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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 LAW CHANGES MAY TRIGGER INTERNATIONAL REPORTING RULES FOR OWNERS OF FOREIGN CORPORATIONS

BY DOUGLAS ANDRE

Under general rules, foreign source income that is earned by a foreign corporation is not subject to U.S. tax until corporate earnings are distributed to shareholders who are U.S. persons. If, however, the corporation is a controlled foreign corporation ("CFC"), certain types of accumulated earnings (called "subpart F income") are taxed currently to the CFC's "U.S. shareholders" (defined broadly as U.S. persons who own at least 10 percent of the CFC's outstanding stock).

In addition to the subpart F anti-deferral rules, U.S. shareholders of a CFC are generally required to file Form 5471, *Information Return of U.S. Persons with Respect to Certain Foreign Corporations*. Form 5471 is filed annually as an attachment to the U.S. shareholder's income tax return and is used to report the U.S. shareholder's allocable share of subpart F income. A $10,000 penalty applies if Form 5471 is not filed when required. A failure to file may also result in a reduction in the taxpayer's ability to claim a foreign tax credit and can extend indefinitely the limitations period for the entire tax return.

Because the CFC rules are viewed as taxpayer unfriendly, U.S. investors in foreign corporations often design their foreign investment structures to avoid CFC status and the subpart F rules.

The 2017 Tax and Jobs Act (the "2017 Tax Act") broadened how the CFC and subpart F rules apply in several ways. First, the 2017 Tax Act expanded the definition of a U.S. shareholder to include a person with a 10 percent or greater interest in the vote <u>or value</u> of the foreign corporation stock. Prior to the change, only voting power was relevant in this context. Second, the 2017 Tax Act expanded the constructive ownership rules to include "downward attribution" from a foreign person to a related U.S. person for purposes of applying the subpart F rules. Finally, prior to the enactment of the 2017 Tax Act, a foreign corporation must have been a CFC for 30 uninterrupted days during the year for the subpart F rules to apply. Beginning in 2018, the corporation must only be a CFC "at any time" during the year for these rules to apply.

Together, these changes may result in more foreign corporations being classified as CFCs and they will likely cause some U.S. persons who previously were not U.S. shareholders to become U.S. shareholders. Such persons may not realize that they now have a Form 5471 filing requirement or appreciate the potential penalty exposure associated with these changes.

We recommend that clients with overseas assets review their investment and business structures to ensure continuing compliance with these rules.

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AVOIDING THE DELAWARE TAX TRAP

BY KASEY PLACE

In our August 2018 newsletter we discussed deliberately triggering the Delaware tax trap to generate savings for clients with excess exemption. However, there are situations where inadvertent application of the Delaware tax trap would be disastrous. This article identifies some of those situations and explains how to avoid the trap when necessary.

As previously explained, 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 (the "first power"), (2) the beneficiary exercises that power to create a second power of appointment (the "second power") and (3) the holder of the second power can validly exercise that power under state law in a way that causes the trust perpetuities period to run from the date of exercise of the second power, rather than from the date of creation of the original trust.

If section 2041(a)(3) applies, the original limited power of appointment is treated as a general power of appointment and the assets subject to that power are included in the powerholder's taxable estate. This results not only in federal (and, potentially, state) estate tax, but also a basis adjustment under section 1014. It also resets the GST tax inclusion ratio and causes the holder of the first power to be treated as the new transferor for GST tax purposes.

Application of the Delaware tax trap can significantly increase the overall tax burden for trusts that are not otherwise subject to the GST tax, either because they were irrevocable on September 25, 1985 ("GST grandfathered trusts"), or because GST exemption was allocated to them ("GST exempt trusts"). Consider the holder of a first power over a GST exempt trust who has no remaining estate or GST tax exemption. She inadvertently triggers the Delaware tax trap. Had section 2041(a)(3) not applied, the trust would have paid no transfer tax at her death. Now, however, it will pay 40% federal estate tax and, if the assets continue in further trust, the trust will be GST non-exempt (because she has no GST exemption of her own to allocate to the trust). Further, the trust assets may be subject to state estate tax, depending on the domicile of the powerholder and the size of her estate. Finally, particularly where the trust assets are subject to valuation discounts, the section 1014 basis adjustment could result in a step-down in basis and therefore increase the capital gain realized upon a subsequent sale of the assets.

Thankfully, for the following reasons, it is harder than one might expect to trigger the trap. First, under most states' laws, the perpetuities period does not restart when a limited power of appointment is exercised. In those states, with very limited exceptions, the trap can only be sprung if the holder of the first power confers a second power that is a presently exercisable general power of appointment – basically an immediate withdrawal right – on the donee. In this author's experience, it is uncommon to grant presently exercisable general powers of appointment through the exercise of a limited power. It is more common to grant successive limited powers or to appoint the property outright.

Second, some states have statutory savings provisions that prevent the Delaware tax trap from applying to GST exempt or GST grandfathered trusts. For example, Delaware law states that "in the case of a power of appointment over property held in trust (the 'first power'), if the trust is not subject to, or has an inclusion ratio of zero for purposes of the tax on generation-skipping transfers … then every estate or interest in property, real or personal, created through the exercise … of the first power… shall, for the purpose of any rule of law against perpetuities, remoteness in vesting, restraint upon the power of alienation or accumulations now in effect or hereafter enacted, be deemed to have been created at the time of the creation of, and not at the time of the exercise of, the first power." Del. Code Ann. tit. 25, § 504(a).

Finally, a perpetuities savings provision in the original trust agreement may prevent the holder of the first power from exercising it in a way that would trigger the trap. For example, including the following language in the trust agreement would make it impossible for section 2041(a)(3) to apply to the subsequent exercise of a power of appointment: "The trustee shall terminate and forthwith distribute any trust created hereby, or by exercise of a power of appointment hereunder, and still held twenty-one years after the death of the last to die of myself and the beneficiaries in being at my death."[1]

Even if none of the foregoing apply, such that inadvertently springing the Delaware tax trap remains a risk, one can always prevent its application by specifically providing in the instrument of appointment that exercises the first power that the vesting date of the trust is tied to the date of creation of the original trust, not to the date on which the first power is exercised. As a result, it should not be difficult for knowledgeable estate planners to avoid the Delaware tax trap when necessary.

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[1] Jonathan G. Blattmachr & Jeffrey N. Pennell, *Adventures in Generation-Skipping, or How We Learned to Love the Delaware Tax Trap*, 24 Real Prop. Prob. & Tr. J. 75 (1989).

THE RESET OF DC's ESTATE TAX EXEMPTION

BY LINDA KOTIS

The Federal Colony has taken a page from The Old Line State[1]s playbook. Effective October 1, 2018, the estate tax exemption for a District of Columbia decedent whose death occurs on or after January 1, 2018, is $5.6 million. Similar to the Maryland General Assembly, the DC Council retreated from its original 2014 plan to match the federal estate tax exemption, and instead decoupled the District's estate tax exemption. Unlike the new Maryland exemption, however, the DC exemption is pegged at one-half of the new federal exemption amount in the 2017 Tax Act and will be indexed for inflation.

Because DC imposes no gift tax on lifetime gifts, DC taxpayers can reduce their taxable estates and benefit themselves and their families without using any DC exemption amount. Recent articles about the new federal estate tax exemption (*IPB March 2018 Newsletter*) and Maryland's decoupling of its state estate tax exemption *(LISI, June 25, 2018*) offer some ideas for federal and Maryland estate tax savings that would also work for DC estates. Strategies include (1) giving assets to a family member whose estate will not exceed the federal or state exemptions and having the donee bequeath assets back to the original donor; (2) funding a Domestic Asset Protection Trust with the grantor as a discretionary beneficiary; and (3) creating a grantor trust and retaining the power to swap assets.

Still other options exist. These include creating a grantor retained annuity trust (GRAT) or a spousal lifetime access trust (SLAT), with the added twist of using life insurance products in conjunction with the trusts. For example, a grantor could use some or all of the after-tax GRAT annuity payments to fund an irrevocable life insurance trust (ILIT) for her children. The ILIT would purchase a policy on the grantor's life. She would make annual exclusion gifts to the ILIT to pay premiums for the policy. Once the GRAT term ended, the ILIT would be the GRAT remainder beneficiary. On the grantor's death, the ILIT would also be the beneficiary of the insurance death benefit. The children as trust beneficiaries would enjoy access to these assets free of estate tax.

As for the SLAT, a husband could create a trust for his wife with their children as remainder beneficiaries. The SLAT could hold marketable securities and own a life insurance policy on the grantor's life. On the husband's death, the insurance proceeds would be paid to the trust, free of estate tax, benefitting his wife and descendants.

In spite of the District's reset of its exemption, opportunities abound to reduce DC estate tax liability. District residents should revisit their estate plans, to review their goals, explore new ways to assist family members, and take advantage of potential tax savings both now and in the future.

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[1]"According to some historians, General George Washington bestowed the name 'Old Line State" and thereby associated Maryland with its regular line troops, the Maryland Line, who served courageously in many Revolutionary War battles." *Maryland at a Glance*

UPDATE ON TAX REFORM 2.0

In September, the House of Representatives passed H.R. 6760, the Protecting Family and Small Business Tax Cuts Act, aimed at permanently extending certain provisions set to sunset in the 2017 Tax Act. Chief among the provisions is the 20% deduction on certain pass-through business income. The Senate has not yet acted on the bill. On November 7, the president indicated interest in working with the new Democratic House Majority to lower income taxes for the middle class in exchange for an increased corporate tax rate. This is a changing landscape and expect more details to come.

IT IS NEVER TOO EARLY TO PLAN FOR THE CERTAIN FUTURE

BY KEN N. JEFFERSON

One need not be a celebrity to learn from the cautionary tales of the recently departed who have left their heirs in tempestuous legal battles. Consider Aretha Franklin, Prince, and James Brown. The former two passed in 2018 and 2016 with no planning arrangements at all. The latter passed in 2006 with outdated documents being contested to this day.

Once ascertained, the full value of each of Aretha's and Prince's taxable estates will be hit with the 40% federal estate tax before anything passes to heirs through intestate succession. Aretha's estimated $80 million estate will benefit from the increased exemption of $11.18 million, but both she and Prince missed many opportunities to reduce their taxable estates by transferring wealth in a tax-efficient manner while alive. Perhaps more unsettling is *In the Matter of the Will of E. Warren Bradway, Deceased* (2018 WL 3097060 (N.J. June 25, 2018)). In 2001, the testator executed a will replacing his 1977 will and naming his then partner as primary beneficiary. The testator and his partner ended their relationship in 2004, and each began a new relationship. In 2006, *using his own blood as ink*, the testator executed a handwritten codicil to his 2001 will naming his new partner as executor and primary beneficiary. The testator passed away in 2016. As part of the probate proceeding, the testator's former partner challenged the validity of the codicil on the basis that the testator did not sign it at the time it was executed. Handwriting analysts opined that the body of the codicil was in the decedent's handwriting. The court reasoned that the decedent would not have gone to such lengths to draft the codicil had he not sincerely intended to amend his estate plan. Clearly this dispute could have been avoided. During the ten years between the execution of the codicil and the testator's death, he could have executed a new will removing the former partner and naming his new partner as primary beneficiary. The blood-ink codicil created unnecessary – not to mention dramatic – ambiguity as to the testator's wishes.

All of these decedents could have taken the simple step of engaging an estate planning attorney. That decision would have substantially reduced subsequent legal expenses associated with the administration of their estates. The advent of year-end income tax planning presents a natural opportunity for clients to revisit their existing estate plans as well, or to create plans for the first time.

IPB IN THE NEWS ...

- Kasey Place and Linda Kotis presented at the D.C. Bar Communities Program, *"Lemons to Lemonade: Making Use of the Delaware Tax Trap" (November 13, 2018)*
- Linda Kotis, Speaker at Women, Influence & Power in Law (WIPLI) Executive Leadership Forum, *Taking Charge of Your Financial Wellness: How to Maximize Your Employee Benefits to Secure a Comfortable Retirement* (October 4, 2018)

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