FEATURE:
ESTATE PLANNING & TAXATION

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Trust Planning After the New Tax Law

New perspectives that may be useful to some clients

President Donald J. Trump signed into law the Tax Cuts and Jobs Act of 2017 (the Act) (more formally referred to as "An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget") on Dec. 22, 2017.[1] The Act made many significant changes directly affecting trust taxation and planning. Some include:

- a different tax rate schedule;
- elimination of many itemized deductions;
- permitting trust-owned pass-through entities to qualify for the favorable tax treatment afforded those entities;
- severe restriction of state and local tax (SALT) deductions by individual itemizers that might change the nearly ubiquitous default rule of creating grantor trusts in favor of non-grantor trusts;
- the pressure for moderate wealth families (about $6 million to $8 million for individuals and $12 million to $15 million for couples) to use the increased temporary wealth transfer tax exemptions by making completed gifts to irrevocable trusts; and
- new electing small business trust rules.

The Act also changed many traditional planning paradigms and, as a result, has had a more significant effect on trust planning than just its direct changes might suggest. We'll explore some of these. While there are risks and uncertainties with some of the planning ideas suggested below, the goal is to identify new perspectives on planning that might be useful to certain clients. No doubt, given the complexity and scope of the Act, new concerns, planning ideas and interpretations will evolve.

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SALT Limitations

A key change made by the Act was to cap deductions for SALT to $10,000 a year. This change will require reconsideration of trust planning:

- When will non-grantor trusts make more sense than grantor trusts for certain settlors in high tax states? You must evaluate that question considering the other changes to the planning environment, such as the temporary doubling of the transfer tax exemptions.
- Can trusts be structured to expand the amount of allowable SALT deductions?
- Trustees may need more closely to monitor distributions when the distributable net income (DNI) attributed to beneficiaries in high income tax states will face a greater net tax cost because of the loss of SALT deductions.

DNI Distributions and SALT

Fiduciaries may have to monitor more closely trust income and distributions of DNI post-Act. For example, if a beneficiary is in a state with no income tax, should distributions be made to that beneficiary to pass trust income out at a lower net tax cost considering the limits on SALT deductions that might adversely affect a beneficiary in a high tax state? Will that tax benefit outweigh the impact of addressing the issues of unequal distributions or loss of asset protection afforded by the trust? Might the trustee loan funds to the beneficiary in the high tax state, thereby avoiding DNI flowing out to that beneficiary (understanding that the trust will have

taxable interest by reason of the loan)? Will the trustee be willing to make unequal distributions if doing so overall saves income taxes? If $50,000 is distributed to a beneficiary in a no tax state and a loan of $50,000 is made to a beneficiary in a high tax state, will the Internal Revenue Service or a state taxing authority respect the loan or recharacterize it as a disguised DNI distribution?

Another new consideration in monitoring distributions is the possible impact on a beneficiary trying to maximize the new Internal Revenue Code Section 199A deduction. The new pass-through entity 20 percent deduction is limited, in general terms, to the lesser of the taxpayer's combined qualified business income or an amount equal to 20 percent of the excess of the taxpayer's taxable income for the taxable year, over the sum of the taxpayer's net capital gains. Might the trustee inquire of beneficiaries whether they require additional income to fully use their IRC Section 199A deduction under the formula limitation? Alternatively, might a beneficiary need to limit taxable income to avoid the phase-out under 199A? If so, perhaps the trust can use the 65-day rule under IRC Section 663(b) to make a distribution of income following the close of the tax year and elect to have it treated (but only to the extent of the greater of DNI or fiduciary accounting income) as pertaining to the prior tax year to facilitate the beneficiary qualifying. Note that DNI may be greater relative to the post-Act fiduciary accounting income because of the elimination of itemized deductions subject to the 2 percent floor.

One of the issues to consider in post-Act trust planning is whether additional tax benefits might be achieved by bifurcating a trust.

Trust Payments of Property Taxes

SALT deductions are limited, but how will the limitation apply to trusts? Section 11042 of the Act provides in part:

> In the case of an individual and a taxable year beginning after December 31, 2017, and before January 1, 2026 … the aggregate amount of taxes taken into account … for any taxable year shall not exceed $10,000 … The preceding sentence shall not apply to any taxes described in paragraph (1) and (2) of subsection (a) which are paid or accrued in carrying on a trade or business or an activity described in section 212.

IRC Section 212 provides in part:

> In the case of an individual, there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year—(1) for the production or collection of income; (2) for the management, conservation, or maintenance of property held for the production of income…

Assume the trust instrument for a directed trust designates that the investment trustee (advisor) must approve the trust's purchase of personal use residential property. That would squarely put the determination of the decision in the realm of being an investment decision, not a distribution decision. Would that suffice to characterize a personal use residence or vacation home as an investment property held by the trust so that the SALT limitation on property tax arguably wouldn't apply? It seems unlikely that this would suffice to characterize a personal use residence as a Section 212 asset.

Dividing Trusts

One of the issues to consider in post-Act trust planning is whether additional tax benefits might be achieved by bifurcating a trust. For example, if one non-grantor trust owns three vacation homes, one used by each of one of the three trust beneficiaries, will the property taxes on those homes be limited to a single $10,000 SALT deduction? It may appear to be so. Might that cap be tripled if the trust were divided into three separate trusts, or three separate trusts were created from inception with substantive differences, so that each trust owned a home and thereby might avail itself of a separate $10,000 property tax deduction? Perhaps. One of the hurdles in this approach are the anti-abuse rules under IRC Section 643(f):

> …under regulations prescribed by the Secretary,

> 2 or more trusts shall be treated as 1 trust if—(1) such trusts have substantially the same grantor or grantors and substantially the same primary beneficiary or beneficiaries, and (2) a principal purpose of such trusts is the avoidance of the tax imposed by this chapter. For purposes of the preceding sentence, a husband and wife shall be treated as 1 person…

However, no such regulation has been adopted or even proposed. The trust instrument itself might permit the trustee to divide the trust, but if the change is significant, the trustee might prefer a non-judicial modification agreement be used instead. Depending on state law, the beneficiaries may be able to agree to modify a single sprinkle trust into three separate trusts pursuant to a non-judicial modification agreement. For example, Delaware statutes Title 12, Section 3342 permits an irrevocable trust to be modified to include any provision that could be included in a governing instrument on the date of the modification with the written consent or written non-objection of the settlor (who must be living), all fiduciaries and all beneficiaries.

The rationale supporting such a division could include an array of reasons. For example, each beneficiary would like to be able to receive distributions and access to trust assets without the other beneficiaries being considered or informed. The IRS may view any trust division that enhances the SALT deduction as suspect, but in the absence of regulations under Section 643(f), the IRS might not prevail in trying to ignore the division into three separate trusts. When the IRC authorizes the issuance of regulations and none are in fact issued, the effect is unclear. In some cases, the courts hold that the regulations are self-executing—the IRC provision is to be given effect even though no regulation has been issued. In other cases, the courts hold that, in the absence of regulations, the IRC provision is ineffective.[2]

BDT Variation

A trust described in and governed by IRC Section 678, commonly known as a "beneficiary defective trust" (BDT), has traditionally been used by a lower wealth settlor (that is, someone with little or no need for estate planning) who creates a trust for a wealthy heir. The trust is structured to be grantor as to the beneficiary/heir, not as to the settlor. This is accomplished through the use of a $5,000 gift to an irrevocable trust with a power of withdrawal, described in the section, which lapses after a time (commonly called a "*Crummey* power"). That heir would often sell assets to the BDT to remove them from her estate, in exchange for a note from the trust. A new spin on the traditional application of a BDT may be useful in limited circumstances after the Act. A wealthy settlor with business interests who resides in a high tax state but has an heir in a low tax state could create a BDT. The BDT, as in the past, would be grantor as to the heir/beneficiary. The parent/settlor could then transfer a business opportunity to the trust so that the income from that opportunity would inure to the trust and be taxed to the heir in a low or no tax state.[3]

Traditional estate tax minimization planning should continue apace given that the estate tax wasn't repealed, and the new exemption is only temporary.

Temporary Exemption Increase

Clients should consider the merits of using the new increased exemptions before they sunset or before a future administration changes the law and rolls back the new exemption amounts. For ultra-high-net-worth (UHNW) clients, the use of the exemptions may simply serve to enhance or expand ongoing planning efforts. However, for moderate wealth clients, using as much of the new exemptions as feasible before they sunset or are changed by a future administration will be more challenging and impacts planning in several ways:

- Moderate wealth clients may need access to trust assets to be comfortable making such large transfers.
- How that access is provided, and the interplay of the SALT rules, may change how practitioners opt to structure some trusts.

- Moderate wealth clients may be inclined to "use it before they lose it" with the new increased exemptions resulting in transfers that are more significant as a percentage of their wealth than traditional trust transfers may have been. Practitioners might consider phasing gift transfers over several future years, obtaining a signed solvency affidavit (even if not required, for example in states like Alaska) prior to each transfer and taking other steps to deflect arguments of a fraudulent conveyance.

Here are several variations in planning for different types of client situations, considering the above objectives.

Moderate wealth clients in low tax states. These clients' objectives are to use the temporary increase in the exemption and preserve access to assets transferred. Moderate wealth clients will need access to assets if they're to gift large new exemption amounts to irrevocable trusts. Traditional grantor trusts that are spousal lifetime access trusts (SLATs), domestic asset protection trusts or other variations the planner might feel comfortable with, and similar planning as common in the past, may be appropriate.

Moderate wealth clients in high tax states. These clients may also wish to use the temporary increase in the exemptions and preserve access to assets transferred, but also save high state income tax. The interplay of a completed gift to use the exemption with a non-grantor trust to save state income tax raises complications different from most traditional planning. Can a non-grantor completed gift SLAT be created? The grantor is treated as the owner of any portion of a trust whose income, without the approval or consent of an adverse party, is or may be in the discretion of the grantor or a non-adverse party or both, distributed to the grantor's spouse or accumulated for future distribution to the grantor or the grantor's spouse.[4] The grantor is treated as the owner of any portion of a trust if the income may be paid to the grantor's spouse without the consent of an adverse party.[5] So, if an adverse party must approve distributions to the grantor's spouse, a SLAT can be a non-grantor trust. This will be a complicated needle to thread. The determination of what constitutes an adverse party is difficult and, in general, uncertain, and the approval itself might constitute a gift. The grantor must not retain: the right to direct disposition of trust income or property; the right to receive trust income; or the right to have the trust pay life insurance premiums on her behalf as that could cause the trust assets to be included in the grantor's gross estate at death. It may be preferable to use a separate irrevocable life insurance trust and not include life insurance on the life of the grantor or the grantor's spouse in a trust that's intended to be non-grantor, to avoid grantor trust status under IRC Section 677(a)(3). Moderate wealth clients wishing to use the new exemption amounts before sunset must use a completed gift for the trust. A gift is complete if the donor "has so parted with dominion and control as to leave him in no power to change its disposition."[6] However, if under the terms of the trust, the grantor retains the power to consent to distributions, the gift is considered incomplete as would be the case in an incomplete gift, non-grantor (ING) trust, as discussed in the article, "Fundamentals of DING Type Trusts."[7] A SLAT that's structured to be non-grantor to save SALT deductions may be referred to as a "SALTy SLAT."

UHNW clients in high tax states. These clients should use the temporary increase in the exemptions to continue existing or new planning (for example, gifts to existing trust structures). The remaining goal is only to save high state income tax. Traditional ING trust planning may be a solution to save high state taxes considering the SALT limitation and avoid incurring gift tax once the new exemption amounts have been used in other planning. Traditional estate tax minimization planning should continue apace given that the estate tax wasn't repealed, and the new exemption is only temporary. From an income tax perspective, UHNW clients in high tax states will be more apt than their wealthy counterparts in low tax states to pursue traditional ING trust planning. These trusts can save state income tax (except for New York, which has expressly legislated against this technique) without triggering gift tax on the transfers. New York Tax Law Section 612(b)(4) provides that when a transfer to a trust is incomplete for gift tax purposes, that trust will be characterized as a grantor trust for income tax purposes. Query whether other high tax states may consider similar modifications to protect their tax base.

For high income moderate wealth clients in high tax states, a variation of the tradition ING that's a completed gift trust, if feasible, may accomplish the dual goals of saving state income taxes and using the new doubled temporary exemption.

UHNW clients in low tax states. The objective for these clients is to maximize estate tax savings before

the sunset of the new exemption provisions or in case the estate tax planning pendulum swings in the opposite direction with the next administration. Traditional estate tax minimization planning with grantor trusts would be a likely planning pattern for these types of clients to continue to pursue.

Charitably Inclined Clients

There's yet another category of clients that might benefit from a variation of traditional trust planning in the new post-Act environment. Lower income clients (assuming that higher income clients may have sufficient charitable contributions to exceed the new doubled standard deduction) may still benefit from creative trust planning in at least one instance. This technique may offer an interesting option for clients who are charitably inclined and unlikely to receive sufficient benefit from bunching itemized deductions into one year or for those unwilling to time their charitable gifts to bunch them in one year. This planning concept may be useful for a religious client who's accustomed to tithing and who wishes to gain some income tax benefit from doing so. Because of the wealth required for this technique, these clients are referred to as being "merely" wealthy. The term "merely" in this context is intended to imply no need for estate tax planning of any significant nature (and hence is a lower wealth level than the moderate wealth level referred to above). This trust can be created to benefit a class of persons including descendants and charities. To avoid grantor trust status, neither the settlor nor the settlor's spouse can benefit from the trust. The client would create a relatively low cost trust in her home state, as it would be unlikely to justify shifting the trust to a more trust tax-friendly state. The client would gift a portion of her securities portfolio to the trust. Distributions to heirs or charitable contributions can be made in the designation of an independent distribution committee. Because the trust is characterized as a non-grantor trust, there's no standard deduction, and income is offset by the charitable contribution deduction so long as the requirements of IRC Section 642(c) are met. This assures that the contributions will provide an income tax benefit and leaves the standard deduction to offset non-trust income on the client's personal return. If the amounts available to allocate to charity exceed what's desired to gift to charity in a given year, those amounts could instead be directed to the heirs listed as beneficiaries of the trust. Although it's not widely known, the Section 642(c) deduction reduces DNI for discretionary distributions to the individual beneficiaries, for example, the settlor's children. Nonetheless, consider structuring and locating the trust so that any taxable income left in the trust wouldn't be subject to state or local income tax.

Example: The client is charitably inclined but lives in a low tax state and is unlikely to ever exceed the new standard deduction amounts. The client gifts $250,000 of marketable securities to a non-grantor trust to benefit named charities (for example, a house of worship the client donates to regularly), children and their descendants. There likely will be little concern about allocating generation-skipping transfer (GST) tax exemption to a trust that's an inefficient use of GST tax exemption (because much of the trust property won't pass to grandchildren or other skip persons who attract GST tax) because the transfer tax exemptions before the Act's doubling them already greatly exceeded the client's wealth. The $250,000 generates $12,500 of taxable income a year. The trustee pays $10,000 to charity and $2,500 to heirs. The trust deducts the $10,000 charitable contribution, and all remaining income passes out to the children as part of DNI. If the trust paid all $12,500 to charity and then made discretionary distributions of corpus to the children, the children would have no gross income to report from the trust.

Ripple Effects

The Act has made a myriad of changes that affect many areas of the tax law. The ripple effects of these changes and how they should be addressed for trust planning will result in more complex and granular planning. Generalizations of how to plan will be less helpful than in the past. Practitioners will have to apply traditional trust planning in new variations to meet the needs of different clients.

Endnotes

1. Public Law 115-97.
2. For a recent case exploring the issue, *see 15 West 17th Street, LLC v. Commissioner,* 147 T.C. No. 19 (2016).
3. *Cf. Bross Trucking, Inc. v. Comm'r*, T.C. Memo. 2014-107.
4. Internal Revenue Code Section 677(a).
5. *Ibid.*
6. Treasury Regulations Section 25.2511-2(b).
7. Jonathan G. Blattmachr and William D. Lipkind, "Fundamentals of DING Type Trusts," 26 *Probate Practice Reporter* 1 (April 2014).