Estate, Tax and Other Planning after the Tax Cuts and Jobs Act of 2017

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Estate, Tax and Other Planning after the Tax Cuts and Jobs Act of 2017

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Planning after the Tax Cuts and Jobs Act of 2017

Introduction

New Law, New Complexity and New Uncertainty

- President Trump signed the Tax Cuts and Jobs Act (P.L. 115-97) on December 22, 2017 ("Act").
- The Act is the most sweeping tax legislation to be enacted in decades.
- The changes affecting estate planning, income taxation of trusts, taxation of business interests and more is dramatic.
- Such dramatic changes to long-time tax laws that have been embedded in economic decision making for decades or more may have disruptive consequences that are difficult to evaluate.
- Generalizations will be dangerous. The reduction of the state and local income tax ("SALT") deductions will have very different impact on taxpayers depending on their state of residence and circumstances.

Rethink Common Planning Scenarios

- The Act has changed the calculus of many common tax planning strategies and decisions, and many of these will push estate planners further into the income tax planning realm. Many aspects of planning need to be rethought.
- Alimony will no longer be deductible or taxable. The conference agreement is effective for any divorce or separation instrument executed after December 31, 2018, or for any divorce or separation instrument executed on or before December 31, 2018, and modified after that date, if the modification expressly provides that the amendments made by this section apply to such modification. How does this impact current and future divorce agreements?

Sunsets and More

- Many of the changes directly affecting individuals will expire, on account of budget considerations, after 2025. Which provisions are targeted to sunset, and those that are not, has important planning implications.
- Practitioners will have to grapple with the potential for changes to the law by a future administration, a possibility that cannot be ignored, but which cannot be quantified.
- Example: The provision doubles the estate and gift tax exemption for estates of decedents dying and gifts made after December 31, 2017, and before January 1, 2026.

Planning after the Tax Cuts and Jobs Act of 2017

Individual Tax Changes

2017 Property Taxes: Hot Off the IRS Press

- The Internal Revenue Service advised tax professionals and taxpayers yesterday that pre-paying 2018 state and local real property taxes in 2017 may be tax deductible under certain circumstances.
- It depends on whether the taxpayer makes the payment in 2017 and the real property taxes are assessed prior to 2018. A prepayment of anticipated real property taxes that have not been assessed prior to 2018 are not deductible in 2017. State or local law determines whether and when a property tax is assessed, which is generally when the taxpayer becomes liable for the property tax imposed.
- See IR-17-191 for more information.

2017 Property Taxes: Hot Off the IRS Press

- Example 1: Assume County A assesses property tax on July 1, 2017 for the period July 1, 2017 – June 30, 2018. On July 31, 2017, County A sends notices to residents notifying them of the assessment and billing the property tax in two installments with the first installment due Sept. 30, 2017 and the second installment due Jan. 31, 2018. Assuming taxpayer has paid the first installment in 2017, the taxpayer may choose to pay the second installment on Dec. 31, 2017, and may claim a deduction for this prepayment on the taxpayer's 2017 return.
- Example 2: County B also assesses and bills its residents for property taxes on July 1, 2017, for the period July 1, 2017 – June 30, 2018. County B intends to make the usual assessment in July 2018 for the period July 1, 2018 – June 30, 2019. However, because county residents wish to prepay their 2018-2019 property taxes in 2017, County B has revised its computer systems to accept prepayment of property taxes for the 2018-2019 property tax year. Taxpayers who prepay their 2018-2019 property taxes in 2017 will not be allowed to deduct the prepayment on their federal tax returns because the county will not assess the property tax for the 2018-2019 tax year until July 1, 2018.

Rates; Inflation Adjustments

- The Act temporarily replaces the existing rate structure with a new lower rate structure. The maximum individual tax rate will be 37%. The rate brackets will be inflation indexed. The lower rates for individuals are temporary, and will sunset with taxable years beginning after December 31, 2025.
- The Act, in contrast to present law, uses as a measure of inflation adjustments the Chained Consumer Price Index for All Urban Consumers ("C-CPI-U"), instead of the Consumer Price Index for All Urban Consumers ("CPI-U"), which will lower/slow the increase in brackets in future years.

Kiddie Tax

- The Act “simplifies” the Kiddie tax by applying ordinary and capital gains rates applicable to trusts and estates to the net unearned income of a child.
- Similar to prior law, taxable income attributable to earned income is taxed according to an unmarried taxpayers’ brackets and rates.
- The new law assures that the child’s tax is unaffected by the tax situation of the child’s parents. This provision sunsets and does not apply to taxable years beginning after December 31, 2025.

Kiddie Tax and the NIIT

- Is there a change to the implications of this to the Net Investment Income Tax ("NIIT")? "The provision simplifies the "kiddie tax" by effectively applying ordinary and capital gains rates applicable to trusts and estates to the net unearned income of a child... Taxable income attributable to net unearned income is taxed according to the brackets applicable to trusts and estates…"
- It would seem that the Conference report suggests the application of a trust tax construct such that the threshold amount for NIIT purposes would be the $12,500 figure at which trusts reach the highest tax bracket.
- However, the threshold amount in IRC Sec. 1411 does not appear to have changed so that a child would appear to still qualify for the $200,000 threshold amount.
- So trust distributions to a child beneficiary might still facilitate avoiding NIIT.

Standard Deduction – New Law

- The standard deduction under current law is $12,700 for married taxpayers filing jointly, and $6,350 for single taxpayers.
- The Act will increase the standard deduction to $24,000 for married taxpayers filing jointly, and $12,000 for single taxpayers. IRC Sec. 63 as amended by Sec. 11021 of the Senate amendment.
- The increase of the basic standard deduction does not apply to taxable years beginning after December 31, 2025. So, whatever planning is pursued must consider that this change itself might be for a limited time period.
- While this change will simplify tax compliance for tens of millions of Americans, and lower their tax burdens, it will also have a wide-ranging impact. Industries that have historically relied on itemized deductions to fuel their business models may be adversely affected. This might affect the housing industry, movers, charities, and more.

Standard Deduction – New Planning

- **Planning Considerations**: Planning for taxpayers might potentially exceed these new thresholds, but will not assuredly do so in every year, changing planning dramatically. The new mode of planning for many taxpayers will be aggressive bunching of the remaining itemized deductions. Planning may require pushing deductions from year 1 into year 2, and in year 2 accelerating deductions from year 3 back into year 2. For some, this might provide the only means to exceed the new high standard deduction thresholds. This may enable taxpayers to periodically bunch deductions into a designated year to exceed the new higher threshold. This might entail bunching charitable deductions to a targeted year and funding a donor advised fund from which donations can be distributed in other years. Charitable remainder trusts might be more common. Planning to incur discretionary medical expenses in that same targeted year will also facilitate exceeding the threshold.

Standard Deduction – Example

- **Example**: Taxpayer, as a result of the loss of SALT and other deductions cannot itemize each year. She has traditionally given about $10,000/year in charitable contributions.
  - In 2019 the taxpayer defers charitable contributions, making none. Instead she makes pledges to charities that she wishes to benefit.
  - **Target Year**: In 2020 the taxpayer donates $30,000 to a donor advised fund. She uses some of those funds to pay off 2019 pledges, makes some gifts in 2020. In 2020, she also made significant home medical improvements resulting in a large deduction for that year.
  - In 2021 she uses some of the funds remaining in the DAF for charitable gifts in 2021 when she will not be making donations. In 2021, she again pushes off donations and medical expenses to 2022 when she will again bunch itemized deductions.
  - In 2022 she again bunches deductions.

Pease Limitation

- This rule had limited itemized deductions to 3% of income over a threshold amount, or 80% of total potential deductions (known as the Pease Limitation). The Act repeals this, but it also eliminates many deductions so it may not have any impact on many taxpayers. The overall limitation will not be as impactful given the other changes. Sec. 68.
- **Planning Consideration**: The repeal of the Pease limitation might help certain high-income taxpayers who make large charitable contributions, especially in light of the new 60% of AGI limitation, garner larger deductions for contributions.
- IRC Sec. 68 as amended by Sec. 1301 of the House bill, and Sec. 11046 of the Senate amendment.

Personal Exemptions

- The personal exemption for a taxpayer, the taxpayer’s spouse, and any dependents have been suspended. The new larger standard deductions discussed above substitute for the lost personal exemptions.
- The suspension does not apply to taxable years beginning after December 31, 2025. Whether this change will benefit or harm taxpayers will vary depending on a myriad of personal factors including the number of dependents, itemized deductions before and after the Act and so forth.
- How will this new rule affect a divorce agreement wherein the parties negotiated which parent/ex-spouse would be entitled to claim exemptions?

Mortgage Interest – New Law

- Home mortgage interest will continue to be deductible at a reduced level. Under current law, interest incurred on up to $1 million of mortgage debt is deductible, but under the Act that amount will be reduced to $750,000. Additionally, only interest on acquisition debt may be deducted. Interest on home equity lines will no longer be deductible.
- IRC Sec. 163(h) as modified by Sec. 1302 of the House bill, and Sec. 11043 of the Senate amendment.

Mortgage Interest – Planning

- Might some clients in high tax states, in future decisions, favor time shares or other arrangements that might be less costly, rather then vacations homes, because of these changes?
- With the restriction on home equity interest deductions taxpayers that have used home equity lines to finance other endeavors might evaluate repaying them depending on the rates and net cost.
- What happens to trusts that own personal use real estate? Will the interest be deductible as an expense under IRC Sec. 212 to hold an investment property? Will the general restriction of the Act prohibit any deduction? How will the differentiation be made? Will it matter if the Investment Trustee is required under the governing instrument to make the determination to purchase and hold the vacation property?

State and Local Income Tax ("SALT") Deduction

- State, local, and foreign property taxes and state and local sales taxes are allowed as a deduction only when paid or accrued in carrying on a trade or business, or an activity described in Code Section 212 (relating to expenses for the production of income). Thus, the provision allows only those deductions for state, local, and foreign property taxes, and sales taxes, that are presently deductible in computing income on an individual's Form 1040 Schedule C, Schedule E, or Schedule F on such individual's tax return.
- The provision contains an exception to the above-stated rule. Under the provision a taxpayer may claim an itemized deduction of up to $10,000 ($5,000 for married taxpayer filing a separate return) for the aggregate of (i) state and local property taxes not paid or accrued in carrying on a trade or business, or an activity described in section 212, and (ii) state and local income, war profits, and excess profits taxes (or sales taxes in lieu of income, etc. taxes) paid or accrued in the taxable year. Foreign real property taxes may not be deducted under this exception.
- The above rules apply to taxable years beginning after December 31, 2017, and beginning before January 1, 2026.

SALT - Planning

- The reduction in SALT taxes will have a very disparate and potentially profound impact. This could have a significant and costly impact on wealthy taxpayers in high tax states that own multiple homes.
- Are there alternative options as noted above to restructure ownership to make taxes deductible? Will home office deductions become more common as taxpayers seek ways to qualify to deduct a portion of their property taxes? Will more vacation property owners seek to rent vacation homes to offset the increased net of tax cost of maintaining such properties?
- While some advisers recommend consideration of “ING” trusts (discussed elsewhere) for moderate wealth clients seeking to take advantage of the new exemption amounts, that may not be an optimal strategy.

SALT and Home Office Deductions

- The restrictions on deducting local property taxes and home mortgage interest might tempt more taxpayers to evaluate the benefits of claiming a home office expense deduction if they otherwise qualify. The reasoning is to garner additional tax deductions if the calculations suggest it to be worthwhile.
- The home office expense is complicated, may result in a portion of the proceeds on the sale of a house being taxable, and in the view of many practitioners leads to a greater likelihood of audit. These and other negative factors have historically dissuaded many taxpayers who might otherwise have qualified for a home office deduction from taking one.

Vacation Homes and Itemized Deduction Limitations -1

- How a vacation home is characterized may have different tax consequences after the Act and some taxpayers may choose to change the characterization of vacation properties as a result.
- A vacation home used solely for personal purposes is treated as a residence. But the restriction, if not loss, of property tax deductions and the loss of home mortgage interest deductions might have taxpayers who intentionally opted not to rent their vacation homes instead pursue that option. Under pre-Act law some taxpayers may have been satisfied with the economic cost of carrying a vacation home based on the tax benefit of their deducting mortgage interest and property taxes on the property. The curtailment of those benefits might mean a need to consider supplementation with rental income, or converting the vacation home to a rental to secure deductions as well as rental income.

Vacation Homes and Itemized Deduction Limitations - 2

- If the vacation home is rented for less than 15 days during the tax year, the income from such a limited rental is not taxable and no deductions are allowable with respect to the rental period. IRC Sec. 280A(g).
- A vacation home is characterized as a personal residence if personal use exceeds the greater of: 14 days; or 10% of the days the home is rented. IRC Sec. 280(A)(d)(1)). For example, if the vacation home is rented 200 days then the taxpayer's personal use can be 20 days, not 14. If personal use is less that both tests then the vacation home is considered to be held as an investment property, although expenses still will still have to be allocated as between personal and business use.
- If the vacation home is rented then mortgage interest paid is subject to interest allocation rules and a portion may be deductible as relating to the rental that may no longer be deductible as relating to the personal use. Reg. §1.163-8T.

Tax Preparation Costs No Longer Deductible - 1

- The Act repealed the deduction for tax preparation expenses. Under the provision, an individual would not be allowed an itemized deduction for tax preparation expenses. The provision would be effective for tax years beginning after 2017. Under current law, these expenses are miscellaneous itemized deductions only deductible in excess of 2% of AGI, so many taxpayers may not have received significant benefit in any event.
- **Planning Consideration**: This will likely result in taxpayers revisiting allocation of tax preparation fees as between business endeavors and personal returns preparation. Practitioners should be alert to possible ethical considerations if they bill the incorrect taxpayer (e.g. the client's business instead of the client for personal non-business services).

Tax Preparation Costs No Longer Deductible - 2

- Practitioners might protect themselves by cautioning clients in retainer agreements or a footer on bills, concerning the improper payment or allocation of fees.
- **Sample Provision**: "How you allocate legal fees, to various persons, entities or trusts could affect whether the payment is tax deductible. It is important that you use checks drawn on the appropriate accounts for the appropriate entities or persons when paying legal fees. Paying personal expenses from a business entity could be argued by a claimant or tax authority as evidence of your disregarding the independence and legal integrity of the entity. If you personally, or another entity, pays for legal fees for the services rendered to that person, entity or trust inappropriately, the IRS might argue that the payment is equivalent to an impermissible additional gift and that the tax position of the trust should not be respected."

No Personal Casualty Loss Deduction

- The new law temporarily restricts the deduction for personal casualty and theft losses. Under the provision, a taxpayer may claim a personal casualty loss only if the loss was attributable to a disaster declared by the President.
- The limitation does not apply with respect to losses incurred after December 31, 2025.
- Taxpayers might wish to reconsider the size of the deductible on their insurance since no tax benefit is likely to be available. For fiduciaries owning personal use assets, e.g., a home occupied by a beneficiary, past practices of structuring insurance with large deductibles may warrant reconsideration.
- IRC Sec. 165 as modified by Sec. 1304 of the House bill, and Sec. 11044 of the Senate amendment.

Alternative Minimum Tax ("AMT")

- The AMT was not repealed under the Act.
- The Act temporarily increases both the exemption amount and the exemption amount phaseout thresholds for the individual AMT. The AMT exemption is increased to $109,400 for married taxpayers filing a joint return (half this amount for married taxpayers filing a separate return), and $70,300 for all other taxpayers (other than estates and trusts). The phaseout thresholds are increased to $1,000,000 for married taxpayers filing a joint return, and $500,000 for all other taxpayers (other than estates and trusts). These amounts are indexed for inflation.
- IRC Sec. 55-59 as amended by Sec. 2001 of the House bill, and Sec. 12001 of the Senate amendment.

Charitable Contribution Deductions

- The percentage limit of AGI deductible for charitable contributions of cash to public charities is increased from 50% to 60%.
- No charitable deduction will be allowed for payments made in exchange for college athletic event seating rights.
- The substantiation exception for certain contributions reported by the donee organizations is repealed.
- IRC Sec. 170 as modified by Sec. 1306 of the House bill, and Secs. 11023, 13703, and 13704 of the Senate amendment.
- The most significant changes affecting charitable giving are the doubling of the standard deduction and the estate tax exemption effectively eliminating income or estate tax charitable contribution deductions for most taxpayers.

Employee Expenses

- The Act eliminates the deduction for expenses attributable to the trade or business of being an employee. Unreimbursed employee expenses had only been deductible if they exceed 2% of AGI.
- For some employees with substantive expenses there will be a greater incentive to be an independent contractor reporting on Schedule C so that expenses can be deducted. For taxpayers in high tax states this incentive will be enhanced by the loss of property tax deductions which also may be in part salvaged if a home-based business is reported.
- Employers might reevaluate expense reimbursement plans considering that employees may no longer obtain a deduction.

Miscellaneous Itemized Deductions - 1

Deductions subject to the 2% floor under prior law are eliminated. The list is remarkably extensive and has been reproduced below from the House report:

- Appraisal fees for a casualty loss or charitable contribution.
- Casualty and theft losses from property used in performing services as an employee.
- Clerical help and office rent in caring for investments.
- Depreciation on home computers used for investments.
- Excess deductions (including administrative expenses) allowed a beneficiary on termination of an estate or trust.
- Fees to collect interest and dividends.
- Hobby expenses, but generally not more than hobby income.
- Indirect miscellaneous deductions from pass-through entities.
- Investment fees and expenses.
- Loss on deposits in an insolvent or bankrupt financial institution.
- Loss on traditional IRAs or Roth IRAs, when all amounts have been distributed.
- Repayments of income.

Miscellaneous Itemized Deductions - 2

- Safe deposit box rental fees, except for storing jewelry and other personal effects.
- Service charges on dividend reinvestment plans.
- Trustee's fees for an IRA, if separately billed and paid.
- Business bad debt of an employee.
- Business liability insurance premiums.
- Damages paid to a former employer for breach of an employment contract.
- Depreciation on a computer a taxpayer's employer requires him to use in his work.
- Dues to a chamber of commerce if membership helps the taxpayer perform his job.
- Dues to professional societies.
- Home office or part of a taxpayer's home used regularly and exclusively in the taxpayer's work.
- Job search expenses in the taxpayer's present occupation.
- Laboratory breakage fees.
- Legal fees related to the taxpayer's job.
- Licenses and regulatory fees.
- Malpractice insurance premiums.

Miscellaneous Itemized Deductions - 3

- Medical examinations required by an employer.
- Occupational taxes.
- Passport fees for a business trip.
- Repayment of an income aid payment received under an employer’s plan.
- Research expenses of a college professor.
- Rural mail carriers’ vehicle expenses.
- Subscriptions to professional journals and trade magazines related to the taxpayer’s work.
- Tools and supplies used in the taxpayer’s work.
- Purchase of travel, transportation, meals, entertainment, gifts, and local lodging related to the taxpayer’s work.
- Union dues and expenses.
- Work clothes and uniforms if required and not suitable for everyday use; and
- Work-related education.
- Repayments of income received under a claim of right (only subject to the two-percent floor if less than $3,000).
- Repayments of Social Security benefits.
- The share of deductible investment expenses from pass-through entities.

IRA Recharacterizations

- The Act repeals the special rule that allows IRA contributions to one type of IRA (either traditional or Roth) to be recharacterized as a contribution to the other type of IRA.
- Thus, for example, under the provision, a conversion contribution establishing a Roth IRA during a taxable year can no longer be recharacterized as a contribution to a traditional IRA (thereby unwinding the conversion). Thus, recharacterization cannot be used to unwind a Roth conversion.
- IRC Sec. 408A as modified by Sec. 1501 of the House bill, and Sec. 13611 of the Senate amendment.

Planning after the Tax Cuts and Jobs Act of 2017

Trust and Estate
Income Tax Changes

Overview of Trust Income Taxation Changes

- Lower individual tax rates so that the maximum rate on trust income retained or distributed will be 37%.
- Elimination of many itemized deductions, most, or perhaps all of which may affect trusts.
- Permitting trust owned pass-through entities to qualify for the favorable tax treatment afforded those entities discussed in a later chapter.
- Severe restriction of state and local income tax (“SALT”) deductions by individual itemizers which might change the nearly ubiquitous default rule of creating grantor trusts in favor of non-grantor trusts and which may as severely (or not) limit trust income tax deductions for certain SALT.
- The pressure for moderate wealth families to use the increased temporary exemption by making completed gifts to irrevocable trusts.
- New ESBT rules.

Trust Income Tax Rates

- The new temporary tax rates for trusts and estates is as follows:
  - Not over $2,550 - 10% of taxable income.
  - Over $2,550 but not over $9,150 - $255 plus 24% of the excess over $2,550.
  - Over $9,150 but not over $12,500 - $1,839 plus 35% of the excess over $9,150.
  - Over $12,500 - $3,011.50 plus 37% of the excess over $12,500.
- These new rates reflect the new maximum tax rate of 37%.
- The inflation adjustment begins after 2018.
- These new rates sunset, however, for taxable years beginning after December 31, 2025. So, practitioners need to be mindful that any changes made, might reverse with that sunset, or perhaps even earlier if another administration modifies the law.

Pass-Through Entity Deduction 199A

- The Act fixed the provision in the Senate version of tax reform that would have limited trusts and estates from taking the deductions permitted for the owners of pass-through entities.
- Specifically, the Act permits trusts and estates to take the deduction similar to other owners of pass-through interests.
- The rules require apportionment between fiduciaries and beneficiaries of any W-2 wages and unadjusted basis of qualified property under the limitation based on W-2 wages and capital.

Trust Deductions: Does 67(g) Trump 67(e)?

- New Code Section 67(g) provides that no miscellaneous itemized deduction shall be allowed. "*SEC. 11045. Suspension of Miscellaneous Itemized Deductions. (A) In General. - Section 67 is amended by adding at the end the following new subsection: "(g) Suspension for Taxable Years 2018 Through 2025. Notwithstanding subsection (a), no miscellaneous itemized deduction shall be allowed for any taxable year beginning after December 31, 2017, and before January 1, 2026. (b) Effective Date. The amendment made by this section shall apply to taxable years beginning after December 31, 2017.*"

Trust Deductions: IRC 67(e)

- IRC Section 67(e) provides an exception to the 2% floor miscellaneous itemized deductions to calculate income for a trust or estate. This special rule applies to deductions which would not have been incurred if the property were not held in a trust or estate. More specifically, IRC Sec. 67 (e) provides: "*Determination of adjusted gross income in case of estates and trusts. For purposes of this section, the adjusted gross income of an estate or trust shall be computed in the same manner as in the case of an individual, except that - (1)the deductions for costs which are paid or incurred in connection with the administration of the estate or trust and which would not have been incurred if the property were not held in such trust or estate, and (2) the deductions allowable under sections 642(b), 651, and 661, shall be treated as allowable in arriving at adjusted gross income. Under regulations, appropriate adjustments shall be made in the application of part I of subchapter J of this chapter to take into account the provisions of this section*."

Trust Deductions: Senate Report

- The Senate report, adopted by the Conference report provides as follows: "*The Senate amendment suspends all miscellaneous itemized* ***deductions that are subject to the two-percent floor under present law*** *[highlight added]. Thus, under the provision, taxpayers may not claim the above-listed items as itemized deductions for the taxable years to which the suspension applies. The provision does not apply for taxable years beginning after December 31, 2025*." The list of items is presumably referring to the house report which listed specific itemized deductions that would be disallowed. The following expenses were listed, those generally inapplicable to trusts have been deleted. Some have been grouped. Comments have been added.

Trust Deductions: Expenses Listed in House Report

- Depreciation on home computers used for investments. Depreciation on a computer a taxpayer's employer requires him to use in his work. Might this make deduction of computer equipment used to track trust investments not deductible?
- Excess deductions (including administrative expenses) allowed a beneficiary on termination of an estate or trust.
- Indirect miscellaneous deductions from pass-through entities.
- Loss on deposits in an insolvent or bankrupt financial institution.
- Safe deposit box rental fees, except for storing jewelry and other personal effects. Could safe deposit boxes for a trust used to safeguard trust assets be treated differently? It would appear not.
- Business liability insurance premiums.
- Service charges on dividend reinvestment plans, the share of deductible investment expenses from pass-through entities, clerical help and office rent in caring for investments, Fees to collect interest and dividends, and Investment fees and expenses. These would appear to confirm that fiduciary fees for investment management are not deductible.

Trust Deductions: Additional Points

- Tax preparation fees have been specifically prohibited as an itemized deduction and would thus not be deductible by a trust unless the trust's expenses are permitted under IRC Sec. 67(e) as unique to a trust for tax preparation of a trust income tax return, regardless of the general IRC Sec. 67(g) limitation.
- Thus, the Act eliminates deductions for miscellaneous itemized deductions that had been subject to the 2% floor. This is a rather extensive list. A few itemized deductions receive special treatment: mortgage interest (limited to interest on $750,000 of home mortgage debt, none on home equity lines), taxes (SALT with a $10,000 cap), casualty/theft losses (only for federally declared disaster zones), charitable contributions, and certain estate taxes.
- Trusts should be permitted to deduct expenses that are dealt with separately, such as those listed in the preceding sentence, as well as SALT expenses and NOLs (subject to the new rules) relating to a trade or business, $10,000 of SALT expenses generally, and estate taxes on IRD.
- It would appear that IRC Sec. 67(e) expenses should survive the changes made by the Act and be permitted to trusts and estates, otherwise the provision of IRC Sec. 67(e) would be superfluous. Note that Congress modified 67(e)(2) regarding 642(b). They did not delete 67(e).

Planning after the Tax Cuts and Jobs Act of 2017

ESBTs

ESBT Summary of Changes

- The Act has made several changes that may affect ESBT's and provided several new instances of leniency which practitioners should be familiar with. These changes include:
- Lowered maximum individual tax rates to 37%. (Act section 11001.)
- Possible application of the "pass-thru" deduction for qualified business income (Act section 11011: new section 199A of the Code).
- Considerations of possibly forfeiting S corporation status to take advantage of the lower 21 percent corporate tax rates. (Act section 13001.)
- New bonus depreciation and larger section 179 expensing deductions which may flow through to the S shareholders, including an ESBT. (Act sections 13101, 13201.)
- Limitations on the deductibility of state and local income taxes ("SALT") by individuals and trusts which may prompt the review of the situs of some ESBTs and the possible move to a state with lower tax burdens. (Act section 11042.)

ESBT Taxation under the Act

- The portion of a trust owning stock of an S corporation with a valid ESBT election is treated as a separate trust while the other assets of the trust are treated as a separate, regular trust for income tax purposes, unless it's a grantor trust.
- The ESBT's share of S corporation income is generally taxed on its share of the S corporation's income at the highest rate of tax imposed on individual taxpayers. The Act has reduced that maximum rate to 37%, although section 1411 ACA 3.8% tax may apply since the NIIT has not been repealed.
- In addition, if the new pass-thru deduction rules apply there may be a further reduction in the rate.
- The ESBT's net income (whether distributed by the ESBT or not) is not taxed to the beneficiaries of the ESBT, although distributions from the ESBT portion may be gross income to the beneficiaries if the non-ESTB portion of the trust, if any, has other net income (DNI). See Treas. Reg sec. 1.641(c)-1(i).

ESBTs, S Corps. and Non-Resident Aliens

- Eligible beneficiaries of an ESBT include individuals, estates, and certain charitable organizations eligible to hold S corporation stock directly. A nonresident alien individual may not be a shareholder of an S corporation and may not be a potential current beneficiary of an ESBT. I.R.C. sections 1361(b)(1)(C) and (c)(2)(B)(v). The Act expands the list of permissible beneficiaries of an ESBT to allow a nonresident alien individual to be a potential current beneficiary of an ESBT. I.R.C. section 1361 as modified by Act section 13541.
- A nonresident alien still may not be a direct owner of S corporation stock.
- Planning Consideration: If steps had been taken to exclude a non-resident alien from inadvertently becoming a beneficiary of an ESBT that may now be reversed permitting such participation.

ESBT Charitable Contributions Now Subject to Individual Rules

- S corporations report to its shareholders their pro rata shares of certain separately stated items of income, loss, deduction, and credit. For this purpose, charitable contributions (as defined in section 170(c)) of an S corporation are separately stated.
- The deductibility of a charitable contribution that passes through from an S corporation depends on the shareholder. Because an ESBT is a trust, the deduction for charitable contributions applicable to trusts, rather than the deduction applicable to individuals, has applied to ESBT's.
- Generally, a trust is allowed a charitable contribution deduction for amounts of gross income, without limitation, which pursuant to the terms of the governing instrument, are paid for a charitable purpose. See I.R.C. section 642(c). No carryover of excess contributions is allowed.
- The Act changes the charitable contribution deduction of an ESBT and provides that the rules generally applicable to trusts are not applicable, but rather the rules of section 170 applicable to individuals control the ESBT's charitable deduction. Thus, the percentage of contribution base limitations and carryforward provisions applicable to individuals apply to charitable contributions deemed made by the portion of an ESBT holding S corporation stock. In addition, the ESBT should be able to deduct the fair market value of property gifted in-kind to charity, subject to applicable percentage limitations. The substantiation rules of section 170 would seem to apply, although those rules do not apply to trusts. IRC Sec. 642(c) as modified by Sec. 13542 of the Act.

Planning after the Tax Cuts and Jobs Act of 2017

Transfer Tax Changes

The Two Paragraphs that Transform Estate Planning

- The Senate amendment is reproduced below. Two short paragraphs that will transform estate planning and the role of estate planners:
- "*The provision doubles the estate and gift tax exemption for estates of decedents dying and gifts made after December 31, 2017, and before January 1, 2026. This is accomplished by increasing the basic exclusion amount provided in section 2010(c)(3) of the Code from $5 million to $10 million. The $10 million amount is indexed for inflation occurring after 2011.*
- *As a conforming amendment to section 2010(g) (regarding computation of estate tax), the provision provides that the Secretary shall prescribe regulations as may be necessary or appropriate to carry out the purposes of the section with respect to differences between the basic exclusion amount in effect: (1) at the time of the decedent's death; and (2) at the time of any gifts made by the decedent.*"

Transfer Tax: Other Changes/Points

- Future inflation adjustments will be based on the chained CPI which should slow the rate of increase of future increments. The base year has been set at 2016.
- Assets held by the decedent at death appear to still obtain a stepped-up to date of death value as under current law. This will remain a cornerstone of planning for many.

Exemption Changes Impact 706s

- What will be the impact of the higher exemption (whatever the final amount) on tax return filings under an $11.2M exclusion?
- Some have speculated that the number of Form 706s will be as few as 1,000 per year.
- The JCT estimates that in 2018-2023 there will be 4,600-5,100 returns filed, with 1,800-1,900 of them taxable.
- The IRS recently released statistics confirming that only 606 estates under $5 million filed no-tax estate tax returns in 2016 (presumably to secure the DSUE). Likely, fewer will heed the advice after the Act.

Portability

- With doubled transfer tax exemptions will clients, other than the ultra-high net worth client, be willing to incur any cost to secure portability of the deceased spouse unused exemption (“DSUE”)? In the future, will clients even be willing to listen to recommendations to file a federal estate tax return if the exemption is doubled?
- For those clients affected, in the event that the estate tax exemption sunsets, loss of portability from failure to file an estate tax return on the death of the first spouse could be a costly mistake.
- Those taxpayers with portable exemptions from a prior deceased spouse might consider using those exemptions before a future administration may negatively affect them. This could take the form of using that DSUE to fund a DAPT.

Claw Back Concerns

- While there was speculation as to whether there would be a claw back if there is a future change of excess exemption, that issue may have been resolved. The Act provides:
- "*(2) Modifications To Estate Tax Payable To Reflect Different Basic Exclusion Amounts.—The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out this section with respect to any difference between— ''(A) the basic exclusion amount under section 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*."
- While the Regulations to be issued will hopefully clarify that claw back will not occur, practitioners might nonetheless caution clients making new exemption gifts of this possible risk.

Planning after the Tax Cuts and Jobs Act of 2017

Planning with the New Exemptions

Planning with the New Exemptions - 1

- If asset protection may be worthwhile, the new exemption should be used as soon as feasible.
- The transfer tax laws are still in flux as a result of the exemption increase, sunset and the uncertainty of what future administrations might do. Infuse flexibility into plans. Married clients should consider forming non-reciprocal, spousal lifetime access trusts (“SLATs”) to which gifts or sales transfers might be made. Single clients might consider self-settled domestic asset protection trusts (“DAPTs”) or hybrid DAPTs (a dynastic trust that has a mechanism to add the settlor back as a beneficiary so that the trust at inception is not a DAPT).
- There are large exemptions, valuation discounts, the availability of grantor retained annuity trusts (GRATs), grantor trusts and other techniques. It is possible that in 2021 a new administration and a Congress with a different composition might successfully resurrect many of the Greenbook proposals made by the Obama administration. Thus, this may prove a valuable window of planning opportunity. Providing flexibility and access to transfers to trusts is critical.

Planning with the New Exemptions - 2

- For large estates, the increased exemption should be used, likely in leveraged transactions to maximize the wealth transfers from the increased exemption. For example, if as some commentators suggest a 10:1 ratio (others suggest a 9:1 and many disagree with this concept entirety) leverage is appropriate on a sale of assets to a trust an additional $10 million of exemption for a married couple might support a $100 million sale of assets to irrevocable trusts. Further, since the IRC Sec. 2704 Regulations have been withdrawn, that sale may be of discounted assets leveraging the wealth transfer upwards of perhaps $130 million of assets on the new exemption amount.

Planning: Simplify/Enhance Existing Transactions

- For more moderate wealth clients who have previously consummated note sale transactions, consideration should be given to immediately funding additional gifts to the purchasing trusts to shore up the economics of those sale transactions. On those transactions, consideration might be given to evaluating the need for the existing guarantees. On much larger transactions, the additional trust “capital” might be supportive, but have no meaningful impact on guarantees. On smaller note sale transactions, that additional $5 million gift might be used to pay off a portion or all of a note, thereby eliminating the IRS IRC Sec. 2036 string argument as to the note.

Planning: Using Low Wealth Family Member Exemptions - 1

- Capture unneeded transfer tax exemptions of family members or others with modest wealth.
- The taxpayer could make a gift of highly appreciated assets to a close family member living in a non-decoupled state who has a modest estate of her own, who could bequeath those assets to the descendants of the taxpayer in a GST exempt long term trust. An obvious drawback of this is loss of control over the assets.
- Create an irrevocable trust with a general power of appointment (GPOA) to a person living in a non-decoupled state who has a modest estate of her own. The presence of that GPOA will cause estate inclusion of trust assets in that person's estate generating no estate tax but an adjustment of basis on her death. The exercise of the GPOA could be conditioned upon the consent of a non-adverse party providing a measure of protection. Alternatively, a limited power of appointment ("LPOA") could be provided to that person and another person can be given the power to convert the LPOA into a GPOA before the power holder's death. If the trust is formed in a jurisdiction that permits silent trusts, is there a need to even inform the power holder of the existence of the GPOA?

Planning: Using Low Wealth Family Member Exemptions - 2

- An upstream GRAT could also be used. Acknowledgement to Turney Berry.
- **Example**: Clients have a net worth substantially in excess of the $22 million. The client's parents have a net worth combined of only $2 million. So, the clients create a GRAT that is calculated to vest in each parent somewhat less than the maximum amount which, when added to their other assets, would not exceed each parent's exemption at the time that each parent dies. The parents bequeath the remainder interest to a trust for the benefit of the client and the client's descendants. This transfer will not only use up the parent's estate tax exemption, but it can utilize each parent's GST exemption (because there is no ETIP with respect to the parent). The IRS should have no objection to this planning because it actually uses exemption, rather than being an assignment on day one (or two) of a nominally valued remainder interest.

Planning: Lower Wealth Clients

- For lower wealth clients, existing documents and planning will have to be reviewed. Many clients in this wealth strata will be inclined to unravel prior planning under the premise of "Why do I need this now?" Practitioners will have to educate these clients as to the value of retaining (whether modified or otherwise) existing planning from a number of perspectives. Many estate planning steps provide asset protection benefits and the transfer tax changes do not minimize the need for that. For some clients if the planning is already in place the modest cost of continuing to maintain that planning may be insignificant relative to the cost of unraveling the planning, and then having to reconstruct it in the future if the law changes yet again (e.g. a reduction in the exemption amount by a future administration).

GST: Late Allocations vs. New Planning

- For taxpayers with estates of a size that there is no need to preserve the new GST exemption, it might be prudent to make late allocations of GST exemptions to existing trusts so that if a future administration rolls back the Act's benefits, those trusts will already be exempt (barring some type of claw back).
- For larger estates, more sophisticated planning may be advisable to shift value from non-GST exempt trusts to GST exempt trusts. For example, a family member may create a new irrevocable trust that is grantor as to the existing non-GST exempt trust, funding that new trust using a portion of her new gift and GST exemption. That new trust might then engage in a transaction with the old non-GST exempt trust to shift value into a more optimal transfer tax structure.

Planning after the Tax Cuts and Jobs Act of 2017

New Trust Planning:

un-INGs, New BDITs, ILITs, and SALTy SLATs

Trusts Structuring Post Act

- Another variation in planning may occur because of the SALT changes. The doubled estate tax exemption and the costlier SALT situation may drive practitioners to thread a new trust tax needle.
- Most trust planning, with one major exception, generally relied upon the creation of grantor trusts. The taxation of trust income to the grantor was an effective tool to burn or reduce the client/grantor’s estate, facilitate further tax oriented planning (e.g. swaps of trust assets for personal cash to obtain a basis step up on highly appreciated trust assets), etc. For ultra-wealthy clients (wealthy relative to the new exemption amounts) that planning may continue.

Trusts Structuring- INGs

- Some high earning clients used incomplete non-grantor trusts to shift income out of the reach of state tax authorities. These trusts were funded with incomplete gift transfers and were structured to avoid grantor trust status. The idea was that income, e.g. a large capital gain on the sale of stock, might be earned inside the ING and avoid high SALT in a high tax state. This technique had become so successful that New York enacted legislation to treat such trusts as grantor trusts subject to New York taxation.
- This will be a great tool for ultra-wealthy clients that have used all of their exemptions and do not need to access assets in irrevocable trusts. For a large swath of clients it will not be the optimal trust structure.

Trusts Structuring- The un-ING

- Another variation in planning may occur because of the SALT changes and the doubled estate tax exemption.
- Clients with moderate (relative to the new high exemption amounts) wealth, who reside in high tax states, a different variation of all the above planning might be preferable if feasible to achieve. These clients, perhaps in a wealth strata of $10-$40 million may be so wealthy that estate tax planning should continue because the higher doubled exemptions may be rolled back in the future. But these taxpayers may not be so very wealthy that they can afford to give up access to those trusts. Further, with the SALT deduction restrictions or elimination it may be prudent to shift investment income to a different low/no tax jurisdiction if feasible.

Trusts Structuring- SALTy SLATs

- Might these clients be able to structure completed gift (unlike the ING trusts), non-grantor (like the ING trusts) trusts to achieve both goals?
- Moderate wealth clients won't make gift transfers they cannot access. So how can they use their temporary exemptions and save the SALT? To provide access to assets in trusts like SLATs might it be feasible to have the spouse as a named beneficiary (or the grantor if in a jurisdiction that permits self-settled trusts) only to receive distributions with the consent of an adverse party to avoid grantor trust status?
- Would such trusts, if feasible from a federal income tax planning standpoint, be able to be planned around New York's anti-ING legislation and avoid grantor trust status for New York purposes?
- A trust may distribute income to the client/settlor's spouse, or accumulate for future distribution to the settlor's spouse, all subject to the required consent of adverse party, and not be characterized as a grantor trust. IRC Sec. 672(a).
- An adverse party might include a person having a substantial beneficial interest in the trust which would be adversely affected by the exercise or non-exercise of the power. This might include trust beneficiaries, such as an adult child (Consideration must be given, of course, to whether an adverse party consenting to the gift would be making a gift.)

Trusts Structuring- BDITs

- Might a variation of the Beneficiary Defective Trust (“BDT”) be used to achieve new planning goals to address the SALT restrictions of the Act? A BDT is an irrevocable trust that is a grantor for trust for income tax purposes as to the beneficiary and not as to the settlor. For example, parent may set up a trust for child, and that trust could be crafted to exclude provisions that would make the trust grantor as to the settlor. The trust would include an annual demand or Crummey power making the trust grantor as to the child/beneficiary.
- In the traditional BDT (BDIT) the parent may create a BDT for a wealthy child with a $5,000 initial gift, so that the child could sell assets to the trust without triggering capital gain because the BDT would be grantor as to the child. A good plan, but how can this be spun for the Act?
- If the parent lives in a high tax state and the child in a no tax state, might a variation of the typical BDIT approach be used by the parent to shift income to a lower SALT environment to save SALT when they are no longer deductible?
- Mom gifts $5,000 to a BDIT that is grantor to son in a low tax state. Mom then directs business opportunity to the trust which has no discernable gift tax value. The income generated will be reported by son in the no tax state. The value of the business opportunity would be grown outside the parent and child’s estate in contemplation of the sunset of the estate tax repeal.

ILITs

- New life insurance plans for most clients may differ.
- Life insurance may be more important for non-reciprocal SLATs (to protect against loss of income when one of the spouse's dies) consider the new high exemptions and the sizable portion of client estates that can be gifted to SLATs.
- Life insurance to pay an estate tax will be less relevant for most clients, until the exemption drops back to a lower amount.
- Perhaps some clients will view permanent life insurance as a ballast to the risk they may perceive in their stock portfolios given the price levels the equity markets have attained.
- Life insurance remains a useful income tax planning tool, growing value inside the tax favored envelope of the insurance policy, lower tax rates might dissuade some from pursuing this, others may see a greater need with the loss of SALT, etc.

Wills and Revocable Trusts

- Consider a default of a multi-part dispositive provisions with state funded credit shelter, marital, GST for excess. How can new wills/revocable trusts be simplified if the law may change by sunset or new legislation?
- What is the incremental cost of a more robust document with document generation software?
- If a client currently has capacity and the risk of the client becoming incapacitated would result in will or revocable trust dispositions the client would not want if sunset occurred, what will be able to be done?
- What of including in a revocable trust a mechanism to make a portion of the trust irrevocable and remove the settlor's rights to lock in a completed gift in the event of incapacity before documents can be updated for sunset or a new law? If the client is alive and has not used exemption and sunset is about to happen the power holder can pull the trigger to use up some of the about-to-expire exemption.

Planning after the Tax Cuts and Jobs Act of 2017

Existing Planning and Documents

Existing Wills/Revocable Trusts: Formula Problems

- Many clients have old documents that do not properly reflect the impact of the new post-Act high exemptions.
- The most common funding problem culprit might be tax defined formulas, e.g. the exemption amount to the credit shelter trust for the benefit of my spouse and all descendants. While that formula might have worked satisfactorily at a $2 million exemption, perhaps even adequately at a $5 million exemption, it may not meet the testator's goals whatsoever at a $10 million inflation adjusted exemption. The nuances of the impact of a formula clause, beyond the mere funding calculation, may be unnoticed by many clients.
- Other formula allocations could also present problems following the doubling of the GST exemption. If the allocation of assets as between children and grandchildren is effected by a formula clause, the results could also be unintended and even catastrophic.

Existing Wills/Revocable Trusts: GST Example

- **<u>Example</u>**: Clients signed wills many years ago when the estate and GST tax exemptions were $1 million. They know they need to revise their wills but they have been waiting (and still are) for certainty in the estate tax laws. Meanwhile their estate has grown to $24 million. On the second death, the GST exempt amount is bequeathed to a trust for grandchildren and the remainder of the estate is divided equally among the children. With a $22 million combined exemption, a credit shelter trust is funded on the death of the first spouse and on the second death, $22 million, the GST exempt amount passes in trust for grandchildren and $2 million passes to their children.

Existing Wills/Revocable Trusts: Capacity Issues

- If the testator's current capacity is questionable so that it is not certain the she has the capacity to sign a new will, perhaps a codicil can be signed thereby retaining the prior will unscathed should capacity become an issue.
- If the testator does not have capacity to sign a new will then perhaps the title (ownership) of assets can be modified to avoid the tax, or a reformation proceeding may have to be brought in court to modify the document to reflect the new law when it is known.

Active Planning Techniques in Process That Aren't Needed

- Is it appropriate, advisable and possible to modify existing planning?
- If a client with what, relative to the new exemptions, is a moderate wealth level, has a long term GRAT or note sale transaction in place, the contractual obligations to continue payments may not be affected by the doubling of the exemption. But while legal requirements of the governing documents continue, what of the client's will power to continue to administer that plan?
- What will occur if clients become lax about formalities of planning? If a GRAT no longer serves its purpose, ignoring annuity payments may trigger a gift tax at inception of the transfer.
- What about the fiduciary duty of the trustee?
- Might a future claimant be able to assert that the failure to adhere to formalities means the transaction is a sham, thus opening the planning to the reach of those plaintiffs?

Weighing Options on Unneeded Planning in Place

- Unwinding existing transactions for what might prove to be only a temporary increase in the estate tax exemption may prove unwise.
- Guide client to ignore sunk costs (the costs of having created the complex plan) and rather weigh only the future variable costs. These are the ongoing cost of maintaining the plan compared to the costs of having to recreate a new plan in a future year if the exemption is rolled back.
- While many might consider the likelihood of the exemption being reduced to $5 million to be modest, the possibility cannot be negated. The cost of making annual annuity or note payments is likely insignificant relative to the cost of creating new planning from scratch in the future if the current planning is unwound.

Simplify Existing Note Sales (and Other Planning)

- **<u>Example</u>**: Clients created a grantor dynasty trust and made a gift of $1 million to the trust and sold an interest in the family business valued at $20 million to the trust. The transaction was supported by a guarantee because their attorney was concerned about the size of the equity (seed gift) in the trust (noting that many practitioners view the size of the seed gift as modest, if any, importance). The couple could use their new additional $5.6 million of exemption to gift additional assets to the trust. The guarantee, if the terms of the governing document permit, may be terminated. The note may be refinanced and different terms applied. The transaction risk profile may be lowered, ongoing guarantee payments avoided, and the matter somewhat simplified.

Existing ILITs

- Many clients created ILITs to pay an estate tax that may no longer apply to them.
- The insurance itself should be reviewed by someone with the capability of evaluating the current policy and any options to modify or repurpose it. Then the trust instrument itself should be reviewed. The options that might be pursued might include one or more of the following:
  - Continue the plan as is.
  - Continue the plan but make a large one-time gift to the ILIT using the increased exemption to avoid the need for future annual gifts or Crummey notices.
  - Modify the life insurance into a paid-up policy and essentially freeze the insurance component of the plan.
  - Exchange the policy for a new policy that better serves current needs. For example, a policy that maximized death benefit might be replaced with a policy focused on cash accumulation that can be borrowed against by the trustee and distributed to the spouse who is a beneficiary in future years.
  - Decant the trust into a new trust that improves the administrative and other provisions.
  - Use a non-judicial modification to modify the trust in a manner beyond what a mere decanting might permit.
  - Terminate the policy and distribute the cash value received to the heirs as beneficiaries of the trust and terminate the trust.
  - Sell the policy into the secondary market and retain the trust (whether in its initial format or modified by a decanting) and invest the proceeds from the policy sale for future distribution to ILIT beneficiaries.

Existing Durable Powers of Attorney - 1

- Revisit gift provisions. Are they useful or necessary considering the exemption doubling? For many clients, the gift provision might warrant elimination by revoking the old power of attorney ("POA") and executing a new one that expressly prohibits gifts.
- For ultra-wealthy clients, the gift provision may be academic (perhaps other than for gifts of future inflation adjustments to the exemption amount) since the new exemptions might be used near-term before they sunset or are changed.
- For more moderate wealth clients, e.g. a couple in the $5-$35 million wealth strata, they might wish to permit transfers of the exemption amounts but only to specified trusts. This might be appropriate if the clients are wary of using the new exemption amounts but want to facilitate further plan in the event they become incapacitated.

Existing Durable Powers of Attorney - 2

- This is an important planning step for clients who are wealthy, but not so wealthy that they are comfortable using the new exemption amounts. What if such a client opts not to plan now, but later is incapacitated and a democratic administration in 2021 proposes legislation to reduce the transfer tax exemption? If the couples’ durable powers of attorney do not permit gifts to the exemption amount vital planning before a change in the law might be precluded.

Planning after the Tax Cuts and Jobs Act of 2017

Life Insurance

Tax reporting for Life Settlement Transactions

- The Act imposes reporting requirements in the case of the purchase of an existing life insurance contract in a reportable policy sale and imposes reporting requirements on the payor in the case of the payment of reportable death benefits.
- The reporting requirement applies to every person who acquires a life insurance contract, or any interest in a life insurance contract, in a reportable policy sale during the taxable year. This is the acquisition of an interest in a life insurance contract, directly or indirectly, if the acquirer has no substantial family, business, or financial relationship with the insured (apart from the acquirer's interest in the life insurance contract).
- An indirect acquisition includes the acquisition of an interest in a partnership, trust, or other entity that holds an interest in the life insurance contract.

Tax reporting for Life Settlement Transactions – Report Details

- Under the reporting requirement, the buyer reports information about the purchase to the IRS, to the insurance company that issued the contract, and to the seller. The information reported by the buyer about the purchase is: (1) the buyer's name, address, and taxpayer identification number ("TIN"), (2) the name, address, and TIN of each recipient of payment in the reportable policy sale, (3) the date of the sale, (4) the name of the issuer, and (5) the amount of each payment.
- On receipt of a report described above, or on any notice of the transfer of a life insurance contract to a foreign person, the issuer is required to report to the IRS and to the seller: (1) the name, address, and TIN of the seller or the transferor to a foreign person, (2) the basis of the contract (i.e., the investment in the contract within the meaning of section 72(e)(6)), and (3) the policy number of the contract.
- When a reportable death benefit is paid under a life insurance contract, the payor insurance company is required to report information about the payment to the IRS and to the payee. Under this reporting requirement, the payor reports: (1) the name, address and TIN of the person making the payment, (2) the name, address, and TIN of each recipient of a payment, (3) the date of each such payment, (4) the gross amount of the payment (5) the payor's estimate of the buyer's basis in the contract. A reportable death benefit means an amount paid by reason of the death of the insured under a life insurance contract that has been transferred in a reportable policy sale.

Transfer for Value Rules and Policy Sales

- The Act provides that the exceptions to the transfer for value rules do not apply in the case of a transfer of a life insurance contract, or any interest in a life insurance contract, in a reportable policy sale. Thus, some portion of the death benefit ultimately payable under such a contract may be includable in income.

Basis of Life Insurance Not Reduced by Cost of Sale

- In Revenue Ruling 2009-13,1003 the IRS had ruled that income recognized under section 72(e) on surrender to the life insurance company of a life insurance contract with cash value is ordinary income. In the case of sale of a cash value life insurance contract, the IRS ruled that the insured's (seller's) basis is reduced by the cost of insurance, and the gain on sale of the contract is ordinary income to the extent of the amount that would be recognized as ordinary income if the contract were surrendered (the "inside buildup"), and any excess is long-term capital gain.
- Gain on the sale of a term life insurance contract (without cash surrender value) is long-term capital gain under the ruling. The Act overrules the above and provides that in determining the basis of a life insurance or annuity contract, no adjustment is made for mortality, expense, or other reasonable charges incurred under the contract (known as "cost of insurance").
- This change specifically reverses the position of the IRS in Revenue Ruling 2009-13 that on sale of a cash value life insurance contract, the insured's (seller's) basis is reduced by the cost of insurance.

Life Insurance: Indirect Changes

- The doubling of the estate tax exemption will eliminate the need for most clients to purchase, or maintain existing, life insurance policies to pay a federal estate tax. Practitioners should caution clients seeking to cancel existing coverage about the risks of a future administration changing the estate tax rules yet again. In some instances, it may also be feasible to repurpose life insurance and existing irrevocable life insurance trusts ("ILITs") to meet new needs, e.g. liquidity, premature death (mortality risk) in a SLAT, and so forth.
- For taxpayers realizing a reduction in marginal income tax costs the use of life insurance as a tax favored envelope may lessen. Other taxpayers, perhaps high-income earners in high tax states, might find that the tax deferral features of permanent life insurance are enhanced by the Act.
- Split-dollar life insurance transactions need to be unwound at some point in time (an exit strategy). For taxpayers with moderate wealth relative to the new exemption amounts using the new gift tax exemption to gift assets to a trust involved in a split-dollar plan may facilitate that trust paying off a split-dollar loan and unwinding a transaction that might no longer be needed.

Conclusion and Additional Information

Conclusion

- The Tax Cuts and Jobs Act, P.L. 115-97, is a massive change to estate planning and a myriad of other Code provisions.
- Many traditional planning constructs will have to be rethought.
- The temporarily doubled transfer tax exemption provides a valuable planning opportunity, but will moderate wealth clients proceed?
- Planning for ultra-high net worth clients is likely to proceed similar to past practices, although greater use of ING trusts might be warranted.
- Trusts might face higher taxes as a result of eliminated deductions, but it is not certain how the changes will be applied to trusts.
- The list goes on and only with time will more of the implications be identified.

Additional information

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A KEY ESTATE PLANNING GUIDE

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- For more information about earning CLE credit for this program or other Martin Shenkman programs please contact Simcha Dornbush at NACLE. 212-776-4943 Ext. 110 or email sdornbush@nacle.com