NOVEMBER 2017

IPB Tax, Trusts & Estates

Ivins, Phillips & Barker
Chartered

This periodic publication highlights developments and trends in trusts and estates from a practical viewpoint based on IPB's experience. 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).

TAX REFORM: KNOWN KNOWNS & KNOWN UNKNOWNS

The House Ways & Means Committee released the "Tax Cuts & Jobs Act" on November 2. To borrow from former Defense Secretary Donald Rumsfeld, "there are things we know we know" about the Republican plan:

- The federal estate tax, generation-skipping transfer (GST) tax and gift tax exemptions would double — from approximately $5.5 million/transferor to $11 million/transferor.
- The gift tax would remain in place, with the tax rate lowered from 40% to 35%.
- The estate tax and GST tax would be repealed in 2024 and stepped-up basis would be preserved.
- The Alternative Minimum Tax ("AMT") would be repealed.
- A $10,000 cap would be placed on the state property tax deduction.
- State and local income tax deductions would be eliminated.
- The mortgage interest deduction would remain for current homeowners and be limited to $500,000 for newly purchased homes. This would apply to purchases on or after November 2.
- Gain from selling a principal residence would be excluded for owners living in home for 5 of last 8 years, for one sale every 5 years, and phased out for incomes over $500,000 (married)/$250,000 (single). Current rules apply to homes occupied 2 out of 5 years, one sale every 2 years, and no income limits.
- Individual brackets would be 0%, 12%, 25%, 35%, and 39.6%. The top 2 rates apply to incomes over $260,000 and $1 million, respectively.
- The current tax rates on capital gains, dividend and interest income, charitable contribution deductions, and 401 (k) plan and IRA structures would remain unchanged.
- The corporate tax rate would be lowered to 20%, down from today's 35%.
- A portion of net business income distributed by a pass-through entity (sole proprietorships, partnerships, LLCs, and S-Corporations) would be treated as "business income" and subject to a maximum 25% rate.
- The remaining net business income would be treated as compensation and taxed at individual rates.
- 529 Plans could include elementary and high school expenses of up to $10,000/year as qualified expenses. A child in gestation would qualify as an account beneficiary.

Most provisions of the bill, if enacted, would apply to tax years beginning after December 31, 2017, though some are effective after the date of the enactment and others in 2024 as noted above.

There are the "known unknowns" such as how the plan will change as it moves through Congress and whether tax reform will be enacted at all. But based on the plan as proposed, here are some takeaways:

- The combination of the defunct 2704 Regs (see page 3), estate and gift tax changes, and a new business entity tax rate would provide tax-saving opportunities for existing and newly organized family-owned partnerships and LLCs.
- Larger lifetime gifts to individuals and trusts could be made and prove especially worthwhile for residents in states with state estate and inheritance taxes but no state gift tax.
- Gifts in the new year could fund a new 529 plan for an elementary or high school age child.

Stay tuned as there may be "unknown unknowns" in the new tax regime as well.

INSIDE THIS ISSUE

1700 Pennsylvania Avenue, N.W.
Washington, D.C. 20006
202.393.7600
www.ipbtax.com

INBOUND INVESTMENTS IN U.S. REAL ESTATE
BY DOUG ANDRE

In our June 2017 newsletter, we discussed international estate planning for non-resident aliens ("NRAs"). We noted that the estate of a non-U.S. decedent may be subject to U.S. estate tax if the decedent owned U.S. real property at death and that the decedent's applicable exclusion amount is $60,000 (compared with $5.49 million for U.S. persons). In this article, we discuss ways an NRA who invests in U.S. real property can minimize overall taxes.

Estate Tax Considerations. The gross estate of a deceased NRA includes real property located in the United States and interests in U.S. companies (*e.g.*, shares of stock in a U.S. corporation). Foreign corporation stock is generally not subject to U.S. estate tax when owned by a non-U.S. decedent (even if the foreign corporation owns U.S. real estate). Thus an NRA can avoid estate tax by holding U.S. real property through a non-U.S. corporation.

Another strategy to avoid U.S. estate tax is to hold U.S. real property in a U.S. corporation but make gifts of the shares of corporate stock. A non-resident alien will not be subject to U.S. gift tax on lifetime transfers of U.S. stock. Because the shares are not owned at death, these assets escape estate tax. Holding U.S. real estate through a U.S. corporation may also avoid home-country taxation and the U.S. branch profits Tax (discussed below).

Income Tax Considerations. Generally, an item of income is taxable to an NRA only if it is "sourced" within the United States. U.S. source income includes rental income from U.S. real property and gains from the sale of U.S. real property. If the rental activities rise to the level of a U.S. trade or business, U.S. income tax will apply on a net basis (meaning income is reduced by applicable deductions). In many cases, non-cash deductions (*e.g.*, depreciation) may significantly reduce the U.S. tax liability stemming from rental activities.

In general, NRAs are not taxed on gains from the sale of U.S. capital assets as long as the assets were not used in a U.S. trade or business. Gains realized by an NRA from the disposition of U.S. real property interests (including stock in a U.S. corporation that owns significant amounts of U.S. real property) are taxed as income effectively connected with a U.S. trade or business, and the tax code requires the purchaser to collect the tax via withholding. Gains from the sale of a foreign corporation owning U.S. real estate will not be subject to U.S. income tax when sold by the NRA; however, the gain may be taxed when the real estate is later sold by the purchaser (*i.e.*, the gain is deferred).

Structuring Options for Investments in U.S. Real Estate. Structuring investments in U.S. real property should take into account whether the real estate will generate current income and whether there is a substantial risk U.S. estate tax may apply. Owning U.S. real estate through a foreign corporation will shield foreign owners from U.S. estate taxes and may reduce U.S. income tax when the shares of the corporation are sold. However, a foreign corporation doing business in the United States in branch form will be subject to a 35% tax on its current earnings and also a 30% "branch profits" tax imposed on the after-tax earnings of the U.S. branch (unless a tax treaty provides otherwise).

Operating through a U.S. corporation will also generally result in two levels of income tax – a 35% entity level tax and a tax on dividend distributions. Stock in a U.S. corporation may be subject to U.S. estate tax if owned by the NRA at death.

Income from U.S. real estate owned through a flow-through entity (*e.g.*, a partnership) will generally be taxed only once at the shareholder level. While this may result in lower income taxes, it may trigger a U.S. income tax filing obligation for the partners. In addition, use of a partnership will generally not shield NRA owners from the estate tax.

Planning to invest in U.S. real estate requires a close analysis of both income and estate tax issues including the client's specific circumstances and whether a tax treaty applies.

2704 REGS ARE DEFUNCT. NOW WHAT?

BY CARTER HOOD

The IRS has withdrawn the Proposed 2704 Regulations, calling their approach to the problem of artificial valuation discounts "unworkable." Section 2704 of the Internal Revenue Code provides special valuation rules for intra-family transfers of interests in corporations, limited liability companies, and partnerships subject to lapsing voting or liquidation rights and restrictions on liquidation. The goal of Section 2704 is limit the use of discounts for lack of control and marketability in family business interests that affect estate, gift, and GST taxes. The impetus for the Proposed Regs was to counteract the "substantial ineffectiveness" of the current regs due to court decisions limiting the application of state law, changes in state law, and taxpayers circumventing the law through assignments and transfers outside of family. Among other issues, comments from practitioners and industry groups noted that the Proposed Regs created substantial compliance and taxation burdens on family-owned businesses that were not similarly applicable to non-family business owners.

What does this mean for closely held businesses? Interests may continue to be transferred to family members without penalty. Legitimate discounts remain an option for ownership of less than a majority interest. Family business owners may assign their interests to the next generation and pay less gift tax now. Lifetime planning to lower estate taxes through business reconfiguration is still a robust approach.

And what happens next? The IRS gave no indication as to whether a modified version of the Proposed Regs would be offered in the future. or if this issue is truly dead.

DIRECTED TRUST: WHO'S WATCHING WHOM?

BY LINDA KOTIS

Dividing Duties. It's become common to create a trust that divides duties among a trustee and advisors. Examples include giving investment powers to the settlor's financial advisor, naming a trusted relative as a distribution advisor, or installing a protector with powers to remove and replace fiduciaries. When trust functions are allocated among several persons, does a trustee have a duty to monitor an advisor's conduct or warn a settlor or beneficiary about matters in which the trustee is not authorized to participate? Similarly, is an advisor obligated to advise as to whether a trustee has followed her directions?

Monitoring Conduct. The trend appears to be relieving a trustee or advisor from the duty to monitor or inform about the other's conduct or decision-making, unless the trust provides otherwise. This is the case under Section 11 of the Uniform Directed Trust Act (the "Act") as approved by the Uniform Law Commission in July 2017. The new Act addresses the powers, limitations, and liabilities of advisors and directed trustees and confirms that such advisors are fiduciaries. Although no state has yet adopted the Act, Section 11 echoes existing state law regarding a trustee's duty under some trust codes. *See, e.g.,* MD Code, Est. & Trusts § 14.5-808(c) and VA Code § 64.2-770(E)3.

Disclosing Facts. But how does this relief comport with a trustee's general duty created by other code and common law obligations? Section 813 of the Uniform Trust Code (UTC) requires a trustee to keep beneficiaries "reasonably informed" about trust administration and "material facts necessary to protect their interests." Virginia and DC adopted this provision in their trust codes, while Maryland omitted it. *See* VA Code § 64.2-775(A); DC Code § 19-1308.13(a); MD Code, Est. & Trusts § 14.5-813. Restatement (Third) of Trusts § 82(1)(c) (2007) applies a similar affirmative obligation, unless the trust states otherwise.

Following Directions. Note that the UTC provisions on directed trusts compel the trustee to act in accordance with an advisor's exercise of her power. This is the case unless the attempted exercise is "manifestly contrary to the terms of the trust" or the trustee is aware that "the attempted exercise would constitute a serious breach of a fiduciary duty" that the advisor owes to the beneficiary. *See, e.g.*, DC Code § 19-1308.08. It seems unreasonable to require a trustee to follow directions, unless some malfeasance is involved, yet also make him responsible to monitor or warn about potential negative outcomes of that direction.

Addressing Duties. If a settlor intends to create a trust with an investment advisor or distribution advisor, the trust should address the duties of trustees and advisors with respect to monitoring or warning about actions of each other. Also, the settlor should seek advice about how the general duty under common law or state statute to keep beneficiaries reasonably informed about trust administration may fit within this framework.

Past Issues of IPB Tax, Trusts & Estates

Volume 1, Issue 1	February 2017
Volume 1, Issue 2	June 2017

FAMILY LIMITED PARTNERSHIPS AND THE NEW PARTNERSHIP AUDIT REGIME

BY KASEY PLACE

New partnership audit rules enacted at the end of 2015 become effective January 1, 2018. These rules are intended to make it easier and less expensive for the IRS to audit partnerships. Among other things, they require each partnership (and each limited liability company ("LLC") that is treated as a partnership for tax purposes), other than certain small partnerships that elect out of the regime, to name a "partnership representative" who has broad authority to bind the partnership in connection with IRS audits and tax litigation. Notably, if any partner is a trust, a partnership or an LLC (including a single-member LLC that is disregarded for tax purposes), the partnership cannot elect out of the regime.

One of the more interesting powers granted to the partnership representative under the new rules is the ability to elect for tax underpayments to be borne by reviewed-year partners, rather than current-year partners. This so-called "push-out election" can have major consequences when the partnership composition has changed between the year at issue (*i.e.*, the reviewed year) and the year the controversy is resolved.

Assume XYZ partnership has four partners in 2016. In 2017, one partner gifts his interest to his children. Another partner sells his interest to an irrevocable trust. Subsequently, the IRS audits the partnership's 2016 return. The parties settle in 2018 for $100,000 of taxes, penalties and interest. If the partnership representative decides not to make a push-out election, the 2018 partners will bear the burden of the additional 2016 tax, to the benefit of the two partners who withdrew in 2017.

It remains to be seen whether the partnership representative's broad authority could be considered a "right to designate the persons who shall possess or enjoy the property [of the partnership] or the income therefrom" within the meaning of Section 2036(a)(2) of the Internal Revenue Code. Rather than risk estate tax inclusion, clients may want to avoid naming the donor as partnership representative of any family limited partnership ("FLP").

The issue is easy enough to avoid, as the new rules permit almost anyone with a substantial U.S. presence to serve, including a non-partner. As a result, FLPs can name a disinterested party as partnership representative.

For additional information on the new partnership audit regime, see "*New IRS Rules Could Give Headaches to Partnerships*" by Ivins, Phillips & Barker partner, Heléna M. Klumpp, available at CFO.com.

IPB IN THE NEWS ...

- *Ivins Selected as One of the 2018 Best Law Firms in America*, U.S. News & World Report
- *Ten Ivins Attorneys Named to 2018 Best Lawyers in America*, including Carter Hood and Eric Fox
- Doug Andre Speaks on "Global Mobility of Employees" Practical Strategies" at the Los Angeles Chapter of the Tax Executives Institute, November 3, 2017
- Eric Fox and Jamie Brown Speak on Controversial Tax" (*Episode 3, Simply Tax Podcast)*, October 19, 2017
- Kasey Place and Linda Kotis Co-Presenters on "*The Unexamined Trust is Not Worth Drafting*," DC Bar: Estates, Trust and Probate Community, September 12, 2017