DEVELOPMENTS IN WEALTH TRANSFER AND ESTATE PLANNING

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OVERVIEW

I. Transfer Tax and Trusts

II. Individual Income Tax Generally

III. Miscellaneous Income Tax Topics

IV. Background and Context of 2017 Tax Act

V. Corporate and Pass-Through Reform

VI. Entity Strategies

VII. Conclusions and Guesses

TRANSFER TAX

2017 TAX ACT CHANGES

- Main Change: Doubled Exclusion Amount
  - No transfer tax if married with less than $22M
- Continues Trend
  - Planning for transfer tax much less important
  - Planning for stepped-up basis much more important

- Prescribed Action
  - If will owe estate tax, give assets away
  - If will not owe estate tax, keep assets and get stepped-up basis
- Estate Tax Liability: function of
  - Future income and asset growth
  - Spending
    - How long you live
    - End of life expenses
  - Tax law at time of death

FUTURE OF THE TRANSFER TAX

- Logic
  - Very high exclusion amount *and* stepped-up basis???
  - Potential Outcomes
    - Reduce exclusion amount
    - Abandon estate tax in favor of capital gains recognition
- Economic and Budgetary Realities
- Politics and Income Inequality

DEALING WITH CURRENT STATE OF AFFAIRS

- Narrow in On Strata of Uncertainty and Complexity
  - Below \$10Mish: focus on basis
  - Between \$10Mish and \$30Mish: ??? 🤷‍♂️ 🤷‍♀️ 🙏
  - Over \$30Mish: carry on as before focusing on transfer tax
- Flexibility is King
  - Clayton QTIPs and similar strategies
  - Formula General Power of Appointment
- Don’t Be Lulled Into Complacency
  - Married couples with more than \$10M still need sophisticated planning

CONCRETE EXAMPLE

- Assume
  - Flat transfer tax rate 40% (which is actually the case)
  - Exclusion amount is round $22M
  - Flat capital gains tax of 20%
  - Smiths have $24M estate currently
    - Includes low-basis legacy position in KO

CONCRETE EXAMPLE

- Engaging in Estate Tax Planning Detrimental
  - Smiths give $4M KO to trust for kids ($1M basis)
  - Smiths dies with $18M
  - If Smiths had kept $4M
    - No transfer tax because estate would be $22M
    - Eliminate $3M of capital gain via step-up
  - Cost of losing step-up is $600K
    - $3M gain x 20% capital gains rate

CONCRETE EXAMPLE

- <u>Not</u> Engaging in Estate Tax Planning Detrimental
  - Smiths do no gifting and die with $26M
  - Estate tax liability of $1.6M
    - ($26M estate - $22M exclusion amount) x 40% transfer tax
  - Received stepped-up basis on $4M KO and saved $600K
  - Net loss of $1M

TRUST ADMINISTRATION

FLEXIBILITY

- Terminology
  - **Decanting**: trustee distributes assets to a new trust
  - **Modification by Consent**: modification of instrument based on consent of trustee, beneficiaries; perfunctory court proceeding with low standard
  - **Non-Judicial Settlements**: modification of instrument or ratification of action
  - **Judicial Modification**: requires proving of conditions to court
  - **Representation of Beneficiaries** ("virtual representation")

FLEXIBILITY TAKEAWAYS

- Old answers may not be good answers
- Potential Scenarios
  - Encourage total return investing
  - Facilitate investment in non-publicly-traded assets
  - Add powers of appointment to achieve estate inclusion and stepped-up basis (which encourages diversification and management)
- Highly complex area that requires sophisticated advice
  - Corporate fiduciaries may need to build additional expertise

DIRECTED TRUSTS

- Terminology: a "trust director" has the power to direct a "directed trustee"
  - E.g., trust director can be in charge of investments and directed trustee can handle reporting, record keeping, distributions, and other functions.
- Intent
  - Get corporate trustees to be willing to serve as directed trustees
  - Make sure trust director's directives get followed

DIRECTED TRUSTS

- Main Thrust of Statute
  - A directed trustee is not liable for following trust director's directives absent "willful misconduct"
  - A directed trustee is (and must be) a fiduciary
  - Robust set of rules governing responsibilities of and interaction between trust director and directed trustee

DIRECTED TRUSTS TAKEAWAYS

- Very clear and robust set of rules to allow an investment manager to serve as a "trust director" and family member or corporate trustee serve as the "directed trustee"
- Investment manager is a fiduciary, and this is a mandatory rule that cannot be altered
  - Necessary to relieve the directed trustee of all liability, which is necessary to get the directed trustee to accept the relationship and follow the directives of the trust director

ASSET PROTECTION

THE BASICS

- Keeping assets in trust
- Multiple beneficiaries and wholly discretionary
- Lifetime QTIPs (i.e., marital trusts)
  - Wife creates trust that pays all income (and potentially principal) to Husband
  - If Husband passes away before Wife, Wife becomes beneficiary of trust
  - Assets out of Wife's estate and not subject to claims of wife's creditors, even after Wife becomes beneficiary
  - Risk: divorce

Self-Settled Asset Protection Trusts (SSAPTs)

- GA/NC/SC/FL/AL Rule
  - Wife places assets in trust for Husband, children, etc.
    - Creditor protection
  - Wife places assets in trust for her own benefit
    - No creditor protection (“self-settled”)
- TN and Other “Trusts-as-Economic-Development-States”
  - If certain criteria met, wife can place assets in trust for her own benefit and have those assets protected from creditors
  - Effective in Georgia and other states???

INDIVIDUAL INCOME TAX

GENERALLY

- 2017 Tax Act: net result is very fact dependent
  - Likely more persons who not pay any tax
- Issues for Discussion
  - Cap on Deductibility of SALT
  - Increased Emphasis on State Income Tax Avoidance
  - Opportunity Zones
  - Captive Insurance Companies
  - Syndicated Conservation Easements

SALT LIMITATION

- Policy Justification: federal government should not subsidize high-tax states
- Criticisms with Policy Justification
  - High-Tax States Have Net Positive Transfer to Federal Government
  - Municipal Bonds?
  - Double Taxation?
- Politically Motivated?

RESPONSES TO SALT LIMITATION

- States and Municipalities
  - Transform Tax Into Charitable Deduction
    - IRS Resisting via Regulations; Litigation
    - Collateral Damage
  - Payroll and Passthrough Taxation
- Individuals
  - Move income and property to business and treat as a business expense (additional incentive)
  - Use trusts

STATE TAX AS CHARITABLE DEDUCTION

- Strategy:
  - Government Sets up Charity It Controls
  - Taxpayers make a gift to the charity and receive a state tax credit (often $.90 on the dollar)
  - On the taxpayer's federal return, taxpayer takes a charitable deduction, which is unlimited
- Precedent: schools and other similar programs
- Proposed Regulations: charitable deduction reduced dollar-for-dollar by tax credit
  - This will eliminate incentive for private school and other related programs in Georgia

USING TRUSTS TO AVOID SALT LIMITATION

- Utilize Restraint
  - Is the game worth the candle?
  - Permanency?
- SALTy SLAT
  - Taxpayer with $10K of income tax and $5K property tax
  - Create Non-Grantor Trust with
    - House with property taxes of $5K
    - Other assets that generate income of $5K
- Trusts in Zero-Tax States
  - If avoid tax entirely, loss of deduction immaterial

USING TRUSTS TO AVOID STATE INCOME TAX

- Strategy: place assets in trust with situs in TN, FL, or other no-tax state
- Practical Caveat: if income is distributed to Georgia resident, pay Georgia tax
- Recent and Current Cases
  - Generally wins for taxpayers
  - Component of larger issue of state taxation and nexus
  - Kaestner case from NC currently before Supreme Court

MATH ON AVOIDING STATE INCOME TAX

- Assume portfolio with 2% dividends/capital gain and 4% deferred growth; 23.8% federal rate
- Avoiding 6% state income tax yields an annual benefit of approximately 10 bps
  - 10 bps over time can be meaningful
  - Problem is annual cost of holding assets in trust with situs in no-tax state
- Be careful assuming game is worth the candle; run the numbers

OPPORTUNITY ZONES

- Policy
  - Unlock potential of assets with low basis
  - Incentivize long-term investment in low-income areas
- Proposition: complex deferral of gain recognition
  - 10% basis increase in year 5; 5% basis increase in year 7
  - Pay tax on 85% of gain in low-basis asset in year 8
    - If sell $1M of zero-basis KO and CG rate 28.8%, owe approx. $250K
    - $1M of proceeds from KO sale still tied up in OZ investment
  - Avoid tax on gain on OZ investment if hold for 10 years
    - If invest $1M year 1 and asset worth $1.6M year ten, no tax on $600K

MATH ON OPPORTUNITY ZONES

- Assume capture all potential tax benefits
- A “regular” investment with a gross return of 7.5% is equivalent to an OZ investment with a gross return of 5%
  - Must consider manager fees, potential for OZ property to get bid up, 10-year lock-up, and other uncertainties.
- **Recommendation**: Be careful, especially if no organic reason to invest and just chasing tax benefits

SYNDICATED CONSERVATION EASEMENTS

- Non-Syndicated Conservation Easements
  - Owner of property transfers bundle of rights to land trust or similar entity
    - E.g., right to develop or subdivide
    - Term is *forever*
  - Owner continues to own property and retains all other rights
    - E.g., right to harvest timber, graze cattle, hunt and fish, etc.
  - Differential in value is a charitable contribution that is deductible for income tax purposes

SYNDICATED CONSERVATION EASEMENTS

- Syndicated Conservation Easements
  - Promoter identifies property with potential for mining (e.g., aggregate or kaolin)
  - Promoter approaches land owner and buys property for $10M, based on current use as timber operation, farm, recreational property, etc.
  - Promoter conducts surveys of minerals and creates an entire business plan that is never intended to be implemented. Promoter then claims value of property is $100M.

SYNDICATED CONSERVATION EASEMENTS

- Promoter creates conservation easement that prohibits mining (but still allows timber, farming, etc.), and claims reduction in value (and thus a charitable contribution) of $95M ($100M mining value less $5M value after easement).
- As part of this process, promoter uses an LLC to effectively sell the charitable deduction. Often, purchasers of the charitable deduction receive $3, $4, or more dollars of deduction for every $1 of investment.

SYNDICATED CONSERVATION EASEMENTS

- IRS Listed Transaction
  - Pay $1 and receive $2.50 of deduction
  - This is the point where the transactions becomes profitable
- Example
  - Effective combined federal and state rate of 45%
  - Pay $100K for $250K deduction
  - Deduction is worth $112,500 ($250K deduction x 45% rate)
  - Profit is $12,500 ($112,500 tax benefit - $100,000 cost)

SYNDICATED CONSERVATION EASEMENTS

- Widespread in Georgia
- Current Status
  - Listed transaction
  - Justice department actions against promoters
  - Bi-partisan congressional scrutiny
  - Many land trusts refuse to receive

CAPTIVE INSURANCE COMPANIES

- Assume client that owns business
- Traditional Insurance
  - Business pays premiums to third-party insurer
  - Absent claim on policy, no return on premiums
- Captive Insurance
  - Premiums < $2.2M per year
  - Client establishes a new insurance company to insure business

CAPTIVE INSURANCE COMPANIES

- Premiums paid are still deductible to business
- Premiums received by captive are not subject to income tax
- When captive is no longer needed, assets are liquidate and receive LTCG treatment

- Issues
  - Ability to Cover Claims: often use reinsurance
  - Qualification as Insurance
  - IRS Scrutiny
  - IRS Court Victories: *Avrahami* and *Reserve Mechanical*

BACKGROUND AND CONTEXT OF REFORM

BACKGROUND AND CONTEXT OF REFORM

- **Primacy of Corporate Reform**
  - Out-of-Sync with Rest of World
  - Earnings Held Offshore; Inversions; Etc.
- **Pass-Through Reform**
  - Widely believed necessary b/c of corporate reform
- **Individual Reform**
  - Rates: issues with lowering corporate without pass-through
  - History: unusual to do corporate reduction without individual
  - Politics: populist environment
  - Budget: revenue raisers

TIMELINE AND PROCESS OF PASSAGE

- Scope of Reform
  - Bill: 530 pages
  - Conference Report: 560 pages
  - **Over 1,000 dense, technical pages**
- Timeline at End of 2017
  - Nov. 2: becomes public; most legislators see for the first time
  - Nov. 16 (14 days later): House passes
  - Dec. 2 (30 days later): Senate passes
  - Dec. 20 (**48 days later**): Conference Committee version passes both chambers

CORPORATE REFORM

OVERVIEW OF CORPORATE REFORM

- Headline: **Reduced Flat-Rate Tax of 21%**
  - AMT repealed
- Other
  - Numerous Miscellaneous Provisions
    - Many apply to passthroughs
    - Expanded Cost Recovery (expensing and depreciation)
    - Compensation and “covered employees”
  - International Provisions

USING C-CORPS FOR DEFERRAL

- Issue: Avoiding Incentive to Convert to C-Corp
- Math for Non-Labor, Ordinary Income
  - Personal: top rate of 40.8% (37% plus NIIT of 3.8%)
  - Corporate: effective rate of 39.8%
    - 21% corporate rate
    - 23.8% (capital gains and NIIT) on net (effective rate of 18.8%)
  - Potential Benefit of Corporate Taxation: Deferral
    - Assume 10 years of deferral and low 4% pre-tax return
    - C-Corp: 5% better off
- Benefits of deferral even greater for other forms if income

HURDLES TO DEFERRAL WITH A C-CORP

- Accumulated Earnings and Personal Holding Co. Taxes
  - Intended precisely to discourage C-Corp from retaining an excessive amount of earnings
  - Prior to 2017 Tax Act everyone avoided C-Corp status, so these provisions have been largely dormant
  - Accumulated Earnings Tax: 20% tax applied to retained earnings in excess of the exemption amount
  - Personal Holding Company Tax: 20% tax on undistributed passive income

ACCUMULATED EARNINGS TAX

- "Active" Business
- 20% tax applied to retained earnings in excess of the exemption amount
  - Modest Thresholds: $250K ($150K for specified service fields)
  - Above Thresholds: requirements to avoid tax
    - Business Needs (specific, definite, and feasible)
    - Estate Liquidity Needs

PERSONAL HOLDING COMPANY TAX

- "Investment Vehicle"
- Generally applies to C-Corp
  - Held by a small number of persons
    - 50% valued held by five or fewer persons (directly and indirectly)
  - With lots of passive income
    - 60% of AGI from passive sources

PASS-THROUGH
REFORM

BACKGROUND AND CAVEAT

- Initial Impetus
  - Technical: avoid unintended consequence of C-Corp provisions
  - Public: importance of small business; populist environment
- Late-Game Concern over Middle-Class Benefits

PROVISION AT THE HIGHEST LEVEL

- Deduction: 20% of Qualified Business Income
  - QBI: income from active trade or business
  - Not an itemized deduction
- Example
  - If have QBI of $100, then taxed on $80
  - Rate = marginal rate x 80%
  - Top Marginal Rate: from 40.8% to 33.4%
    - (37% x 80%) + 3.8%
  - **For every $10,000 of income, save $740 or 7.4%**

LIMITATIONS RELATED TO JOB CREATION

- QBI: where the income comes from; eligibility
  - Domestic active trade or business
  - Excludes:
    - Investment income like capital gains and qualified dividends
    - Income earned as an employee
    - Income from personal services (health, law, accounting, etc.)
- Wages Paid: what is done with the income; limitation
  - Deduction limited to 50% of the wages paid by the entity

LATE-GAME, PROBLEMATIC CHANGES

- Changes
  - Real Estate Provisions
  - Middle-Class Provisions
- Criticism: job creation???

REAL ESTATE PROVISIONS

- Alternate Wages-Paid Limitation
  - Fairly or unfairly known as the Corker Kickback
  - 25% of W-2 wages paid plus 2.5% of depreciable property used to create QBI
- REITs and PTP: default qualification

LATE-GAME MIDDLE-CLASS PROVISIONS

- Policy and Process
  - 70% of passthrough income goes to the top 1%
  - A few senators refused to support unless changes
- Result: loosening of requirements for “middle-class”
  - QBI and Specified Service:
    - Qualify if below $315K m/f/j, phaseout up to $415K
    - Married attorney with $300K income gets 20% deduction

PROBLEMS WITH MIDDLE-CLASS PROVISIONS

- Definition of Middle-Class
  - 2016: household with $315K was in top 1.8%
- Disparate Treatment: Specified Service vs. Employee
  - Specified services qualify if under threshold
  - Employees still cannot qualify
- No wages paid requirement
  - No attempt to tie to job creation in any fashion

ENTITY STRATEGIES

High-Level Issues

- Impact on Day-to-Day of Business
- Permanency of Rules?
- Accuracy-Related Penalties

Strategies

- Stay Passthrough and Qualify for 199A Deduction
- Convert to a C-Corp
- Weird Stuff
  - Cooperatives
  - Controlled Foreign Corporations (Kennedy-era provision)

QUALIFY FOR 199A DEDUCTIONS

- Non-Service Providers (owners of active business)
  - Create QBI
  - Create wages paid or depreciable property
- Service Providers (doctors, lawyers, etc.)
  - Avoid employee status
  - Manage taxable income to stay below threshold
- Create multiple taxpayers (i.e., trusts)

C-CORP CONVERSIONS

- Issues
  - As practical matter, can you defer the second tax on dividends paid
  - Accumulated Earnings and Personal Holding Company Tax
  - Permeance of Law?
  - Difficulty of Undoing the Conversion
- Sense of What's Going On: more talking than doing

CONCLUSIONS AND GUESSES

DEBT, SPENDING, AND REVENUE

- Debt
  - At 77% of GDP, higher than any time in history outside WWII
  - From 1957 to 2007, ratio average 36% and never exceeded 50%
  - By 2028, projected to reach roughly 105% of GDP
- Spending
  - 2018: 20.6% of GDP
  - From 1965 to 2017, averaged 20.4%
  - Non-Defense Discretionary Spending: 3.1% of GDP
- Revenue
  - Much more variable
  - Currently about 16% to 17% of GDP
  - Right around to slightly below recent historical average

DEBT TRENDS

- Prior Debt Spikes (generally related to wars)
  - Roughly 10-15 years after war ended, debt-GDP was cut in half and back near historical norms
  - Debt generally reduced by combination of spending returning to normal and increased tax revenue from post-war boom
- We are 10 years from 2008, and debt-GDP ratio has just kept climbing
  - Clear that as a country we don’t truly care
  - Perhaps unclear how much it really matters

OPINIONS ON 2017 TAX ACT

- Fiscally Irresponsible
  - $1.5M trillion increase in debt over 10 years
  - Very unlikely to outperform conservative dynamic scoring
- Not Seeing the Big Picture
  - Economic growth is not as simple cutting taxes
  - To sustainably pay less in taxes over an extended period of time, we need more people who can afford to pay tax
  - To have more people that pay taxes, we have to figure out how to help restore “the middle class”

OPINIONS ON 2017 TAX ACT

- Benefits
  - Direct: overwhelmingly benefit the wealth, especially the wealthy that own lots of capital assets
  - Indirect: ?????
- Execution
  - Poor at Best
    - Clarity
    - Fairness
    - Simplicity
  - Corporate better than passthrough

GUESSES ABOUT FUTURE

- 2017 Tax Act Not Maintain Its Current Form Very Long
  - Cost of Partisan, Closed-Door Process (see e.g., ACA)
  - Corporate has the most staying power
  - Passthrough and SALT most likely to change
- Hard to Cut Spending
  - Non-defense discretionary spending near historical lows
  - Neither party has the stomach to deal with Social Security and Medicaid
- Revenue Pressure
  - Numbers of households with ability to pay tax is not increasing
  - Taxpayers making over $75K will come under pressure