IPB Tax, Trusts & Estates

Volume 2, Issue 2

August 2018

Ivins, Phillips & Barker
Chartered

This periodic publication highlights developments and trends in trusts and estates from a practical viewpoint based on IPB's experience. This issue continues our focus on planning opportunities due to estate tax and income tax changes in the Tax Cuts and Jobs Act of 2017 (the "Tax Act") affecting individuals and businesses. IPB's attorneys can navigate the complexities of the Tax Act to help clients obtain meaningful tax benefits. Our goal is to share our insights with wealth and philanthropy advisors, corporate fiduciaries, accountants and other advisors in a way that is accessible and actionable. We welcome feedback and additions to our mailing list (*ipb@ipbtax.com*).

IRC § 199A Twenty Percent Deduction for Non-Corporate Entities

By Douglas Andre

Newly enacted Section 199A permits owners of non-corporate businesses to deduct up to 20 percent of the owner's share of income from the business. Like many of the tax law changes that were included in the Tax Act, section 199A is a temporary provision, due to expire after 2025.

The section 199A deduction is available to taxpayers other than corporations. Individuals operating as sole proprietorships, partnerships, S corporations, trusts and estates that carry on a qualified trade or business are potentially eligible to claim the deduction.

An eligible taxpayer can deduct up to 20 percent of his or her qualified business income defined as the net effectively connected income from a U.S. trade or business. Excluded from the definition of qualified business income are capital gains, dividends and dividend equivalents, interest income, currency gains and gains from notional principal contracts. While most types of investment income are excluded, rents and royalties are not.

The statute contains several limitations and restrictions that reduce the availability of the full 20 percent deduction. The first limit phases in reductions to the deduction when the business owner's taxable income exceeds certain thresholds. For married taxpayers filing a joint return, the limitation phase in begins at $315,000 of taxable income for 2018 (indexed for inflation). For taxpayers filing a single return, the threshold is $157,500.

A second limitation prevents income from specific service businesses from counting as qualified business income. Ineligible businesses include health, law, accounting, financial services and any business whose principal asset is the "reputation or skill" of one or more of the business owners or employees.

A third restriction limits the amount that can count as qualified business income to formulaic derived amounts based on what the business spent on depreciable property and payroll. The effect of this limitation is that owners of businesses with significant W-2 wages and/or significant investments in depreciable property will benefit most from the deduction.

Business owners now face a choice of entity quandary: whether the section 199A deduction or the new 21% corporate tax rate (also part of the Tax Act) provides a more meaningful benefit (recognizing that section 199A expires after 2025).

Section 199A contains several areas of ambiguity and there are numerous questions regarding how the law will operate. Proposed Treasury regulations were released in August 2018 that resolved some of these ambiguities. The regulations provided some clarity regarding the types of businesses whose principal asset is the "reputation or skill" of the owners or employees. The proposed regulations also include "aggregation rules" for taxpayers who have pass-through income from multiple sources.

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MAKING LEMONADE FROM LEMONS: TAX SAVINGS FROM THE DELAWARE TAX TRAP

BY KASEY PLACE

As a result of the Tax Act, the estate tax exemption is approximately $11.18 million per person in 2018. Such a high exemption amount means many clients will have exemption to spare. A client who has a limited power of appointment over a trust for her benefit may be able to put that excess exemption to good use. If the trust would otherwise be subject to generation-skipping transfer ("GST") tax at the client's death or if the trust assets have significant built-in gain, the client could generate significant savings by triggering the so-called "Delaware tax trap."

The Delaware tax trap refers to section 2041(a)(3) of the Internal Revenue Code. Under section 2041(a)(3), trust property is included in a beneficiary's taxable estate if (1) the beneficiary has a limited power of appointment, (2) the beneficiary exercises that power to create a second power of appointment (the "second power") and (3) the second power can be validly exercised under state law in a way that causes the rule against perpetuities to run from the date of the exercise of the power, rather than the date of creation of the original trust.

Section 2041(a)(3) was enacted in 1951 in response to a Delaware law that otherwise would have allowed trusts to avoid transfer tax indefinitely. Initially it was viewed as something to avoid. Hence the name. Over time, however, practitioners discovered that it can be beneficial to spring the trap in certain circumstances. One such circumstance is when a beneficiary has unused estate tax exemption and the trust would otherwise be subject to GST tax. Another such circumstance is when the beneficiary has unused estate tax exemption and the trust anticipates significant capital gains when its assets are sold.

In states that follow the common law rule against perpetuities, a beneficiary can only trigger the Delaware tax trap if the second power is a presently exercisable general power of appointment. This is not an appealing option for most clients because a presently exercisable general power of appointment would allow successor beneficiaries to take the money out of trust. However, states that have enacted the Uniform Statutory Rule Against Perpetuities ("USRAP") offer a possible solution.

Section 2(c) of the USRAP says the rule against perpetuities of a trust that is funded in tranches will run from the date of initial funding. This prevents the Trustee from having to track a separate perpetuities period for each contribution. A beneficiary of an irrevocable trust in a USRAP state ("T1") who wishes to spring the trap could create and fund a separate irrevocable trust ("T2") that confers a limited power of appointment on his or her children. The beneficiary would then exercise her power of appointment over T1 to appoint the assets to T2. Under section 2(c) of the USRAP, the rule against perpetuities should be measured from the date T2 was originally funded, not the date T1 was created. As a result, section 2041(a)(3) should apply.

For clients who don't have significant assets in their taxable estate, practitioners will have to find creative ways to take advantage of the increased exemption amount. Using section 2(c) of the USRAP to trigger the Delaware tax trap is one such approach and can generate significant tax savings under the right circumstances.

OVERCOMING MARYLAND'S "TAKE-BACK" OF ESTATE TAX EXEMPTION

BY LINDA KOTIS

Maryland has decoupled its state estate tax exemption amount from the federal estate tax, and now the exemption will be $5 million for 2019 estates. For decedents dying during 2018, the state exemption is set at $4 million. The exemption amount will <u>not</u> be indexed for inflation. This is essentially a "take-back" since the Maryland General Assembly had previously decided in 2014 to increase the state exemption to match the federal exemption beginning in 2019.

Maryland has also added state-level portability of the decedent's remaining exemption amount for use by the surviving spouse. As with the federal deceased spousal unused exemption (DSUE) now in place, this means that if the first spouse to die does not use her entire Maryland state estate tax exemption, her executor may permit the surviving spouse's estate to later use the unused exemption.

With the new $11.18 million federal estate tax exemption, additional lifetime gifts take on particular significance for taxpayers who live in Maryland (or other states) which do not impose a gift tax. Removing assets from Maryland estates now could result in greatly reducing future estate tax liability.

A $5 million lifetime gift could be made to a grantor trust to benefit the grantor's children or other family members. The asset value would be frozen on the date of the gift. Any appreciation would be free of gift tax and estate tax. For a couple concerned about losing access to assets during lifetime, each spouse could give $3 million to a Spousal Limited Access Trust (SLAT) for the other. An advantage is that any SLAT income or principal distributions to one spouse would be indirectly available to the other spouse as well, such as for shared living expenses or vacations together.

The Maryland DSUE could enhance the total state estate tax exemption amount available on the second spouse's death. This could be done by creating a federal and state QTIP Marital Trust for the benefit of the first spouse to die and "porting" the unused federal and state exemptions to the second spouse's estate. This could help narrow the gap between the state estate tax and federal estate tax liability on the death of the second spouse.

The change in Maryland law may disappoint those who were hoping for a "huge" new state estate tax exemption to match the federal exemption amount in the Tax Act. Still, opportunities exist to reduce state estate tax liability under the new law. For more information, see *Minding the Gap: The Mismatch Between Maryland's 2019 Estate Tax Exemption and the New Federal Estate Tax Exemption*.

Past Issues of IPB Tax, Trusts & Estates

Volume 1, Issue 1	February 2017
Volume 1, Issue 2	June 2017
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UPDATE ON PENALTIES FOR FAILING TO DISCLOSE FOREIGN FINANCIAL ACCOUNT

BY DOUGLAS ANDRE

A recent case in the U.S. Court of Federal Claims concluded that a regulatory cap on the penalty for willfully failing to file a Foreign Bank Account Report ("FBAR") did not apply given that higher caps were incorporated in later enacted legislation. See *Norman v. United States,* No. 15-872T (Fed. Cl. July 31, 2018). U.S. persons that have signature authority over or a financial interest in one or more foreign financial accounts are required to file the FBAR if the aggregate balance in such accounts exceeds $10,000 during the reporting year. Failing to file the FBAR can trigger extremely harsh penalties, especially if the IRS deems the failure to be willful. The *Norman* case makes clear that the willful FBAR penalty can reach as high as 50% of the account balance or $100,000 – whichever is greater. Please contact us if you have any questions regarding the disclosure rules regarding offshore financial accounts and assets.

IPB IN THE NEWS ...

- Ten Ivins Attorneys Named to 2019 Best Lawyers in America, including Carter Hood and Eric Fox (August 15, 2018)
- Doug Andre Presents at University of Florida Law, *International Estate Planning and Compliance Refresher* (July 26, 2018)
- *Minding the Gap: The Mismatch Between Maryland's 2019 Estate Tax Exemption and the New Federal Estate Tax Exemption* by Linda Kotis (June 25, 2018)

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