in a decedent's estate because the partners could unanimously agree to terminate the partnership. Practitioners had expressed concern that Powell could be extended to other multiparty arrangements in which the parties could agree to terminate an arrangement or contractual agreement. The Cahill case is significant because the Tax Court used its reasoning in Powell in the context of a split-dollar arrangement to deny summary judgment to an estate on the issue of estate inclusion.

In Cahill, a split-dollar arrangement was established in 2010. The decedent's son, as agent under the decedent's power of attorney, created an irrevocable trust to acquire life insurance policies on the son and the son's wife. The decedent's son was also the trustee of the decedent's revocable trust. In 2010, the decedent's revocable trust borrowed $10 million and used the loan proceeds to acquire the life insurance policies. The irrevocable trust was named as the owner of the policies. The two trusts entered into a split-dollar agreement to provide that the revocable trust would be reimbursed for the $10 million it had advanced for the premium payment. The decedent died in December 2012. On the estate's federal estate tax return, the estate valued the estate's reimbursement right at $183,700, based on the period of time that would elapse before the policies would mature at the death

of the decedent's son and his wife. The IRS issued a notice of deficiency claiming that the reimbursement right should be valued at the cash surrender value of the policies on the date of the decedent's death ($9,611,624), pursuant in part to code Sections 2036, 2038 and 2703. In addition, the IRS assessed penalties of over $2.2 million based on negligence and either a gross or substantial valuation misstatement.

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

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

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

Constitutionality of State Taxation of Trusts

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

Kaestner 1992 Family Trust v. North Carolina Department of Revenue[2]

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

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

North Carolina imposes income tax on trusts based on the residence of the beneficiaries. Pursuant to N.C.G.S. Section 105- 160.2, "[t]ax is computed on the amount of the taxable income of the estate or trust that is for the benefit of a resident of this State." For the tax years of 2005–2008, the trust paid in excess of $1.3 million in taxes on its accumulated

income to the North Carolina Department of Revenue based on Kaestner's residence in North Carolina.

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

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

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

Fielding v. Commissioner of Revenue[3]

Under Minnesota law, a trust is taxed as a Minnesota resident if the grantor was a Minnesota resident when the trust became irrevocable. In Fielding, the Minnesota Supreme Court held that the state's trust taxation statute was unconstitutional as applied to the trusts at issue. In Fielding, four trusts were created by a Minnesota resident in 2009. The trusts became irrevocable in 2011, when the grantor was still a Minnesota resident; as a result,

the trusts were classified as resident trusts under the Minnesota income tax statutes. In 2014, the trusts sold stock and were subject to Minnesota income tax on the full amount of the gain under the applicable taxation statute. During the year at issue, no trustee had been a Minnesota resident; the trusts were not administered in Minnesota; the records of the trust's assets and income were maintained out of state; and three out of four of the trusts' beneficiaries lived outside of Minnesota.

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

Important Planning Considerations for 2018 and 2019

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

Review Formula Bequests

Many estate plans utilize "formula clauses" that divide assets upon the death of the first spouse between a "credit shelter trust," which utilizes the client's remaining federal estate tax exemption amount, and a "marital trust", which qualifies for the federal estate tax marital deduction and postpones the payment of federal estate taxes on the assets held in the marital trust until the death of the surviving spouse. While the surviving spouse is the only permissible beneficiary of the marital trust, the credit shelter trust may have a different class of beneficiaries, such as children from a prior marriage. With the TCJA's increase in the exemption amounts, an existing formula clause could potentially fund the credit shelter trust with up to the full federal exemption amount of $11.18 million. This formula could potentially

result in a smaller bequest to the marital trust for the benefit of the surviving spouse than was intended, or even no bequest for the surviving spouse at all. There are many other examples of plans that leave the exemption amount and the balance of the assets to different beneficiaries. Taxpayers should review any existing formula clauses in their current estate plans to ensure they are still appropriate given the increase in the federal exemption amounts and the implications of the potential sunset of these exemption amounts. In addition, taxpayers should consider alternative drafting strategies, such as disclaimers, to maintain flexibility in their plans.

Income Tax Basis Planning

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

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

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

beneficiary's assets and applicable exclusion amounts and should be discussed with advisors.

529 Plan Changes

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

Planning to Utilize Increased Federal Exemptions

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

Gifting Techniques to Take Advantage of the Increased Applicable Exclusion Amount

Taxpayers may want to consider making gifts to utilize the increased federal exclusion amount. It is less expensive to make lifetime gifts rather than making gifts at death, because tax is not imposed on dollars used to pay gift tax but estate tax is imposed on the dollars used to pay estate tax. In addition, taxpayers may benefit by removing any income and appreciation on the gift from their estate. However, taxpayers should seek advice if they have used all of their applicable exclusion amount and would pay federal gift tax on any gifts. Making gifts that result in significant gift tax payments may not always be advisable in the current environment.

A countervailing consideration of lifetime gifting is that the gifted assets will not get a step-up in basis upon death (as would assets held at death) and will thus generate capital gains tax if they are subsequently sold for an amount higher than their basis. Accordingly, the

decision of whether and how to embark on a lifetime gifting strategy depends on a number of factors, including the bases of the transferor's various assets, their projected income and appreciation, the total amount of the transferor's assets and the transferor's remaining applicable exclusion amount. For individuals with assets far exceeding their applicable exclusion amounts, lifetime gifting of high-basis assets generally may be recommended. However, individuals with total assets close to or below their applicable exclusion amounts should exercise caution before making gifts of low basis assets. Instead, those individuals should consider holding their assets until death in order to achieve a step-up in basis upon death, while minimizing estate taxes. Of course, maintaining a comfortable standard of living is a factor that also must be considered.

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

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

Other Techniques to Take Advantage of the Increased Applicable Exclusion Amount

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

- Sales to Trusts. Taxpayers should also consider utilizing the increased federal exemption amounts through sale transactions to grantor The increased federal exemption may provide a cushion against any asset valuation risk attendant with such sales. Taxpayers who enter into such sale transactions should consider taking advantage of the adequate disclosure rules to start the three-year statute of limitations running.

- Loan Forgiveness. If taxpayers are holding promissory notes from prior estate planning transactions, from loans to family members, or otherwise, they should consider utilizing some or all of the increased federal exemption amounts to forgive these notes.

- Allocation of GST Exemption to GST Nonexempt Trusts. If a taxpayer's existing estate plan utilizes trusts that are subject to GST tax (GST nonexempt trusts), consideration should be given to allocating some or all of the taxpayer's increased GST exemption amount to such trusts.

- Balancing Spouses' Estates. For married taxpayers, if the value of the assets owned by one spouse is greater than the increased federal exemption amounts and greater than the value of the assets owned by the other spouse, consideration should be given to transferring assets to the less propertied Such a transfer would provide the less propertied spouse with more assets to take advantage of the increased federal exemption amounts, especially the increased GST exemption, which is not portable to the surviving spouse upon the first spouse's death. Taxpayers should be mindful, however, that transfers to non-U.S. citizen spouses are not eligible for the unlimited marital deduction for federal gift tax purposes, and such transfers should stay within the annual exclusion for such gifts ($152,000 in 2018) to avoid federal gift tax. Note that the annual exclusion for gifts (to donees other than a spouse) is $15,000 in 2018.

- Life Insurance. Taxpayers may wish to review or reevaluate their life insurance coverage and needs with their insurance advisers.

- Other Planning Options. Taxpayers should also consider other means for utilizing the increased federal exemption amounts, such as triggering a transfer under Section 2519 of the code of a surviving spouse's qualified terminal interest property in a marital trust or the formation and funding of an entity that purposely violates code Section 2701, in

each case utilizing the increased federal gift tax exemption amount.

Review and Revise Your Estate Plan to Ensure It Remains Appropriate

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

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

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

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

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

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

Finally, in view of the potential sunset of many pertinent provisions of the act, estate plans should provide for as much flexibility as possible. As noted above, formula bequests should be reviewed to ensure they are appropriate under current law and consideration should be given to granting limited powers of appointment to trust beneficiaries to provide flexibility for post-mortem tax planning. A trust protector (or trust protector committee) may also be appointed to give a third party the ability to modify or amend a trust document based on changes in the tax laws or unforeseen future circumstances, or to grant certain powers to trust beneficiaries that may have tax advantages under a new tax regime (such as the granting of a general power of appointment to trust beneficiaries in order to obtain a stepped-up basis in trust assets at the beneficiary's death).

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

Nongrantor trusts should consider making income distributions to beneficiaries. Trust beneficiaries may be taxed at a lower taxed rate, especially due to the compressed income tax brackets applicable to non-grantor trusts. Additionally, a complex, non-grantor trust with undistributed annual income over $12,500 will be subject to the 3.8 percent Medicare surtax. However, some or all of the Medicare surtax may be avoided by distributing such income directly to beneficiaries who are below the individual net investment income

threshold amount for the Medicare surtax ($200,000 for single filers, $250,000 for married couples filing jointly and $125,000 for married individuals filing separately).

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

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[1] Estate of Powell v. Commissioner, 148 T.C. 18 (2017).

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

[3] Minnesota Supreme Court, No. A17-1177, July 18, 2018.