ORANGE Bank&Trust COMPANY

ESTATE PLANNING REPORT

Orange Bank & Trust Company • Trust Services Division

Inaugural Issue

PLANNING THOUGHTS

Early responses to TCJA

Estate planners still are digesting the implications of the Tax Cuts and Jobs Act of 2017. There may be some unexpected consequences from retargeting the federal estate tax to the very largest estates.

"Upstream" estate planning

The doubling of the amount exempt from the federal estate tax has shifted the focus of tax planners from death taxes to the basis step-up at death. Forgiveness of tax on built-in capital gains can be very valuable. Techniques used to reduce asset valuations for intrafamily transfers, so as to reduce transfer taxes, may prove counterproductive if they impair the step-up in basis.

Some estate planners are using creative ways to capture additional basis boost. Given the large exemption, these ideas are more worthwhile than they were in the past. Some strategies were reviewed recently in *Tax Notes* by Jonathan Curry ["TCJA Supercharges 'Upstream' Estate Tax Planning Techniques," April 2, 2018].

Run the money through an elderly parent's estate

One approach is to involve an elderly relative who has little wealth. Carlyn McCaffery outlined a scenario in which a wealthy individual has $10 million worth of highly appreciated securities to be transferred to children. An irrevocable trust would be created, funded with the securities. An elderly parent would be given a general power of appointment over the trust. At the parent's death, there will be an estate inclusion, triggering the basis step-up. Assuming that the current estate tax exemption levels are still in place at the parent's death, there is no transfer tax cost for the basis step up.

Of course, there is the danger that someone who has a power of appointment over a trust may choose to exercise it, diverting the trust assets away from the intended beneficiaries. The simplest solution to that potential problem is to not inform the power holder of the existence of the power, according to Jonathan Blattmachr. "The cases are legion that the assets are included in your estate under section 2041 even if you didn't know about the general power," he said.

A less devious alternative would be to provide that the power only can be exercised with the consent of an adverse party.

GRATs

A grantor retained annuity trust (GRAT) also may be employed to capture added basis step-up. In the usual GRAT, a trust is established for a term of years, with the grantor retaining annuity payments sufficient to bring the gift taxes on the funding of the trust down to zero. When the trust terminates, the remaining trust assets (if any) pass to children or other beneficiaries at no additional gift tax cost. The strategy works best if the assets appreciate significantly during the trust term.

The new approach is to make a parent the remainder beneficiary, so as to obtain a basis step-up for the assets before they pass to the children. This also transfers future growth in the trust assets tax free, What's more, the parent may use his or her generation-skipping transfer tax exemption to apply to the trust. The donor will have used up only his or her own lifetime gift tax exemption.

Life insurance

The role of life insurance in estate planning is being reevaluated by many. If an estate is not likely to owe federal estate tax, why keep the policy in force? The question becomes more acute if variable premiums were set using investment return assumptions that haven't been met. In that case, the policyholder may be looking at a premium increase for an asset no longer seen as necessary for easy estate settlement.

The first point to remember is that the exemption increase is temporary; it expires in 2026 under current law. Some have argued that the exemption will be reversed sooner than that if the presidency changes hands in 2020. Unless the policyholder can guarantee a death before the federal exemption returns to its 2017 level, the life insurance still will play an important role in the estate plan.

The second point is that the growth in value of life insurance accumulates tax free, and the future payment of proceeds also will be free of income taxes. That tax freedom is hard to beat by investing in a taxable portfolio.

Still, if Congress should move to make the exemption permanent, or even eliminate the federal estate tax entirely, prospects for the life insurance industry will shift dramatically.

CASES AND RULINGS

2018 unified credit is revised.

Rev. Proc. 2018-18, 2018-10 IRB 392, modifying Rev. Proc. 2017-58

Last fall the IRS announced that the federal estate and gift unified credit for 2018 would be $5.6 million. When the exempt amount was doubled in the Tax Cuts and Jobs Act (TCJA), most people assumed that meant the 2018 exemption would be $11.2 million. Not quite.

TCJA changed the manner for determining inflation adjustments for the tax code. Instead of the Consumer Price Index, a chained CPI will be used, which takes into account the fact that consumers may make substitutions in purchases as prices rise. The change is expected to slow the rate of increases to inflation-linked tax provisions.

The new rule applies to the unified credit. Accordingly, the IRS has announced that the 2018 unified credit will be $11.18 million, a reduction of $20,000.

The CPI is reported monthly, but the chained CPI is reported annually, in February, and is finalized one year later. Unless the government alters its schedule for the calculations, this may at times make it impossible to know the exact current value of the unified credit.

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An FSC is not a DISC.

Celia Mazzei et. al. v. Comm’r, 150 T.C. No. 7

In 1977 Mazzei obtained a patent for an injector that mixes chemicals with water, and he started a business selling injectors in 1978. The business prospered. In 1984 he began selling injectors overseas through foreign distributors.

Mazzei was a member of the Western Growers Association (WGA). Sometime in the 1990s, WGA began a program that combined interests in a foreign sales corporation (FSC) with an IRA. In 1998 the Mazzei family signed up. Mazzei, his wife, and his daughter each funded a Roth IRA with $2,000. An FSC was formed to handle Mazzei’s foreign sales, and each Roth IRA purchased a one-third interest in the FSC. The family accountant looked over the arrangement and declared it to be legitimate.

Each year the FSC collected payments for foreign sales, paid appropriate U.S. taxes, and distributed the balance as dividends to the Roth IRAs. Over a five-year period, more than $500,000 was sent to the three Roth IRAs.

The IRS came after the Mazzeis for excess contributions to their Roth IRAs. The Tax Court concurs, using a substance over form analysis. The Roth IRAs were exposed to no risk, and they had no upside potential. The company controlled by the Mazzeis had complete discretion in directing payments to the FSC. Accordingly, the payments to the Roth IRAs were not dividends but contributions by the owners. The only solace for the taxpayers was that penalties were abated because they relied upon professional advice in implementing their plan.

A vigorous dissent points out that the Tax Court recently was reversed by the Sixth Circuit Court of Appeals in a nearly identical case [*Summa II*, 848 F.3d 779, reversing T.C. Memo 2015-119). The dissent suggests that the majority is acting like Caligula, who posted tax laws in fine print and so high that the Romans could not read them, because the majority is substituting judge-made law for the clear language of the tax code.

The majority answered that *Summa* involved a Domestic International Sales Corporation, not an FSC, and *Mazzei* is appealable to the Ninth Circuit, not the Sixth.

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Resolution of an ambiguous phrase in a trust does not sacrifice GSTT "grandfather" status.

Private Letter Ruling 201814002

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

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

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

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

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

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2010 basis elections still are being made.

Private Letter Ruling 201749003

2010 was the year without an estate tax. The trade-off was that it was also the year without an automatic basis step-up for inherited property. Instead, estate executors were required to allocate basis adjustments to the property passing through the estate. The general allocation was $1.3 million (reduced to $60,000 for nonresident noncitizens), and an additional $3 million was allowed for property received by a surviving spouse.

The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 reinstated the estate tax for 2010, but it also gave executors of estates of decedents dying in that year a choice. They could elect to dodge the estate tax and have the basis adjustment rules apply instead. The date for making that election was set at November 15, 2011 [Notice 2011-66, 2011-35 I.R.B. 184], and later was extended to January 17, 2012 [Notice 2011-76, 2011-40 I.R.B. 479]. However, the IRS did leave the door ajar, by stating that executors might get an extension of the due date under IRC §301.9100-3.

That was the relief requested in this private ruling. Decedent was a nonresident alien who died in 2010. His surviving spouse received his U.S. situs property. The spouse did not make the election in a timely manner, but no reasons are suggested in the ruling for the failure. Nevertheless, the spouse now wants to make the election.

The IRS holds that the spouse reasonably and in good faith relied on a qualified tax professional, and the tax professional failed to make, or failed to advise the spouse to make, the election. Another 120 days was granted for filing the paperwork.

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WASHINGTON TALK

Technical corrections work under way. The Joint Committee on Taxation has begun its analysis of the Tax Cuts and Jobs Act to find areas where the legislative language appears garbled or not matched properly to legislative intent, according to the JCT Chief of Staff, Thomas Barthold, at a Federal Bar Association conference in early March. It's apparently going to be a big job, comparable to the Tax Reform Act of 1986, which was enacted on a much longer time frame. Whether a technical corrections bill appears this year is uncertain, as Democrats have signaled that they may need extensive hearings on the matter before proceeding.

Some 26 tax provisions expired in 2017, mostly in the energy area. At a mid-March hearing, there were 22 witnesses testifying in favor of extending these credits and tax favors for at least another year. House Ways and Means Committee Chair Kevin Brady (R-Texas) dislikes temporary tax provisions that need to be revisited annually, especially given the substantial tax overhaul just enacted in December. He appears to favor making some provisions permanent, while allowing the rest to lapse. The preliminary estimated cost of making all the provisions permanent would be $92 billion over ten years. Some $35 billion of that amount would be for biodiesel support.

According to a new survey of CEOs, 69% foresee an increase in repatriated funds following the changes of the Tax Cuts and Jobs Act. Some 18% expect to repatriate 10% or more of their offshore earnings, and 66% will share the savings with their customers.

An unrelated survey of 137 CEOs showed a significant uptick in business optimism, though perhaps not directly related to the new tax law. Some 93% expect an increase in corporate sales in the next six months, and 68% foresee an increase in capital spending. Both figures are up sharply from the final quarter last year.

IRS Criminal Investigation division Chief Donald Fort told a Federal Bar Association conference that IRS is increasingly concerned about the role of virtual currencies, such as bitcoin, in tax fraud cases. Use of these currencies makes it much harder for the IRS to "follow the money." The reporting of gains and losses from the use of virtual currencies has been lax. In some cases virtual currency has been used in place of an ordinary bank account, thus escaping IRS scrutiny. Should virtual currency usage become more routine in business transactions, the IRS' challenge will be magnified.

Senate Democrats have released a proposal for funding more government spending on infrastructure. Revenue would be obtained by scaling back the just-enacted Tax Cuts and Jobs Act. Specific targets include:

- reversal of the enlarged exemption from the alternative minimum tax;
- reversal of the doubling of the unified credit against estate and gift taxes;
- raising the corporate tax rate to 25%;
- closing the carried interest loophole; and
- bringing back a 39.6% top income tax rate.

All told, these changes are projected to increase federal revenue by roughly $1 billion over the next ten years. An increase in the gas tax was not a part of the proposal. Query: Does this mean that the Democrats finally have given up on the idea of lowering to $3.5 million the amount exempt from federal estate tax?

Catherine Hughes from the Treasury Office of Tax Legislative Counsel told a February meeting of the ABA Section of Taxation that there is some uncertainty about the deductibility of executor and trustees fees, now that miscellaneous itemized deductions no longer are permitted. There's also a question concerning those fees when an estate or trust terminates. Excess deductions may be miscellaneous deductions in the hands of the beneficiaries, even if they were not so characterized in the hands of the terminating entity.

Hughes also told the group that the Service is working on guidance to avoid clawbacks in the event the unified credit drops back to $5 million, as now scheduled. Gifts that were not taxable when made should not become taxable in an estate in a later year simply because the unified credit is reduced (something that never has happened in the history of the federal transfer tax). The concept is easy to state, but the guidance may prove difficult to write.

In February the IRS warned of a new scam variation that begins when scammers steal information from tax professionals. The criminals then deposit money in the taxpayer's real bank account.

In one version of the scam, criminals posing as debt collection agency officials acting on behalf of the IRS contacted taxpayers to say that a refund was deposited in error, and they asked the taxpayers to forward the money to their collection agency. In another version, the taxpayer who received the erroneous refund gets an automated call with a recorded voice saying that he is from the IRS and threatens the taxpayer with criminal fraud charges, an arrest warrant, and a "blacklisting" of their Social Security Number. The recorded voice gives the taxpayer a case number and a telephone number to call to return the refund.

Erroneous refunds are possible, and the IRS has a process in place to return them. They do not involve buying gift cards or doing wire transfers.

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