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TOPIC: A Few Select Insights from the 2019 Heckerling Institute on Estate Planning.

MARKET TREND: State law developments and planning ramifications resulting from the Tax Cuts and Jobs Act ("TCJA") were the focus of discussions at the 2019 Heckerling Institute on Estate Planning.

SYNOPSIS: Presenters at the 2019 Heckerling Institute on Estate Planning highlighted the continuing ripple effect of the TCJA on planning, including the release of several regulations designed to implement TCJA provisions (including pass-through entity taxation and estate tax "claw back"), the allocation of the higher generation skipping transfer (GST) tax exemption to pre-TCJA transfers, and the application of tax deductions in non-grantor trust planning. Given the highly-mobile and extended nature of today's families, state law developments also factored considerably into the discussions, particularly the potential for estates and trusts to face tax exposure from multiple states.

TAKE AWAY: Heckerling presenters emphasized that flexibility in planning will remain key for families and advisors through the on-going roll-out of the TCJA and related guidance. Given the TCJA's temporary nature, the possibility for future tax law changes depending on future election outcomes, and the many moving parts of planning for the "modern" family, successful plans will require active management and on-going monitoring of both federal and state tax and legal developments.

Below are a few select insights from the 2019 Heckerling Institute on Estate Planning, reflecting notable federal and state legacy planning developments post-TCJA.[1]

CONTINUING IMPLICATIONS OF THE TCJA

Legal and Regulatory Developments. As part of the continued focus on the life insurance and legacy planning ramifications resulting from the TCJA (see *WRMarketplace Nos. 18-01, 18-06, 18-10, 18-11, and 18-12*), this year's Heckerling presentations reviewed recent legal and regulatory developments, including those designed to implement various TCJA provisions. Prior AALU reports have covered several of these developments:

- §199A. Issuance of final regulations under Internal Revenue Code ("**Code**") §199A regarding the taxation of income from pass-through entities (*WRNewswire 19.02.12*).
- Anti-Claw Back. Issuance of proposed regulations preventing potential "claw back" of the use of the temporarily higher federal gift and estate tax exemption (*WRMarketplace No. 19-01*)
- Generational Split Dollar. Tax Court opinions in *Est. of Cahill* and *Est. of Morrissette* regarding generational split dollar life insurance arrangements (*WRMarketplace Nos. 18-18* and 18-26)

Presenters also noted additional trends and clarifications generated by the TCJA, including:

Allocation of Increased GST Exemption. There was some uncertainty regarding the effective date provisions of the TCJA in connection with the allocation of the temporarily higher GST tax exemption, specifically whether the increased exemption could be allocated to transfers made or trusts created before 2018. The Joint Committee on Taxation's so-called "Bluebook" (i.e., the General Explanation of Public Law 115-97), which was finally released near the end of 2018, confirms via a detailed example that the increased GST exemption can be allocated to pre-2018 transfers.

WHY IT MATTERS: As the GST tax applies at a flat 40% rate, GST tax planning is integral to the success of many multi-generational irrevocable trusts, including many irrevocable life insurance trusts. Due to the complexity of the tax and related exemption allocation rules, however, many long-term trusts can end up only partially GST-exempt, undermining the trusts' original goals and potentially limiting their longevity. Yet potential "fixes," such as qualified trust severances (see *WRMarketplace No. 16-18*), are rarely simple or inexpensive. Now, with the Bluebook's confirmation that the higher GST exemption under the TCJA may be allocated to pre-TCJA trusts, clients may have a window of opportunity to use the increased exemption to make partially-exempt trusts fully exempt.

Use of Non-Grantor Trusts. Non-grantor trusts are taxed as separate entities at their own tax brackets, which subjects them more quickly to the highest income tax rates on their undistributed income. Yet they also benefit from a separate set of deductions, including for trustees' fees and certain other administration expenses and charitable contributions. Recent developments clarify the application of these deductions:

- Deductions for Fees/Expenses. The TCJA's elimination of miscellaneous itemized deductions under Code §67(a) had created some confusion as to whether estates and non-grantor trusts could still deduct executors' and trustees' fees and certain other estate and trust expenses under Code §67(e). Notice 2018-61 confirms the continued availability of these deductions, with the IRS stating that it intends "to issue regulations clarifying that estate and non-grantor trusts may continue to deduct expenses described in §67(e)."

- Charitable Deductions. Charitable contributions made by a non-grantor trust are not subject to a percentage limitation, but such contributions must be (1) of gross income and (2) made pursuant to the terms of the trust agreement. From the IRS's perspective, a court order to modify a trust's terms to authorize such charitable contributions will **not** suffice, unless the court order resolves some controversy in the interpretation of the trust's terms in this regard.[2] Further, the IRS has successfully argued to limit a non-grantor trust's deduction for charitable donations of appreciated property to the "gross income" the trust paid to buy that property (i.e., its adjusted basis in the property), rather than the property's fair market value.[3] In other words, the trust should have sold the property and then contributed the cash proceeds to obtain a full deduction.

WHY IT MATTERS: The TCJA's enactment renewed interest in non-grantor trust planning, as the separate deductions available to a non-grantor trust may result in less taxes on a combined basis for the trust creator and the non-grantor trust, as opposed to using a grantor trust (where the trust's income and deductions would be taxed to the grantor based on his personal rates and limitations) (see *WRMarketplace Nos. 18-03* and *18-15*). Non-grantor trusts also may provide further opportunities in charitable planning, since they are not subject to the same restrictions on charitable contributions as individuals, who must comply with income percentage limitations and itemize to take advantage of the charitable deduction (which may occur less often due to the higher standard deduction, the $10,000 cap on deductions for state and local taxes, and the elimination of most individual miscellaneous itemized deductions). Accordingly, clients may want their trust agreement to permit charitable contributions (perhaps at the direction of a trust advisor or distribution committee) to provide flexibility and additional options for managing the trust's tax liability.

STATE LAW TRENDS

State Estate Taxation. Thirteen jurisdictions impose a separate estate tax with varying exemption amounts -- Connecticut, D.C., Hawaii, Illinois, Maine, Maryland, Massachusetts, Minnesota, New York, Oregon, Rhode Island, Vermont, and Washington.[4] While several of these states had tied their exemption levels to match the federal estate tax exemption amount, most have reverted to a separate exemption after the TCJA. As of now, only Connecticut's exemption will eventually match the TCJA's federal estate tax exemption amount as of 2023.

Hawaii and Maryland have enacted portability of their exemption between spouses. Otherwise, most decoupled states permit a separate marital QTIP trust election for their state estate tax (except for D.C. and Vermont).[5] Such elections, however, raise the question of which state may tax the property if the surviving spouse moves after the first spouse's death. For example, in a recent case, a husband passed away in Michigan in 1989 (before the repeal of the state death tax credit and the associated decoupling issues), creating a marital trust for his surviving wife, for which federal and Michigan QTIP elections were made. The wife later moved to, and passed away in, Maryland in 2013. Maryland sought to impose its estate tax on the QTIP trust assets; however, the court rejected this position, holding, in part, that Maryland law requires that a Maryland QTIP election be made to trigger inclusion of the trust assets in the surviving spouse's estate for Maryland estate taxation.[6]

WHY IT MATTERS: Many families today are highly mobile, extended across the country, and have property and/or entities in multiple jurisdictions. Accordingly, they must consider their potential planning and tax exposure at the state level, possibly in more than one state. For example, more than one state-only QTIP trusts may be needed if a deceased spouse owns property that may be subject to state estate tax in multiple states. Clients, however, must weigh any potential tax benefits against the additional complexity these trusts create. Some clients may prefer to pay a state-level estate tax rather than deal with the added administrative costs and complications. Regardless, the review and on-going monitoring of the location of family members and assets and any applicable local laws is a crucial component of planning for the modern family.

State Trust Taxation. State income taxation of non-grantor trusts has become a hot topic, particularly as states seek to generate additional tax revenue. State income tax rates applicable to non-grantor trusts vary significantly from state to state (e.g., from 0% to over 13%). While the rules and factors for determining the residence of a trust for state income tax purposes also differ by state, they typically fall into the following categories: (1) residence of the trust creator ("grantor") during life in the state when the trust was created, funded, and/or became irrevocable for *inter vivos* trusts, or at death for a trust created under a will; (2) residence of a beneficiary in the state; (3) residence of a trustee in the state; or (4) administration of the trust in the state.

However, basing state trust taxation solely on the residence of a trust grantor or a beneficiary, without additional state connections, has come under challenge. State cases, including in Illinois, Minnesota, New Jersey, North Carolina, and Pennsylvania, have held this connection, alone, to be insufficient for purposes of state income taxation.[7] Now, two certiorari petitions have been filed with the U.S. Supreme Court, one dealing with state trust taxation based on a grantor's residence (*Fielding v. Commissioner of Revenue)* and the other on a beneficiary's residence (*Kaestner 1992 Family Trust v. North Carolina Dept. of Revenue)*. Currently, the *Kaestner* petition has been accepted for U.S. Supreme Court review.

WHY IT MATTERS: State income tax on a trust's undistributed income can be a significant draw on trust resources, depending on the state(s) in which the trust is a deemed a tax resident. Currently the migration of a trust's grantor or beneficiaries may unexpectedly expose the trust to new state income tax systems. Further, the appointment of (or changes to) trustees and potentially other trust fiduciaries (such as trust protectors and/or investment, distributions, and business advisors) that are resident in multiple states also may result in potential taxation in several jurisdictions. With proper planning during the initial formation and ongoing administration of a non-grantor trust, however, families may be able to control or change factors that impact the determination of a trust's state tax residency. For example, families and advisors should carefully consider the state for trust creation. For existing trusts, state tax exposure also may be addressed by changing the place of trust administration by a trust amendment or decanting, by changing or naming additional trustees, by dividing a single trust into separate trusts for separate beneficiaries, and/or changing the situs of trust assets.

Trust Modifications. While judicial and nonjudicial modifications and decanting have become commonplace in trust planning, the availability of these options should not be assumed, even when all parties agree. In a recent Florida case,[8] a trust became irrevocable after the grantor's death in 2010. The income beneficiary (the grantor's son) and the charitable remainder beneficiaries subsequently agreed to terminate the trust and distribute its assets outright on an actuarial basis. The trust agreement did not specifically prohibit early terminations but did include a spendthrift clause. One co-trustee did not agree to the termination. The court sided with this trustee, holding that the facts did not reflect that: (1) there was any waste of trust assets; (2) the purposes of the trust had been fulfilled, or (3) termination was in the best interest of the beneficiaries when considering the grantor's intent. The court also found that there was no indication that the trust's administration expenses were unusual or that market fluctuations created a real risk that the grantor's intent would be thwarted..[9]

WHY IT MATTERS: To serve their intended purpose, multi-generational or dynasty trusts must be irrevocable and remain in place for generations. Over time, however, many changes can occur with respect to tax laws, a family's needs, and/or the statutes that govern trust administration. The ability under state law to modify the terms of a trust and/or to decant the assets into a new, updated trust (with or without court approval) can improve the prospects that a trust will fulfill its objectives, making this issue a key factor when evaluating potential trust jurisdictions. As the trust grantor's intentions will likely play a key role in any legal analysis, the grantor also may want to specifically authorize a decanting or appoint a person (such as a trust protector) with the ability to modify or seek modification of the trust terms if flexibility is desired. Avoiding mandatory distribution language and other fixed beneficial interests also will enhance future trust flexibility.

Intersection of State Laws and Grantor Trusts. While grantor trusts are disregarded with respect to the grantor for federal income tax purposes, they remain separate entities under state trust law, which can raise fiduciary considerations when trust planning attempts to take advantage of certain grantor trust features. For example, state courts have considered the ability of a grantor to exercise a trust substitution power to "swap" trust assets with other assets of equivalent value (including promissory notes),[10] and, in some cases, have limited this ability on the basis that the assets for substitution were not of an equivalent value to the trust assets. Due to the potential adverse effects to the trust and beneficiaries, a court also may be unwilling to compel a trustee to reimburse the grantor for the income tax liability generated by the trust or to allow a grantor to seek modification of a trust to terminate grantor trust status, even if the grantor is struggling with the economic burden of paying the trust's tax liability.[11]

WHY IT MATTERS: Grantor trusts are a mainstay of legacy and life insurance planning. Since grantor trust transactions with a grantor are disregarded: (1) no taxes result from loans or sales between the grantor and grantor trust and (2) transfers of a life insurance policy on the grantor's life between a grantor and the trust are not "transfers for value," which provides significant flexibility for planning. The availability of a substitution power also can allow the grantor to swap out lower basis assets to obtain a basis step up in his estate or to help manage a trust's investment performance. The flexibility achieved by grantor trust status may be limited, however, if the grantor cannot affect the substitution power, which may necessitate working closely with a cooperative trustee. Further, the trade-off for the flexibility provided by grantor trusts, including substitution powers, is the grantor's continuing payment of trust's income taxes without any corresponding benefit, which may be difficult for the grantor to sustain over the long-term Accordingly, if possible, the trust should contain a discretionary tax reimbursement for the grantor, and, as a backup, the trust should provide the grantor with the discretion to terminate grantor trust status if he no longer can or wants to pay the trust's income taxes. Note, however, that termination of such status should not require any discretionary action by the trustee, as it may infringe on the trustee's fiduciary duties to the trust beneficiaries.

TAKE-AWAY

Heckerling presenters emphasized that flexibility in planning will remain key for families and advisors through the on-going roll-out of the TCJA and related guidance. Given the TCJA's temporary nature, the possibility for future tax law changes depending on future election outcomes, and the many moving parts of planning for the "modern" family, successful plans will require active management and on-going monitoring of both federal and state tax and legal developments.

NOTES

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[1] For a more detailed discussion of these insights, *see* materials prepared by Steve R. Akers, Turney P. Berry, Samuel A. Donaldson, Charles D. "Skip" Fox, IV, Jeffrey N. Pennell, Charles A. "Clary" Redd, and Howard M. Zaritsky (edited by Ronald D. Aucutt) for "Recent Developments 2018)" as presented by Steve R. Akers, Samuel A. Donaldson, and Amy K. Kanyuk on January 14, 2019 at the 53th Annual Heckerling Institute of Estate Planning; Steve R. Aker, "Heckerling Musings 2019 and Current Developments," February 2019 at www.bessemer.com/advisor; Ronald D. Aucutt, "Top Ten Estate Planning and Estate Tax Developments of 2018," ACTEC Capital Letter No. 47, January 2, 2019; materials prepared by Martin M. Shenkman, Esq. for "Heckerling 2019 Review," as presented by Martin M. Shenkman and Jonathan G. Blattmachr, Esq., February 15, 2019.

[2] See CCA 201747005.

[3] See *Green v. U.S.,* 880 F.3d 519 (1/12/2018). The IRS arguably limits the deduction because the trust never sold or exchanged the property and thus never realized or was taxed on the inherent gain.

[4] Note that Iowa, Kentucky, Maryland, Nebraska, New Jersey, and Pennsylvania impose an inheritance tax on assets passing to certain individuals.

[5] A New York state QTIP election is permitted where no federal estate tax return is required to be filed or where a federal estate tax return is filed that also makes a QTIP election.

[6] See *Controller of the Treasury v. Taylor*, 189 A.3d 799 (Md Ct. Special App. 2018).

[7] See e.g., *McNeil v. Commonwealth of Pennsylvania*, Pa. Comm. Court, No. 651 F.R. 2010, 173 F.R. 2011 (2013); *Linn v. Department of Revenue*, 2013 Ill. App. 4th 121055 (2013); *Residuary Trust A u/w/o Kassner v. Director, Division of*

Taxation, 2015 N.J. Tax LEXIS 11, 2015 WL 2458024 (N.J. Sup'r Ct. App. Div. 2015), *aff'g* 27 N.J. Tax 68 (N.J. Tax Ct. 2013); *Kaestner 1992 Family Trust v. North Carolina Dept. of Revenue*, 814 S.E.2d 43 (N.C. June 8, 2018), aff'g 789 S.E.2d 645 (N.C. App. 2016); *Fielding v. Commissioner of Revenue*, 2018 WL 3447690 (Minn. July 18, 2018), aff'g 2017 WL 2484593.

[8] *Horgan v. Cosden*, 249 So.3d 683 (Fla. Dist. Ct. App. May 25, 2018),

[9] See also *In re Shire* (299 Neb. 25, 907 N.W.3d 263 (Feb. 16, 2018)).

[10] *See e.g., In re Matter of Condiotti*, No. 14CA0969 (Col. App. July 9, 2015 unpublished opinion); *Thomas Benson v. Robert Rosenthal*, No. 15-782, 2016 WL 2855456 (E.D. La. 2016); *Schinazi v. Eden*, 338 Ga. App. 793, 792 S.E.2d 94 (Ga. App. 2016); *Manatt v. Manatt,* 2018 WL 3154461 (S.D. Iowa May 2, 2018). Note that in *Benson,* the court refused to issue a summary judgment rejecting such a swap on the basis that the note was not of equivalent value.

[11] *Millstein v. Millstein*, 2018 WL 3005347 (Ohio Ct. App.) and 2018 WL 1567801 (Ohio Ct. App.).