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Estate Planning and Tax Reform: Wealth Transfer Structures Under the New Tax Law

TUESDAY, FEBRUARY 5, 2019

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Today's faculty features:

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Estate Planning and Tax Reform: Wealth Transfer Strategies under the New Tax Law

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New U.S. Tax Rules

Historic Tax Reform (Tax Cuts and Jobs Act):

- Changes to tax rates for individuals and corporations
 - Individual Tax Rates:
 - Still 7 tax brackets
 - 37% top tax rate (previously 39.6%)
 - 3.8% NIIT remains – 40.8% highest rate (previously 43.4%)
 - Long term capital gain rates of 0%, 15% and 20%
 - Corporate Tax Rates:
 - Flat 21% rate (previously 35% top rate)
 - Change is permanent
- Dramatic impact on non-U.S. persons investing in the U.S.

New U.S. Tax Rules

Tax Deductions and Exemptions:

- Changes to itemized deductions
- Increased estate tax exemption
 - \$11,400,000 gift and estate tax exemption (U.S. persons)
 - Reverts to \$5,700,000 (indexed for inflation) in 2026
 - \$11,400,000 generation skipping transfer tax exemption (U.S. persons)
 - Proposed 20.2010(c)-1 regulations – no clawback
 - **Non-U.S. person estate tax exemption remains at \$60,000**
 - No gift tax exemption amount beyond \$15,000 annual gift tax exclusion
 - Exception: \$155,000 annual gift tax exclusion to non-citizen spouse
 - Offshore corporate devise still feasible

New U.S. Tax Rules

20% Qualified Business Income Deduction:

- Qualified Business Income: domestic net income from all qualified U.S. trades or businesses
- Specified Services and W-2 Wage Limitation:
 - Taxable income below \$157,500 (\$315,000 for married filing jointly) – no limit
 - Taxable income above \$157,500 (\$315,000 for married filing jointly) – limitation in phases:
 - Lesser of
 - (1) 20% of QBI and
 - (2) greater of (i) 50% of the W-2 wages paid or (ii) 25% of W-2 wages paid plus 2.5% of certain capital assets
 - Phaseout for specified service trade or business: health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services and “reputation based businesses”

New U.S. Tax Rules

Carried Interest:

- 3-year holding period for long-term capital gain
 - Capital gain passed through to fund managers via partnership profits in to or held exchange for investment management services
 - “Applicable Partnership Interest” - partnership interest that is transferred by a taxpayer in connection with the performance of services by the taxpayer or a related person in any applicable trade or business, even if the taxpayer made contributions to the partnership
- Lack of clarity if applicable to S-Corps
- Lack of clarity on how to calculate 3-year holding period

New U.S. Tax Rules

Choice of Entity:

- C-Corp, S-Corp or passthrough
 - Changes in rate structure and limitations on deductions makes choice complicated
 - Old tax rate structure favored passthrough entities
 - Capital intensive businesses that reinvest rather than distribute profits may prefer corporate structure with lower tax rate
 - S-Corps receive special treatment under new law
- Decreased corporate tax rate changes investment structures – review existing investment structures
 - Corporate rates may change structures for substantial commercial real estate investments

New U.S. Tax Rules

Disposition of Foreign Partnership Interests:

- New tax law affects structuring foreign investment in U.S.
 - Territorial approach to taxing disposition of foreign partnerships
 - Foreign partner in domestic or foreign partnership may be treated as effectively connected to U.S. trade or business
 - Gains from sale of interest in partnership potentially taxable to non-U.S. seller
 - 10% withholding tax on sale of partnership interests unless transferor certifies that is not a foreign corporation or non-U.S. person

New U.S. Tax Rules

Elimination of 30-Day Rule:

- New tax act eliminated 30-Day Rule
 - U.S. beneficiaries of foreign trusts and estates previously had 29 days to cure controlled foreign corporation tax problems in the estate
 - Expanded definition of U.S. shareholder – includes U.S. person who owns at least 10% of vote or 10% of value of foreign corporation
 - One day of ownership of “tainted” assets may produce phantom income for U.S. shareholders
 - Irrevocable trust may avoid the 30-Day Rule trap
 - Potential negative capital gains consequences for U.S. beneficiaries
 - Private Placement Life insurance is a potential solution

New U.S. Tax Rules

Foreign Anti-Deferral Regime:

- New tax act mandates that U.S. shareholders of controlled foreign corporation include in income their ratable share of CFC's global tangible low-taxed income (GILTI)
 - Similar to Subpart F income

Planning in Light of Changes

General:

- Prioritize updating wills
- Make gifts to utilize higher estate, gift, and GST tax exemption
 - Scheduled to sunset in 2026, but there are two presidential elections before then
- Asset titling is even more critical
 - Portability mitigates estate tax issues, but not GST tax

Planning in Light of Changes

Gifts Now:

- Proposed regulations indicate no clawback—use it or lose it
- If access to assets is still needed, can use inter vivos QTIP, SLAT
- *Wandry*-type defined value clauses can protect against tax and also make sure you use the most exemption possible

Planning in Light of Changes

Greater Emphasis on Income Tax Planning/Basis Step-Up:

- Making existing trusts includible
 - Encroach principal
 - Modify/decant
 - Create GPA if permitted under the terms of the trust
 - Trigger Delaware Tax Trap – Section 2041(a)(3)
- Exercising substitution power can move high-growth assets into estate to maximize basis step-up
- Upstream planning
 - Limited by § 1014(e)

Planning in Light of Changes

Greater Need for Flexibility:

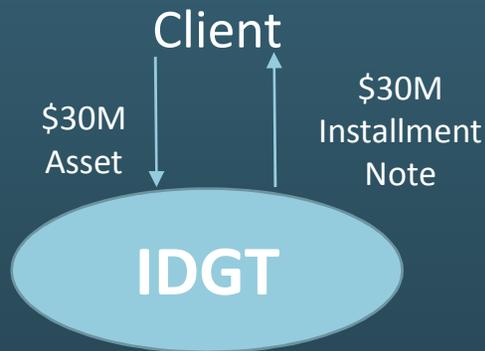
- Preserving ability for post-mortem planning
 - QTIP-able credit shelter trusts
 - Disclaimer trusts

Planning in Light of Changes

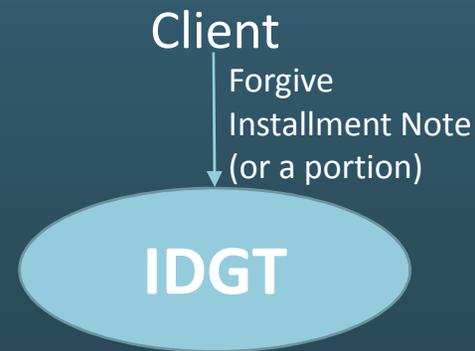
Gift Planning:

- Sale to IDGT can provide ready-made method of using exemption before it expires

2019



2025



Planning in Light of Changes

GST Exemption Planning:

- Upstream planning to utilize older generation's excess GST exemption
- Pre-fund generation-skipping ILITs as part of GST exemption usage
 - If GST exemption goes back down and client has no exemption remaining, client cannot make further contributions without causing mixed inclusion ratio

Planning in Light of Changes

GST Exemption planning:

- Inter vivos QTIP w/ reverse QTIP election
 - Useful if excess GST exemption but no gift/estate exemption
 - On beneficiary spouse's death, original donor spouse can become a beneficiary (and QTIP election can be made again)
 - Preserves continued access to assets at parents' level
 - Per Treas. Reg. § 25.2523(f)-1(f), *Ex. 10, 11*, future contingent income interest does not cause inclusion under §§ 2036 and 2038 if donor spouse dies first
 - Many states' spendthrift laws do not consider this a self-settled trust

Planning in Light of Changes

States with lower exemption amounts:

- Even more reason to make gifts now
 - Even states with estate tax generally have no gift tax
 - New York's 3-year inclusion rule does not apply to decedents dying on or after January 1, 2019
- “Lesser of” formulas for credit shelter trusts
- Most states do not allow portability

A Look Ahead to 2026

Planning with Little or No Exemption Remaining:

- Even if exemption does not actually go back down in 2026, clients may use exemption in anticipation of decrease
- Post-2025 transfers may incur gift and/or GST tax
 - Benefits of making gifts even if tax incurred
 - Lower effective gift tax rate than estate tax rate (28.6% vs 40%)
 - Earlier gifts make Section 2035(b) less likely to apply
 - Disadvantages of making gifts and paying tax
 - Incurring tax now means property generates less income
 - Lost basis step-up
 - Removing appreciation from estate is transfer tax-neutral

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Ms. McCall is a Pillsbury partner and the Chair of the firm’s Estates, Trusts and Tax Planning practice who has been recognized by Chambers for the National, Western and Northern California Regions and by Best Lawyers and Super Lawyers in California and New York. She has been named Wealth Management Lawyer of the Year for the last 3 years (2017-2019) by Corporate INTL and M & A Today. She is based in the Silicon Valley, New York and Palm Beach offices and represents private clients. She is a leading authority on U.S. and international gift and estate planning. Ms. McCall is admitted to practice law in California, Florida and New York.

Ms. McCall crafts tax-savings business succession and estate transfer plans that preserve wealth and enhance family relationships. Her clients include internationally renowned museums and corporations, charities, foundations, high net worth families and individuals, fiduciaries and nonprofits. Jenny's experience includes complex trust and estate administration and litigation; gift and generation-skipping transfer taxes; spousal rights of election and rights of adopted children; endowments; and tax aspects related to disposition of corporate holdings and financial transactions.

Ms. McCall is a Fellow of the American College of Trust and Estate Counsel (“ACTEC”), where she serves as a member of the *International Tax Planning* and *Estate and Gift Tax* committees. She has lectured extensively and conducts seminars on estate and tax planning.

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Tyson D. Willis is an associate in the Private Wealth Practice of Arnall Golden Gregory LLP.

Mr. Willis focuses his practice on crafting and implementing successful wealth transfer planning strategies, including estate and gift tax planning, charitable giving, family business succession planning, and estate administration. Mr. Willis also has experience in creating and advising tax-exempt organizations, including both public charities and private foundations.

Mr. Willis received his juris doctor from Harvard Law School, and his LL.M. in Taxation from New York University where he was an M. Carr Ferguson Scholar and a research assistant to Professor Noël Cunningham in preparing the fifth edition of *The Logic of Subchapter K*. While earning his JD, Mr. Willis worked as a teaching fellow in the Harvard economics department, and was a semi-finalist in the ABA Law Student Tax Challenge where his team received the award for Best Written Submission. Prior to attending NYU, Mr. Willis worked as a prosecutor.

Mr. Willis enjoys playing tennis and spending time with his wife and four children.

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