2017 Tax Act-SELECTED RECENT DEVELOPMENTS IN ESTATE PLANNING FROM 2017

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Inflation Adjusted Amounts for 2018

- Gift Tax Annual Exclusion - Increases from $14,000 to $15,000
- Special Use Valuation under Section 2032A – Increases from $1,120,000 to $1,140,000.

Conservation Easements

- The ability to claim a charitable deduction for certain "qualified conservation contributions" was provided by Congress in 1980.[1] Such a deduction requires a contribution of a "qualified real property interest" to a "qualified organization", "exclusively for conservation purposes."

Example: Mrs. Donor owns 100 acres of undeveloped land adjacent to Highlands, NC. In order to ensure that the property is maintained in a pristine condition, she burdens the property with an easement which forbids development, and she then gives that easement to The Georgia-Alabama Land Trust, Inc. Her qualified independent appraisal finds that the property has a fair market value based on "highest and best use" development of $5 million, but when subject to the restrictive easement it has a fair market value of only $1.5 million. Mrs. Donor is entitled, under IRC §170(h), to an income tax charitable deduction of ($5 million less $1.5 million) $3,500,000.

- As a result, and active business has developed around syndicating gifts of such conservation easements through partnerships, and selling partnership interests to investors who wish to benefit from the charitable deduction.
- Because the value of such a syndicated partnership interest is a function of the value of the income tax deduction, the IRS has perceived that abuses have occurred in the appraisal process, in which appraisers have developed valuation theories which are not reflected in objective comparable transactions.

- In 2017, the IRS formally identified certain syndicated conservation easement transactions as "listed transactions" subject to special disclosure by the taxpayer and scrutiny by the IRS. These transactions involve investors who receive promotional materials that offer prospective investors in a pass-through entity the possibility of a charitable contribution deduction that equals or exceeds an amount that is 2-1/2 times the amount of the investor's investment.

Asset Protection Trusts

- In 2017, Michigan became the 18th state to statutorily sanction self-settled asset protection trusts.
- A majority of the states (including Georgia) have retained the traditional common law approach, that one may not create a trust for the benefit of oneself and prevent one's creditors from seeking the payment of the donor's debts from the assets of such a trust.

- The big question in this arena remains unanswered - whether a resident of Georgia can create a trust for himself in Delaware and rely on Delaware law to protect those assets from the claims of a Georgia creditor.
- Remember the “full faith and credit” clause of the Constitution.

Valuation of Interests in Family Partnerships and LLCs

- **§2704 Regs**. The proposed §2704 Special Valuation regulations are dead – a casualty of President Trump's executive order to all departments directing repeal of regulations which "(i) impose an undue financial burden on United States taxpayers, (ii) add undue complexity to the Federal tax laws, or (iii) exceed the statutory authority of the Internal Revenue Service."

- **<u>A "Bad Facts" Valuation Decision (which may be helpful to many)</u>** - In the <u>Estate of Powell</u>, the Tax Court dealt with a partnership which was formed by the deceased taxpayer's son acting under a power of attorney shortly before the taxpayer's death. On behalf of taxpayer, son transferred $10 million in cash and marketable securities to the partnership in exchange for a 99% limited partnership interest. Each of taxpayer's children contributed an unsecured promissory note for a 1% general partnership interest. On behalf of the taxpayer, son immediately thereafter used taxpayer's limited partnership interest to fund a charitable lead annuity trust, valuing the limited partnership interest at a discount and claiming a gift tax charitable deduction for the value of the annuity payable to charity. Taxpayer dies seven days later.

The approach to such cases in recent years has been developed by the court in cases like Kimball and Bongard, requiring that the taxpayer present a bona-fide non-tax reason for creation of the partnership or find estate inclusion under §2036(a)(1).

However, in Powell, the court apparently seized on the power of attorney relationship of son to attribute some “retained control” to the taxpayer, including partnership interest in the taxable estate under §2036(a)(2).

As a result, the Powell decision is likely to muddy the waters in valuation disputes for more normal cases.

For many, however, the estate tax is no longer an issue and the income tax basis at death is a more valuable focus. The Powell decision may provide a rational basis for including partnership interests in the estate with no discount, generating a higher basis.

"ING" Trust Rulings

- Irrevocable non-grantor trusts ("ING" Trusts") have received much attention as vehicles to avoid payment of state income tax on undistributed trust income and capital gain.
- One creates a trust in a state with no income tax, transfers low basis assets to the trust, and the trust sells them. Federal tax is owed, but the trust might avoid paying any state tax.

- The issue is how to create such a trust under which the grantor can be a beneficiary, along with other family members, but not have the trust classified as a grantor trust pursuant to IRC §§671-677.
- Designing such a trust is challenging, but the IRS will issue a favorable private letter ruling finding (1) that the transfer of assets to the trust does not constitute a taxable gift, (2) that distributions from the trust will not result in taxable gifts, and (3) that the taxpayer will not be treated as the owner of the trust for income tax purposes pursuant to the grantor trust rules.

Life Insurance Developments

- **Life Settlement Transactions** - The 2017 Tax Act imposes reporting requirements on the purchase and sale of an existing life insurance policy in any "life settlement transaction" which is within the definition of a "reportable policy sale." It would also make any "reportable policy sale" subject to the transfer for value rules of IRC §101 by excluding the application of the exceptions, thereby making the insurance death benefit subject to income tax.

- **Private Placement Variable Life** - Private placement life insurance products continue to generate substantial interest among wealthy families who would like to segregate a portion of their investments into a portfolio in which income and gains can be tax deferred (if not tax free) under the rules of §72.

Flexibility of investments is always a key issue.

The IRS' primary focus is the degree of control which the policy owner can exert over the investments in the policy. If the policy owner is found to have too much control over selection and timing of investment decisions, its position is that the policy owner is taxed directly on the investment results inside the policy.

In PLR 201705003, the IRS issued a favorable opinion on the creation of investment options which would provide attractive flexibility.

The Tax Cuts and Jobs Act of 2017

This legislation results in the most sweeping change to the tax environment since the Internal Revenue Code of 1986. It will have a significant impact on most individual and business taxpayers.

- **Estate Tax, Gift Tax, Generation Skipping Transfer Tax**
  - **Increase in Exemption** - The exempt amount applicable to estate tax, gift tax, and the generation skipping transfer tax is doubled, effective for decedents dying after, and gifts made after, 2017 and before 2026. With inflation adjustments, the exempt amounts for 2018 will be $11,180,000 per individual, or $22,360,000 for a married couple (often referred to in rounded form as $11.2 million and $22.4 million).

– **Claw Back -** If Congress does not take further action before 2026, these exemptions will revert to their current level ($5.6 million plus inflation adjustment), but under the current structure of the law, most practitioners believe that the use of the larger exemptions before 2026 will be "grand fathered" even if the exemptions are later reduced.

  - Example: Marvin is unmarried and has a total estate valued at $20 million. Before the exemption amount is reduced in 2026, Marvin makes a gift to a trust for his children in the amount of $11 million, using his exemption to avoid paying any gift tax.

If the exemption reverts to $6 million in 2026 (ignoring inflation) the following illustrates the tax treatment of his death in 2028:

	No Gift	After Gift
Gross Estate	$20,000,000	$ 9,000,000
Adjusted Taxable Gifts	$ 0	$11,000,000
Tax Base	$20,000,000	$20,000,000
Gross Estate Tax	$ 5,600,000	$ 5,600,000
less Credit for Gift Tax	$ 0	$ 2,000,000
Net Estate Tax Payable	$ 5,600,000	$ 3,600,000

The credit for gift tax payable is computed based on "the law in effect at the decedent's death", or $11 million gift less $6 million exemption - $5 million taxable, at 40% rate = $2,000,000.

The Act now directs Treasury to generate regulations as may be necessary to address any difference in the exclusion amount at the time of a gift and the amount at the time of death.

– **<u>Important to Review Formula Clauses in Wills and Trusts</u>** - A typical formula clause in a marital deduction Will leaves the full amount of the estate tax exemption to a trust for the joint benefit of the surviving spouse and children, and leaves to the marital deduction share only that part of the estate in excess of the exemption. In larger estates, it is not uncommon to find a formula clause leaving the amount of the GST exemption to trusts for grandchildren. With the increase of the exemptions to more than $11 million, this might result in a great deviation from the testator's intent, and may be unnecessary to avoid estate tax.

Income Tax - Individual Taxpayers

- **Changed Tax Brackets**. Much of the early discussion was focused on compressing the tax rates in order to "simplify" the tax code. That did not happen. The number of brackets is unchanged, but somewhat reduced. The following are comparisons of the old and the new tax rates applicable to single individuals and to married taxpayers filing a joint return:

Single Taxpayer Comparison

Taxable Income	2017 Tax Owed	2018 Tax Owed	Change	
$75,000	$14,489	$12,440	($2,049)	-14%
$150,000	$34,982	$30,290	($4,692)	-13%
$250,000	$65,899	$63,190	($2,710)	-4%
$350,000	$98,899	$98,190	($710)	-1%
$500,000	$153,819	$150,690	($3,129)	-2%
$750,000	$252,819	$243,190	($9,629)	-4%
$1,000,000	$351,819	$335,690	($16,129)	-5%

Married Filing Joint Return Comparison

Taxable Income	2017 Tax Owed	2018 Tax Owed	Change	
$75,000	$10,318	$8,619	($1,699)	-16%
$150,000	$28,978	$24,879	($4,099)	-14%
$250,000	$57,717	$48,579	($9,138)	-16%
$350,000	$90,717	$75,379	($15,338)	-17%
$500,000	$143,231	$126,379	($16,852)	-12%
$750,000	$242,231	$216,879	($25,352)	-10%
$1,000,000	$341,231	$309,379	($31,852)	-9%

Looking at the tax rates alone, it is clear that the largest percentage benefits are conferred on the lower income brackets.

The tax rates, however, are only a part of the picture.

The Act also makes significant changes in the deductions allowable in computing one's taxable income.

– **Marriage Penalty** - It is clear that the "marriage penalty" is still alive. Single filers reach the top bracket with $500,000 of taxable income, while the combined income of married couples reaches the top bracket at only $600,000.
– **Special Tax Rates** - The special tax rates (15% or 20%) applicable to long term capital gains and qualified dividends are unchanged.
– **Additional Medicare Taxes** - The 3.8% Medicare surtax on net investment income above a certain threshold (which is actually part of the Affordable Care Act) is unchanged.

- **Alternative Minimum Tax** - The AMT for individual taxpayers is retained, but the exemptions are increased and the phase-out of the exemption does not become an issue until taxable income exceeds $1,000,000 (joint returns) or $500,000 (single filers).
- **Student Loans** - The Act retains the deductibility of interest paid on student loans.

– **Standard Deduction and Personal Exemptions** - Personal Exemptions are repealed, and the Standard Deduction is substantially increased, producing the following combined effect:

	Current Exemption + Std Deduction	New Law Std Deduction
Single Taxpayer	$10,400	$12,000
Unmarried Head of Household [1]	$17,450	$18,000
Married Filing Joint [1]	$28,900	$24,000

[1] Assumes taxpayer(s) and 2 dependents

While the total exempt amount is not materially changed, the increased Standard Deduction is likely to result in many more taxpayers not wrestling with itemized deductions. Note that this will result in an additional amount of state income tax payable for some. In Georgia (and most states), a taxpayer is required to use the same filing status on the state return which was used on the federal return. Therefore, if a Georgia taxpayer has $10,000 of itemized deductions, she is likely to elect to use the $12,000 standard deduction on her federal return. In that case, she is also required to use the $2,300 standard deduction on her Georgia return.

– **Itemized Deductions** - The Act makes substantial changes to the available itemized deductions:

- **Medical Expenses** - After much highly publicized discussion, the deduction for medical expenses was not only retained, but was increased for 2017 and 2018. In those years, the threshold which must be exceeded before medical expenses become deductible is reduced from 10% of adjusted gross income to 7.5% of adjusted gross income. After 2018 the threshold returns to 10%.

- **Mortgage Interest** - The deduction for mortgage interest paid on acquisition indebtedness incurred after 12/15/17 is limited to the interest on principal indebtedness of not more than $750,000. On mortgage loans prior to that date, the $1,000,000 limit of the prior law is retained, but those loans can not be refinanced in an amount exceeding the previous balance.   The deduction for interest on home equity lines of credit is repealed, regardless of when it was incurred.

- **State and Local Taxes** - The deduction for state and local income taxes and property taxes not related to a trade or business or investment activity is limited, in the aggregate, to $10,000 beginning in 2018.

  Investment interest and interest on debt incurred in the carrying on of a trade or business are not subject to the $10,000 limitation.

- **Miscellaneous Itemized Deductions** - The Act suspends all miscellaneous itemized deductions which have been subject to a "floor" of 2% of adjusted gross income under current law. These will include investment counsel expenses, home office expenses, licenses and regulatory fees, dues to professional and business societies, subscriptions to business or professional journals, etc.). The deduction for tax preparation fees, moving expenses, and alimony payments would be repealed after 2018.

- **Alimony Payments** - Alimony payments arising from divorce after December 31, 2018 will not be deductible to the payor spouse and will not be taxable income to the payee. A grand fathered divorce arrangement which is subsequently modified will continue to be subject to the old rules unless the modification provides that the changes made by this Act are to apply. This provision does not sunset after 2025. This change will probably have a substantial impact on the negotiation of divorce settlements, because the parties will no longer be able to shift the income tax liability from the wealthier spouse to the former spouse in a lower tax bracket.

- **Charitable Contributions** - The deduction for charitable contributions is mostly unchanged. The deductibility of cash gifts to a public charity, currently subject to a deduction limitation of 50% of adjusted gross income, will now be allowable up to 60% of adjusted gross income. The 80% deduction for contributions made for college athletic seating rights is repealed.
- **Phase Out** - the current law mandating a phase out of itemized deductions to the extent that income exceeds a certain level is repealed. Therefore, for those taxpayers itemizing their deductions, they will be able to use 100% of their deductions regardless of the amount of their taxable income.

- **Exclusion on Gain From Sale of Home** - The exclusion of up to $250,000 (single) or $500,000 (married joint) of capital gain realized on the sale of a principal residence remains unchanged for taxpayers who have owned and occupied their principal residence for 2 of the previous 5 years.
- **Section 529 Accounts** - Beginning in 2018, permitted distributions for "qualified higher education expense" will include tuition at public, private, or religious elementary or secondary schools, up to $10,000 per student during the year.

- **<u>Pass-Through Business Income</u>** - Individual taxpayers (as well as trusts and estates) will be allowed a deduction from taxable income for 20% of "domestic qualified business income" which is taxable to them through a partnership (or limited liability company taxed as a partnership) or an S corporation or a sole proprietorship.

  Qualified business income means the net amount of income, gain, deduction and loss with respect to the conduct of any trade or business <u>except for</u> certain "service" businesses described below.

  Where taxpayers' taxable income exceeds $157,500 (for individual taxpayers) or $315,000 (for married filing jointly) the amount of the deduction is limited to the greater of 50% of their W-2 wages, or the sum of 25% of W-2 wages plus 2.5% of the basis in qualified property used in such business.

This 20% deduction is phased out for certain "service businesses" involved in health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, investment management, trading or dealing in securities, or any business where the principal asset of such trade or business is the reputation or skill of one or more of its owners or employees." For some reason, the engineering and architecture professions are not treated as a "service business" for this purpose.

Like-Kind Exchanges - The non-recognition of gain on exchanges of property held for production of income or conduct of a business (§1031) will be limited to real property. The ability to defer gain recognition on exchanges of tangible personal property (machinery, airplanes, etc.) is repealed for years beginning after 2017.

Income Tax - Corporate Taxpayers

- **Tax Rate** - The current tax rates which have been applicable to corporate taxpayers are as follows:

Corporate Income Tax Rates
through 2017

Taxable Income ≥	Taxable Income ≤	Tax Amount is		
$0	$50,000	$0	+	15%
$50,000	$75,000	$7,500	+	25%
$75,000	$100,000	$13,750	+	34%
$100,000	$335,000	$22,250	+	39%
$335,000	$10,000,000	$113,900	+	34%
$10,000,000	$15,000,000	$3,400,000	+	35%
$15,000,000	$18,333,333	$5,150,000	+	38%
$18,333,333				35%

For tax years beginning after December 31, 2017, the corporate tax rate is a flat 21% of taxable income. There is no special rate for personal service corporations. This tax rate is applicable to "C corporations". Income from "S corporations" is taxable to the shareholders of the corporation, with the benefit of the 20% deduction on "pass through" income described above to the extent the requirements are met.

Alternative Minimum Tax - The corporate alternative minimum tax is repealed. Note, this might beneficially impact funding buy-sell arrangements with corporate owned life insurance.

- **Bonus Depreciation** - Increased from 50% to 100% for "qualified property" placed in service after Sept. 27, 2017 and before 2023. Sec. 179 expensing for tangible personal property placed in service after 2017 is increased to $1,000,000.
- **Interest Deduction** - Interest deductions for businesses with average annual gross revenue over $25 million for the three prior years generally are limited under the Act to 30% of the corporation’s adjusted taxable income computed without regard to depreciation, amortization, or depletion deductions for taxable years beginning after 2017 and before 2022.

- **Other Deductions** - The corporate deductions for entertainment expenses and membership dues are repealed. Expenses for certain meals and beverages will continue to be 50% deductible when associated with operating a trade or business Interest deductions for corporate taxpayers will be subject to some new limitations, generally 30% of adjusted taxable income. There are exceptions for smaller businesses.

- **Net Operating Losses** - Net operating losses (NOLs) are deductible only up to 80% of taxable income (determined without regard to the deduction). Under pre-Act law, they were fully deductible. NOLs cannot be carried back to prior years, as was permitted under pre-Act law (certain exceptions for farming and some insurance companies,) but indefinite carryforwards will continue to be allowed.

Estate Planning Beyond 2017

These changes in the tax environment will bear review by almost everyone who has engaged in estate planning for their family. However, we must keep in mind that the "tax tail" should not be allowed to "wag the dog." It is always best to begin an estate planning discussion by identifying the objectives which one wishes to achieve, <u>other than minimizing taxes.</u>

- **Review Current Wills and Trusts** - It is especially important to look at the structure of current estate planning documents considering the impact of the increased estate tax exemption on formula clauses. There may no longer be a tax reason to fund a credit shelter trust at the death of the first spouse, and if there are other reasons why such a trust is desirable then using the estate tax formula to define it may now be inappropriate.

- **Review Application of GST Tax** - Even with no estate tax liability, many people are interested in "protecting assets" through younger generations, to avoid having the family wealth dissipated through improvident investments, bad marriages, etc. Such plans generally employ multi-generation trusts for which the GST tax will be an issue, and the GST Exemption is not portable. A QTIP trust for the surviving spouse, coupled with a "reverse QTIP election" can preserve the first deceased spouse's GST exemption.

- **<u>Basis Adjustment Planning</u>** - For most families, the estate tax will no longer be a problem, but there will still be great value in planning to minimize income tax. The assets of a decedent's estate are still qualified for a basis step-up under §1014, even though there is no estate tax liability.
  - **<u>Give Beneficiary a Testamentary General Power.</u>** Consider providing that, upon the death of a trust beneficiary, the beneficiary might have a power to direct distribution of the trust property to his creditors, the extent that his estate is otherwise solvent.

– **Use a Retained Income Gift Trust for Gifts of Appreciating Property.** The big disadvantage of gifting is the loss of the basis step-up at the donor's death. Such gifts only remove from the donor's estate the growth and income from the property after the date of the gift. The donor can create a trust under which the donor retains the right to all the income for life, with the remainder at death passing to children (or trusts). For gift tax purposes, the donor is treated as having made a completed gift of the entire trust corpus (using the exemption to avoid paying any gift tax.) Then, from year to year, the trust can allow for distribution of all appreciation in value to the children or their trusts. Each year, all of the growth is carved out and transferred to the children, which does not constitute a gift. When the donor dies, the original trust property is included in the donor's estate under §2036, causing a basis step-up and restoring the full value of the exemption used to make the gift.

- **<u>Gifts to Spousal Support Trusts</u>** - Gifts to a trust for the support of the donor's spouse can be an attractive way of using the increased exemption before it reverts to the lower amount, while preserving access to trust income. This can actually work with both spouses making such gifts to a trust for their respective spouse, but care must be taken to avoid the reciprocal trust doctrine.

- **Decanting to Undo or Revise Prior Planning** - Many people will find that they have irrevocable trusts in place which are no longer important for avoidance of estate taxes. In addition, those trusts may not provide the level of asset protection for the beneficiaries which would be preferred. In many such cases, a new trust can be created which reflects the current wishes of the family, and assets of the current trust can be transferred to the new trust. Many states have statutory law which governs these transactions. Georgia has no statutory law, but has established common law which often permits such planning by the trustee of the existing trust.

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