Happy New Year to all Section members! It appears that 2018 will be a dynamic year for all of us beginning with the new federal tax law, “Tax Cuts and Jobs Act,” signed by the President into law on Dec. 22, 2017 that kicked in on Jan. 1, 2018 and the new Power of Attorney Act, N.C.G.S. Chapter 32C.

Our winter Section Council meeting was held via conference call due to “snowmaggedon” on Jan. 17, 2018. Our Section authorized two additional scholarships for Continuing Legal Education (CLE) held in Feb. 2018 for the Basics of Will Drafting and Estate Administration classes. These scholarships are new and in addition to the scholarships that will be offered for our Annual Meeting held in July 2018. Be on the lookout for the scholarship information for the Annual Meeting to be held at Kiawah Island, July 26 through 28, 2018.

The Ad Hoc Committee continues to plan and coordinate all issues related to the Annual Meeting and CLE at Kiawah. Our sponsors are amazing and continue to surprise us annually with their dedication to the Annual Meeting. The committee’s goal is to increase the quality of the breakfast offerings. We are working with the NCBA CLE department to make this happen. We also are focused on keeping our tuition low and continuing to amaze our members with quality of the CLE and the other events.

The Legislative Committee members are furiously drafting legislation for the 2018 Short

The Chair’s Comments

Linda F. Johnson

In what has been heralded by one side of the political aisle as an extraordinary opportunity to fix a broken tax system and criticized by the other as a hastened effort that only added to its complexity and the benefits provided to special interest groups, Congress passed what is informally known as The Tax Cuts and Jobs Act (the "Act") on Dec. 20, 2017, and the President officially made it the most impactful tax legislation reforming the Internal Revenue Code (the “Code” or “IRC”) enacted in over 30 years on Dec. 22, 2017. As estate and tax planners, regardless of where any personal views fall as to the propriety and ultimate efficacy of the Act to achieve its intended purpose, the reality is that we now face the task of advising individual clients how best to handle their personal affairs in a tax-efficient manner going forward under the Act. This article attempts to identify significant items of note for individual taxpayers and provide some observations on the Act’s impact on estate and tax planning as we move ahead.

Preliminary Considerations

Before delving into the substance of the Act, however, it is important to note certain principles that advisors should keep in mind when evaluating its details and the effect it will have on taxpayers.

The Byrd Rule and Continuing Political Uncertainty

The end of 2017 witnessed a feverish back-and-forth between the House of Representatives and Senate, with bills introduced by both houses ushered through committees and votes on their respective floors at an unprecedented pace. In the end, the terms of the Senate bill largely prevailed because of the more stringent requirements imposed upon it by the so-called “Byrd Rule,” which requires that legislation be revenue-neutral if it is not to be passed by a supermajority of 60 votes. This limitation was relaxed somewhat by a Senate budget resolution passed to allow for any tax reform to cost up to $1.5 trillion based on a “scoring” of its costs and “revenue raisers,” but even with that additional flexibility, Republicans in Congress still had to choose the portions of their tax reform agenda to prioritize at the expense of others.

The political rhetoric surrounding the Act promised tax breaks for both individuals and businesses alike, but in an effort to shore up sufficient room within these Senate budgetary constraints and allow the Act to be passed by the only politically feasible option of a simple majority, many of the individual tax breaks are made temporary—generally sunsetting back to their current forms after 2025—while most of the tax breaks afforded to businesses are made permanent, with a notable

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The Chair’s Comments, continued from the front page

Session and 2019 Long Session. Further, the Legislative Committee has scrambled to review and provide comments on a proposal for a North Carolina version of the Uniform Collaborative Law Act (the “revised Uniform Act”), which has been proposed for presentation by the General Statutes Commission (GSC) to the General Assembly in the upcoming Short Session. The Legislative Committee was given a very short time for comment on the proposal by the NCBA but has been able to provide feedback. The proposal would apply the revised Uniform Act to all practice areas, which is an expansion of the traditional use of collaborative law in family law settings. The revised Uniform Act even allows states to limit application of the revised Uniform Act only to family law disputes. The Legislative Committee has made the GSC aware that the areas of probate law and fiduciary litigation are unlike many others, because in these matters, at least one party to any dispute always owes certain fiduciary duties to other parties. Additionally, certain disputes arising in these areas – namely, guardianships, caveat actions, and estate and trust proceedings involving minor children – invoke the legal rights of parties who are legally unable to appear, participate, or consent to the collaborative law process in any way. While it is clear that the collaborative law process is a voluntary procedure, it is unclear how and when the consent of a decedent, an incompetent person, a minor beneficiary, or a fiduciary is to be given. The Legislative Committee has grave concerns about the application of the collaborative law process to: guardianship proceedings, where the loss of legal rights is at stake; in rem proceedings, such as caveat matters; and proceedings involving the interests of a minor. In addition, the Legislative Committee has concerns regarding the parties to a collaborative law process and whether those parties without a direct interest in the dispute (such as a corporate or otherwise non-interested fiduciary) would be required. The Committee also questions the effect of the revised Uniform Act upon the information rights of estate and trust beneficiaries. This review and effort is being undertaken in cooperation with the Elder & Special Needs Law Section, which shares our concerns. Our committee will address the revised Uniform Act with Mr. John Sarratt, Chair of the Collaborative Law Committee of the Dispute Resolution Section, a partner with Harris, Sarratt & Hodges, LLP, and a director on the Board of Directors and the president of the North Carolina Civil Collaborative Law Association, a North Carolina nonprofit corporation formed on Nov. 3, 2017. The Legislative Committee will also provide comments to the GSC on the Uniform Law Commission Guardianship Act.

The CLE Committee reports that the new North Carolina Uniform Power of Attorney Act CLE held on Nov. 3, 2017 was an outstanding success. Over 351 attorneys attended the live program, 176 attorneys attended the video replay and 485 on-demand units have been sold. I am pleased that so many of our members are educating themselves on the new law. There is still time to see the video replay of the live program or take several of the on-demand units. Education is the key to the success of the new Power of Attorney act.

On Feb. 8 and 9, 2018 there was a live program on the Basics of Will Drafting and Revocable Trusts and Basics of Estate Administration. The newly updated Estate Administration Manual was the program material for one day. There may be a joint CLE with the Tax Section in April, and the Advanced Estate Planning CLE will be May 18, 2018. Our Annual Meeting and CLE will be held at Kiawah Island Resort, July 26 through 28, 2018.

An edition of The Will and The Way will be published in spring of 2018. If you are interested in authoring an article, please contact our editor-in-chief, Lucy Siler (lsiler@jahlaw.com).

A new publication from the NCBA covers fiduciary litigation and is currently being written by members of the Fiduciary Litigation Committee. It is ninety percent complete. The Estate Administration Manual has been updated and published by dedicated members of our Section. Thank you to our Editors-in-Chief, Jessica Hardin and Anna Winger, and all of the chapter editors. A huge thank you to our committees and their members for these two resources which support our areas of practice.

On behalf of our Section, our Ethics Committee is drafting a response to the State Bar on FEO2, which addresses an attorney’s duties in advising an executor with regard to the handling of estate funds. The State Bar responded to our response in Dec. 2017 after FEO2 passed. The Will and The Way will feature an article in its next edition outlining the responsibilities of attorneys.

We are continuing to support the NCBA in its pro bono efforts. The current project being considered is an outreach to Rocky Mount, North Carolina.

Please contact me directly at LJohnson@ssjlaw.net if you want to volunteer for a committee in our Section. It is good for your soul and the Section. “Life’s most persistent and urgent question is, what are you doing for others?” — Martin Luther King, Jr.
exception being the new Code Section 199A deduction for 20% of certain business income generated by pass-through entities, which also sunsets after 2025. Republicans have deflected criticism for this distinction, and the implied favoritism of businesses over individual Americans, by responding that the individual taxpayer benefits would almost assuredly be extended by a future Congress. For purposes of this article, focused on taxes imposed on individuals, the provisions of the Act described can be assumed to be applicable only for taxable years beginning after Dec. 31, 2017 and before Jan. 1, 2026.

In any event, the scheduled sunset dates have to be accounted for in adapting to changes brought about by the Act. Any or all of the reforms under the Act could fail to be extended, if they are to sunset, or even be repealed earlier by a future Congress, especially in light of the partisan nature of the legislation and the general political atmosphere. Only time will tell, but in the interim taxpayers and advisors should understand that any tax planning done in response to the Act may need to be reevaluated, altered, or, at the most extreme, reversed based on changes in political winds. The most effective tax planning, therefore, will involve measures a taxpayer can live with even if the tax benefits from the planning change, for one reason or another, in the future.

Forthcoming Technical Amendments and Regulations

The speed with which the Act was drafted and passed left much to be desired in its clarity and details in some places. In other places, the Act simply places responsibility on Treasury to issue clarifying Regulations, which could take some time, if the past is any indication and especially in light of the funding challenges facing the Internal Revenue Service. No matter what, the terms of the Act in some cases will prove frustrating to taxpayers and advisors who value the comfort of certainty.

An additional layer of complexity is added with technical corrections to the Act that will be required, as those will not fall within the confines of budgetary legislation in the Senate and therefore will require a supermajority vote. Given the current political climate between Republicans and Democrats, any legislation could easily fall victim to partisanship and be stalled by Congressional Democrats. Taxpayers and advisors are therefore faced with the additional challenge of navigating certain portions of the Act, based on the best available information to them at the time, to deal with what appears will be ongoing uncertainty for quite some time.

Inflation Adjustments

Adjustments for inflation are now generally being calculated using the Chained Consumer Price Index (CPI) for All Urban Consumers (C-CPI-U) (“chained CPI”) in place of regular CPI adjustments, and this is made permanent regardless of whether it is applied to tax brackets, exemption amounts, or deductions that otherwise sunset. The key difference between a chained CPI calculation and the regular CPI calculation no longer used is that chained CPI accounts for changes in a consumer’s habits as a result of rising prices in certain goods and resulting substitutions the consumer may make. This manner in which adjustments to inflation are now calculated means that inflation is determined to move more slowly and, as a consequence, base amounts included in the Act subject to adjustment will also increase more slowly than they would under the prior adjustments. The net effect, therefore, is that in many cases taxpayers, whose income presumably will appreciate at rates faster than the rate of the chained CPI adjustments, will “creep” into higher tax brackets and exemption amounts and slowly become phased out from, or subject to limitations on, benefits they might be entitled to at the outset of the Act. References in this article to inflation adjustments can be assumed to use this methodology, unless otherwise indicated. Note, however, that certain inflation adjustments which are retroactive to a date prior to the advent of chained CPI under the Act are adjusted using standard CPI for the period between the beginning date for the base amount and the date on which chained CPI adjustments begin under the Act.

Individual Income Tax Brackets, Personal Exemptions, Standard Deductions, and Child Care Credits

As a starting point, individual taxpayers are now subject to seven income tax brackets for ordinary income ranging from a 10% rate up to a 37% rate for income exceeding $600,000 for married taxpayers (assumed for this article to be married taxpayers filing joint returns) and $500,000 for unmarried taxpayers (assumed to be taxpayers who are not surviving spouses or filing with head of household status). IRC § 1(j). The brackets are as follows for taxable income of married and unmarried taxpayers:

<table>
<thead>
<tr>
<th>Income Range</th>
<th>Tax Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Married</strong></td>
<td></td>
</tr>
<tr>
<td>Income not over $19,050</td>
<td>10% of income</td>
</tr>
<tr>
<td>Income over $19,050 but not over $77,400</td>
<td>$1,905 plus 12% of the excess over $19,050</td>
</tr>
<tr>
<td>Income over $77,400 but not over $165,000</td>
<td>$8,907 plus 22% of the excess over $77,400</td>
</tr>
<tr>
<td>Income over $165,000 but not over $315,000</td>
<td>$28,179 plus 24% of the excess over $165,000</td>
</tr>
<tr>
<td>Income over $315,000 but not over $400,000</td>
<td>$64,179 plus 32% of the excess over $315,000</td>
</tr>
<tr>
<td>Income over $400,000 but not over $600,000</td>
<td>$91,379 plus 35% of the excess over $400,000</td>
</tr>
<tr>
<td>Income over $600,000</td>
<td>$161,379 plus 37% of the excess over $600,000</td>
</tr>
<tr>
<td><strong>Unmarried</strong></td>
<td></td>
</tr>
<tr>
<td>Income not over $9,525</td>
<td>10% of income</td>
</tr>
<tr>
<td>Income over $9,525 but not over $38,700</td>
<td>$952.50 plus 12% of the excess over $9,525</td>
</tr>
<tr>
<td>Income over $38,700 but not over $82,500</td>
<td>$4,453.50 plus 22% of the excess over $38,700</td>
</tr>
<tr>
<td>Income over $82,500 but not over $157,500</td>
<td>$14,089.50 plus 24% of the excess over $82,500</td>
</tr>
<tr>
<td>Income over $157,500 but not over $200,000</td>
<td>$32,089.50 plus 32% of the excess over $157,500</td>
</tr>
<tr>
<td>Income over $200,000 but not over $500,000</td>
<td>$45,689.50 plus 35% of the excess over $200,000</td>
</tr>
<tr>
<td>Income over $500,000</td>
<td>$150,689.50 plus 37% of the excess over $500,000</td>
</tr>
</tbody>
</table>
This generally results in more compressed tax brackets, a corresponding drop in the effective tax rate imposed on individual taxpayers, and the “marriage penalty” becoming relevant only for married taxpayers falling in the highest bracket. With some very minor modifications to a few bracket levels, the long-term capital gains brackets and the resulting rates applicable for qualified dividends otherwise remain the same. IRC §§ 1(j)(5); 1(h)(11)(A). All individual income tax brackets under the Act, as well as the permanent brackets returning after the sunset, are to be adjusted for inflation. IRC §§ 1(j)(3)(B); -(f)(2)(A).

Individual taxpayers will be entitled to a standard deduction of $24,000 for married taxpayers and $12,000 for unmarried taxpayers, in each case also adjusted for inflation. IRC § 63(c)(7). Individual taxpayers will no longer be able to deduct personal exemptions for themselves and their dependents, but the child tax credit, although not adjusted for inflation, is doubled to $2,000 per child, includes $500 for certain other dependents, and has higher thresholds for a phase-out at $400,000 for a married taxpayer and $200,000 for an unmarried taxpayer. IRC §§ 151(d)(5); 24(h)(2); -(3); -(4)(A).

The “kiddie tax,” applying to any child under the age of 18 or with “earned income” of less than half of what is necessary for the child’s support and who is either the age of 19 or a student under the age of 24, is also modified so that unearned income of a child above a nominal threshold is taxed at rates commensurate with the rates applicable to trusts and estates, resulting in that income being subject to a higher effective rate than would otherwise be applicable to the child’s parents under prior law. IRC §§ 1(g)(2)(A); -(j)(4).

The Net Investment Income Tax (NIIT), imposing a 3.8% surtax on net investment income, remains in place. The threshold amounts for the tax to begin at $250,000 for married couples and $200,000 for single taxpayers also remain the same.

Income Tax Deductions

Aside from lower income tax rates, most taxpayers will experience the largest effect on their tax liabilities as the result of changes to their ability to take itemized deductions from expenses for which they have become accustomed to receiving a tax benefit. This and other changes under the Act will encourage taxpayers to alter their personal affairs going forward.

Miscellaneous Itemized Deductions

As a tradeoff to the higher standard deduction, miscellaneous itemized deductions previously subject to a floor of 2% of adjusted gross income are suspended, meaning that a multitude of expenses previously relied upon by many taxpayers to offset their income no longer provide a tax benefit, although one item of note is that the miscellaneous itemized deduction for estate tax paid on income in respect of a decedent (IRD) is not subject to the 2% floor and, therefore, not suspended. IRC § 67(g). Consistent with the suspension of miscellaneous itemized deductions subject to the 2% floor, the Pease limitation applicable to higher income taxpayers, causing the phase-out of certain deductions above certain income thresholds, is also suspended. IRC § 68(f).

State and Local Tax Deductions

The limitation imposed on deductions for state and local taxes (SALT) in the form of property, sales, and income taxes has become one of the most controversial and publicized aspects of the Act because of its disproportionate effect on residents of certain states over others. A taxpayer’s deductions for state and local taxes not attributable to a trade or business or the production of income are now capped at $10,000 for both married and unmarried taxpayers, with that limitation not adjusted for inflation. IRC § 164(b)(6).

After passage of the Act, many states experienced a rush of residents attempting to pay 2018 property taxes prior to 2017 year-end in an effort to be able to deduct those amounts on their 2017 returns. The IRS, in response, issued guidance in the form of IR -2017-210 distinguishing between 2018 property taxes which had been assessed as of the time of payment, in which case the deduction would be allowed, and those which had not yet been assessed, in which case the deduction for prepayment would be disallowed. Advisors quickly began to identify inconsistencies between the advisory and the plain terms of the statute, however, so the deductibility of any such payments remains unclear. Certain states are exploring alternate means of taxation that would be less detrimental to its residents, such as a tax on employers for wages paid, which would be deductible as a business expense, or a charitable contribution to the state, able to be deducted by a resident, followed by the issuance of a state income tax credit. States have also considered bringing legal challenges to the constitutionality of the Act’s effect on state income taxes.

Mortgage Interest Deduction

The mortgage interest deduction is modified so that interest may only be deducted on new indebtedness secured by a personal residence of up to $750,000 for a married taxpayer and $375,000 for an unmarried taxpayer (down from $1,000,000 and $500,000, respectively), with interest on existing indebtedness for the purchase of a personal residence on or before Dec. 15, 2017 (or as a result of a binding contract in effect at that time that meets certain other requirements) being allowed as a deduction under the previous higher limitations. IRC § 163(h)(3)(F)(i) (II)–(IV). Deductions for interest paid on a home equity line of credit (HELOC) are now disallowed except in the case of HELOC loans used to acquire, construct, or substantially improve a residence. IRC §§ 163(h)(3)(B); (3)(B); -(F)(i)(I).

Charitable Deduction

With the significantly increased standard deduction reducing the number of taxpayers who itemize deductions and, therefore, benefit from taking a charitable deduction, those impacted taxpayers may be discouraged from making charitable contributions. However, the ability to make large cash charitable contributions to qualifying organizations, including public charities, has improved by raising the limit of cash contributions able to be deducted in a single year to 60%, as compared to 50% previously, of a taxpayer’s adjusted gross income. IRC § 170(b)(1)(G). Any contribution which becomes subject to the limitation and therefore is not deductible in a particular year will be carried forward up to 5 years and be applied against the taxpayer’s adjusted gross income limitation in each succeeding year. IRC § 170(b)(1)(G)(ii).

Alimony Payments

Payments of alimony are disallowed as a deduction to the payor and, as a result, no longer reportable as income to the payee,
for divorce or separation instruments entered into after Dec. 31, 2018 or any preexisting divorce or separation agreements modified after that time if the modification expressly provides that the new rules are to apply. § 11051 of the Act. Relatedly, the payee no longer must consider alimony payments as compensation for purposes of retirement account contribution deductions. § 11051(b)(5)(C) of the Act (striking the third sentence of IRC § 219(f)(1)).

Other Deductions of Note

In addition to the deductions discussed above in more detail, there are also changes to the adjusted gross income floor applicable to the deduction available for medical expenses under IRC Section 213 (reduced from 10% to 7.5% for 2017 and 2018), the ability to deduct personal casualty losses under IRC Section 165(h) (limited to losses from federally declared disasters from 2018 to 2025), the exclusion available for qualified moving expense reimbursement under IRC Section 132(a)(6) (suspended from 2018 to 2025 except in the case of armed service members), and the ability to deduct moving expenses under IRC Section 217(a) (suspended from 2018 to 2025).

Roth Contributions and Recharacterizations

A Roth recharacterization, whereby a traditional individual retirement account (IRA) is converted into a Roth IRA and, depending upon the performance of the assets in the converted account, recharacterized back to a traditional IRA if the assets underperform, is no longer allowed, although the IRS has indicated that conversions entered into in 2017 may still be recharacterized within the permissible period. IRC § 408A(d)(6)(B)(iii).

A regular contribution to a Roth IRA can still, however, be reformed to a contribution to a traditional IRA. Based on indications included in the Conference Committee Report to the Act, a “backdoor” Roth IRA contribution is also now sanctioned after previous uncertainty as to whether it could be challenged under the step transaction doctrine.

529 Accounts and ABLE Accounts

529 accounts, which allow for funds to be invested on a tax-free basis so long as they are ultimately used to pay for qualified education expenses for eligible post-secondary educational institutions, can now, in addition, be used to fund expenses for tuition of up to $10,000 per year at elementary and secondary schools. IRC §§ 529(c)(7); -e(3)(A). ABLE accounts created for a disabled beneficiary, which previously could only receive contributions in a single year from one or more donors in the aggregate amount of the gift tax annual exclusion then in effect, are now eligible for additional contributions above the annual exclusion amount to be made by the account beneficiary to the extent of his or her compensation for the year. IRC § 529A(b)(2)(B). A tax-free rollover may also be made from a 529 program account to an ABLE account, subject to the contribution limits in effect for the ABLE account and provided the beneficiary for both accounts is the same or a member of the same family, if the 529 account funds could be put to better use through an ABLE account for a disabled family member. IRC § 529(c)(3)(C)(III).

Individual Alternative Minimum Tax (AMT)

The alternative minimum tax (AMT) for individuals remains in effect, although it will be less relevant given the elimination of personal exemptions, the limitations imposed on deductions, and an increase in the exemption amounts for married taxpayers to $190,400 and for unmarried taxpayers to $70,300 and phaseouts of the exemptions now beginning at $1,000,000 and $500,000, respectively, and thereafter adjusted for inflation. IRC § 55(d)(4).

Gift, Estate, and Generation-Skipping Transfer (GST) Exemptions

In the gift, estate, and generation-skipping transfer (GST) tax arena, the basic exclusion amount for estates has been doubled to $10,000,000, with that amount adjusted for inflation from 2011, resulting in the same increase in the exclusion for gifts during a taxpayer’s lifetime and generation-skipping transfers. IRC § 2010(c) (3)(C). The inflation adjustment takes place using chained CPI starting in 2017. § 11002(d)(1)(CC) of the Act. While the inflation-adjusted amount for 2018 has not yet been officially set, calculations estimate it to be $11,180,000, the slight difference between this amount and double the amount of the 2018 exemption calculated under prior law being attributable to the use of chained CPI instead of a regular CPI adjustment. The annual gift tax exclusion is anticipated to be consistent with previous estimates at $15,000.

In light of the scheduled sunset of the exemption amounts down to their pre-Act schedules after 2025, Treasury is given the authority to issue “clawback” regulations as to the difference between the exemption amount when gifts were made during a taxpayer’s lifetime and the exemption amount in effect at his or her death. IRC § 2001(g)(2).

Planning Considerations

The possible avenues for tax and estate planning as a result of the Act are numerous and varied.

Existing estate plans should be evaluated to determine if changes are necessary as a result of the Act, for instance, because of the use of formula allocation clauses. An estate plan keyed off of the estate or GST tax exemption amounts that leaves unused exemption to one set of beneficiaries with the remainder to another might no longer be consistent with a taxpayer’s wishes. While formula clauses are necessary to avoid undesirable income tax consequences in many cases and provide flexibility to fluctuate with changing exemption amounts, the continued increase in the exemption amount—dramatically so, if considered relative to the much lower exemptions in effect in recent years—could cause, from failing to revisit an estate plan, a result much different from what a taxpayer would desire for his or her estate.

For example, a charitably inclined taxpayer might have desired to “zero-out” estate taxes by leaving his or her unused estate tax exemption amount to family members, with the remaining amount to pass to charity. The dramatic increase in the exemption amount, dependent upon the taxpayer’s net worth, might now result in the taxpayer’s family members receiving the entirety of the taxpayer’s estate, leaving the charity that the taxpayer also desired to benefit out of luck. Similar concerns could easily arise in a blended family context where a taxpayer has left the exemption amount to his or her children with the remaining amount taking advantage of the marital deduction by passing for the benefit of a second spouse. Or consider the possibility that a taxpayer may have planned to allocate or distribute assets using all of his or her GST tax exemption directly to grandchildren or, alternatively, among trusts to one or more children who themselves have children, so as to prevent a taxable termination upon the death of...
a child, with an equalized amount of GST non-exempt assets passing to a child who is not anticipated to have children of his or her own, in which case a taxable termination is not a concern. It is not hard to imagine a client who has forgotten about his or her estate plan over the last decade and could now have very different dispositive objectives from what was roughly estimated at that time.

When it comes to tax planning, the Act has further solidified statements by commentators in recent years that the traditional unilateral focus on a single class of taxation is a thing of the past. Instead, tax planning for individual taxpayers will need to be increasingly customized to take into consideration benefits to be obtained both from gift, estate, and GST tax planning as well as income tax planning. Customized tax planning is especially important for taxpayers with “borderline” taxable estates (or the potential for growth in their net worth to result in taxable estates), both during the duration of the increased gift, estate, and GST tax exemptions and after the sunset, and could come in many forms.

**Income Tax Planning**

As a basic step for income tax planning, taxpayers will want to consider concentrating deductions in particular years, such as a large charitable contribution being made in a single year instead of being spread across multiple years, itemizing deductions in the year of the contribution and then using the increased standard deduction in other years.

As a more involved opportunity to reduce income tax liability, taxpayers negatively affected by deduction limitations imposed by the Act could consider using non-grantor trusts. While non-grantor trusts (i.e., trusts structured to be separately taxable from the grantor) are less advantageous for North Carolina residents than they might be for residents of other states because they currently cannot be sitused out-of-state to avoid North Carolina state income tax unless none of the trust beneficiaries reside in North Carolina, using non-grantor trusts to avoid the SALT limitations (combined, possibly, with the income limitations for the Code Section 199A pass-through deduction for certain business income) could prove to be useful. For a discussion of the Code Section 199A deduction and its application to non-grantor trusts, see “Business Tax Planning and Fiduciary Income Tax After Tax Reform” in this newsletter.

The economics of SALT deductions are not particularly impressive on a standalone basis, but if able to be leveraged over multiple trusts in an efficient manner, meaningful income tax savings could result. Assume, for example, a taxpayer has 4 children and 2 grandchildren. The taxpayer could create 6 separate non-grantor trusts for which each descendant is the primary beneficiary and transfer business interests to it which generate income subject to North Carolina state income tax. Assuming the taxpayer would also otherwise pay federal income tax on that income at the highest 37% rate and the North Carolina state income tax liability for each trust is at least $10,000, each trust would provide an additional $3,700 per year in tax savings solely from additional SALT deductions, for an annual total of $22,200. Additional savings would also result to the extent the business interests qualify for a deduction under Code Section 199A and now avoid the phase-out beginning at $157,500 of taxable income for unmarried taxpayers (including trusts) and $315,000 for married taxpayers, in the case of “specified service businesses,” or the phase-in of W-2 wages and depreciable property limitations, in the case of others. Alternatively, if no beneficiary is a North Carolina resident, it may be possible to structure trusts to avoid North Carolina state income tax. Of course, these calculations cannot be considered in a vacuum and would need to be evaluated relative to the transaction costs of creating and administering the trusts. If the taxpayer’s net worth would cause him or her to be subject to estate tax at death, it might also be more beneficial for any trust he or she creates to be a grantor trust, allowing the taxpayer to pay its income tax liability from his or her own funds.

At death, a taxpayer will also want to ensure that his or her remaining estate tax exemption is exhausted to the extent possible to cause a step-up in basis, which has been retained under the Act, for any built-in gain property included in his or her gross estate (also considering that built-in loss property would be stepped down at death). Pre-mortem planning for this purpose could involve swaps of assets from grantor trusts outside of the taxpayer's estate if the taxpayer holds high-basis or built-in loss assets that would not benefit from a basis adjustment at the taxpayer's death relative to low-basis assets owned by the trust. An independent Trustee of a trust might also be used to grant a general power of appointment to the taxpayer over built-in gain property to the extent of any remaining exemption. Use of exemption for a basis step-up might prove particularly effective with an older relative with a short life expectancy, whether through the grant of a general power of appointment in an existing trust or creation of a new trust with a general power of appointment such that property passes to the intended recipient at a higher stepped up basis after the relative's death.

A taxpayer having excess exemption and who also has a limited power of appointment over trust property for his or her own benefit may consider whether exercising that power of appointment under his or her will could be beneficial to trigger the “Delaware tax trap” by creating a presently exercisable general power of appointment for another beneficiary, resulting in inclusion of the appointed property in the taxpayer's estate under Code Section 2041(a)(3) and a basis step-up. The ability to exercise the Delaware tax trap involves significant uncertainty in many cases, including under North Carolina law, so this technique must be carefully evaluated based on the particular circumstances. The benefit to using the Delaware tax trap for a basis step-up, however, as opposed to granting a beneficiary of a trust a general power of appointment or distributing trust property to the beneficiary outright, is the beneficiary's level of control over the exercise, the ability to avoid having to engage (and convince) an independent Trustee to act, possible creditor protection for the beneficiary, and the fact that an outright distribution or granting of a general power of appointment cannot be “undone” if circumstances change. Presumably the beneficiary, with the help of advisors, will also be able to determine best whether estate inclusion of the trust assets will be beneficial in the overall context of his or her estate plan.

Family entities such as family limited liability companies or family limited partnerships with interests that would be discounted from the underlying value of their assets in an estate at a taxpayer's death might also be unwound or the terms of their governing documents amended so the includible property is no longer subject to a discount or, alternatively, low-basis property could be distributed to the taxpayer during lifetime in liquidation of his or her interest. In the closely-held business context, steps could be taken to address a taxpayer's ownership of S corporation stock at death with there being no equivalent to a Code Section 754 election for S corporations as
there is for partnerships causing an “inside basis” step-up upon the taxpayer’s death. The result in the case of an S corporation might be a mismatch of gain and loss in that an S corporation selling assets piecemeal after a taxpayer’s death will continue to recognize gain on those assets flowing through to its shareholders, and only upon liquidation of the deceased shareholder’s stock (which did receive a basis step-up at the taxpayer’s death) will the new owners of the stock be able to take advantage of a loss which results from a liquidation of stock with basis in excess of the underlying company assets. Low-basis assets might be distributed from the S corporation to the taxpayer or the S corporation otherwise restructured to address this issue.

Gift, Estate, and GST Tax Planning

Many taxpayers will want to proceed with traditional gift and estate tax planning separately or in conjunction with income tax planning, either because they are currently subject to the estate tax, even at the higher exemption amount, or in preparation for the eventual sunset of the increased exemption amount. This might involve gifts or sales to grantor trusts or non-reciprocal spousal lifetime access trusts (SLATs) for married taxpayers to avoid the regrets many taxpayers faced after planning in 2012 that left them without even indirect access to trust property. Depending on a taxpayer couple’s net worth, and whether they are anticipated to remain subject to the estate tax at death, it may or may not make sense to structure SLATs either as grantor trusts, so that income tax payments can be made by each grantor (rather than the trust) without incurring gift tax, or as non-grantor trusts, to obtain income tax benefits. A previous sale to a grantor trust in exchange for a promissory note might be wound down by gifting assets to the trust to pay off the outstanding note principal.

There is, albeit unlikely in the views of many commentators, the possibility that a subsequent decrease in the gift tax exemption could involve some type of “clawback” provision for taxpayers who have used their excess exemption in the interim. If no clawback is to take place, planners might, closer to the effective date of the sunset, consider options to benefit a taxpayer from the exemption amount to be “lost.” If he or she is not willing or able at that time to make a completed gift, one approach may be to structure the transfer of a subordinate interest into trust and trigger the zero-valuation rules under Code Section 2701 intentionally to use the excess exemption, which is then credited back to the taxpayer at his or her death for estate tax purposes. In the interim, the taxpayer would be able to retain an interest with a preferred return to the subordinate interest involved in the deemed transfer for use during his or her lifetime.

Structuring Estate Plans

The technical tax aspect of estate planning will involve structuring a decedent’s estate plan to allow for a balancing of income tax and estate tax benefits. This will supplant the use of traditional “A/B trust planning” in many cases in favor of added flexibility after the taxpayer’s death, in the case of a married couple, to allow a basis step-up to occur at the death of both spouses.

For example, a married couple’s estate plan might provide for assets to pass to a marital trust eligible for a QTIP election upon the death of the first spouse, which could be split into separate trusts to the extent desired to make only a partial QTIP election, having up to 15 months to make that determination. A portability election would be made to preserve the deceased spouse’s unused exemption (DSUE) amount for the surviving spouse, and a reverse QTIP election would allow for the use of the deceased spouse’s GST exemption over the marital trust assets. A disclaimer option, notwithstanding its own limitations, could also be added to reroute assets to a credit shelter trust to avoid a “leaky” non-QTIP marital trust providing for income payments to bring assets back into the surviving spouse’s taxable estate, with the added benefit of facilitating trust funds more easily reaching the couple’s descendants as beneficiaries of the credit shelter trust after the death of the first spouse (unlike a marital trust, which would only be for the direct benefit of the surviving spouse).

A “Clayton QTIP” structure might also be used, allowing an unrelated executor to choose what, if any, assets over which to make a QTIP election, causing those assets to be funded to a marital trust for the benefit of a surviving spouse to be included in the surviving spouse’s estate and receive a second basis step-up upon the death of the surviving spouse. Any remaining assets would be separately funded to a credit shelter trust to make use of the deceased spouse’s exclusion amount and prevent subsequent inclusion in the surviving spouse’s estate.

Final Thought

Given the myriad changes, the coming years will prove challenging for tax and estate planners, but never more than before is there the opportunity for addressing a client’s unique needs in a shift away from traditional planning techniques. While significant uncertainty remains as to the future of the reform brought about by the Act, taxpayers and advisors can work in tandem to make the best of the Act for our clients.

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How to Avoid a Headache at the Bank

By Andrea Chomakos and Deborah King

As estate planning attorneys, we are well versed in the process of estate administration and have expectations of how others should acknowledge and respect the documents that we prepare for our clients – wills, trusts, powers of attorney. And many times things work as expected – our clients walk into a bank branch, meet with a branch manager or other employee, and present a power of attorney, letters testamentary, or trust document and the bank adds the agent to the principal’s account, closes the decedent’s account, or establishes the trust account as requested.

However, sometimes, things are not as seamless. Hiccups definitely are frustrating for our clients, in particular as these issues often arise in the context of an already stressful situation – a loved one is sick or has died, the task at hand is not routine and the legalese is incomprehensible. But, financial institutions are subject to increasing regulations from both the state and federal government, and policies have been developed to address potential risks to financial institutions and to protect customers and their confidential information. At the root of most of the frustration is a lack of understanding of the regulations to which the banks must adhere. Your Section’s Council has reached out to the North Carolina Banker’s Association (the “Association”) and invited a member from the Association to join the Section’s Council as a liaison and to co-author a series of articles to address some of the issues we have heard you raise in dealing with financial institutions in estate and planning related matters. This article will present several common situations that arise in dealings with banks and explain the North Carolina statutes applicable to the banks so that you can advise and assist your clients in being prepared in transacting with a financial institution.

Power of Attorney

It is important to remember that banks have a number of strict rules that they must comply with, which derive from federal and state laws and other regulations. Those rules are intended to protect both the bank and its clients. In the context of powers of attorney, it is important for the bank to confirm that the power of attorney is valid and the person presenting the power of attorney has the appropriate authority to act under it.

The North Carolina legislature recently adopted the Uniform Power of Attorney Act (effective Jan. 1, 2018). That new act will help address two common situations encountered by banks (and other third parties presented with a power of attorney) under the prior statute. Previously, N.C.G.S. Section 32A-9 stated:

“(b) No power of attorney executed pursuant to the provisions of this Article shall be valid subsequent to the principal’s incapacity or mental incompetence unless it is registered in the office of the register of deeds of that county in this State designated in the power of attorney, or if no place of registration is designated, in the office of the register of deeds of the county in which the principal has his legal residence at the time of such registration or, if the principal has no legal residence in this State at the time of registration or the attorney-in-fact is uncertain as to the principal’s residence in this State, in some county in the State in which the principal owns property or the county in which one or more of the attorneys-in-fact reside. A power of attorney executed pursuant to the provision of this Article shall be valid even though the time of such registration is subsequent to the incapacity or mental incompetence of the principal.” (emphasis added).

So, if the principal was incapacitated and the agent presented a power of attorney that had not been recorded, the bank could not treat the agent as having the authority to act on behalf of the principal. The new act does not require a power of attorney to be registered subsequent to the principal’s incapacity, and extends this rule to powers of attorney executed before the effective date of the new law.

The other issue that the new act addresses is lack of clarity regarding whether a power of attorney is durable or springing. The new act provides that a power of attorney is effective immediately, unless specifically provided to be springing. This is the opposite presumption from the prior law. Practitioners should be careful in how clients execute the new statutory form, to avoid any confusion on the effectiveness of the power of attorney. Further, to the extent that a power of attorney is springing, the bank will necessarily require additional information and documentation to determine whether the power of attorney is effective.

Agents should be prepared with this information and documentation when presenting a springing power of attorney to a bank.

While the new statutory form should be viewed as an improvement over the current statutory form and may be sufficient in many cases, a well drafted custom power of attorney that clearly states the powers of the agent is a helpful tool as well. While the statutory form provides for a number of powers to be granted to the agent, it is not all-inclusive and unique issues can arise that are not covered under the power of attorney.

Under certain circumstances, it may be difficult for a bank to determine if the agent is acting within the scope of the power of attorney and one option is for a bank to contact the attorney that drafted the power of attorney. Discussing the power of the attorney with the bank is a valuable service you can provide. Additionally, banks are required by regulators and the state to take steps to detect financial elder abuse and are aware that a power of attorney is a favored method for those trying to take advantage of the elderly. Providing information to the bank may avoid the filing of an unnecessary financial elder abuse report or help the bank determine that a report should be filed. Once a financial elder abuse report is filed pursuant to N.C.G.S. Section 32C-1-120(9) the person that has filed or is aware of the filing is not required to follow the directions of the agent.

Safe Deposit Box

Another area where clients may become frustrated is in trying to access a decedent’s safe-deposit box. There are specific rules in North Carolina regarding the access to a deceased person’s safe de-
posit box. N.C.G.S. Section 28A-15-13(c) allows a safe deposit box to be opened without the presence of a clerk of court when:

“[T]he person requesting the opening of the decedent's safe-deposit box is a qualified person. In that event, the qualified person shall make an inventory of the contents of the box and furnish a copy to the institution and to the person possessing a key to the box if that person is someone other than the qualified person.”

A qualified person includes a qualified personal representative, a person with an order of summary administration, co-lessee or a deputy. A deputy is "a person appointed in writing by a lessee or cotenant of a safe-deposit box as having right of access to the safe-deposit box without further authority or permission of the lessee or cotenant, in a manner and form designated by the institution." N.C.G.S. § 28A-15-13(a)(1a).

Thus, if an individual goes to the bank with a copy of the will or just the decedent's death certificate, and no qualifying letters testamentary or administration, the bank cannot give that person – who is not a qualified person – access to the safe deposit box. Of course the quandary of “but the will is in the safe deposit box” always triggers sympathy, but is not the magic key to grant the bank authority to open the box. This is why clients should be advised not to put the will in the safe deposit box! However, when these situations arise, the clerk or representative of the clerk must access the box and take inventory of the box, including taking the will and filing it. Because of this cumbersome statutory procedure, clients should be advised not to retain the original will in a safe deposit box or to otherwise designate on the safe deposit contract a person who can access the box.

Joint Accounts

Another common issue is obtaining financial information for a decedent's accounts, to report to the court and/or IRS with the decedent's estate tax return. However, if the account is jointly owned, the bank must be cognizant of the customer information as it pertains to the other account owner. Specifically, when the decedent owns a joint account that is held as joint with right of survivorship, on the death of the decedent the account automatically becomes the property of the survivor and the bank has to guard the financial information of the surviving owner. Financial institutions understand the personal representative's needs and if informed of the situation can generally comply with the request for account statements that cover periods prior to and including the date of death. Thus, if a personal representative explains why the statements are being requested, the bank can usually comply with the request.

In addition to requesting information about joint accounts, a personal representative may believe that the estate owns a portion of a joint account. When a bank reviews a joint account after the death of the decedent to determine ownership, the bank must comply with the terms of the account agreement. A client may believe that the account is owned as joint tenants with right of survivorship, but the account application may state that the account is a joint account without a designation of rights of survivorship. In this situation, depending on when the account was established, it may be classified as a tenant-in-common account. Accordingly, the bank is obligated to treat the account as owned per the account application. While this may be frustrating to the parties who thought the account was joint with right of survivorship, the bank must comply with the applicable laws and account application.

Conclusion

The combination of statutes, regulations and coping with the sickness or death of a loved one can be stress inducing but with careful preparation estate planning attorneys can help minimize that stress for their clients. Hopefully the above tips, along with well drafted documents, can help avoid a call from a frustrated client.

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If you have any suggestions for additional article topics related to this work please contact either one of them.
Business Tax Planning and Fiduciary Income Tax After Tax Reform

By Thomas Cooper

The Tax Cuts and Jobs Act (the “Act”) has sought to overhaul the tax regime applicable to American businesses under the Internal Revenue Code (the “Code” or “IRC”), with the goal of encouraging investment in, and the growth of, business activity. While much is still left to be determined as to the ultimate impact of the Act on the American economy, it is certainly the case that changes brought about by the reform will fundamentally alter the manner in which some business owners and operators choose to handle business operations, finances, and management. In the context of businesses which are closely held, owners may come in the form of owner-operators, individual investors, or, with trust ownership, being especially applicable to closely held businesses passed down from one family generation to another, trust fiduciaries. Each may face unique challenges, but as a general matter, businesses and their owners and operators, together with their advisors, now face the task of adapting to the new law so that they may continue to operate in a tax-efficient, but also practical, manner. This article attempts to note certain items of significance for business owners, operators, and advisors and important planning approaches they might use to adjust to the Act.

Portions of the Code affecting businesses not discussed here have undergone change as well—substantial change, in some cases, such as the transition to a “territorial” system in the international tax arena. Many provisions related to business taxation also pertain only to certain industries, such as the life insurance, farming, or alcoholic beverage industries, and some others affect only publicly traded companies. The substance of those are outside the scope of this article, which focuses on the impact of the Act, generally, on closely held, domestically owned and operated businesses. While relevant to the operations of closely held businesses, this article also does not fully address all provisions of the Act relating to employee compensation and benefits or depreciation methods and other managerial accounting issues, since those are less relevant to the high-level tax planning addressed in this article.

Preliminary Considerations

As a starting point, business owners, operators, and advisors should consider certain principles to guide their analysis of tax planning involving businesses.

Political Uncertainty

Unlike the portions of the Act applicable to individual taxpayers, most of the benefits afforded to businesses are made permanent with the exception of the new Code Section 199A deduction for pass-through income. Much in the same way there also exists political uncertainty for the tax reform on individuals, however, political forces could always cause an unexpected change to the Code which mitigates or reverses benefits that might be obtained from structuring a business in a certain manner. Any further reform could even cause tax planning measures to become counterproductive in the long run, such as an increase in the corporate tax rate. Accordingly, businesses, possibly even more so than individuals, notwithstanding the “permanence” of items affecting businesses under the Act, should be mindful of the possible need to pivot in the event of further tax reform.

Need for Additional Guidance

Guidance on the Act is also lacking in many places, which is especially problematic given that certainty of the tax effects of a transaction or business arrangement is often crucial for businesses. Treasury has acknowledged the need to allocate resources to provide additional support on issues, particularly on the Code Section 199A deduction and the new interest expense limitations, but taxpayers will be forced in the interim to operate without additional direction. Treasury has also indicated that general guidance on the new three-year holding period applicable to profits interests for long-term capital gain treatment is less of a priority given its more limited application to taxpayers.

Non-Tax Considerations

A business might evaluate an opportunity for tax planning in conjunction with the non-tax benefits of a restructuring or reorganization. For example, a business might desire to streamline its expansion efforts or operations, position itself for a sale, minority investment, or other liquidity event, support its efforts to deleverage, or obtain financing at a lower cost of capital, or improve the terms of a buy/sell arrangement among its owners. A restructuring or reorganization combined with estate planning might also facilitate additional asset protection for an individual owner’s business interests. Where direct cost savings from tax planning are less substantial, tax and non-tax benefits combined might still provide a net benefit for a business or owner and weigh in favor of taking proactive measures.

Corporate Income Tax

The corporate income tax rate is now simplified with a new 21% flat entity-level tax rate imposed on C corporations, including personal service corporations, to replace the graduated rates previously in place of up to 35%. IRC § 11(b). The corporate alternative minimum tax (AMT) has been repealed, with a refundable amount for future years being used to account for credits received in prior years. IRC §§ 55(a); 53(e).

The dividends received deduction is adjusted downward consistent with the lower overall corporate tax rate so that non-qualified dividends from domestic corporations not constituting small business investment companies (SBICs) or corporations owned more than 20% by the recipient corporation are now 50% deductible. IRC § 243(a)(1).
The accumulated earnings tax for corporations will apply in excess of a $250,000 credit, generally, with a $150,000 credit applied to corporations engaged in services similar to those constituting specified service businesses for the Code Section 199A deduction discussed below, with a few notable differences. IRC § 1561(a). The types of businesses subject to this lower credit include service corporations with principal functions in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting. IRC § 535(c)(2)(B). Unlike the Code Section 199A definition of “specified service businesses,” for which the deduction for pass-through income becomes limited above certain income thresholds, engineering and architecture are included here, and athletics are omitted.

Income Tax on Estates and Trusts

Estates and non-grantor trusts, which, unlike grantor trusts, are treated as standalone taxpayers for federal income tax purposes, are now subject to four income tax brackets for ordinary income ranging from a 10% rate up to a 37% rate, consistent with the range of rates for individual taxpayers, but as has been the case for some time, the top 37% rate for estates and trusts becomes applicable at a much lower threshold of $12,500. IRC § 1(j). The brackets for taxable income for estates and trusts are as follows:

<table>
<thead>
<tr>
<th>Income not over $2,550</th>
<th>10% of income</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income over $2,550 but not over $9,150</td>
<td>$255 plus 24% of the excess over $2,550</td>
</tr>
<tr>
<td>Income over $9,150 but not over $12,500</td>
<td>$1,839 plus 35% of the excess over $9,150</td>
</tr>
<tr>
<td>Income over $12,500</td>
<td>$3,011.50 plus 37% of the excess over $12,500</td>
</tr>
</tbody>
</table>

The long-term capital gains brackets remain the same. All income tax brackets, as well as the permanent brackets returning after the sunset, are to be inflation-adjusted using chained CPI, (discussed in more detail in “Individual Estate and Tax Planning After Tax Reform” in this newsletter) and sunset back to their original levels after 2025. IRC §§ 1(j)(3)(B); -(f)(2); -(e). Nominal exemption amounts also remain.

Income Tax Deductions

The central focus for many businesses will be the effect of the Act on income tax deductions which are either being introduced for the first time or modified from their previous form.

Pass-Through Income

One of the most notable results of the Act in any area is the ability for non-corporate taxpayers owning interests in pass-through entities, meaning entities that are not separately taxed for federal income tax purposes, such as S corporations and partnerships, to deduct a portion of the domestic income generated from operations of a trade or business. Code Section 199A introduces this new concept, which borrows from the deduction previously available under Code Section 199, repealed by Section 13305 of the Act, for domestic production activities.

Any non-corporate taxpayer receiving “qualified business income” (QBI) from a trade or business in the form of a pass-through entity may take a deduction of up to 20% on that income, not to exceed the taxpayer's taxable income (excluding net capital gain) for the year. IRC §§ 199A(a)–(b). QBI is limited to income effectively connected with a trade or business in the United States excluding capital gains, dividends, interest and annuity income (other than that attributable to a trade or business), gains from commodities and currency transactions and derivatives, compensation, and, in the case of a partnership, guaranteed payments or other payment for services rendered by a partner and therefore is limited to income generated from the actual operations of the trade or business. IRC §§ 199A(c)(3)–(4). If the determination of QBI in any year actually comes to a loss, the loss amount is carried forward to subsequent years to offset any later-generated QBI. IRC § 199A(c)(2). This will be a standalone deduction not considered an itemized deduction on Schedule A. Deductions are also permitted for real estate investment trust (REIT) dividends, cooperative dividends, and publicly traded partnership (PTP) income, but the analysis here will focus on QBI.

The extent of the deduction that is permitted is dependent on one or more of (1) the taxpayer's taxable income for the year, (2) whether the QBI is derived from a “specified service business,” and (3) W-2 wages paid and “qualified property” owned by a business generating QBI and not classified as a specified service business. Unlike many of the business tax reforms made under the Act, this deduction, as noted above, is only temporary, as it sunsets for taxable years after 2025. IRC § 199A(i).

A specified service business includes a trade or business involving the performance of services in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees or owners, investing and investment management, or trading or dealing in securities, partnership interests, or commodities. IRC § 199A(d)(2) (referencing IRC § 1202(e)(3)(A)). While architecture and engineering were specifically removed from this list, it is unclear whether certain businesses conducted by architects or engineers could still separately fall into the “reputation or skill” prong of the term. Unfortunately, what does and does not constitute a specified service business based on this aspect of the term and other generalities is hardly clear and will result in confusion for many taxpayers across a wide variety of businesses.

Qualified property is depreciable property owned by a trade or business at the end of a taxable year for the production of income and for which the depreciable period has not ended. For purposes of determining the depreciable period, the property is deemed to have a depreciable period of no less than 10 years. IRC § 199A(b)(6)(B).

If a married taxpayer (assumed for this article to be a married taxpayer filing joint returns) has taxable income below a threshold amount of $315,000 or an unmarried taxpayer has taxable income below a threshold amount of $157,500, in each case adjusted for inflation, the taxpayer can deduct the full amount of 20% of QBI eligible for the deduction. If a taxpayer has taxable income in excess of those amounts, however—between $315,000 and $415,000, in the case of a married taxpayer, and $157,500 and $207,500, in the case of an unmarried taxpayer, in each case adjusted for inflation—the deduction either phases out, in the case of QBI generated by a specified service business, or limitations based on the W-2 wages.
paid by a business and its qualified property, in the case of a non-specified service business, become phased in.

With respect to QBI from any specified service business for taxpayers having taxable income in excess of the upper end of the phase out thresholds, a taxpayer becomes completely ineligible for any deduction. In the case of any other businesses the taxpayer’s deduction becomes fully subject to limitations based on the business’ W-2 wages and qualified property. In that case, the deduction is limited to the greater of (1) 50% of the W-2 wages paid by a business or (2) the sum of 25% of its W-2 wages and 2.5% of the “unadjusted basis immediately after acquisition” of its qualified property, which would include the cost basis of property at the time it is placed in service, although the effect of certain subsequent changes to basis, as a result of a Code Section 754 election adjustment, for example, is unclear.

For partners of a partnership and shareholders of an S corporation, the deductible amount is determined at the partner or shareholder level. W-2 wages are apportioned to them based on their allocable shares of wage expenses, and qualified property is apportioned to them based on their allocable shares of depreciation. IRC § 199A(f). Treasury is given authority to issue regulations governing the application of the deduction to tiered entities. IRC § 199A(f)(4)(B). In a last-minute change to the legislation for the Act, trusts and estates owning business interests also became eligible for the deduction, with W-2 wages and qualified property limitations to be apportioned among a trust and its beneficiaries similar to the rules previously in effect for the Code Section 199 deduction. IRC § 199A(f)(1)(B).

So much for the simplification of the Code promised leading up to the Act. The pass-through deduction introduces enormous complexity and arbitrarily rewards some types of businesses over others, likely prompting many taxpayers to rearrange their business affairs to ensure the greatest eligibility for the deduction. While planning opportunities exist to take full advantage of the deduction, taxpayers and their advisors should understand that any claim of a deduction under Section 199A also causes a taxpayer’s margin of error to be cut in half from 10% to 5% in assessing a substantial understatement penalty for the taxpayer’s entire return. IRC § 6662(d)(1)(C).

**Interest Expense**

The ability to deduct interest expense is now limited for businesses having more than $25 million in average annual gross receipts for the 3 years prior to a taxable year, with the limitation generally equal to the sum of any business interest income earned by a business during the taxable year and 30% of other taxable income, subject to adjustments for NOLs, any Code Section 199A deduction, and prior to 2022, depreciation and amortization. IRC § 163(j). A shorthand for the adjustments to income subject to the 30% limitation is earnings before interest, taxes, depreciation, and amortization (EBITDA) prior to 2022 and earnings before interest and taxes (EBIT) for 2022 and thereafter. Pass-through entities are subject to this limitation at the entity level, with adjustments made to income and basis for their owners to the extent necessary to accommodate an entity-level determination. IRC § 163(j)(4). Any interest expense that is disallowed in a particular year is carried forward to subsequent years. IRC § 163(j)(2).

Certain lines of business are not subject to the limitation, some on an elective basis, including a real property trade or business, which can make an irrevocable election. IRC § 163(j)(7)(B). The tradeoff to such an election is that the electing real property trade or business is then required to use the alternative depreciation system (ADS) for nonresidential real property, residential real property, and qualified improvement property (i.e., nonresidential real property with interior improvements made after the property was placed into service), allowing for less efficient depreciation than might otherwise be permitted. IRC § 168(g)(8).

**Excess Business Losses and Net Operating Losses**

A non-corporate taxpayer’s “excess business losses,” meaning a taxpayer’s deductions attributable to a trade or business (including losses incurred at the shareholder or partner level in the case of pass-through businesses), now cannot offset non-business income, such as income from passive investment, in excess of $250,000 for single taxpayers and $500,000 for married taxpayers, adjusted for inflation, with the limitation to sunset after 2025. IRC §§ 461(l)(1); -(3); -(4). Any excess business losses are instead treated as net operating losses (NOLs) and must be carried forward to offset business income in future years. IRC § 461(l)(2).

Deductions for NOLs are now also capped in most cases for any taxable year at 80% of taxable income. With certain exceptions, the 2-year carryback that was previously allowed has been eliminated, but unlimited carryforwards are now permitted in most cases. IRC §§ 172(a); -(b)(1)(A). Note that the statute contains a disconnect in the effective dates of the amendments, with the changes to the NOL deduction to be effective for taxable years beginning after Dec. 31, 2017 but the changes to carryforwards and carrybacks to be effective as to taxable years ending after Dec. 31, 2017. § 13302(c) of the Act. The Conference Report for the Act indicated that the provisions affecting NOLs were to be effective for taxable years beginning after Dec. 31, 2017. A technical correction may have to be made to reconcile the difference.

**Depreciation and Expensing**

Expenses associated with certain depreciable business assets, now including elected roof, HVAC, fire protection, and alarm or security systems, may be immediately expensed up to $1,000,000, if all property subject to the expensing during a taxable year does not exceed $2,500,000, in each case adjusted for inflation, instead of being deducted over time subject to a depreciation schedule. IRC §§ 179(d)(1)(B); (f).

Similarly, “bonus depreciation,” allowing expensing of a percentage of basis for certain depreciable assets before applying a regular depreciation schedule, including used depreciable assets at the time they are first placed in service by a business, has also been expanded to allow higher percentage amounts to apply to acquired assets in earlier years, stepped down in later years before ultimately being phased out altogether. IRC §§ 168(k)(1)(A); -(6). The bonus depreciation schedule to be applied to adjusted basis of property is as follows:

<table>
<thead>
<tr>
<th>Year</th>
<th>Percentage of Adjusted Basis</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sept. 27, 2017-2022</td>
<td>100% of adjusted basis</td>
</tr>
<tr>
<td>2023</td>
<td>80% of adjusted basis</td>
</tr>
<tr>
<td>2024</td>
<td>60% of adjusted basis</td>
</tr>
<tr>
<td>2025</td>
<td>40% of adjusted basis</td>
</tr>
<tr>
<td>2026</td>
<td>20% of adjusted basis</td>
</tr>
<tr>
<td>2027 and later years</td>
<td>No deduction</td>
</tr>
</tbody>
</table>
Charitable Contributions

The treatment of charitable contributions by partnerships has now been brought somewhat in parity with the treatment of charitable contributions by S corporations by providing that the standard loss limitation rules to which a partner is subject are now applicable to charitable contributions from the partnership, but only to the extent of the basis of contributed partnership property (and not its fair market value). IRC § 704(d)(3).

Elected small business trusts (ESBTs) are no longer subject to gross income limitations on charitable contributions made pursuant to their governing instruments and, instead, the charitable deduction requirements for individuals apply. IRC § 641(c)(2)(E).

Partnerships

A substantial built-in loss, for which an adjustment of basis is to take place upon a transfer of a partnership interest regardless of whether a Code Section 754 election is in place at such time, now includes the allocation of a loss of more than $250,000 to a transferee partner if the partnership assets were sold for fair market value at the time of transfer. IRC §743(d)(1)(B). While a basis adjustment previously had to take place if the partnership's basis in partnership property exceeds its fair market value by more than $250,000, this new requirement prevents the allocation of gain, loss, deductions, and credits in a manner that would provide the transferee partner with a loss in excess of that amount.

Technical terminations of partnerships, which occur if more than 50% of capital and profits in a partnership are transferred within a 12-month period, have been removed. IRC 708(b)(1). While technical terminations were usually something to be avoided and may have been caused in many cases inadvertently, they also could be useful in cases if triggered intentionally such as to make a different Code Section 754 election (other than with respect to the incoming partner) or employ different Code Section 704(c) allocation methods.

Profits Interests

Profits interests in a partnership provided in exchange for a partner's services, sometimes referred to in the investment management context as "carried interests," are no longer able in certain cases to take advantage of long-term capital gain treatment on "capital gain with respect to such interests" for a disposition having a holding period of less than 3 years. The practical effect, therefore, is that owners of such profits interests will be taxed at an ordinary income rate for dispositions with a holding period of 1 to 3 years, which incur an entity level tax, the intended treatment of interests owned by S corporations, for which income is taxed to individual shareholders on a pass-through basis, and whether S corporation shareholders should also be subject to the new holding period limitation, is unclear. Based on the express terms of the statute, a profits interest housed in an S corporation would not be subject to the limitation, although Treasury has indicated an intent to issue guidance to close the "loophole."

Unrelated Business Taxable Income

Unrelated business taxable income (UBTI), in the case of multiple investments in separate unrelated trades or businesses made by a single tax-exempt organization, is now computed separately for each trade or business, including any NOL resulting from a particular trade or business, so that loss from one trade or business cannot offset UBTI incurred from another. IRC § 512(a)(6).

Electing Small Business Trust Shareholders

Nonresident aliens are no longer taken into account in the "look-through" rules for ESBT beneficiaries as S corporation shareholders and are now permitted to be current beneficiaries of ESBTs, subject to the other general shareholder requirements imposed upon ESBTs. IRC § 1361(c)(2)(B)(v).

Like-Kind Exchanges

Like-kind exchanges, which were previously available for investment property other than real property used in a trade or business, are now limited only to real property. § 13303 of the Act.

Accounting Methods

The cash method of accounting is generally prohibited for C corporations (other than personal service corporations) or partnerships with a C corporation partner, but with a gross receipts floor amount that exempts smaller businesses. That amount has been increased to $25,000,000, adjusted for inflation, up from $5,000,000 previously, of the average annual gross receipts of the business for its prior 3 taxable years. IRC § 448(c)(1).

The accrual method of accounting used by businesses is now subject to a limitation on the “all events” test whereby income is required to be recognized for tax purposes no later than it is recognized in certain financial statements for a business, including audited financial statements provided to a third party such as a lender or investor. IRC §§ 451(b)(1)(A); -(3)(A)(ii). Additional flexibility is added, however, for recognition of advance payments, other than rent, insurance premiums, payments on financial instruments, and certain other payments, which may now be elected to be deferred until the year following the year in which they are received (subject to the requirement that they be included in income earlier as a result

instances, there still remain questions that will need to be answered as to determining the actual holding period to be applied against the profits interests, and a misalignment of incentives is now potentially created between service providers and capital investors in the investment management context.

Another material issue in the statute is that an “applicable partnership interest” does not include “any interest in a partnership directly or indirectly held by a corporation.” IRC § 1061(c)(4)(A). While the aim of the statute certainly was to exclude C corporations, which incur an entity level tax, the intended treatment of interests owned by S corporations, for which income is taxed to individual shareholders on a pass-through basis, and whether S corporation shareholders should also be subject to the new holding period limitation, is unclear. Based on the express terms of the statute, a profits interest housed in an S corporation would not be subject to the limitation, although Treasury has indicated an intent to issue guidance to close the “loophole."
of being recognized in a financial statement). IRC § 451(c).

Any change in the accounting methods used by a business as a result of the increased exemption for small businesses, the financial statements limitation, or the permitted advance payments deferral is to be adjusted in accordance with Code Section 481, including by obtaining the consent of Treasury. § 13221(d) of the Act.

Planning Considerations

For businesses, it is important when considering tax planning objectives that advisors take a holistic approach, as tax benefits brought about by one provision of the Act might have an offsetting effect on another. Effective planning will involve all types of advisors—attorneys, accountants, business advisors both inside and outside of a business, life insurance advisors, financial advisors, and any other parties having input as to the operation and ownership of a business—to arrive at a solution that is both beneficial and workable. Situations are rarely the same, but there are general starting points for various options to be evaluated. From there, models employing different assumptions can be fine-tuned to make projections suggesting an appropriate course of action.

Choice of Entity

The most fundamental principle guiding business tax planning is the form of entity a business chooses to assume, both at inception and, in some cases, later over the course of its existence. A C corporation, S corporation, limited liability company, and partnership now each offer separate potential advantages and disadvantages to a business dependent on its operations and assets, the stage of its lifecycle, and its anticipated income or loss and cash flow.

Based on tax rates, for example, a C corporation, with income initially to be taxed at an entity-level 21% rate and with distributions thereafter assumed to be taxed at a deferred 23.8% rate—which, at a 35% entity-level rate previously, was a non-starter for many businesses—could now be considered most advantageous on a purely hypothetical basis compared to an up-front rate of up to 40.8% taxed to individuals owning interests in S corporations or partnerships (assuming that an S corporation shareholder or partner of a partnership is taxed in the highest individual bracket and remains subject to the 3.8% net investment income tax (NIIT), which must be applied to C corporation dividends). A C corporation arrangement might also possibly meet the requirements of a qualified small business so that all or a portion of income from a later stock sale is excluded from an owner’s income under Code Section 1202.

Business owners, however, should consider any rate arbitrage together with the risk inherent in having a business housed in a C corporation in the event the corporate tax rate is later increased. C corporation owners also must contend with accumulated earnings taxes or personal holding company taxes, which are imposed to prevent attempted deferrals for obtaining a lower effective tax rate. A C corporation might block losses that would ultimately be better used by an individual owner on a pass-through basis, if not hampered by the excess business loss limitation. A C corporation’s income will not qualify for the Code Section 199A deduction to its business owners.

There is no one-size-fits-all approach. There are a multitude of additional considerations that drive a choice of entity, which may ultimately outweigh basic income tax rate efficiency, in some cases to a large degree. Among others, business owners will want to consider the following:

- The need to provide preferred returns to certain owners.
- The need to attract certain types of investors, such as tax-exempt organizations, foreign investors, or venture capitalists, all of which, for various reasons may prefer a C corporation (or the use of a “blocker” C corporation as an investment vehicle).
- The possibility of in-kind distributions of property to owners.
- The need for special allocations of items of gain, loss, deductions, or credits or for a particular owner to be allocated liabilities of the business.
- The benefit of adjusting the “inside basis” of business assets upon the occurrence of certain events.
- A desire to make charitable contributions of business property.
- The use of a fiscal year of reporting not tracking the calendar year.
- Whether business owners also serve as employees or otherwise provide services to the business.
- Fringe benefits provided to employee-owners.
- The ability to issue equity compensation.
- The application of employment and Social Security taxes.
- The application of the NIIT.
- The application of state franchise and excise taxes.
- The application of the AMT to individual owners.

As a general matter, it is much easier to move assets into a business entity at the outset of a business venture than it is to move them from a business entity in one form to another, and for existing businesses, reversing course after an initial choice of entity might prove challenging as a result of negative tax consequences from any transition. The effects of converting to and from C corporations, S corporations, and partnerships or otherwise moving assets among them are most notably dependent upon the built-in gain or loss of the owners’ interests in a business, the built-in gain or loss of the assets owned by the business, the types of assets owned by the business, and the outstanding liabilities of the business at the time a conversion in corporate form might take place. A highly leveraged business with depreciable assets or with a low asset turnover (resulting in a larger mismatch between basis and fair market value) might experience a much more dramatic tax effect upon a conversion than a business with little leverage and little built-in gain or loss in its owners’ interests and its assets. A conversion from one corporate form to another might also require significant ancillary administration and legal work, such as revisiting material contracts, redoing payroll and employee benefits, and staff training. That all being the case, an existing business likely will, first, want to evaluate a reorganization within its current form before undergoing such a significant change.

Restructuring and Reorganizations

Because a wholesale conversion from one form to another might prove to be too burdensome, businesses, particularly pass-through businesses, should first consider options to reorganize and restructure tax items within their current forms to the extent necessary to obtain a tax benefit.

In the case of pass-through businesses, a large part of that analysis will involve taking full advantage of the Code Section 199A deduction. For both specified service business and non-specified
service businesses alike, business owners having income in excess of the phase-out thresholds, in the case of specified service businesses, and the phase-in thresholds, in the case of non-specified service businesses, may be able to minimize the effects of the phase-out or phase-in using various techniques, some more involved than others.

For non-specified service businesses where the owners are subject to the qualified property and W-2 wage phase-in thresholds, immediate expensing of property might reduce taxable income, for example, but the expensed property is then not eligible to count as qualified property since it is not considered depreciable property. A simple alternative might be to use bonus depreciation as a substitute, which achieves a similar objective in an immediate reduction of income and also allows the depreciated property to be deemed to be placed in service for the minimum 10 year term for purposes of the pass-through deduction. As another simple measure, independent contractors working primarily for a single business might be hired full time as employees to increase W-2 wages. Implementing a retirement plan may reduce an owner-employee’s income below the threshold amounts, keeping in mind the offsetting effect a retirement plan has on W-2 wages.

For either specified service businesses or non-specified service businesses with insufficient W-2 wages and qualified property, non-grantor trusts might be used to disperse taxable income so that it is separately earned in amounts falling within the phase-out or phase-in thresholds, although in the case of specified service businesses, there also may be difficult non-tax considerations to address, such as whether particular businesses can be owned by non-professionals under applicable state law. Depending on the particular tax circumstances of an individual owner, these trusts may or may not be structured as completed gifts for federal gift tax purposes to remove the business interests from the owner’s taxable estate for estate tax purposes. In any event, the fact that a trust will have its own separate threshold amount for pass-through income may result in an additional deduction, and multiple trusts can be used to leverage additional deductions.

Take the case of a married taxpayer with 4 children and 2 grandchildren and who owns a business generating $1,260,000 of QBI a year. A non-grantor trust for each descendant as the primary beneficiary could be created to absorb taxable income up to the $157,500 threshold for individual taxpayers and bring the taxpayer’s own taxable income down to the $315,000 threshold for married taxpayers, resulting in annual savings after giving effect to the deduction of up to $11,332 per trust (ignoring the rate differential thresholds between individual taxpayers and trusts) and up to $12,836 for the taxpayer, dependent on the other taxable income thresholds between individual taxpayers and trusts) and up to $12,836 for the taxpayer, dependent on the other taxable income included on the taxpayer’s individual return, or up to $80,828 total per year. If a greater amount of QBI is being generated, in the case of a business earning $3,150,000, for example, and distributions are also separately made in respect of individual descendants (or trusts to which they are the taxpayers as a result of having a withdrawal right under Code Section 678), total savings could be obtained of up to $157,844 per year, although the actual amount of savings could very well be lower depending upon the descendants’ marital status and the other taxable income included on the descendants’ individual returns. Nonetheless, non-grantor trust arrangements such as these might also allow for multiple state and local tax (SALT) deductions for which an individual taxpayer would not otherwise be eligible, as well as deductions to be taken for administrative fees. Conversely, however, the potential application of the NIIT would have to be considered, as well as the disallowance of expensing deductions under Code Section 179 in the case of non-grantor trusts.

Businesses with consolidated operations might also consider segmenting separate lines of business so that specified service businesses are segregated from non-specified service businesses. If, for example, a business owns its own real estate for its operations, consider whether a related party lease, the rent for which is deductible by one party as a business expense and the QBI for which is deductible by the other under Code Section 199A, might be an option between affiliated entities. Some businesses could form a separate management company and outsource their back office services to a specified service business. These means of “earnings stripping” might allow for a full business expense deduction on one end and a pass-through deduction of 20% of the QBI generated from that expense on the other. While it is likely that tiered entity regulations will attempt to address situations such as these, there could be structures, created also to serve a non-tax business purpose, that could reach a beneficial tax result.

Like a wholesale conversion in corporate form, any restructuring process will potentially involve revisiting material contracts, retitling assets, and obtaining consents from lenders and owners, so the amount of effort involved should be evaluated at the outset before proceeding.

**Income Recognition, Expensing, and Deleveraging**

In light of new limitations on losses, deductions, and expenses now imposed under the Act, taxpayers will need to become more aware of the timing of income and how it can best be offset or managed within these new parameters. Businesses may consider reducing outstanding debt if they are now subject to the interest expense limitations. A decision between expensing or depreciating property will become important based on its ultimate impact on a taxpayer’s income recognition and the effects that has on loss limitations and deductions.

Managing income streams will be particularly important for taxpayers seeking the pass-through deduction. For charitably inclined taxpayers, a charitable remainder trust might allow income to be efficiently recognized over time while also achieving a taxpayer’s charitable objectives. The use of non-grantor trusts might also allow income to be streamlined through the flexibility afforded to trustees with the 65-day rule for trust distributions. In any event, businesses will need to make projections and put together models so that they are able to gauge expectations in terms of income and deductions so as not to miss tax savings opportunities.

**Buy/Sell Arrangements and Corporate Life Insurance**

Buy/sell arrangements will need to be evaluated in the context of any reorganization or restructuring among business owners to ensure that they are still consistent with each owner’s individual goals as well as the welfare of the business itself. Given the increase in the estate tax exemption (at least through 2025), perhaps liquidity will be less of a concern upon death for some owners and, therefore, the need for a buyout upon an owner’s death can be revisited, particularly for an owner who does not have a management role in the business.

As a result of the repeal of the corporate AMT, life insurance might also now be used as a buy/sell redemption funding mechanism for C corporations not previously exempt from the corporate AMT or which
otherwise risked becoming subject to the corporate AMT upon the receipt of policy proceeds. This approach could simplify a redemption of corporate stock at a shareholder’s death in lieu of each of the remaining shareholders maintaining separate policies and allow for better pricing on a single policy versus multiple policies that are separately owned.

Final Thought

The Act has presented numerous challenges to future tax planning for businesses, and accordingly, an understanding of the reform is important, together with consideration of the uncertainty that remains. Significant opportunities exist for effective tax planning, and with a thorough analysis of the provisions of the Act and the manners in which they interact, business owners, operators, and advisors can adapt effectively.

Thomas Cooper is an attorney in the Charlotte, North Carolina, office of Moore & Van Allen PLLC.

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Recent Developments

By the Trusts and Estates Team of Moore & Van Allen PLLC

Federal Statutes


Federal Cases

Estate and trusts funded from estate liable as transferees for corporate income tax unpaid after sham transaction.

In Billy F. Hawk, Jr., et al. v. Commissioner, T.C. Memo 2017-217 (Nov. 6, 2017), a decedent’s estate and surviving spouse were the successors-in-interest to the decedent’s bowling alley business, which was organized as a C corporation. After the decedent’s death, the estate and surviving spouse caused the corporation to sell its bowling alley-related assets, causing a $2.7 million gain. Then, in the same calendar year, the estate and surviving spouse participated in a sham transaction that purported to be a sale of the corporation’s stock to a third party buyer for cash, but the buyer essentially paid the purchase price to the shareholders with the corporation’s own money. The buyer paid a premium for the stock above the amount of the corporation’s net assets as reduced by the built-in capital gain, representing that it could offset the built-in capital gain with operating losses from other businesses the corporation would undertake after the stock sale and therefore cause the corporation to pay no capital gains tax. In reality, the corporation was essentially liquidated in favor of the shareholders and the buyer, and it subsequently existed as a shell for several years without ever paying any income tax. The Service issued a notice of deficiency, and finding the corporation insolvent, it proceeded against the estate, the two marital trusts funded from the estate, and the surviving spouse for the unpaid corporate income tax, including penalties and interest, under the transferee liability provisions of Code § 6901. The court denied the taxpayer’s argument that the circumstances of the destruction of the conserved property was so remote having superior rights to the charitable recipient in the conserved property. The court denied the taxpayer’s argument that the circumstance of the destruction of the conserved property was so remote having superior rights to the charitable recipient in the conserved property. The court denied the taxpayer’s argument that the circumstance of the destruction of the conserved property was so remote.
as to be negligible and therefore disregardable under Regulations § 1.170A-14(g)(3). The deed included a savings clause intended to ensure compliance with the conservation easement regulations, but because any deemed amendment of the deed pursuant to the savings clause required the mortgage lender's consent if the mortgage lender's rights would be adversely affected, the court ruled that the savings clause was ineffective. The court also rejected the taxpayer's argument that the restriction on subordinating a charitable recipient's rights is per se unenforceable if interpreted strictly because a hypothetical tax lien on the property would always be superior to the interests of a charitable recipient, distinguishing hypothetical tax liens from security interests existing at the time of the donation of a conservation easement.

Conservation easement deduction denied when property could be transferred to a non-qualified organization.

In Salt Point Timber, LLC, et al. v. Commissioner, TC Memo 2017-245 (Dec. 11, 2017), the Tax Court denied an income tax deduction for the grant of a conservation easement when the property subject to the easement could be transferred to someone other than a "qualified organization" for purposes of Code § 170(h). Although the property subject to the easement could only be transferred if the transferred property would be subject to a "comparable conservation easement," the Tax Court found that (i) "comparable" was meant to refer to the terms of the easement, not the holder of the easement, and (ii) applicable state law's definition of the holder of a conservation easement was not limited to qualified organizations for federal income tax purposes. The court also found that the possibility of a transfer in violation of the regulations was not so remote as to be negligible and therefore could not be disregarded under Regulations § 1.170A-14(g)(3).

Federal Administrative Developments

Service yet to confirm revised inflation adjustments for 2018 as based on new tax law.

The Service originally released inflation adjustments for 2018 on Oct. 19, 2017 in Rev. Proc. 2017-58, which included increasing the estate and gift tax basic exclusion amount and GST exemption amount to $5.6 million and increasing the annual gift tax exclusion amount to $150,000. However, Public Law 115-97, enacted on Dec. 22, 2017, changed the method by which such inflation adjustments are calculated, in addition to changing the base amount to which the basic exclusion amount adjustments are applied from $5 million to $10 million. Calculations based on the methodology prescribed by the new law indicate a 2018 estate and gift tax basic exclusion amount of $11.18 million and an annual gift tax exclusion amount of $15,000, but as of Jan. 31, 2018, the Service had yet to officially confirm those amounts.

Service issues preliminary guidance with respect to certain uses of donor advised funds.

In Notice 2017-73 (Dec. 4, 2017), the Service announced that it is considering proposing regulations regarding donor advised funds to the following effects: (i) a distribution from a donor advised fund to a distributee organization that permits the donor or a related person to attend an event organized by the distributee organization results in a prohibited benefit to the donor under Code Section 4967, even if the donor individually contributes the portion of the event admission price that is considered non-deductible for individual income tax purposes; (ii) a distribution from a donor advised fund to a distributee organization to which the donor has made a charitable pledge is not a prohibited benefit to the donor under Code Section 4967, even if the distributee organization considers the donor advised fund distribution as fulfilling the charitable pledge, and regardless of whether the pledge is legally enforceable under state law, so long as the organization administering the donor advised fund makes no reference to the donor's pledge in making the distribution; and (iii) for purposes of determining whether an organization receiving a distribution from a donor advised fund is publicly supported, the distribution is deemed to have been made by the donor, and not the organization administering the donor advised fund. The Service further requested public comments regarding the tax treatment of donor advised funds, including but not limited to comments regarding (a) the proposed rules discussed above, (b) coordination between private foundations and donor advised funds, (c) whether a distribution from a private foundation to a donor advised fund should be deemed a qualifying distribution for the private foundation's minimum distribution requirements under Code Section 4942 if the distributed funds are not subsequently distributed from the donor advised fund for charitable purposes within a certain time frame, and (d) how donor advised funds with multiple donors might be treated for purposes of the proposed rule deeming distributions from donor advised funds to be made from the donors thereof for purposes of determining the public support of the distributee organization. The deadline for comments is March 5, 2018.

Service denies income tax charitable deduction for trust income appointed to charities under power of appointment added by state court trust modification.

In CCM 201747005 (Nov. 24, 2017), a state court, but not the highest court in the state, approved a petition to modify an irrevocable trust to give a trust beneficiary the inter vivos power to appoint trust income to two charities. The modification was apparently pursued under a state statute equivalent or similar to Uniform Trust Code Section 416, Modification to Achieve Settlor's Tax Objectives (which is enacted in North Carolina as N.C.G.S. § 36C-4-416). The beneficiary in fact exercised the power of appointment to appoint trust income to the charities, and the trust deducted the appointed amounts from the trust's gross income pursuant to Code Section 642(c)(1). Though trust income transferred to charities via the exercise of powers of appointment is typically deductible under Code Section 642(c)(1), the Service ruled in this case that the deduction was disallowed because the Service did not respect the court modification of the trust, and therefore, in the Service's eyes, the distributions to the charities were not made pursuant to the governing instrument of the trust, as Code Section 642(c)(1) requires. The Service explicitly stated that it believed the purpose of the modification was to avoid taxes and disregarded that the state court found that the modification was made "in order to achieve the settlor's tax objectives" and was neither "inconsistent with a material purpose of the trust" nor "contrary to the settlor's probable intention." The Service relied on Comm'r v. Bosch, 387 U.S. 456 (1967) for the premise that it was not bound by the court modification because the approving court was not the highest court in the state. The Service further denied an income deduction for the trust under Code Section 661 (which describes distributable net income), ruling that distributions to charities are not eligible for
the Code Section 661 deduction and are only eligible for the Code Section 642(c) deduction, despite the Code and Regulations being ambiguous with respect to the matter of whether a distribution to a charity is deemed ineligible for the Code Section 642(c) deduction may then be deducted under Code Section 661.  

**Deathbed purchases of GRAT remainder interests by grantor for promissory notes were ineffective to reduce grantor's taxable estate by note amounts.**

In CCM 201745012 (Nov. 9, 2017), the grantor of two grantor retained annuity trusts (the “GRATs”) purchased the remainder interests in the GRATs from a trust for the benefit of his descendants in exchange for promissory notes, and then the grantor died the next day. For estate tax purposes, the grantor’s executor included the entire amount of the GRAT assets in the grantor’s gross estate and deducted the amount of the promissory notes as claims against the estate. However, the Service determined that the GRAT remainder interests received by the grantor pursuant to the sales did not constitute “adequate and full consideration in money or money’s worth” for the promissory notes because the entire GRAT assets would have been included in the grantor’s gross estate upon his death anyway, and consideration that is “adequate and full” for estate tax purposes must augment the grantor's gross estate. The deathbed timing of the sales was critical to the Service's finding.

**Service approves non-grantor incomplete gift trusts.**

In PLR 201742006 (Oct. 20, 2017), PLR 201744006 (Nov. 3, 2017), PLR 201744007 (Nov. 3, 2017), PLR 201751001 (Dec. 22, 2017), PLR 201751002 (Dec. 22, 2017), and PLR 201751003 (Dec. 22, 2017), the Service approved a series of requests that trusts not be deemed grantor trusts for income tax purposes and that transfers to the trusts not be deemed to be completed gifts for gift tax purposes. Under each trust, (i) the grantor remained a beneficiary, but distributions to the grantor were subject to the approval of other trust beneficiaries, so the trust was not a grantor trust under Code Section 676; (ii) the grantor retained an inter vivos power to appoint the trust property among trust beneficiaries other than the grantor, but because the power was only exercisable for purposes of health, maintenance, support, and education, the trust was not a grantor trust under Code Section 674; (iii) the grantor retained a broad testamentary limited power of appointment over the trust assets, which along with the grantor's inter vivos power of appointment caused the grantor's transfers to the trust to be incomplete gifts because the grantor's powers to reallocate the trust assets were held in a non-fiduciary capacity; and (iv) the power to direct distributions held by the beneficiaries other than the grantor was not a general power of appointment, the exercise of which would have been a gift by such beneficiaries, because no beneficiary could make a distribution to himself or herself without the approval of another beneficiary with an adverse interest. Each trust was most likely intended to redomesticate the grantor's assets in a state with income tax laws that were more favorable than those of the grantor's domicile while still allowing the grantor to benefit from the assets during the grantor's lifetime, the grantor to direct the passage of the assets at the grantor's death, and the basis of the assets to be stepped up at the grantor's death.

**Distribution and repayment agreement between trustees and remainder beneficiary of charitable remainder trust caused neither self-dealing nor a taxable expenditure.**

In PLR 201745001 (Nov. 9, 2017), the Service found that an agreement between the trustees and the sole remainder beneficiary of a charitable remainder trust under which the trustees would accelerate distributions to the remainder beneficiary after the termination of the trust's non-charitable annuity term but before the administration of the trust was complete so long as the remainder beneficiary returned any funds needed by the trustees to pay future liabilities of the trust and indemnified the trustees did not result in self-dealing or an impermissible taxable expenditure by the remainder beneficiary, which was classified as a private foundation. Although the grantor of the trust was a disqualified person with respect to the remainder beneficiary, because the trustees were not disqualified persons with respect to the remainder beneficiary, the agreement was not self-dealing. In addition, because the remainder beneficiary would not have received any funds used to pay future liabilities if the trustees had retained the trust's assets until final administration was complete, the repayment of funds to the trustees to pay such liabilities would not be a taxable expenditure by the remainder beneficiary.

**Dividends were constructively received by controlling shareholder of C corporations when declared and recorded on corporations' books.**

In PLR 201741012 (Oct. 13, 2017), a shareholder wholly owned one C corporation and was the controlling majority shareholder of another. The corporations declared dividends to the shareholder in three successive years, but not all of the declared dividends were actually paid to the shareholder in the year of declaration. The Service ruled that for income tax purposes, the dividends were effective when declared.

**Tax-exempt trust's income from partnerships was subject to unrelated business income tax.**

In Technical Advice Memorandum 201741019 (Oct. 13, 2017), the Service found that because a tax-exempt trust’s ownership of partnership interests and debt-financed property were not substantially related to the trust’s tax-exempt purpose, the trust was subject to unrelated business income tax with respect to those assets. The nature of the assets and the trust’s argument regarding their relationship to the trust’s tax-exempt purpose were redacted from the memorandum.

**“No rule list” updated.**

In Revenue Procedure 2018-3 (Dec. 29, 2017), the Service declared that it would not issue private letter rulings regarding whether a joint venture between a tax-exempt organization and a for-profit organization furthers an exempt purpose of the tax-exempt organization. In addition, the Service announced it will no longer issue private letter rulings regarding the grant of an extension to file a portability election under Section 2010(c)(5)(A) of the Code and instead refers taxpayers to the procedure set forth in Revenue Procedure 2017-34.

**Procedures for domestic rulings and determination letters updated.**

In Revenue Procedure 2018-1 (Dec. 29, 2017), the Service clarified that it retains the ability to revoke rulings relating to issues that have been subsequently added to the “no rule list.” The Service also announced that all user fees for rulings and determination letters must now be submitted via www.pay.gov, and it provided several clarifications regarding the calculation and refunding of such user fees under certain circumstances.
In Revenue Procedure 2018-5 (Dec. 29, 2017), the Service announced that organizations seeking reinstatement of tax-exempt status after a revocation thereof must file Form 1023, and not Form 1023-EZ, if they are seeking a different foundation classification than they had before. The Service further provided that the Form 1023 application fee will now be $600 regardless of the annual receipts of the applying organization. Previously, organizations averaging not more than $10,000 in annual receipts paid an application fee of $400, while other organizations paid $850. The group exemption application fee was also reduced from $3,000 to $2,000.

Proposed Section 2704 regulations withdrawn.

In Notice of Proposed Rulemaking, Federal Register, Volume 82, Number 202B, Page 48779 (Oct. 20, 2017), the Service formally withdrew the proposed regulations under Code Section 2704 regarding the treatment of lapses of liquidation rights in and the valuation of family-controlled entities for estate, gift and generation-skipping transfer tax purposes.

North Carolina Cases

Premarital agreement provision made separate property of one spouse retain its character despite improvement of property using marital funds during marriage.

In Hankins v. Hankins (17-186) (Jan. 2, 2018), a husband had owned two parcels of real property prior to his marriage to his wife, but the properties were improved using marital property funds during the marriage. When the husband and wife divorced, the trial court determined in their equitable distribution proceeding that the properties were partially the husband’s separate property and partially marital property. However, the North Carolina Court of Appeals reversed, ruling that the properties were entirely the husband’s separate property because the couple’s premarital agreement provided that each spouse would retain all property belonging to that spouse prior to the marriage, including “all interest, profits and rents which may in time accrue, or result in any manner from increase in value, or be collected for use of the same in any way.”

Contract to make wills not found in absence of specific contractual language in wills.

In Moore v. McKenzie, 805 S.E.2d 536 (N.C. Ct. App. 2017), a husband and wife made concurrent reciprocal wills, each of which left the decedent’s property to the surviving spouse as between them, or if none, to the wife’s son (who was the husband’s stepson). After the wife died, leaving all of her property to the husband, the husband revoked his prior will and made a new will leaving all of his property to his stepdaughter, whom he also named as executor. After the husband’s death, the stepson claimed that the husband breached a contract with his deceased wife to make wills in favor of the stepson. After the trial court granted summary judgment against the stepson, the North Carolina Court of Appeals affirmed, finding that because no contractual language appeared in the earlier wills, neither the husband nor the wife were bound to retain the terms of those wills, and the husband was free to execute a subsequent will.

Other State Cases

Summary judgment denied to online service provider regarding prohibition of release of digital assets.

In Ajemian v. Yahoo!, Inc., 478 Mass. 169 (Oct. 16, 2017), after a decedent died intestate, Yahoo! refused to permit the decedent’s personal representatives to access the decedent’s Yahoo! e-mail account, asserting that (i) the federal Stored Communications Act (SCA) prohibited Yahoo! from providing such access, and (ii) alternatively, Yahoo!’s terms of service provide it with the discretion to refuse to provide such access. The personal representatives sued, and the Supreme Judicial Court of Massachusetts denied Yahoo!’s claim for summary judgment, finding that (i) Yahoo! was not prohibited under the SCA from disclosing stored electronic communications to an intestate decedent’s personal representative, and (ii) there existed an issue of material fact as to whether Yahoo!’s terms of service constituted a valid contract between the decedent and Yahoo! The court found that, although the decedent’s personal representatives did not constitute the decedent’s agents for purposes of the SCA because they were appointed by state probate court rather than by the decedent himself, they, as personal representatives, were able to lawfully consent to the disclosure of the decedent’s electronic communications as required by the SCA. Therefore, Yahoo! was not prohibited from disclosing such communications. In addition, the Court found that, assuming Yahoo!’s terms of service agreement allowed Yahoo! to withhold such communications, Yahoo! had failed to provide enough evidence to the court that a meeting of the minds had occurred between Yahoo! and the decedent with respect to the terms of service, and the court remanded the matter of whether a valid contract existed. Unlike North Carolina, Massachusetts has not adopted the Revised Uniform Fiduciary Access to Digital Assets Act (RUFADAA). However, similar findings would likely be reached with respect to a North Carolina decedent who died intestate. Under North Carolina’s version of RUFADAA, the content of electronic communications is not required to be released by a service provider unless the decedent specifically authorizes such disclosure, which is unlikely in the case of an intestate decedent. Otherwise, a valid terms of service agreement governs.

Decedent’s online contacts and calendar information, but not e-mail communications, were required to be disclosed to decedent’s personal representative.

In Matter of Serrano, 54 N.Y.S. 3d 564 (June 14, 2017), the Surrogate’s Court of New York for New York County, following New York statutes, required Google to release a decedent’s contacts and calendar information to the personal representative of the decedent’s estate because such information constituted a catalogue of electronic communications (and not electronic communications themselves), whereas the content of the decedent’s e-mails, as electronic communications, were not required to be released to the personal representative absent the establishment by the personal representative that the release of such information would be reasonably necessary for the administration of decedent’s estate. The applicable New York statutes are adapted from the Revised Uniform Fiduciary Access to Digital Assets Act, which North Carolina has also adopted in substantially the same form.

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