BESSEMER TRUST

ACTEC 2019 Summer Meeting Musings
(Including "Restocking the Advisor's Toolkit with Income Tax Planning Strategies")

June 2019

The American College of Trust and Estate Counsel is a national organization of approximately 2,500 lawyers elected to membership. One of its central purposes is to study and improve trust, estate and tax laws, procedures and professional responsibility. Learn more about ACTEC and access the roster of ACTEC Fellows at **www.actec.org**.

This summary reflects the individual observations of Steve Akers from the seminars at the 2019 Summer Meeting and does not purport to represent the views of ACTEC as to any particular issues.

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Introduction

Some of my observations from the 2019 ACTEC Summer Meeting Seminars in Vancouver, British Columbia on June 26-29, 2019 are summarized below. (At the request of ACTEC, the summary does not include any discussions at Committee meetings.) This summary does not contain all of the excellent information from the seminars, but merely selected issues. The summary is based on the presentations at the seminars, but the specific speakers making particular comments typically are not identified.

Items 1-34 come from the "Stand Alone" program titled "Restocking the Trust Advisor's Toolkit with Income Tax Planning Strategies." Items 35-61 come from seminars generally addressing various cross-border issues.

Items 1-34 are observations from a Stand Alone Program: "Restocking the Trust Advisor's Toolkit with Income Tax Planning Strategies."

Items 1-16 are observations from Session 1: Introduction and Income Taxation of Individuals by Professor Samuel A. Donaldson and Gregory V. Gadarian

1. 2017 Tax Act Brief Overview

Legislation in December 2017 (that does not have a formal name – it passed the House as the "Tax Cuts and Jobs Act" but that named was dropped when approved by the Senate) made massive changes, including cutting the top rate applied to C corporations to 21% as well as making various changes for individuals. The 2017 Tax Act resulted in significant changes in income tax planning for individuals – what Prof. Donaldson calls "carbon based" taxpayers.

For a more detailed discussion of provisions of the 2017 Tax Act, see Selected Highlights of 2017 Tax Act and Estate Planning Considerations, found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**.

Most of the changes described below for individual taxpayers apply only for 2018-2025. One glaring exception is that the new alimony rule is permanent.

Items 2 - 15 discuss various issues from the 2017 Tax Act relating to the federal income taxation of **individuals**.

2. Rates

The most substantial individual tax cuts from the 2017 Tax Act came from adjusting the ordinary income tax rate tables. The rates of the various brackets were adjusted somewhat (the top rate decreased from 39.6% to 37%), but the biggest change was to increase dramatically the taxable income levels for the various brackets. For example, the taxable income level for the top bracket was increased from $470,700 in 2017 to $600,000 in 2018 for married taxpayers filing jointly (with the taxable income of the top bracket increasing to $612,350 in 2019).

The capital gain/qualified dividends tables remained the same (other than inflation adjustment changes). Before 2018, the 23.8% capital gains rate applied to taxpayers in the top 39.6% ordinary income bracket (which was $470,700 for married filing jointly taxpayers in 2017). In 2018, the 23.8% rate applied to married taxpayers filing jointly with $479,000 of taxable income (vs. $600,000 for the top ordinary income tax bracket). Why did the capital gains rates not adjust along with the ordinary income tax rates? Because capital

gains rates are more politically sensitive and the overall permissible revenue impact of the 2017 Tax Act under the reconciliation process could not be achieved if the capital gains brackets had been adjusted as well.

The change made to the standard deduction, though, (as discussed below) means that substantially more taxpayers will be in the 0% bracket for capital gains and qualified dividends. For example, in 2019, the taxable income level for the 15% bracket starts at $78,750 (married filing jointly). With a $24,400 standard deduction, a married couple can have up to $103,150 of income before having to pay any taxes on capital gains or qualified dividends.

3. Net Investment Income Tax (3.8%)

The net investment income tax (3.8%) applies to taxpayers with adjusted gross income over $200,000 for single individuals, $250,000 for married filing jointly. These thresholds are not inflation-adjusted. This was not changed by the 2017 Tax Act, and this will not change in 2026.

4. Standard Deduction

For simplicity, the House version was going to replace the combination of the standard deduction, personal dependency exemptions (which had various complications), and child tax credit with an increased standard deduction (but the Senate reinstated an even increased child tax credit, discussed below).

The standard deduction almost doubled for married individuals filing jointly, the standard deduction for 2018 before the 2017 Tax Act would have been $13,000, and it increased to $24,000 in the 2017 Act.

5. Child Tax Credit

Before 2018, the child tax credit was just $1,000 per child and phase-outs began for joint filers at $110,000 AGI (before itemized deductions), and at $130,000 AGI the child tax credit phased out totally. The House version would have eliminated this credit, but the Senate kept the credit and expanded it to $2,000 per child, and the AGI phase-out does not begin until $400,000 (not indexed) of AGI (married filing jointly). The Act also increases the refundable portion of the credit and adds a $500 nonrefundable credit for qualifying dependents other than qualifying children. The expanded child tax credit provision has a very large revenue impact–projected at $573.4 billion over ten years.

6. Miscellaneous Itemized Deductions Suspended

No miscellaneous itemized deductions are allowed. These include almost all deductions for individuals other than home mortgage interest, charitable deductions, and state and local tax deductions (now limited to $10,000, discussed below). Other less important deductions still permitted are casualty losses and medical expense deductions. Miscellaneous itemized deductions were previously subject to the "2% floor" rule of §67(a), but are now disallowed entirely through 2025.

7. Home Mortgage Interest Deduction

The home mortgage interest deduction remains largely because of lobbying efforts by the residential real estate industry, which was fearful that the desirability of home ownership would decline substantially without the deduction. ("When were you last happy? When you rented. If anything broke you just called the landlord.... You had staff.")

The home mortgage interest deduction was revised by limiting the interest deduction to acquisition debt (to buy, build, or improve a home) of $750,000 for debt incurred after December 15, 2017 rather than $1.0 million (married filing jointly). (Even refinancing of prior acquisition debt does not impact the $1.0 million ceiling amount that applies to acquisition debt incurred on or before December 15, 2017.) The interest deduction for home equity indebtedness (any other debt secured by the home) is suspended entirely after 2017, with no grandfathering for pre-existing home equity indebtedness.

8. Charitable Deductions

The 2017 Act continues to provide that charitable contributions are deductible, with an increased percentage limitation on cash contributions to pubic charities – i.e., 60% of the "contribution base" (generally AGI with a few modifications), up from 50%. Uncertainty exists as to whether the new 60% limit applies if the individual also makes any noncash charitable gifts during the year.

9. State and Local Taxes Deduction

After considerable negotiation, the deduction for state and local income, sales, and property taxes (colloquially referred to as "SALT") not related to a trade or business or a §212 activity is retained but limited to $10,000 (not indexed) for joint filers and unmarried individuals. This will have more of an impact on high-tax states. (The highest tax states are New Jersey, New York, California, Hawaii, and Minnesota.)

The $10,000 limit applies only to personal SALT, not to business SALT or SALT on investment property. For example, if a vacation home is rented and not used for more than 14 days by the owner, the rental income can qualify as investment income, and a deduction is permitted for the full amount of state and local tax. If the property is a business (if it is not used at all for personal use and the individual spends at least 250 hours per year in renting the property), it also qualifies for the rental safe harbor under §199A and qualifies for the 20% deduction for qualified business income. Regulations clarify that states' creative workarounds by providing a credit for certain charitable contributions benefitting the state will not work; the SALT deduction is reduced by the amount of any state or local tax credit the taxpayer receives in consideration for the charitable payment.

10. Alimony

Alimony payments will not be deductible and will not be income to the recipient. In addition, §682 is repealed; that section provided that if one spouse created a grantor trust for the benefit of the other spouse, following the divorce the trust income would not be taxed to the grantor-spouse under the grantor trust rules to the extent of any fiduciary accounting income that the donee-spouse is "entitled to receive." These provisions apply permanently, not just through 2025.

11. Kiddie Tax

The 2017 Act continues but simplifies the Kiddie Tax by applying ordinary and capital gains rates applicable to trusts and estates, which often are higher than the parents' rates, which had previously applied to the unearned income of the child. The child can still take advantage of the $200,000 threshold for protection from the 3.8% net investment income tax.

12. Pease Limitation Suspended

The Pease limitation (reducing most itemized deductions by 3% of the amount by which AGI exceeds a threshold amount [$313,800 in 2017 for married couples] but with a maximum reduction of 80%) is eliminated for 2018-2025. Eliminating the Pease limitation may have little impact for many taxpayers, however, in light of the suspension of most itemized deductions. Eliminating the Pease limitation can still be important for individual taxpayer itemizers who have substantial charitable or home mortgage interest deductions (as well as the SALT deduction, up to $10,000).

13. Section 199A Qualified Business Income Deduction

A complicated provision in new §199A provides tax-favored treatment of business income from passthrough entities (sole proprietorships, partnerships, limited liability companies, or S corporations) that are not subject to taxation under Subchapter C and that will be taxed at the individual tax rates of the owners, which could be as high as 37%. The deduction under §199A reduces the wide discrepancy (21% vs. 37%) in the top rates at which business income would be taxed, depending on whether the business is taxed as a C corporation or as a proprietorship or passthrough entity.

Very generally (but with various limitations and exceptions), the §199A deduction is a deduction for the individual owner's tax calculation equal to 20% of the individual's qualified business income; the 20% deduction results in an effective top rate of (1 – 0.20) x 37%, or 29.6%. This deduction is subject to various limitations, the most important of which apply to taxpayers with taxable income over a certain threshold amount and are (1) based on the wages paid by the business or wages plus the basis of its property, or (2) in certain specified service businesses (designed to prevent converting what would otherwise be normal service compensation income into business income). The deduction is allowed to individuals, trusts and estates.

The IRS has finalized regulations (remarkably quickly) about §199A. The regulations generally take pro-taxpayer positions.

For a more detailed discussion of the §199A deduction and the final regulations under §199A, see Item 7 of the Estate Planning Current Developments and Hot Topics Summary (July 2019) available at **www.bessemertrust.com/for-professional-partners/advisor-insights**.

14. Like-Kind Exchanges

Like-kind exchanges under §1031 are allowed beginning in 2018 only for real estate (not trucks for trucks, etc.). This only impacts like-kind exchanges under §1031 and not like-kind exchanges under other Code sections (such as §1202 qualified small business stock exchanges or §1035 life insurance exchanges).

15. Making Individual Changes Under 2017 Act Permanent Has Substantial Revenue Impact

A July 8, 2019 report from the Joint Committee on Taxation (JCS-1-19) estimates a cost of nearly $920 billion for 2020-2029 for making the individual portions of the 2017 Act permanent, as proposed by the President's fiscal 2020 budget proposal. By far the most expensive provision is making the individual income tax brackets permanent, representing $747 billion. Other big ticket items are increasing the individual AMT exemption amounts and phase-out thresholds ($396 billion) and the Section 199A qualified business income

deduction ($251 billion). Doubling the estate, gift, and GST exemption amounts costs $44 billion. Interestingly, the cost of increasing the standard deduction ($425 billion) and modifying the child tax credit ($284 billion) is almost exactly offset by repealing the deduction for personal exemptions (-$700 billion).

16. Charitable Deduction for Real Estate Partial Interests or Partnership Interests

Charitable deductions for real estate partial interests or for partnership interests generally must be reduced by the valuation discount attributable to the partial interest or partnership restriction. That could be avoided by giving the charity a put right to sell the property back to the donor at a pro rata portion of the full fair market value of the property. (For gifts to charitable remainder trusts, the donor could not repurchase the property because of self-dealing restrictions, but the donor could guarantee that the trust could sell the property at an amount equal to at least the full fair market value.)

Items 17-18 are observations from Session 2: Social Security and Medicare Benefits by Gregory V. Gadarian

17. Social Security Benefits

a. ***Full Retirement Age***. The full retirement age is 65 for those born in 1937 or earlier, increasing in stages from age 65 to 66 for those born in 1938-1942, age 66 for those born in 1943-1954, and increasing in stages from age 66 to age 67 for those born in 1955-1959, and age 67 for those born in 1960 and later.

b. ***Collecting Early***. Retirement benefits can be started as early as age 62, but a permanent reduction in benefits will apply. Waiting until full retirement age is a no brainer for most people, unless they cannot obtain work (and need cash flow for basic support) or have serious health issues AND are single.

c. ***Deferring Starting Benefits Beyond Full Retirement Age***. If benefits do not begin before or at the full retirement age, the annual benefits will permanently be increased, as follows for an individual whose full retirement age is 66: age 66-100%, age 67-108%, age 68-116%, age 69-124%, age 70 (or later, but there is no reason to defer to a later age)-132%. These are called "delayed retirement credits."

   At age 70, the maximum benefit is reached. If a worker defers receiving benefits, the benefits go up 8% per year, so from age 66 to age 70, the benefit would increase by 32% to about $46,000 per year.

d. ***Impact of Continuing to Work After Receiving Benefits***. If the worker begins receiving benefits before the full retirement age, a reduction in benefits will occur for earnings above a certain amount. Starting with the month the worker reaches full retirement age, there is no reduction for earnings.

e. ***Retirement Benefit Amounts***. The maximum retirement benefits in 2019 at full retirement age (66) for a person who always earned the maximum in the Social Security system for 35 years are as follows depending on when the benefits begin: age 62 – $2,279 per month; age 66 – $2,861 per month; and age 70 – $3,878. COLA adjustments apply and the amount may change in future years. These monthly amounts translate to annual amounts of $27,348, $34,332, and $46,536.

f. ***Deciding When to Apply for Benefits***. Factors in the decision of when to begin receiving benefits include the person's health status and life expectancy (e.g., if the person will die at age 64, it would be better to begin receiving benefits at age 62), the need for income, whether the worker plans to work, and the needs of survivors.

The COLA adjustments are made based on the initial base level of payments, so the COLA adjustments magnify the impact of the reduction for early payments. Taking early payments also impacts the level of survivor benefits following the worker's death. Another advantage of delaying payments is that the benefits are based on the 35 top years; dropping out four years or more from the late 1970s (when the earnings limit was *much* smaller) and adding the four most recent years of earnings results in a higher benefit level.

In 2017, over 50% of U.S. retirees claimed benefits before reaching age 66. Indeed, 30% of men and 34% of women began benefits at age 62. Waiting until age 70 may be preferable for many people, but in 2017, just 3.8% of men and 5.6% of women delayed claims until that age, based on data from the Social Security Administration.

In making the decision to delay receiving benefits from age 66 to age 70, observe that about 12½ years are required to recover the four lost years of benefits – 14 years taking into account the time value of money. Therefore, the decision to defer benefits means that the worker thinks that the worker or the worker's spouse will live to age 82.5 (or age 84 taking into account the time value of money). If a husband and wife are both age 62, a 78% chance exists that at least one of them will live to age 85. Another factor to consider is that if the worker is likely to continue working until age 70, the individual will have a higher base for computing benefits as his or her 35 highest years, thus increasing the "principal insurance amount" even before the "delayed retirement credits" are applied.

The decision of when to apply for benefits also involves other issues, such as spousal benefits, because the higher payments would be received for the lifetime of the surviving spouse. Commercial resources that can assist in maximizing Social Security benefits include reasonably priced software from MaximizeMySocialSecurity.com and SocialSecurityChoices.com and the "AARP Social Security Calculator" available for free at http://www.aarp.org/work/social-security/social-security-benefits-calculator/.

Deborah Tedford (Mystic, Connecticut) has pointed out that, counter-intuitively, some studies show it is more important for those with fewer savings to delay Social Security than those with substantial assets (and other income). As average Americans age, their savings tend to diminish, and the higher monthly benefits become increasingly important.

g. **Spouse's Benefits**. Very generally speaking, after a worker files for benefits, the spouse can apply to receive a benefit equal to 50% of the amount the worker would be entitled to receive at full retirement age (whether the worker is receiving benefits before or after age 66), but the spousal benefits are reduced permanently if the spouse has not reached his or her full retirement age. However, only one spouse at a time can claim spousal benefits. A spouse must be legally married to the worker at the time of the application is filed and for at least one continuous year before that.

The Bipartisan Budget Act of 2015 impacted the Social Security claiming options of spouses. See Item 2.i of the Current Developments and Hot Topics Summary (December 2016) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**.

h. **Survivor's Benefit**. After a worker has died, the surviving spouse is entitled to surviving spousal benefits after reaching age 60. The spouse must have been married to the worker at least nine months before the date of death unless the worker died accidentally.

(1) If the spouse elects to begin receiving survivor benefits before reaching his or her full retirement age, the survivor benefits are reduced (by 1-28.5% depending on how early the election is made).

(2) If the worker had not started collecting benefits, the widow or widower benefit (assuming it is not reduced because of electing to receive it before the survivor's full retirement age) is 100% of the worker's "primary insurance amount" that would have applied when the worker reached full retirement age.

(3) If the worker was receiving benefits at the time of his or her death, the widow or widower benefit will be equal to the amount the worker was actually receiving (again, unless reduced because the survivor elects to begin receiving benefits before his or her full retirement age). **Thus, one of the advantages for a worker to defer applying for benefits until age 70 is to increase the "two-life annuity" available to the spouses from Social Security.**

(4) The widow or widower will lose the survivor benefits if he or she remarries before age 60 unless the subsequent remarriage ends. Remarriage after age 60 does not impact the entitlement to survivor benefits.

i. **Social Security Benefits for Minor Children**. A worker's unmarried minor child can receive benefits if the worker is deceased or receiving retirement or disability benefits, and if the child is younger than age 18 or is 18-19 years old and a full-time student (no higher than grade 12). Therefore, deferring the receipt of benefits past full retirement age would prevent the child from receiving child benefits until payments to the worker begin (and the child benefits would not receive the 8% per year increase for deferring benefits past age 66 when they do start).

If a grandparent adopts a grandchild who is under age 18, the adopted grandchild can receive benefits once the grandparent starts receiving benefits. (Furthermore, if a grandparent provides more than half the support of a grandchild, even though never adopted if the grandchild's parents are disabled or deceased, the grandchild will be eligible for benefits through the grandparent and can qualify for Medicare two years after qualifying for Social Security benefits.)

j. **Other Potential Benefits**. Benefits may also be available in certain cases for ex-spouses following a divorce, for disabled children, and for parents of the worker.

18. Medicare and Penalties for Late Enrollment

Medicare is a federally subsidized health insurance program, enacted in 1963.

An individual first qualifies for Medicare at age 65 (several exceptions allow benefits at an earlier age). At age 65, the individual should go online and apply for Medicare, even if not claiming benefits. Medicare has four parts.

Part A pays for hospitals for "in-patient" services. Part A costs the individual nothing (if the individual or the individual's spouse paid FICA taxes at least 10 years) and it does not impact the amount of other benefits available to the individual.

Part B pays for doctors (generally for "out-patient" services). The monthly premium depends on the individual's income level. For 2019, the monthly premium ranges from $135.50 to $460.50, depending on the income level.

Part C is called Medicare Advantage. An individual can elect to join a Medicare Advantage Plan in the individual's locality. It operates like an HMO – the provider agrees to pay all healthcare costs.

Part D is a prescription drug plan. If not covered by other medical insurance, persons reaching age 65 should enroll in a Part D drug plan, which is heavily subsidized by the government so that the individual is not paying market rates. Individuals must choose among plans, to match their particular drug needs.

Penalty for Late Enrollment in Part B and Part D. If the individual is not covered under a group health plan for the individual or the individual's spouse, a late enrollment penalty applies for not enrolling in Part B upon reaching age 65. The penalty is 10% more for each full 12-month period, and this penalty will apply for the remainder of the individual's lifetime.

A penalty also applies for Part D premiums for the drug prescription plan after the initial enrollment period a period of 63 or more days in a row occurs when the individual does not have Part D or other creditable prescription drug coverage. The penalty is an additional 1% of the base beneficiary premium for each month the person was eligible for Part D and not covered by a creditable drug prescription plan, and lasts as long as the person has Part D drug coverage.

***Key Pointer*: This penalty is huge and lasts for life. Enrolling timely for Part B and Part D is extremely important. For Part B, this is at age 65 if the person is not covered by a group health plan, or within an 8-month "special enrollment period" after the individual is no longer covered by a group health plan.**

Items 19-24 are observations from Session 3: Income Taxation of Estates and Trusts by David A. Berek, Professor Samuel A. Donaldson, and Karen Sandler Steinert

19. Brief Overview Summary of Taxation of Nongrantor Trusts

The taxation of trusts is sometimes referred to as conduit taxation (somewhat like for partnerships or Sub S corporations) but that is not entirely true. Flow-through income results from trust distributions and is not automatic. The reporting of taxable income is bifurcated between the trust and beneficiaries.

Any distribution from an estate, whether of income or principal, will generally "carry out" the income of the estate to the beneficiary to the extent of the estate's distributable net income (DNI). §661 (deduction to estate); §662 (income to beneficiary). DNI is the taxable income of the estate with certain modifications. §643(a). If the distributions exceed the amount of DNI, the DNI is carried out proportionately to the beneficiaries who receive distributions (under "tier" rules, the income is allocated proportionally to the recipients of mandatory income distributions, and then allocated to charitable beneficiaries, and then to non-charitable beneficiaries receiving discretionary distributions). The character of income in DNI (ordinary dividends, qualified dividends, tax exempt income, etc.) is also carried out proportionately.

Important timing differences can exist for estates (and for trusts that make the election under §645 to be taxed as part of the estate). Unlike for individuals, trusts and some other entities, estates may have a taxable year separate from the calendar year. For example, this can result in a delay of when income tax must be paid on estate income that is taxed to a beneficiary.

The trustee has two mechanisms for impacting the manner in which taxable income is allocated between the trust and the trust beneficiaries: (1) The amount of trust income that is included in determining the trust's DNI (the trustee has some flexibility in this determination, particularly with respect to capital gains); and (2) The amount of trust distributions in a particular year (and whether distributions within the first 65 days are treated as having been made in the prior year under the "65-day rule of §663(b)).

20. Brief Overview Summary of Taxation of Grantor Trusts

The income and deductions of grantor trusts are generally reported directly to the settlor of the trust (or the deemed owner of a trust subject to §678). If the qualified Subchapter S (QSST) election is made for a trust, §678 applies to treat the beneficiary as the deemed owner of the portion of the trust that consists of S corporation stock. See Rev. Rul. 92-84.

21. Trust Taxable Income

As for individuals and other entities, a trust's taxable income is its gross income less deductions. One of the special deductions for a trust is the "income distribution deduction" (available up to the amount of the trust's distributable net income, or DNI).

Some of the other differences in determining a trust's taxable income, as compared to an individual's taxable income, are as follows.

- A trust or estate has a deduction in lieu of a personal exemption ($600 for estates, $300 for trusts required to distribute all income, and $100 for other trusts). This deduction is not subject to the phase-out rules that used to apply to an individual's personal exemption under §151(d)(3).
- The 2% floor on miscellaneous itemized deductions under §67 applies to trusts and estates only with respect to "costs which are paid or incurred in connection with the administration of the estate or trust and would not have been incurred if the property were not held in such trust or estate." §67(e). This has resulted in a tortured litigation history, culminating in the Supreme Court *Knight* case and the issuance of detailed regulations. These types of trust or estate expenses continue to be considered in determining the trust's "adjusted gross income," but other trust miscellaneous itemized deductions are suspended through 2025. IRS Notice 2018-61.
- Different charitable deduction rules apply for trusts and estates. No percentage limitations apply, a deduction is allowed only for amounts of gross income distributed to charity (§642(c)(1)), and a "set-aside" deduction is allowed for amounts of gross income that are permanently set aside for charity even though the income has not actually been distributed to charity during the current taxable year (§642(c)(2)).
- Special rules apply to S Corporation income for electing small business trusts (ESBTs). The trust pays a flat tax equal to the highest rate applicable to trusts (currently 37%) on the income attributable to the S corporation items. §641(c).

- Certain items claimed as administrative expense deductions on the federal estate tax return cannot also be deducted on the estate's income tax return. §213(c). Most estate administration expenses can be deducted on either the estate income tax return or the estate tax return, but not both returns.

22. Trust Distributable Net Income

a. **Function and Role**. DNI places a limit on the amount of the distributions deduction and on the amount and character of the current income that is attributed to the income beneficiaries.

b. **Computation**. The DNI of a trust or estate is its taxable income, with several modifications. A major modification is that capital gains are generally excluded, but can be included in particular circumstances (discussed immediately below).

c. **Capital Gains in DNI—General Rule and Regulatory Exceptions**. Capital gains ordinarily are excluded from DNI (so that capital gains are ordinarily taxed at the estate or trust level). Treas. Reg. §1.643(a)-3(a). However, the regulations provide that capital gains will be included in DNI if they are, (1) "pursuant to the terms of the governing instrument and applicable law" or (2) "pursuant to a reasonable and impartial exercise of discretion by the fiduciary (in accordance with a power granted to the fiduciary by applicable local law or by the governing instrument if not prohibited by applicable local law)":

> (1) Allocated to income (but if income under the state statute is defined as, or consists of, a unitrust amount, a discretionary power to allocate gains to income must also be exercised consistently and the amount so allocated may not be greater than the excess of the unitrust amount over the amount of distributable net income determined without regard to this subparagraph § 1.643(a)-3(b));
>
> (2) Allocated to corpus but treated consistently by the fiduciary on the trust's books, records, and tax returns as part of a distribution to a beneficiary; or
>
> (3) Allocated to corpus but actually distributed to the beneficiary or utilized by the fiduciary in determining the amount that is distributed or required to be distributed to a beneficiary.

Treas. Reg. §1.643(a)-3(b).

Planning observations are highlighted below.

(1) Allocating Capital Gains to Income. Consider providing in the trust instrument that the trustee has the *discretion* to allocate capital gains to income; **no consistency requirement exists in Treas. Reg. §1.643(a)-3(a)(1) regarding allocating capital gains to income,** so the trustee could exercise its discretion each year whether to allocate capital gains to income. *See* Reg. §1.643(b)-1 (the proposed regulation required consistency, but that was dropped in the final regulation).

Distributions from flow-through entities are typically treated as fiduciary accounting income rather than principal unless the distribution is part of a liquidating distribution. Under the Revised Uniform Principal and Income Act (RUPIA) and the Uniform Fiduciary Income and Principal Act (UFIPA), cash distributions from a flow-through entity with capital gains that are taxed to the trust are treated as being allocated to income and therefore meet exception (1) so that the capital gain from the entity would be included in DNI. (If the entity distributes less than all of its taxable income, whether the capital gain is distributed is unclear.) Capital gain that is distributed in the ordinary course of partnership operations and that is allocated to the trust on the Schedule K-1 of a partnership or LLC is permitted to pass through to the beneficiaries. *Crisp v. United States,* 34 Fed. Cl. 112 (1995).

Net short term capital gain from a mutual fund is treated as fiduciary income under the Uniform Fiduciary Income and Principal Act.

(2) **Capital Gains Allocated to Corpus and Consistently Treated as Part of Distributions**. Give the trustee the authority to treat principal distributions as consisting of capital gains realized during the year. This is sometimes referred to as a "deeming" rule. Treas. Reg. §1.643(a)-3(e) Exs. 2-3. The consistency requirement is emphasized in the regulations. Treas. Reg. §1.643(a)-3(e) Exs. 2, 12, 13.

(3) **Capital Gains Allocated to Corpus but Actually Distributed or Considered in Determining Amount to be Distributed**. No provision in the regulation requires that this authority be exercised consistently. As an example, a trustee may study the trust income and income tax brackets of the trust and its beneficiaries in making a decision about what distributions to make, and the trustee might specifically acknowledge that in determining the amount of distributions, it has considered the trust income tax situation and the capital gains of the trust. However, the examples in the regulations for Exception (3) are rather narrow and do not include an example with that rationale.

(4) **Example Clause.** An example clause (provided by Greg Gadarian) giving the trustee discretion to utilize the flexibilities afforded by the regulation to cause capital gains to be in DNI is as follows:

> The Trustee (other than a Trustee who is also a qualified beneficiary, and other than the Grantor) may allocate realized short term capital gains and/or realized long term capital gains to either trust income or trust principal, and such gains shall be includable in distributable net income as defined in I.R.C. § 643 and the regulations thereunder (1) to the extent that such gains are allocated to income; or (2) if such gains are allocated to principal, to the extent they are distributed to the trust beneficiary, or used by the Trustee in determining the amount distributable to the trust beneficiary, or treated consistently on the trust's books, records, and tax returns as part of a distribution to the trust beneficiary.

23. Fiduciary Federal Income Tax Resource

For a much more detailed discussion of the federal income taxation of trusts and estates, see Items 1-22 of the ACTEC 2016 Summer Meeting Musings (the Stand Alone seminar at that meeting was described as a "Fiduciary Income Tax Boot Camp") found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**.

24. *Kaestner* Supreme Court Case Regarding Constitutionality of State Trust Income Taxation

a. **Case Synopsis**. In a 9-0 decision, the U.S. Supreme Court upheld lower court findings that the taxation of undistributed income from a trust by North Carolina based solely on the beneficiaries' residence in North Carolina violated the Due Process Clause, but the Court emphasized that its ruling was based on the specific facts of the case for the specific tax years in question.

The first paragraph of the opinion is an excellent synopsis of the case and the Court's holding.

> This case is about the limits of a State's power to tax a trust. North Carolina imposes a tax on any trust income that "is for the benefit of" a North Carolina resident. N. C. Gen. Stat. Ann. §105–160.2 (2017). The North Carolina courts interpret this law to mean that a trust owes income tax to North Carolina whenever the trust's beneficiaries live in the State, even if—as is the case here—

> those beneficiaries received no income from the trust in the relevant tax year, had no right to demand income from the trust in that year, and could not count on ever receiving income from the trust. The North Carolina courts held the tax to be unconstitutional when assessed in such a case because the State lacks the minimum connection with the object of its tax that the Constitution requires. We agree and affirm. As applied in these circumstances, the State's tax violates the Due Process Clause of the Fourteenth Amendment.

North Carolina Department of Revenue v. The Kimberley Rice Kaestner 1992 Family Trust, 588 U.S. __ (2019)(Justice Sotomayor), concurring opinion (Justice Alito, joined by Chief Justice Roberts and Justice Gorsuch), *aff'g Kaestner 1992 Family Trust v. North Carolina Department of Revenue*, 814 S.E.2d 43 (N.C. June 8, 2018), *aff'g* 789 S.E.2d 645 (N.C. App. 2016), *aff'g*, 12 CVS 8740 (N.C. 2015).

The decision is narrow in the sense that North Carolina may be unique in looking solely to the residency of a beneficiary, including a beneficiary whose interest is "contingent," but the opinion does respect the fundamental character of trusts and recognizes the distinct interests and functions of the settlor, trustee and beneficiaries. In addition the opinion implies that the Court's recent opinion in *South Dakota v. Wayfair, Inc*. 585 U.S. __ (2018), will not have a major impact on the analysis of the constitutionality of state taxation of trusts. While the trend of cases over the last four years has been to find state taxation of trusts on various grounds to be unconstitutional (with most of those cases addressing systems that tax trusts based on the residency of the settlor of the trust), the Court goes out of its way to make clear that it is not addressing any of the other regimes for state taxation of trusts. The opinion provides minimal guidance as to the constitutionality of those various systems (or the North Carolina beneficiary-based system under other facts), but reiterates and applies traditional concepts that due process concerns the "fundamental fairness" of government activity and requires "minimum contacts" under a flexible inquiry focusing on the reasonableness of the government's action.

For a more detailed analysis of the *Kaestner* opinion and planning alternatives in light of the opinion, see Kaestner Trust – Supreme Court Guidance for State Trust Income Taxation found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**.

b. **Massive Refund Actions**. The result of *Kaestner* is that at least 400 protective claims for refund have been filed. The North Carolina Department of Revenue has published a notice that persons who filed a "Notice of Contingent Event" based on the contingency of the pending *Kaestner* case must file an amended return within six months after the contingent event concluded, which would be six months after the date of the June 21, 2019 *Kaestner* opinion, or by December 21, 2019. Taxpayers who had not previously filed a Notice of Contingent Event relating to the *Kaestner* opinion must file an amended return or a refund claim within the statute of limitations for obtaining a refund.

c. **Significance (and Insignificance) of *Kaestner***. The Due Process and Commerce Clauses of the U.S. Constitution both place limits on the ability of a state to tax income when the income is not directly produced within the state. In particular, courts over the last century have grappled with when a state can tax the undistributed income of trusts based on some connection to the state and still satisfy the Due Process Clause's requirement of fundamental fairness. A number of state court cases have addressed this issue (increasingly over the last decade), but *Kaestner* is the U.S.

Supreme Court's first effort to address this important issue regarding state taxation of trust income in many decades, and the case reiterates established guidance regarding the Due Process Clause's limits on the ability of states to tax income and the general principles for when a state can tax trust income under the Due Process Clause. For that reason, the case is highly significant.

The opinion is very limited, however, in establishing guidelines for what specific connections that a state has with a trust income *will satisfy* the due process requirements. Professor Sam Donaldson's view is that this was an extremely easy case because of the almost complete absence of contacts with North Carolina as, he says, is indicated by the "deeply divided 9-0 opinion."

d. **Open Questions Even for a Beneficiary-Based State**. A handful of states use a beneficiary's residence as at least one factor in determining whether the trust is a resident trust. The opinion leaves open whether the presence of certain factors might justify state trust taxation based on beneficiary contracts, such as if the beneficiary—

- received some income during the year in question (or possibly even in a prior year),
- had the right to demand income from the trust during that year (for example under a "health, education, maintenance, and support" standard),
- had a vested interest in ultimately receiving that trust income (for example, one of the factors that California uses in taxing the undistributed income of trusts is whether any "non-contingent" beneficiaries reside in California),
- had some control over trust decisions short of being a trustee (for example if the beneficiary was an investment advisor), or
- had the ability to remove and replace trustees.

e. **Guidance as to Factors That Would Justify State Taxation of Trust Income**. Page 6 of the *Kaestner* opinion addresses three taxing regimes that do pass the Due Process Clause's "minimum contacts" requirement—

(1) taxation of actual trust distributions to a state resident (*Maguire v. Trefry*),

(2) taxation based on the residence of the trustee (*Greenough v. Tax Assessors of Newport*), and

(3) possibly taxation based on the place of administration (cases *suggesting* that is constitutional are *Hanson v. Denckla* (involving personal jurisdiction, not trust taxation, issues), and *Curry v. McCanless*).

In addition, cases are clear that states can (and do!) tax trust income that comes from sources within the state (sometime referred to as "source income").

Although states may tax trusts based on the presence of the trustee in the state, some states do not use that as a factor for fear of discouraging banks from locating in the state (a prime example is North Carolina, which is home to several large national banks).

f. **Minimal Guidance as to Settlor-Based Regimes**. The most prevalent factor that is used by states for taxing undistributed trust income is whether the trust was originally created by a resident of the state. The opinion provides little guidance regarding whether those systems will satisfy the due process requirements unless the settlor had the "power to dispose of" the trust property (*Curry v. McCanless*), or the "right to

revoke" the trust (*Graves v. Elliott*). Beyond those cases, in which the settlor retains the clear power to control or possess the trust property, the opinion gives no guidance regarding the constitutionality of settlor-based taxing regimes.

Although a few exceptions exist, a wide variety of state cases have found that systems based solely on the existence of a resident-settlor do not satisfy due process requirements. See Item 20.d of the 2012 Heckerling Musings found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights)** for a history of such cases and see Item 22.a of the Current Developments and Hot Topics Summary (December 2014) found **here** and Item 17.c of the Current Developments and Hot Topics Summary (December 2017) found **here** and available at **www.bessemertrust.com/for-professional-partners/advisor-insights** for a discussion of the trend of more recent cases finding such systems unconstitutional.

In many situations, the fact that a settlor lived in the state years earlier when the trust was created may result in even less contacts with a trust currently than the beneficiary situation addressed in *Kaestner*.

Even among settlor-based regimes, the constitutionality analysis may vary. Taxation of testamentary trusts by the state of the decedent's residence may have a somewhat greater possibility of withstanding constitutional challenge than inter vivos trusts because of the utilization of the state's probate courts in the establishment of the testamentary trusts. The courts have generally focused their constitutional analysis of state taxation of trusts under the Due Process Clause (and the involvement of the local courts in creating the trust is an additional contact with the state that may help support the existence of the required "**minimum contacts**" required for due process), but the state taxation must also be permitted under the Commerce Clause, which requires a **substantial nexus** between the activity being taxed and the taxing state, and the local court involvement might help in establishing that the required substantial nexus exists.

Another variance is that some settlor-based state regimes also add a "nonresident resident trust" exception (such as New Jersey and New York); the state cannot tax the income of a "resident trust" created by a resident-settlor if no trustees, assets or source income are present in that state.

g. **Planning Opportunities**. Settlor-based state systems can sometimes create planning opportunities for trusts created by residents in other states. For example, New York resident-settlors may create trusts with New Jersey trustees and assets and not be subject to New York taxation (because of the absence of a New York trustee or New York assets) or New Jersey taxation (because the trust was not created by a New Jersey testator or settlor).

Selecting a trustee (or trust protector or trust advisor) that is located in a state that does not tax trusts will be determinative for many situations. If a bank is chosen, consider selecting a bank that is incorporated or administered in a state that does not tax trusts or that would require some fact in addition to the mere presence of a trustee in the state.

h. **Impact of Decanting Statute**. One of the reasons the Court gave for concluding that the beneficiaries did not have the requisite "minimum connection" with the income being taxed was that they were not assured of ever receiving the income. The tax years in question were 2006-2008, and the trust agreement said that the trust would terminate in 2009. To reason that the beneficiaries were not assured of receiving the

income when the trust would terminate in the *following* year (as to the 2008-year tax) may seem somewhat of a stretch. Apparently, as of 2008, the Court would have been relying on the fact that the trustee had the authority to distribute the assets to a longer-term trust under the New York decanting statute, so the beneficiaries were not assured of receiving the income. Indeed, the trustee consulted with the beneficiary and in accordance with her wishes the trustee decanted the trust into a new trust under the New York decanting statute (N.Y. Est., Powers & Trusts Law Ann. §10-6.6(b)).

i. **Orchestrated Plan**. Declining to make distributions to the North Carolina beneficiaries and decanting the trust to a new longer term trust were part of a structured plan to build the best facts to fight the North Carolina tax.

j. **Supreme Court Will Not Hear *Fielding***. In *William Fielding, Trustee of the Reid and Ann MacDonald Irrevocable GST Trust for Maria V. MacDonald, et al., v. Commissioner of Revenue*, 916 N.W.2d 323 (Minn. July 18, 2018), the court addressed the Minnesota statute providing that an inter vivos trust is treated as a resident trust if the grantor was a Minnesota resident when the trust became irrevocable. The Minnesota Tax Court held that the system violated the Due Process and Commerce Clauses and the Minnesota Supreme Court held that Minnesota's taxing of the trust violated the Due Process Clause. The state filed a certiorari petition with the United States Supreme Court. The Court did not address that petition while the *Kaestner* case was pending, but it denied the petition on June 28, 2019.

Kaestner is likely the only guidance the Supreme Court will give about the constitutionality of state trust taxation systems for decades to come.

Items 25-34 are observations from Session 4: Income Taxation of C Corporations, S Corporations and Partnerships by Professor Samuel A. Donaldson, S. Stacy Eastland, and Brian C. Sparks

25. Brief Overview of Major Opportunities and Pitfalls of C Corporations, S Corporations, and Partnerships

a. **C Corporations**.

Opportunities. (1) Section 1202 qualified small business stock offers the opportunity of avoiding all gain on the sale of the stock if the stock is held at least five years.

(2) A smaller current tax applies than for pass-through entities (21% vs. 37%, though the §199A deduction may reduce the 37% effective rate for some business owners), and payments may still be made to owners without applying a second tax (the "double tax") on dividends by making compensation, interest, or rent payments to shareholders, as appropriate (see more detail about tax rate comparisons in Item 26.d below).

Pitfalls. (1) The double tax issue is discussed above and in Item 26.d below.

(2) The accumulated earnings tax is a 15% penalty tax that can be assessed by the IRS at its discretion if a corporation has undistributed taxable income beyond amounts required for reasonable business needs. The tax is often alleged by the IRS in audits of C corporations as leverage for negotiations. Planners making an initial review of C corporation balance sheets should look first to retained earnings and inquire about large amounts of retained earnings. The business needs for the retained earnings should be documented **before** the IRS asserts the penalty tax.

b. **S Corporations**. Based on the number of returns filed (Form 1120 for C corporations and Form 1120S for S corporations), there are about three times as many S corporations as C corporations**.** Certain requirements must be satisfied in order to make the S elections, but planning opportunities are available to work around the various requirements. The major requirements and possible workarounds are: (1) domestic corporation (just have the company co-organized in the U.S.); (2) no more than 100 shareholders (but members of the same family, counting down six generations from a common ancestor, are treated as one shareholder for this purpose – "you and Kevin Bacon may be members of the same family"); (3) no NRA shareholders (drop the assets into an LLC and have the NRA as a co-owner of the LLC); (4) no business entity shareholder (disregarded entities – such as a partnership or LLC owned by a single grantor and grantor trusts of that grantor – are ignored, and if a business entity wishes to be a shareholder, drop the assets into an LLC and the business entity can be a co-owner of the LLC); and (5) single class of stock (but voting and non-voting stock is allowed).

Opportunities. (1) The self-employment tax does not apply to the flow-through income from S corporations, only to compensation received from the S corporation. In reviewing whether a company seems to be paying adequate compensation, realize that on average about 41-47% of the profits of S corporations are paid as compensation to shareholder-employees, and so stay "in the middle of the herd." If, for example, the company is paying only 2% of the profits as compensation, then "have the talk" with the owner.

(2) Gain shifting is permitted (indeed, required) with S corporations; if a shareholder contributes an asset with built-in gain and the asset is later sold by the corporation, the gain is allocated pro rata to all owners, but with a partnership, the built-in gain would have to be specially allocated to the partner that contributed the built-in gain asset.

Pitfalls. (1) "Two percent shareholders" (which paradoxically do not include 2% shareholders but only include shareholders who own more than 2%) do not qualify for certain fringe benefits.

(2) The basis for shareholders' stock is not adjusted upward to reflect liabilities of the S corporation. (That is allowed for partnerships.) This creates a planning opportunity. When initially reviewing balance sheets of S corporations planners should look for liabilities of the corporation. Refinance the debt so that shareholders borrow from the outside lender and contribute or loan the funds to the corporation; the shareholder will then have basis for that debt (*Miller v. Commissioner*). Banks lending to S corporations will likely require the shareholder to guarantee the debt in any event.

Hazards of Former C Corporations. (1) The built-in gains tax can apply to S corporations that formerly were C corporations if the built-in gain asset is sold or distributed, but the recognition period is now only five years (rather than 10 years or seven years as under prior law). The corporation pays a tax equal to the highest rate for C corporations (now 21%) times the net recognized built-in gain for the taxable year or, if less, the corporation's taxable income of the taxable year. §§1374(b)(1), 1374(d)(2)(A). The corporate level tax imposed under §1374 passes through to shareholders as a loss with the same character as the corresponding gain giving rise to the tax, lessening the double tax impact to some extent. Possible ways to avoid or minimize this tax are (i) wait out the recognition period before selling or distributing

the built-in gain assets, (ii) make a like-kind exchange under §1031 (now allowed only for real estate), but the §1374 taint is preserved in the asset received, thus merely deferring the tax, and (iii) the corporation could make a charitable deduction of the asset (the corporation would not have a gain so the §1374 tax would not apply, and the shareholders would reduce the basis of their stock only by the basis of the built-in gain asset, not by the full market value of the asset, thus assuring that the gain is not effectively later taxed upon a sale of the shares or a liquidation of the corporation).

(2) If the C corporation used the LIFO accounting method, it must change to the FIFO accounting method and must recapture the income that the corporation would have received if it had used the FIFO method (but the recapture amount can be reported over four years) §1363(d).

(3) If the S corporation has "accumulated earnings and profits" (e & p) from when the corporation was a C corporation, and if the S corporation's "passive investment income" exceeds 25% of its total gross receipts, the corporation pays a tax equal to the highest tax rate for C corporations (now 21%) times the "excess net profit income" and if the tax is imposed for three years in a row, the S corporation must revert to being a C corporation. The general purpose is to limit the benefits of S corporations to those companies engaged in active businesses and not a place to park retained earnings from C corporation years for investment. This can be managed by (i) paying out all of the C corporation years accumulated retained e & p, or (ii) managing the gross receipts and the investments so that the passive income does not exceed 25% of the gross receipts (and for sure does not exceed 25% three years in a row).

c. **Partnerships**.

Basic Mechanics. Partnership taxation is complicated for tax professionals, let alone business advisors or business owners. Professor Sam Donaldson has an outstanding overview summary of the basic mechanics of the partnership tax, which is quoted with his permission.

V. PARTNERSHIPS

A. THE BASIC MECHANICS

1. Formation

Like a corporation, formation of a partnership is also a painless event. A partner will not recognize gain or loss upon a transfer to the partnership in exchange for an interest unless the contribution consists of services. IRC §721. Note that a partner does not need to be an 80-percent owner to achieve non-recognition, as does the shareholder of a corporation. To preserve any gain or loss not recognized, the partner's basis in the partnership interest equals the sum of the bases of the properties transferred to the partnership in exchange for the interest. IRC §722. The partnership also takes a carry-over basis in the property received from the partner. IRC §723.

2. Operation

The tax items of a partnership pass through to the partners. IRC §§701; 702. Unlike an S corporation, however, the partners of a partnership are generally free to allocate these tax items among the partners as they wish, so long as these allocations have "substantial economic effect." IRC §704(b). Thus, equal partners in a partnership may agree to allocate all losses to one partner and all tax-exempt income to the other partner, so long as the allocations have "substantial economic effect." The flexible tax allocations make the partnership a more attractive business vehicle to most business owners.

Allocations have "economic effect" if the partnership agreement requires, for the full term of the partnership, that: (1) capital accounts be created and maintained in the manner set forth in the regulations (see Treas. Reg. §1.704-1(b)(2)(iv)); (2) liquidating distributions be made in accordance with the partners' positive capital account balances; and (3) any partner with a deficit balance in his or her capital account

following liquidation of the partnership be unconditionally obligated to restore the amount of the deficit (see Treas. Reg. §1.704-1(b)(2)(ii)(b)). A partner's capital account balance is the amount he or she would be entitled to receive upon liquidation of the partnership. A capital account is increased by the net value of any contributed cash or property and the partner's share of partnership income items. It is decreased by the value of any distributions to the partner and the partner's share of partnership loss and deduction items.

If the partnership agreement complies with the first two requirements but does not comply with the third requirement, the allocation can still have economic effect under an alternate test. See Treas. Reg. §1.704-1(b)(2)(ii)(d). Assuming the economic effect test is met, an allocation will be respected if it is **substantial**. While various standards for substantiality are provided in the regulations—a general rule as well as a rule for shifting and transitory allocations—the focus is whether the allocation will affect substantially the dollar amounts to be received by the partners from the partnership. See Treas. Reg. §1.704-1(b)(2)(iii).

3. Distributions

As you would expect, distributions from a partnership are generally tax-free since the partners have already taken the partnership's tax items into account on their own income tax returns. No gain is recognized upon a distribution to a partner except to the extent the amount of cash distributed exceeds the partner's outside basis immediately before the distribution. IRC §731(a)(1). No gain or loss is recognized by the partnership. IRC §731(b). If a partner receives cash or property regardless of the partnership's profitability, however, the distribution may constitute a "guaranteed payment" that will be treated as compensation income. IRC §707. . . .

4. Liquidation

The basis of property (other than money) distributed to a partner in liquidation of the partner's interest in the partnership is an amount equal to the partner's basis in the partnership interest reduced by any money distributed in the same transaction. IRC §732(b). Liquidation of a partner's interest is defined as the termination of the partner's entire interest in the partnership by means of a distribution or series of distributions. See IRC §761(d). Loss is not recognized by a partner upon a distribution ***except*** that loss ***is*** recognized on a distribution in liquidation of a partner's interest where no property other than cash, unrealized receivables, and inventory items are received by the partner. IRC §731(a)(2). The amount of the loss (which is considered to be loss from the sale or exchange of the partnership interest) is equal to the excess of the partner's basis in the partnership interest over the sum of the cash distributed to the partner and the adjusted basis of the distributed property under IRC §732.

Opportunities. (1) Flexibility – tremendous flexibility exists in allocating taxable income among partners – as long as the allocations of taxable income also have substantial economic effect.

(2) If a §754 election is in place, upon the sale of a partner's interest or upon the death of a partner, the inside basis of assets attributable to that partner's interest in the partnership will be adjusted to reflect the basis of the transferred partnership interest (e.g., reflecting the basis adjustment at death under §1014). For community property, an inside basis adjustment is also made with respect to the deceased partner's surviving spouse's community property interest (which also received a basis adjustment under §1014). The inside basis adjustment applies only as to the successors of the transferred partnership interest, and not as to other partners. (This, in effect, will require keeping separate books as to the different partners, thus increasing the accounting costs.)

Pitfalls. (1) Complexity – with increased flexibility comes increased complexity. For example, even aside from the partnership tax complexities, transfers of interests having special allocations may run afoul of §2701.

(2) While partners do not have to be an 80% partner to avoid gain on the contribution of appreciated assets to a partnership (as is required for corporations), gain recognition can occur on contributing appreciated assets if the partnership is treated as an "investment company." §721(b). See Item 28.b below.

(3) Disguised sales and mixing bowl rules – If an appreciated asset that is contributed to the partnership is distributed to any other partner within seven years, or if other non-cash assets are distributed to the contributing partner, the contributing partner will recognize the built-in gain on the contributed asset. §§704(c)(1)(B); 737. See Item 28.a below.

(4) Distributions of cash can result in gain if the cash exceeds the partner's basis in the partnership interest; otherwise distributions of property do not generate gain *except* that distributions of marketable securities are treated as cash distributions unless an exception applies (one of which is that the partnership is an "investment partnership"). §731(c).

(5) Sales of partnership interests can yield ordinary income. The portion of the gain or loss on the sale of a partnership interest allocable to unrealized receivables or inventory items will be treated as ordinary income or loss (§751(a)).

26. Selection of Entity: C Corporation vs. Pass-Through Entity

a. **General Factors**.

Types of Entities. The types of entities are sole proprietorships, general partnerships, limited partnerships, LLCs, S corporations, and C corporations. The first five of those are taxed at the individual owner's level. The C corporation is a separate taxable entity.

Another newer type of entity recognized in some states is the Series LLC, which is a single LLC but with different divisions (or "series") for specific activities; the rights of the owners of each separate series is accounted for by the books and records of the entity. Some planners tend to avoid series LLCs because businesses often do not keep excellent records.

Tax Reporting. An advantage of C corporations is that reporting income by the shareholders is easier, with no complicated Schedule K-1 to report all of the flow-through income from the entity. Some venture investors prefer C corporations for this reason, among others.

Fringe Benefits. C corporations also may provide somewhat better fringe benefits in various respects.

Current Income Tax Cost. Under the 2017 Tax Act, C corporations have a maximum rate of 21%, and for corporations that do not distribute a substantial part of their earnings, the current income tax cost may be lower than pass-through entities (as discussed below).

Income that is distributed from the C corporation is generally taxed as a dividend, resulting in double taxation, once at the corporate level, and again at the individual shareholder level. The only way to avoid the eventual second level of tax is if the stock (1) qualifies for the gain exclusion under §1202 as qualified small business stock, or (2) is sold after the shareholder's death when the basis of the stock is adjusted to its fair market value at the date of death.

Limited Liability. Shareholders of a C or S corporation, members of an LLC, and limited partners of a limited partnership have limited liability (creditors of a limited partner or member of an LLC are generally limited to obtaining a "charging order" against the owner's interest, rather than acquiring the interest directly (though in some states, the creditor will have a foreclosure remedy)). The partners of a general partnership or the general partner of a limited partnership typically have joint and

several lability for all of the debts of the entity (unless the partner is in a corporate or LLC "wrapper," in which event the liability is limited to the assets of that corporation or LLC (assuming it is adequately capitalized).

Self-Employment Tax. The FICA tax is 7.65% for the employee and 7.65% for the employer, for a total of 15.3%. Taxpayers who do not receive wages but are paid through a partnership pay a self-employment tax of 15.3%. Shareholders of S corporations and limited partners of limited partnerships do not pay self-employment tax on flow-through income (but do pay self-employment tax on any compensation received from the entity).

b. **General Comparison of C Corporations and Pass-Through Entities under 2017 Tax Act.** The maximum income tax rate for C corporations was reduced to 21% under the 2017 Tax Act. The current income taxation for shareholders of C corporations, assuming the shareholder is in the top bracket and lives in a state with a 5% state income tax that is not deductible (i.e., the individual taxpayer is over the $10,000 limit with other state and local taxes), is summarized as follows. Assume the corporation has income of $100,000. The corporate tax is 26% (21% federal rate and 5% state rate), or $26,000, leaving $74,000 after tax income for the corporation.

If the corporation distributes all of the $74,000, the shareholder pays a 28.8% rate (20% federal tax rate + 3.8% net investment income tax rate + 5% state income tax rate) on the dividend, or $21,312, leaving $52,688. Therefore, the overall current income tax rate is about 47%. For a shareholder in lower personal income tax brackets, the shareholder might receive a net of $59,200, resulting in an overall current income tax rate of about 41%.

On the other hand, if the corporation will accumulate all of its income, the corporation will merely pay the 26% rate currently, thus resulting a lower income tax cost than if the income were earned in a pass-through entity. (Professional firms tend to distribute all of their profits, however, and excess accumulations beyond the reasonable business needs may be subject to the 20% accumulated earnings tax.)

Income from a pass-through entity may be entitled to a deduction under §199A of 20% of the qualified business income from the entity, which translates to an effective 29.6% federal rate ([1 - .20] x 37%, = 29.6%). In addition, the owner would be subject to a state rate (say 5%) and may be subject to the self-employment tax and the 3.8% tax on net investment income, which could result in a current aggregate tax cost up to about 46%.

c. **Section 199A Deduction for Qualified Business Income**. The 20% deduction for qualified business income under §199A is summarized in Item 7 of the Estate Planning Current Developments Summary (July 2019) found **here** and available at **www.bessemer.com/advisor**.

d. **More Detail on Tax Rate Comparisons**.

(1) **C Corporation**. C corporations are subject to a 21% federal tax rate (not increasing in 2026). If the corporation makes dividend distributions (e.g., distributions not treated as compensation or loan repayments), the remaining 79% is generally subject to a 23.8% federal rate (20% tax on dividends + 3.8% net investment income tax (NIIT)). The resulting effective rate for corporate income that is distributed is 39.8% [21% + (remaining 79% x 23.8%)]. C corporation income is not eligible for the §199A deduction.

(2) **Pass-Through Entity Income**. Income from pass-through entities is taxed directly to the individual owners. The general tax rate is 37% though 2025 (increasing to 39.6% in 2026), but adjustments apply depending upon whether the income is business income qualifying for a §199A deduction of 20%, whether the owner actively participates in a business so that the 3.8% net investment income tax (NIIT) does not apply, or whether the activity is passive (and therefore subject to the 3.8% NIIT).

(3) **Table of Comparative Rates**. Sam Donaldson provides the following table of comparative rates. (Unlike the discussion in Item 26.b above, this table only provides federal rates and does not include any estimated state tax rate.)

Situation	Rate
C corporation, pay taxes but no dividend distributions	21.0%
C corporation, pay tax and distribute remaining income as dividend; dividend taxed at 20% + 3.8% NIIT, or 23.8%	39.8%
S corp or Partnership - business income and materially participate (so no NIIT); no §199A (for example, if SSTB)	37.0%
S Corp or Partnership – passive income or business income and not materially participate (so 3.8% NIIT applies), no §199A deduction	40.8%
S Corp or Partnership – business income, materially participate (so no NIIT), qualify for 20% §199A deduction	29.6%
S corp or Partnership – business income, materially participate (so no NIIT), after 2025	39.6%
S corp or Partnership – passive or business income and no material participation (so subject to NIIT), after 2025	43.4%

e. **Comparisons**. A business for which no §199A deduction is available (if the owner has taxable income over the applicable threshold and the wage/UBIA/SSTB limitations disallow any deduction) and that retains profits for growth or to reduce debt may prefer being a C corporation (21% vs. 37% [39.6% after 2025]). Even if the business income qualifies for the full 20% §199A deduction in a pass-through entity, being a C corporation still has an 8.6% advantage (21% vs. 29.6%).

The comparative advantage of being a C corporation that retains profits is even greater if the entity has passive income (or business income in which the owner does not materially participate in the business) because the 3.8% NIIT would also apply to flow-through income from a pass-through entity, resulting in a rate differential of 19.8% (40.8% - 21%), and 22.4% after 2025 (43.4% - 21%).

When the C corporation ultimately distributes its profits or liquidates, the second level of tax will apply, resulting in an overall tax of 39.8%, but in the meantime the tax savings could be used for growth or paying debt. The pre-tax compounding may more than mitigate the after-tax effect of double taxation. Furthermore, the double tax may be mitigated (or eliminated if the sale occurs after a basis step-up at the death of a shareholder) if the C corporation stock is sold before the accumulated income is distributed.

After 2025, the double tax disadvantage no longer applies even if profits are distributed currently (39.8% for C corp vs. 39.6% or 43.4% for pass-through entity).

f. **Other Considerations**. Another advantage of being a C corporation is that individual shareholders may exclude up to 100% of gain from a sale of stock held more than five years if the corporation is a "qualified small business" under §1202. Also, no restrictions exist on the types of permissible owners (restrictions do apply for S corporations).

Disadvantages of C corporations includes that a 20% accumulated earnings tax can apply if reasonable business needs for accumulating profits do not exist (§531). A possible personal holding company tax (§541) or other complications can arise for C corporations (such as under §§ 269 and 482).

Another important planning consideration is the uncertainty of future tax laws. The C corporation rate could be increased at some point, removing much of the incentives discussed above for using a C corporation.

g. **Example Planning Scenario – Reorganize Business So Amount Needed for Consumption is in Pass-Through Entity and Amount for Future Growth is in C Corporation**. If distributions for consumption cannot be justified as compensation but will be treated as dividends, a double tax will apply from a C Corporation, resulting in an overall tax rate of 39.8%. Alternatively, structure the business so that the portion producing distributions that will be needed for consumption will be in a pass-through entity (not subject to the 21% tax at the corporate level). The portion producing profits not needed for consumption can be retained for growth or debt payment with only a 21% tax until profits are ultimately distributed.

27. Simulate Deduction of Investment Management Fees

a. **Restriction on Deduction of Investment Management Expenses**. The 2017 Tax Act suspended the deduction of "miscellaneous itemized deductions" through 2025 (§67(g)). This includes almost all deductions for individuals other than the charitable deduction, state and local tax deduction (up to $10,000 each year), and home mortgage interest deduction. As a result, investment management expenses, deductible under §212, generally are not deductible at all by individuals (and correspondingly, for owners of pass-through businesses).

That restriction does not apply to expenses in carrying on a trade or business under §162, however (because §162 expenses are deductible in arriving at adjusted gross income (§162(a)(1)), "itemized deductions" do not include deductions allowable in determining adjusted gross income (§63(d)(1)), and "miscellaneous itemized deductions" are itemized deductions other than those listed in §67(b)).

b. **Restructure Family Office Structure**. Several cases over the last year have approved structures in which a separate entity (i.e., a family office entity) conducts a trade or business of investment management to manage the investments of various investment partnerships. The separate entity (which could be a corporation or an LLC, for example) serves as the general partner of each of the separate investment partnerships, but the investment partnerships may remove the entity as investment manager at any time. The separate entity is responsible for paying all of the expenses of outside advisors, investment expenses, etc., and in return for its services receives a net profits interest for its services as manager that is substantially different from the investment return received by the investors. (For example, the entity might

receive a fee that is 0.5% of assets under management and 6% of the Net Income each year.) The separate entity does not have the same owners as the owners of the various investment partnerships.

Section 162 provides that a deduction is allowed to individuals or corporations for "all ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business." Such expenses are deductible in full by the trade or business. In contrast, §212 permits individuals to deduct expenses paid or incurred for the production or collection of income or for the management of property held for the production of income, but such expenses are subject to certain limitations that do not apply to deductions under §162, including that they are "miscellaneous itemized deductions" that are not deductible from 2018 through 2025, and otherwise are subject to the 2% floor rule of §67(a).

The net profits interest paid to the separate entity as manager reduces the taxable income of the investment partnerships, and the investment expenses paid by the separate entity are deductible as trade or business expenses. The effect is that the investment expenses are not included in the net income reported to the investors in the investment partnerships, and the expenses are deductible by the separate entity – as long as they can be deducted as trade or business expenses under §162.

c. **Supporting Case Law**. The general structure described above was approved in *Lender v. Commissioner*, T.C. Memo. 2017-246, and in a stipulated Order granted in *Hellmann v. Commissioner*, Docket Nos. 8486-17, 8489-17, 8494-17, 8497-17 (Nov. 9, 2018). Those cases rely on *Commissioner v. Groetzinger*, 480 U.S. 23 (1987), which states that for a trade or business to exist, "the taxpayer must be involved in the activity with continuity and regularity and … the taxpayer's primary purpose for engaging in the activity must be for income or profit."

d. **Helpful Factors; Best Practices**. To help satisfy the *Groetzinger* test that the management services are provided with continuity and regularity, and that the entity's primary purpose is to generate an income or profit, the separate entity should—

- have the obligation to pay outside advisory fee and expenses,
- have employees with appropriate education and professional background for their respective responsibilities,
- have work schedules for each employee with schedules of the work performed,
- have income against which to take the deductions,
- be beneficially owned by different owners than the investors in the investment partnerships; ideally the overlap should be less than 20% of profits and capital,
- contract with third party service providers in its own name,
- be adequately capitalized,
- have an investment/business purpose for the separate existence of the separate entity, such as providing specialized tailored management opportunities (i.e., differing investments for different investment partnerships), economies of scale, consolidation of the management and control of assets of various investors, and continued management and preservation of family assets.

The family office separate entity might be structured as a C corporation instead of an LLC, because C corporations may more likely be respected by the IRS as engaged in a "trade or business" (Rev. Rul. 78-195), and profits allocated to a C corporation are not subject to the 3.8% NIIT.

If ownership of the separate entity is transferred downstream, consider the impact of §2701 with respect to valuing the net profits interest.

Comply with detailed securities law issues that will apply to the family office.

e. **Expensive**. Structuring, implementing, and maintaining this structure is expensive. Some planners suggest that this type of structure should not be considered unless the client has over $100 million of investment assets (and some planners would say $200 million).

28. Diversification and Basis Shifting Using Partnerships

a. **Background**. Property distributions from a partnership are generally tax-free. Cash distributions are taxable to the extent that the distributed cash exceeds the partner's basis in the partnership interest (§731(a)(1)), and a distribution of marketable securities may be treated as a cash distribution unless the partnership is an "investment partnership" making a distribution to an "eligible partner" (§731(c)).

In light of the general rule that property distributions are tax-free, disguised sale abuses could result. For example, assume partner A contributes appreciated property, partner B contributes an equal value of cash, and after several years, the partnership liquidates, distributing the appreciated property to partner B and the cash to Partner A. After the IRS lost various disguised sales cases, several code sections were enacted to address disguised sales. However, complying with those provisions leaves open the possibility of obtaining diversification without gain realization by using partnerships.

Distribution of Appreciated Property to Non-Contributing Partner Within 7 Years. If one partner contributes property to a partnership that is distributed to another partner within seven years of the contribution, any built-in gain or loss at the time of contribution must be recognized by the contributing partner at the time of the distribution. §704(c)(1)(B). The built-in gain is not recognized if the property is distributed to the contributing partner, and for that purpose, any successor to the contributing partner's interest is treated as the contributing partner to the extent of the built-in gain allocable to the successor's interest. Reg. §1.704-4(d)(2).

Distribution of Different Non-Cash Property to Contributing Partner Within 7 Years. If a partner contributes appreciated property to a partnership and, within seven years of such contribution, receives a distribution of other non-cash property, the contributing partner must recognize the built-in gain on the appreciated property (or, if less, the excess of the distributed property's outside basis immediately prior to the distribution minus any cash received in the same distribution.) §737.

b. **Diversification Possibilities for Some Types of Assets If Wait 7 Years After Contributions**. If the parties wait at least seven years after contributions of appreciated property before making distributions to the partners, property contributed by one partner may be distributed to another partner without any gain recognition by either partner. The basis of property (other than cash) distributed to a partner in liquidation of the partner's interest is an amount equal to the adjusted basis of such partner's interest in the partnership reduced by any cash distributed in the same transaction. §732(b). In light of these rules, partners may receive diversified assets without gain recognition if distributions are not made for at least seven years.

A limitation on this type of diversification planning is the "investment company" rule in §721. Partners generally do not immediately recognize built-in gain when contributing appreciated assets to a partnership. §721(a). However, if the partnership is an "investment company," a taxable sale is deemed to occur. §721(b). In general, an investment company includes a partnership if more than 80% of its value in assets (excluding cash and nonconvertible debt obligations) are held for investment and are readily marketable stocks or securities, or interest in regulated investment companies or REITs. §351(e)(1). Observe that real estate is not included in this list. Therefore, if at least 20% or more of the partnership assets consist of business or investment real estate, the investment company rules will not apply. Furthermore, regulations add that the transfers to the partnership must result in a diversification of the transferors' interests in order for it to be an investment company, and a diversification of the transferors' interests will not occur if all transferors contribute a diversified portfolio of stocks and securities meeting the 25% and 50% tests in §368(a)(2)(F)(ii). Reg. §1.351-1(c)(6)(i).

c. **Distributions of Low Basis Assets to Older Partner*.*** Consider making in-kind distributions of property to an older partner prior to his death. The partner generally receives in-kind distributions of property with a basis equal to the partnership's basis in that asset, but not in excess of the partner's outside basis in his partnership interest. If the partner has a low basis in his partnership interest, the partner will receive the asset with a low basis. The partner will die owning the low-basis asset, which will obtain a basis step-up not limited by discounts.

d. **Basis Strip and Basis Shift*.*** Assume (in a greatly oversimplified example) that a partnership has two assets, one with a high basis and one with a low basis, and assume the assets have been in the partnership for over seven years so that there are no mixing bowl or disguised sales rules that apply. The partnership wants to sell or re-depreciate the low basis asset, so it would like to achieve a basis adjustment for that asset. The preferred approach is to make a liquidating distribution of the high basis asset to the older partner. The distribution results in the older partner receiving the asset with a zero basis (assuming his outside basis in his partnership interest was zero). (This is referred to as a "basis strip.") He will die with the zero-basis asset and get a full basis step-up, not impacted by discounting of the partnership interest. As long as a §754 election is in place, the stripped basis that was lost (when the high-basis asset was distributed, converting it into a zero basis asset) is moved to the low-basis asset remaining in the partnership for the benefit of the younger partners. §734(b). The estate could contribute its high-basis asset (after the basis step-up at death) back into the partnership.

The net effect of this strategy is (a) an immediate full basis step-up on the asset for which a basis adjustment is needed, (b) not limited by valuation discounts, (c) basis has effectively been moved from one high basis asset to another low basis asset, (d) this was accomplished without anyone dying, and (e) without gain recognition.

Achieving this result in a real world situation beyond the oversimplified facts described above requires complex partnership tax structuring. The complex structuring includes using partnership divisions (to separate a particular high basis and low basis asset into a separate partnership, and to make the §754 election just for that separate partnership; if the partners keep the same percentages in the separated partnerships, both of them are considered continuation partnerships without any change in §704(c) responsibility.)

An alternative approach, if the partnership does not have a high basis asset to distribute to the older partner, is for the partnership to borrow funds and purchase an asset. The partnership's basis in the purchased asset will be its cost basis. If the purchased high-basis asset is distributed to the older partner, the basis will be stripped from the older partner (who will have a basis in the asset equal to the partner's basis in his or her partnership interest), and the high basis in that asset will be shifted to other assets remaining in the partnership.

29. Simulate Section 754 Election on Death of S Corporation Shareholder

a. **Section 754 Election for Partnerships**. If a §754 election is in effect for the year in which a sale or exchange of a partnership interest occurs (including a liquidating distribution) or a partner dies, a basis adjustment is made under §734 to increase or decrease the transferee's share of the partnership's basis for its assets (the "inside basis") to match the transferee's basis for his partnership interest (the "outside basis"). Reg. §§1.743-1(b) and (d).

b. **Simulation for S Corporation; Sell Assets and Liquidate in the Same Year Following a Shareholder's Death.** Assume for simplicity that an S corporation owns a single asset worth $1.0 million and a zero basis.

- At the shareholder's death, his stock receives a basis adjustment to fair market value under §1014; assume that no discounts apply and the stock basis is $1.0 million. (Also assume the asset is not income in respect of a decedent because the stock basis adjustment at death must be reduced by the value attributable to items constituting IRD to the decedent. §1367(b)(4)(B).)
- If the S corporation sells the asset for $1 million, the gain flows through to the shareholder, resulting in a flow-through $1.0 million capital gain to the shareholder. §1366(a)(1)(A). (The character of the gain could be partly ordinary income to the extent that the sold assets are inventory, accounts receivable, or recapture income assets.)
- The shareholder's basis in his stock is increased by the amount of the flow-through income allocation (§1367(a)(1)(A)), so the stock basis becomes $1 million + $1 million, or $2.0 million.
- If the S corporation is liquidated, the shareholder will have a capital loss of $1 million ($1 million of liquidation proceeds - $2 million stock basis).
- If the sale of the asset and the liquidation of the corporation occur in the same year, the capital gain and capital loss will offset. (If the gain is partly ordinary income, only $3,000 of ordinary income could be offset by the capital loss.) The sale and liquidation do not have to occur in the year of death; they just need to occur in the same year for the capital gain to be offset by the capital loss.
- The result is that the shareholder ends up owning assets with a high basis, rather than owning an S corporation that holds low basis assets, and did not recognize net gain in achieving that result.
- If the decedent is a majority shareholder rather than the sole shareholder, the executor will have to consider the tax consequences of the liquidation on minority shareholders (who would not have received a stock basis adjustment under §1014 assuming they had not died).

c. **Trap Regarding Liquidation of S Corporation Following a Shareholder's Death**. If the liquidation does not occur until the year after the sale, the shareholder may have a big gain in the year of the sale and a big capital loss in the subsequent year, and the shareholder may not have other gains to be offset by the loss in the subsequent year. The capital loss may not be usable for years into the future.

30. Simulating Nonqualified Stock Option, But Taxing Spread as Capital Gain Rather Than Ordinary Income

a. **Basic Tax Effects of Nonqualified Stock Options**. An employee may be granted an option to acquire stock at a certain price; typically the right to acquire the share does not vest until some later time. Basic tax effects are as follows.

(1) Grant date – no taxable event (assuming the option has no "readily ascertainable fair market value" (§83(e)(3)).

(2) Vesting date – no taxable event (still assuming no "readily ascertainable fair market value").

(3) Exercise date – spread between fair market value of stock and exercise price is compensation income (§83(a)) (taxed at ordinary income rates and subject to FICA).

(4) Sale date – When the stock is sold, the sale generates capital gain, either short- or long-term based on how long the stock was held after the option was exercised. The basis in the stock for determining gain is the fair market value of the stock at the exercise of the stock option.

b. **Simulated Non-Qualified Stock Option**. The employee borrows from an outside lender money to purchase a convertible bond from the employer. The bond can be converted at any time into a number of shares equal to the face amount of the bond on the date the bond is purchased. (Assume that is 1,000 shares). The bond will have a designated maturity date, say 10 years. At some point before the maturity date, the employee may make the decision to exercise the conversion right and convert the bond into 1,000 shares of the employer's stock. If the stock has appreciated in the meantime, the appreciation of the 1,000 shares from the time the convertible bond was acquired will be capital gain to the employee (rather than ordinary income). The employee might sell some of the stock at that point, at least enough to pay off the loan to the outside lender.

The key to this tax treatment is the treatment of the convertible bond as a pure debt instrument, rather than as a combined debt and right to acquire stock. Convertible bonds have been treated by the courts and IRS as debt rather than a combined debt and right to acquire stock, even in the compensation context. *Hunt Foods and Industries, Inc. v. Commissioner*, (9th Cir. 1974); *Chock Full O' Nuts v. U.S.* (2nd Cir. 1971); Rev. Rul. 71-420; PLRs 8243235 & 8151040.. The only time the IRS has held otherwise is when the employee borrows funds from the company to acquire the convertible debt on almost the same exact terms as the underlying bond (almost the same interest, same term, etc.) PLR 199931044.

An example of this favorable treatment is PLR 8243235. No income was triggered on the purchase of a convertible debenture because no spread existed between the debenture's purchase price and the stock value at that time. Upon conversion, the employee's basis in the stock was the employee's original basis in the debenture (i.e., the purchase price of the bond). The holding period of the stock after conversion

included the holding period of the debenture. Therefore, as long as the bond had been held for the required long-term holding period, the employee could immediately sell the stock and get long-term capital gain treatment.

31. Structuring Trust to Be Grantor Trust as to Beneficiary; Beneficiary Deemed Owner Trust (BDOT)

a. **Distinction from "BDIT."** If a trust is not a grantor trust as to the trust's settlor and if a beneficiary has a Crummey power to withdraw **all of the contributions** to a trust, the beneficiary would be the deemed owner of the trust under §678(a)(1) during the period of time while the withdrawal power exists and arguably under §678(a)(2) after the withdrawal power has lapsed. This has been termed a "beneficiary defective inheritor's trust" (BDIT) by Richard and Steve Oshins. In contrast, the beneficiary deemed owner trust (BDOT) gives the beneficiary the right to withdraw **all taxable income** during the year, and the beneficiary is the deemed owner under §678(a)(1).

b. **Why the BDOT Works under §678(a)(1)**. Observe the highlighted words below in §678(a)(1):

> "A person other than the grantor shall be treated as the owner of **any portion** of a trust with respect to which: (1) such person has a power exercisable solely by himself to vest the corpus **OR the income** therefrom in himself…"

For this purpose, "the income" means taxable income. Therefore, the beneficiary should have the right to withdraw all of the income, including capital gain.

Support for recognizing the beneficiary as the deemed owner of the trust, including capital gains, comes from *Campbell v. Commissioner*, T.C. Memo 1979-495, and PLR 201633021.

In PLR 201633021, trust #1 had the power to withdraw from trust #2 "any dividends, interest, fees and other amounts characterized as income under §643(b) of the Code" and the net short term capital gains and the net long term capital gains. Trust #1 did **not** have the power to withdraw principal of trust #2 beyond the taxable income. The ruling concluded that all of the taxable income of trust #2, including the net capital gains, were taxed to trust #1 under §678(a)(1). *See* Reg. §1.671-2(a)(6).

c. **Concerns**.

Newness. A body of case law or common usage does not yet exist for this planning alternative.

How Long Must Withdrawal Right Exist? Planners diverge greatly as to when grantor trust status commences and how long the withdrawal period must exist before grantor trust treatment applies. Some planners say mere seconds will suffice, but the conservative approach is for the withdrawal power over income to exist for the entire year.

Impact of Lapse of Withdrawal Power in Excess of "5 or 5" Power. The planner must deal with the implications of a lapse of the right to withdraw all income during the year if the beneficiary chooses not to withdraw the income. *Fish v. U.S.*, 432 F.2d 1278 (9th Cir. 1970), held that the 5% amount, when applied to a power to withdraw "all or part of the net income of the trust for that year" was only 5% of the income, not 5% of all of the trust assets. *See also* Rev. Rul. 85-88. One possible approach to

bolster being able to apply the 5% test amount against the entire trust corpus is to provide that the withdrawal power is the greater of the net taxable income or 5% of the trust corpus and clarify that the withdrawal power can be satisfied out of the entire corpus of the trust.

Applicability of Rev. Rul. 85-13. Even if the beneficiary is treated as the deemed owner of the corpus, whether the Rev. Rul. 85-13 analysis would be applied to a beneficiary treated as the deemed owner under §678(a)(1) by reason of the power to withdraw income, rather than having the power to withdraw the entire contribution to the trust, **is not certain.** Stacy Eastland points out that the regulations addressing single member LLCs as disregarded entities clearly say that **all activities** between the single owner and the LLC are disregarded, and he suggests, in order to bolster the position that a beneficiary's sale of assets to a BDOT is disregarded for income tax purposes, having the BDOT create an LLC in which the BDOT is the only member, and the beneficiary should **sell to that LLC** rather than directly to the BDOT.

Spendthrift Protection Issues. The beneficiary's creditors ordinarily could not reach assets in a third-party spendthrift trust. Does that change because the beneficiary had the power to withdraw assets from the trust? Is the beneficiary treated as a transferor to the trust as to that portion of the trust? Most states treat the withdrawal powers that were within the "5 or 5" amount as not causing the beneficiary to be treated as having made a transfer to the trust for creditor access purposes. *E.g.,* Tex. Prop. Code §112.035(e) & §112.035 (f)(B)(3). *See* Ed Morrow, *IRC 678(a)(1) and the "Beneficiary Deemed Owner Trust" (BDOT)*, LEIMBERG ESTATE PLANNING NEWSLETTER #2516 n.64 (Sept. 5, 2017)(also references a 50-state survey chart prepared by Mr. Morrow regarding trust assets subject to withdrawal powers).

d. **Example Uses.**

- The surviving spouse could be the deemed owner of the testamentary credit shelter trust and marital trusts (allowing the credit shelter trust to grow faster if the spouse pays taxes and the marital trust could enter into freezing transactions with credit shelter trust).
- Following the surviving spouse's death, the primary beneficiary of any testamentary trust could be the deemed owner, allowing the beneficiary to transact with the trust, pay the trust's taxes, be a trustee, have a limited power of appointment, be a discretionary beneficiary, etc., all without estate inclusion.
- Beneficiaries of inter vivos trusts could be deemed owners, providing the advantages of BDITs but without the limitation that only limited amounts could be contributed to the trust.
- An administrative advantage is that having the beneficiary as the deemed owner eliminates the need to file fiduciary income tax returns for the trust.
- An independent trustee or trust protector could have the flexibility to eliminate the withdrawal power for a particular future year if the trust would be having a huge sale in that year and parties agree that the beneficiary should not be taxed as the deemed owner and that giving the beneficiary a withdrawal power over what could be a very large amount would not be desirable.

- Freezing transactions between trusts could occur if they had the same deemed owner or if one trust was the deemed owner of the other trust (as in PLR 201633021).

e. **Further Discussion**. For a more detailed discussion of BDOTs, see Item 16 of the Estate Planning Current Developments Summary (December 2018) found **here** and available at www.bessemer.com/advisor.

32. Another Trust with Beneficiary as Deemed Owner under Section 678: QSST

Another way of achieving the advantages discussed in Item 31.d above of having the beneficiary of a trust as the deemed owner for income tax purposes is to allow the flexibility for a trust that owns stock of an S corporation to make the QSST election, which causes the trust to be treated as a grantor trust as to the beneficiary with respect to the S corporation stock in the trust. §1361(d)(1)(B); Reg. §1.1361-1(j)(8). (After making the QSST election, all of the trust income would have to be distributed annually to the beneficiary—but the S Corporation does not have to distribute all of its income.) The beneficiary could sell much of his or her remaining non-voting stock in the S corporation to the trust (if it is sold for a note, the note should be secured by the S stock, not just the income from the stock). The trust is only treated as a grantor trust with respect to the S stock. However, if the trust later sells some or all of the S stock, the sale will be taxable to the trust and not to the beneficiary-deemed owner. Reg. §1.1361-1(j)(8). Therefore, the beneficiary's purchases of S stock from the QSST are not treated as disregarded sales.

In a post-mortem context, this approach could be used to cause the credit shelter trust and marital trust to be treated as having the surviving spouse as the deemed owner as to S stock in those trusts. This allows substantially more flexibility to structure freezing transactions between the marital trust and credit shelter trust.

An advantage of the QSST over a BDOT as a way of creating a trust with a beneficiary-deemed owner is the certainty of treatment under the QSST rules, but the deemed-owner treatment under the QSST approach is only available for S stock held by the trust.

33. Planning Opportunities with Disregarded Entities

a. **Disregarded as an Entity**. A partnership or LLC that has a single owner is disregarded as an entity separate from its owner for federal tax purposes. Reg. §§ 301.7701-1(a) & 301.7701-2(c)(2). For example, if the single owner-grantor (or a grantor trust) rents real estate from the LLC, the rent payments would be disregarded for income tax purposes and would not be taxable income to the disregarded entity. Similarly, sales between the disregarded entity and the deemed owner (including any grantor trusts having that owner as the deemed owner of the trusts for income tax purposes) would not result in taxable transactions.

b. **Valuation Discounts Still Apply**. Even though the entity is disregarded for all federal tax purposes, if separate legal entities exist (such as an LLC owned by the grantor that is the general partner of a partnership comprised of the grantor and grantor trusts as limited partners), case authority recognizes that valuation discounts for lack of marketability and control still apply when valuing the various interests for federal gift tax purposes. *E.g., Pierre v. Commissioner*, 133 T.C. No. 2 (2009); *Estate of Mirowski v. Commissioner*, 95 T.C. Memo 2008-74.

c. **Substantial Flexibility, Such as Grantor's Ability to Repurchase Assets from Disregarded Entity without Discount.** As an example, assume that a gift is made of an interest in an LLC that owns real estate. If the LLC is a disregarded entity, with the donor as the deemed owner, the donor could repurchase the real estate from the LLC at a later time (maybe even if it has a negative basis). When the real estate is purchased in its entirety, no discount would apply. In effect, the donor may have transferred a minority interest in the LLC at 70% (with a 30% discount), but later repurchase the underlying real estate at 100%, resulting in a valuation arbitrage as well as recovering the basis adjustment at death with respect to the gift.

Similarly, that approach could be used if interests in the LLC have been sold for a note or have been transferred to a GRAT and liquidity is needed for making note payments. The grantor could purchase assets from the LLC (without a discount) and the liquid proceeds could be distributed to be used for making note payments or annuity payments.

This is one reason that implementing transfer planning with disregarded entities, owned by the donor and various grantor trusts or other disregarded entities that are deemed owned by the donor, can be very advantageous.

d. **Leveraged Disregarded Entities**. Making transfers of interests in leveraged disregarded entities reduces the economic risk of the transfer. For example, if a grantor trust directly uses leverage to purchase assets, any decline in the asset value reduces the net value of the trust by that same amount, and a relatively small amount of depreciation of the combined assets could wipe out the trust. For example, assume that a trust with $10 million purchases $20 million of assets for a $20 million note. The trust has a net value of $10 million, and a 33% depreciation of the total assets would eliminate all of the trust's net value. On the other hand, the trust could contribute $2.22 million to a disregarded entity (LLC), which in turn could purchase $20 million of assets for a note (9:1 ratio). The trust benefits from all of the future growth of the combined $30 million of assets, but if the LLC's assets decline in value, only the trust's $2.22 million contribution to the LLC is at risk.

Alternatively, a grantor might create a leveraged disregarded entity (contribution of $1 million to an LLC that buys $9 million of assets from the grantor for a note) and sell or give the interest in the LLC with a net value of $1 million less appropriate discounts to a grantor trust or GRAT. The trust's only risk is the loss of its $1 million of net value even though it benefits from all of the growth of the $10 million of assets.

e. **S Corp Owned by Disregarded Entities**. A partnership or LLC typically cannot be a qualified shareholder of an S corporation. But if it is a disregarded entity treated as owned by an individual (or other permissible shareholder), the disregarded entity is a permissible S shareholder. *E.g*. PLRs 200439027-028. For example, an LLC owned by various grantor trusts could be the shareholder of an S corporation.

34. SECURE Act Would Increase Age for Required Distributions and Curtail "Stretch-Out" Planning for Retirement Accounts

The **SECURE Act** proposal (H.R. 1994, Setting Every Community Up for Retirement Enhancement Act of 2019) would make various changes regarding retirement benefits. The bipartisan proposal was unanimously approved by the House Ways and Means Committee and approved by the House on May 23, 2019 by a vote of 417-3 (with 12 non-votes). Similar proposals have been introduced in the Senate (S. 972, introduced by

Senators Grassley (R-Iowa) and Wyden (D-Oregon) and S. 1431, introduced by Senators Portman (R-Ohio) and Cardin (D-Md)). The primary Senate measure, S. 972, is known as the Retirement Enhancement and Savings Act. Among the proposed changes in the SECURE Act are the following:

- Changing the age that determines the beginning date for required minimum distributions (April 1 of the following year) from 70 ½ to 72 (effective for individuals who reach age 70½ after December 31, 2019) (costing $8.86 billion over 10 years) (A similar Senate proposal would extend the required beginning date age to 75 and remove it entirely for pensions worth up to $100,000);
- Eliminating the prohibition on contributions to an IRA after age 70½;
- Allowing pooled plan providers;
- Requiring that long-time part-time workers be included in 401k plans;
- Allowing a participant to withdraw $5,000 in the year after a child is born to or adopted by the participant;
- Permitting expanded uses of Section 529 plans, including for certain apprenticeship programs and payments on certain qualified education loans, (but provisions in the initial program expanding §529 plan benefits to homeschooling expenses were deleted in the provision passed by the House);
- Requiring annual disclosures of estimated projected lifetime income under annuity elections; and
- Mandating that distributions from defined contribution plans (and IRAs) be made within 10 years following the death of the participant, with exceptions for a beneficiary that is a spouse, a minor child (distributions would have to be made within 10 years after the child reached majority), a disabled or chronically ill person, or a person not more than 10 years younger than the participant (saving $15.7 billion over 10 years); the 10-year distribution rule would apply whether or not distributions to the participant had begun before the participant's death, and would apply to participants who die after December 31, 2019.

The 10-year mandatory payout provision after death is more generous than a 5-year limit that was proposed in prior similar proposals. The mandatory payout provision following death generally pays for the remaining provisions in the proposal. The Joint Committee on Taxation on May 22, 2019 released estimates that the Act would have a net revenue impact over 10 years of a negative $389 million, which is relatively revenue neutral.

A small handful of Republican Senators have expressed concern over various provisions (or omissions) from the proposal (in particular, Senator Ted Cruz wants a provision allowing people to use 529 accounts to pay for home school expenses). Until those conflicts are resolved, Majority Leader McConnell has indicated he is unlikely to schedule the bill for floor debate in the Senate. *See* Warren Rojas, *Disgruntled GOP Senators Block Bipartisan Retirement Bill*, BNA BLOOMBERG DAILY TAX REPORT (June 4, 2019).

For individuals still wanting a stretch IRA, a possible planning alternative is to have the IRA payable to a charitable remainder trust that would last for the lives of one or more beneficiaries, with remainder to charity (and the remainder must be at least 10% of the value contributed to the trust). Because the CRT is tax exempt, no income tax would be due upon the payment of the IRA to the CRT.

Items 35-38 are observations from a seminar at the Summer Meeting: The Role of the Lawyer in the Global Fight Against Money Laundering and Terrorist Financing by Carolyn Ann Reers and Martin J. Rochwerg

35. Reporting Requirements under Various Regimes for Financial Institutions

a. **Early Steps – U.S. Legislation Including Bank Secrecy Act (1970) and Patriot Act (2001).** U.S. laws addressing money laundering include the Money Laundering Control Act of 1986 (18 U.S.C. §§1956 & 1957 (2009)) (criminalizing money laundering), and the U.S. Patriot Act (31 U.S.C. §§5311-5332 (2001)), modifying the Bank Secrecy Act of 1970 (also known as the Currency and Foreign Transactions Reporting Act), which requires financial institutions in the U.S. to keep certain records and report suspicious activity that might signify money laundering or other criminal activities.

Various laws in the United States address terrorism, including the Antiterrorism and Effective Death Penalty Act passed in 1996 and amended in 2001, and the Intelligence Reform and Terrorism Prevention Act passed in 2004.

b. **Foreign Account Tax Compliance Act (FATCA) (2010)**. Tax evasion became a focal point in 2008 and 2009 with the exposure of the UBS tax evasion scandal and the existence of billions of dollars in Swiss bank accounts, much of it from U.S. account holders who were not reporting income from the funds to the U.S.

The Foreign Account Tax Compliance Act (FATCA) was enacted by Congress in 2010 to target tax evasion by U.S. taxpayers using foreign accounts. FATCA requires foreign financial institutions to report to the IRS information about financial accounts held by U.S. taxpayers, or by foreign entities in which US taxpayers hold a substantial ownership interest. FATCA generally requires the foreign financial institution to conduct due diligence, to determine if the account owners are U.S. citizens, and to report information about accounts owned by U.S. citizens to the United States. Any institution that did not comply had a 30% withholding tax on source income coming out of the U.S. The exchange of information was not reciprocal; the U.S. did not send similar information to foreign countries.

The FATCA requirements were difficult to implement, so the IRS negotiated multiple intergovernmental agreements with foreign governments to implement FATCA in a way that complied with the foreign local laws. The transmission of information under these agreements was to be reciprocal, but the reciprocal flow of information to foreign governments has been limited and not automatic.

c. **Common Reporting Standard (CRS) (2012)**. When FATCA was first enacted, other countries were outraged that the U.S. was unilaterally requiring banks in their country to divulge information about U.S. account holders. Eventually, the other countries decided that was a good idea and ultimately developed the Common Reporting Standard (CRS) system as a way of exchanging information with other countries about financial information of owners connected with those other countries.

CRS began in 2012 as a pilot initiative of five European countries to follow the FATCA model as a multilateral reporting tool on beneficial ownership. In 2014, the system was adopted by the Organisation for Economic Cooperation and Development (OECD) with a model treaty and Multilateral Competent Authority Agreement. CRS has now been adopted by over 100 jurisdictions.

The participating countries agree under a "common reporting standard" to share information automatically about assets and income in one country of persons having connection with another participating jurisdiction. Each jurisdiction can adopt rules about what accounts are reportable to that jurisdiction. (While the U.S. has a taxation system based on U.S. citizenship or residence, most countries use a variety of other standards (such as nationality) to determine the basis for taxing persons or entities.) For "reportable accounts" the information required to be shared includes 1) the name, address, tax identification number and date and place of birth of each reportable person, 2) the account number, 3) the name and identifying number of the Reporting Financial Institution, 4) all types of investment income, and 5) the account balance or value and sales proceeds as of the end of the relevant period.

Financial institutions required to report under CRS include not only banks but also other financial institutions such as brokers and certain investment vehicles.

Reportable accounts include accounts held by individuals and entities (**including trusts** and foundations) and the standard includes a requirement to look through passive entities to report on the individuals that ultimately control the entities.

The details about the common reporting standard are quite lengthy – hundreds of pages long. The information and reporting requirements under CRS are significantly broader than under the FATCA model.

The United States has not committed to the Multilateral Competent Authority Agreement. (Because of FATCA, the U.S. does not feel a need to be part of the information sharing system of CRS.) In light of the fact that the U.S. does not report under the CRS rules, some concern exists that "bad actors" may want to set up accounts in the U.S. in order to hide the account information from foreign governments. As a result, U.S. planners and financial institutions should confirm that legitimate reasons exist for setting up accounts in the U.S. other than avoiding CRS reporting.

d. **Detailed Customer Due Diligence Requirements Including Disclosure of Beneficial Ownership (FINCEN Requirements Adopted in 2016)**. FinCEN (the U.S. Department of the Treasury Financial Crimes and Enforcement Network) has adopted disclosure requirements for financial institutions including the beneficial ownership of assets. See Item 38.d below.

36. Financial Action Task Force (FATF) – Beyond Just Financial Institutions

a. **General Purposes**. The Financial Action Task Force ("FATF") was first formed in 1989 during the G7 Summit in Paris, France. It is an intergovernmental group of 37 member jurisdictions, two regional organizations, and other associate members. Its purpose is to counter money laundering and terrorist financing. The member countries are expected to adopt the recommendations of the Task Force.

Within a year after FATF was created in 1989 it adopted 40 Recommendations for financial institutions to combat money laundering.

In 2011, the scope of FATF was extended to cover terrorist financing.

Each country periodically evaluates whether it is implementing the recommendations, and there is a periodic mutual evaluation as well. The last mutual evaluation of the U.S. was in 2016.

b. **Extension Beyond Financial Institutions to Gatekeepers Including Lawyers**. In 1999, FATF sought to expand its rules beyond financial institutions to Designated Non-Financial Businesses and Professions (DNFBPs). These are persons deemed to be gatekeepers to domestic and international financial systems, and FATF believes they should comply with the 40 Recommendations.

   The DNFPB gatekeepers include lawyers, notaries, accountants, trust company service providers, real estate agents, casino operators, art dealers and dealers in precious metals and stones.

   The American Bar Association and ACTEC have been actively engaged with FATF regarding lawyers as gatekeepers since the DNFBP initiative began two decades ago.

c. **Risk Based Approach for Legal Professionals (2008)**. In an effort to limit applying the rules governing financial institutions to lawyers, notaries, and other designated legal professionals, a working group of U.S. lawyers engaged with lawyers from other countries to adopt a risk-based approach. In 2008, FATF adopted the Risk Based Approach Guidance for Legal Professionals. It is a broad template from which member companies can generate tailored guidance appropriate to their respective legal systems.

   A central focus of the Recommendations and the Risk Based Approach is FATF's position that member nations should adopt laws, rules, and regulations that impose (1) Customer Due Diligence, (2) Suspicious Transaction Reporting and (3) No Tipping Off obligations on lawyers and other DNFBPs. FATF and the OECD are hostile to the idea that attorney-client privilege or confidentiality outside the context of litigation should prevent lawyers from having to comply with those three obligations.

   That effort by FATF has met substantial resistance in the U.S. particularly, but in other countries as well, because those obligations are contrary to certain bedrock principles governing the attorney-client relationship. In an effort to recognize professional privilege and confidentiality standards that are hallmarks of the attorney-client relationship, the FATF Recommendations apply to legal professionals only when they undertake specified transaction activities (not including litigation) described in Recommendation 22. Those areas (in which FATF says the Customer Due Diligence, Suspicious Activity Reporting and No Tipping Off obligations would apply) include lawyers assisting in buying and selling real estate or business entities, organizing contributions for the creation, operation, or management of companies, or creating, operating, or managing legal persons or arrangements (which they mean to include trusts).

d. **U.S. Found Noncompliant as to Various Recommendations in 2016 Mutual Evaluation, Including as to Legal Professionals**. The last mutual evaluation of the U.S. was in 2016. It concluded that the U.S. was non-compliant with four of the 40 Recommendations, those being Recommendation 22 (customer due diligence), Recommendation 23 (other measures, including reporting of suspicious transactions and no tipping off), Recommendation 24 (transparency and beneficial ownership of legal persons, including access to beneficial ownership and control information by DNFBPs), and Recommendation 28 (regulation and supervision of DNFBPs, including establishing an effective system for monitoring DNFBPs).

e. **FATF International Expert Group Meeting on Legal Privilege (2018)**. FATF continues to press the issue with the U.S. In November 2018 FATF convened an International Expert Group Meeting on legal privilege, and a discussion paper circulated before the meeting addresses various headline stories that have involved lawyers and concludes that legal professional privilege can be used to conceal beneficial ownership and obstruct or delay investigations.

f. **U.K. Approach**. Beginning in 2002 the U.K. has implemented the customer due diligence, suspicious activity reporting, and no tipping off obligations for lawyers. Solicitors can go to jail for violating those requirements.

g. **Canadian Experience**. A Canada Supreme Court case in 2015 held the provisions of the Proceeds of Crime (Money Laundering) and Terrorist Financing Act of 2000 that forced lawyers to report certain transactions by their clients violated the Charter of Rights and Freedoms and would not be enforceable.

Various provinces have specific rules and know-your-client requirements for lawyers, but the information that lawyers are required to collect is not intrusive.

37. United States Approach to FATF's Positions Regarding Lawyers

a. **Resistance to FATF Position**. The U.S. has resisted making lawyers gatekeepers to the financial system, and no federal or state law requires lawyers to assume the obligations that FATF recommends and that most European nations have embraced. The ABA and ACTEC have been able to convince U.S. lawmakers and the U.S. Treasury that self-regulation of lawyers and a concerted effort at education of lawyers about money laundering and terrorist financing issues is sufficient.

b. **Voluntary Good Practices Guidance for Lawyers (2010)**. The "Voluntary Good Practices Guidance for Lawyers to Detect and Combat Money Laundering and Terrorist Financing" document resulted from the collaborative work of various sections of the ABA and of ACTEC.

c. **ABA Formal Ethics Opinion 463 (2013)**. ABA Ethics Opinion 463 makes clear that the Model Rules "neither require a lawyer to fulfill a gatekeeper role, nor do they permit a lawyer to engage in the reporting that such a role could entail," but that lawyers should undertake client due diligence as appropriate to avoid facilitating illegal or criminal activity.

d. **Lawyer's Guide to Detecting and Preventing Money Laundering (2014).** In 2014 the ABA in collaboration with the International Bar Association and the Council of Bars and Law Societies of Europe published "A Lawyer's Guide to Detecting and Preventing Money Laundering."

e. **Model Rules.** U.S. lawyers maintain that the Model Rules of Professional Responsibility include sufficient guidance regarding client due diligence, suspicious activity reporting, and no tipping off obligations.

(1) **Client Due Diligence/Know Your Client**. As to client due diligence, Model Rules 1.2(d), 1.16, 2.1, and 8.4 are relevant.

Model Rule 1.2(d). "A lawyer *shall not* counsel a client to engage, or assist a client, in conduct that the lawyer knows is criminal or fraudulent…" (All states except California and the District of Columbia have adopted this rule.) The comments make clear that this involves transactions for which the lawyer "knows or reasonably should have known" the conduct is criminal or fraudulent.

Model Rule 1.16. "Except as stated in paragraph (c), a lawyer *shall not* represent a client, or if representation has commenced shall withdraw, if the representation will result in a violation of the rules of professional conduct or other law…"

Observe that model rules 1.2 (d) and 1.16 are "shall not" rules, not "may decline to" rules.

Model Rule 2.1 addresses considerations a lawyer may consider in giving advice and *Model Rule 8.4* addresses misconduct for violating the Rules, committing a criminal act, or engaging in conduct involving dishonesty, fraud, deceit, or misrepresentation.

(2) **Suspicious Transaction Reporting.** *Model Rule 1.6.* "A lawyer may reveal information relating to the representation of a client to the extent the lawyer reasonably believes necessary:

(1) to prevent reasonably certain death or substantial bodily harm;

(2) to prevent the client from committing a crime or fraud that is reasonably certain to result in substantial injury to the financial interests or property of another and in furtherance of which the client has used or is using the lawyer's services;

(3) to prevent, mitigate or rectify substantial injury to the financial interests or property of another that is reasonably certain to result or has resulted from the client's commission of a crime or fraud in furtherance of which the client has used the lawyer's services;

(4) to secure legal advice about the lawyer's compliance with these Rules…"

(3) **No Tipping Off**. *Model Rule 1.4(a)* states that "A lawyer shall: … (5) consult with the client about any relevant limitation on the lawyer's conduct when the lawyer knows that the client expects assistance not permitted by the Rules of Professional Conduct or other law."

38. Beneficial Ownership Reporting

a. **FATF Position**. Recommendation 24 deals with transparency and beneficial ownership of legal persons, and states that "[c]ountries should consider measures to facilitate access to beneficial ownership and control information by financial institutions and DNFBPs …"

As late as April and May of 2019, several meetings of FATF representatives have emphasized the importance of transparency as to the beneficial owner of "legal persons and arrangements."

b. **Fourth and Fifth EU Anti Money Laundering Directives**. The Fourth Directive (adopted May 20, 2015) mandates that EU member states use a central register to hold information on beneficial ownership for corporate and other legal entities (including trusts) incorporated or based in their jurisdiction.

The Fifth Directive (adopted July 9, 2018) requires that the registers under the Fourth Directive be made available to the public, but registers for trusts are not yet required to be publicly accessible. (The U.K. has established a registry for trusts.)

c. **DAC6 EU Legislation on Reportable Cross Border Arrangements**. DAC6 will require entities to make disclosures on reportable cross border transactions, which could encompass massive amounts of transactions. Planners are very interested in seeing how Europe deals with the mandates of DAC6 with respect to trusts and whether countries will start establishing public registries for trusts.

d. **Beneficial Ownership Rules in United States**.

(1) **FinCEN Rulemaking**. The Financial Crimes Enforcement Network (FinCEN) published a final rule on September 29, 2017 requiring that financial institutions identify and verify the identity of beneficial owners of legal entity customers. A "beneficial owner" is defined as (i) each individual who, directly or indirectly, owns 25% or more of a legal entity customer, and (ii) an individual with significant responsibility to control, manage, or direct a legal entity customer. If a trust is a 25% or more owner, the beneficial owner is the trustee (and no further inquiry is made, for example regarding the settlor or beneficiaries of the trust). Other than reporting the trustee of a trust as the beneficial owner of 25% or more of an entity, the rule does not apply to trusts.

The financial institution is required to maintain the information, but (unlike in some countries), the regulations do not require the formation of a national registry of beneficial ownership information for entities. ACTEC commented on the proposed regulations and urged that disclosure of individual owners not be required for trusts. The result in the regulations not to include disclosing the beneficial owners of private trusts is a significant benefit to ACTEC Fellows and others involved with trusts.

(2) **Geographic Targeting Orders (GTOs)**. FinCEN issued its first geographic targeting orders (GTOs) in 2016, requiring U.S. title insurance companies to identify the natural persons behind shell companies used in all-cash purchases of residential real estate in certain cities deemed at high risk for money-laundering. The orders were expanded in 2018 to cover more cities and provide a uniform $300,000 threshold for reporting. The most recent GTOs, issued May 15, 2019, cover Boston, Chicago, Dallas-Fort Worth, Honolulu, Las Vegas, Los Angeles, Miami, New York City, San Antonio, San Diego, San Francisco, and Seattle.

(3) **Congressional Efforts**. In 2007, the "Stop Tax Haven Abuse Act" (S.681) was introduced by Senators Levin, Coleman and Obama. It was reintroduced in early March, 2009. Among other things, it would have required some disclosure of beneficial owners of companies. Another bill from that same time period, "The Incorporation Transparency and Law Enforcement Assistance Act," (S.2956) introduced in May 2008 would have required secretaries of state to keep lists of who are the actual beneficial owners of entities.

Legislative activity has emerged again in the current Congress about the disclosure of beneficial ownership of entities. The Corporate Transparency Act of 2019 (H.R. 2513) would require reporting of anyone who directly or indirectly exercises substantial control over a company or receives substantial economic benefits from the assets of a company (the meaning of which would be left to future rulemaking). The proposal is much broader than the requirements that FinCEN adopted for reporting by financial institutions. It would appear to apply to anyone who creates a company. The information would have to be filed with FinCEN and would be available to law enforcement without a subpoena or warrant. Two other similar bipartisan bills were filed in the Senate in June, 2019.

The ABA opposes that legislative approach and is working on a draft proposal about beneficial ownership that would require a responsible party for an entity to collect the beneficial ownership information about the entity and make it available for a person having a lawful subpoena or warrant.

e. **Beneficial Ownership Rules in Canada**. The Financial Transactions and Report Analysis Centre (FINTRAC) is collecting beneficial ownership information from financial institutions and allied sources to find out who owns and controls entities and trusts – information such as the directors and owners of entities, and known beneficiaries of trusts.

British Columbia is taking steps to reduce the incredibly expensive housing prices there. The Land Owner Transparency Act passed May 16, 2019. It establishes a public registry of who owns and controls every piece of land in British Columbia (using a 10% rather than a 25% owner level as being indicative of control). Another initiative is having a condominium pre-sale registry with pre-sale details of beneficial owners that will be publicly available.

Items 39-49 are observations from the Seminar at the Summer Meeting: Going the Distance—Examination of Estate Planning Across the World's Longest International Border by Leigh-Alexandra Basha, Cheyenne J.H. Reese, Raj A. Malviya, and Carmen S. Theriault

39. Canadian Legal Systems and Succession Law

Canada is a constitutional monarchy and a Federation with 10 provinces and three northern territories. The provinces and territories have a common law system, except for Québec which has a civil law system. Both federal and provincial law impacts estate planning and succession planning.

40. Choice of Law

a. **General Rule**. For immovable property (real property), the law of the real property situs generally governs. Restatement (Second) of Conflicts of Law §§239 (will validity and effect), 279 (disposition under trusts). For movable property (everything else) the law of the decedent's domicile generally governs. Restatement (Second) of Conflicts of Law §§263 (will validity and effect). For trusts that own personal property, the choice of law in the trust will govern disposition as long as a substantial relationship to the jurisdiction selected exists and the application of the law does not violate a strong public policy of the state with the most significant relationship to the trust.

b. **Specialized Rules**. The Washington Convention on Wills in 1973 addressed what has become known as the Uniform International Wills Act. A handful of countries have adopted the act. Various other countries (including the U.S.) are signatories of the Convention, but in the U S. the Convention must be adopted by each state under the Uniform International Wills Act.

A European Union regulation, known as Brussels IV, has been adopted in the EU countries other than the U. K., Ireland, and Denmark. The general rule is that the governing law in which the deceased was "habitually resident" controls with respect to the succession of property. However, persons having a nationality (i.e., citizenship) different from the place of their last habitual residence have the option to choose the law of their nationality to apply to their succession. For example, a U.S. citizen could provide in the will that the law of their nationality (i.e., the U.S.) will apply for succession issues rather than the law of the last habitual residence. **In this manner, the forced heirship provisions generally applicable in the E.U. could be avoided by U.S. citizens with ties to or who have property in the E.U**. For a more detailed discussion of Brussels IV, see Item 36 of the ACTEC 2015 Summer Meeting Musings found here and available at **www.bessemertrust.com/for-professional-partners/advisor-insights**.

41. U.S. Resident for Income Tax Purposes

U.S. Citizens and residents are subject to US income tax on their worldwide income. A U.S. income tax resident, in general, is someone who (1) is a lawful permanent resident or (2) satisfies "the substantial presence test."

The substantial presence test is satisfied if (1) the individual is present in the U.S. for at least 31 days during the calendar year at issue, **and** (2) the individual is present in the U.S. for a total of 183 days during a three-year look back period (counting each day in the current year, one-third for each day in the first preceding year, and one-sixth for each day in the second preceding year). Some foreign individuals are excepted from satisfying the substantial presence test, such as government officials, and some persons will fall under treaty relief provisions for dual residence.

42. U.S. Income Tax of Non Resident Aliens (NRAs)

For this purpose, an "alien" means someone who is not a U.S. Citizen. (A Canadian panelist pointed out that Canada does not call noncitizens aliens – "We don't call them aliens. That's rude.")

a. **General Rule**. The general rule is that NRA's are taxed on (1) income effectively connected with the conduct of the U.S. trade or business, and (2) income not effectively connected but from a U.S. source that is fixed or determinable, annual or periodical, such as U.S. interest, dividends, rents, royalties, and salaries.

b. **Exceptions**. Various exceptions from the general rule apply, including (1) interest on bank deposits, (2) portfolio interest on debts of U.S. obligors issued on or before July 18, 1984, which is potentially subject to 30% withholding, (3) capital gains (with certain exceptions), (4) interest, dividends, royalties, which may be taxed at reduced rates under a treaty, and (5) the 3.8% tax on net investment income, which does not apply to NRAs.

c. **Rates**. Income tax rates for NRAs are generally as follows. US source income tax is subject to 30% withholding at the source (subject to lower treaty rates), and income effectively connected to a U.S. trade or business is taxed on a net basis at graduated rates up to 37% (generally no withholding). The taxpayer can elect to treat U.S. rents as effectively connected income.

43. U.S. Transfer Tax

a. **Residency; Application**. The U.S. transfer tax applies to the worldwide assets of transferors who are U.S. citizens or who are domiciled in the U.S. The transfer tax also applies to U.S. situs assets (described below).

   The same rates and exclusion amounts apply for the worldwide assets of U.S. citizens or domiciliaries. (The estate tax marital deduction is available for assets passing for a non-citizen spouse only if the assets pass to a qualified domestic trust.)

b. **Domicile**. "A person acquires a domicile in a place by living there, for even a brief period of time, with no definite present intention of later removing therefrom. Residence without the requisite intention to remain indefinitely will not suffice to constitute domicile, nor will intention to change domicile effect such a change unless accompanied by actual removal." Reg. §20.0-1(b)(1). The test is subjective, based on a variety of factors.

Income tax residence does not necessarily result in an estate tax domicile, and being a green card holder does not necessarily mean that the person has a U.S. domicile for federal transfer tax purposes. However, having a green card reflects an intent to remain in the U.S. indefinitely and supports subjective aspects of the domicile test.

Practice Tip: "When many factors help support a determination of a U.S. domicile but other factors support a non-U.S. domicile, it may be helpful for the U.S. practitioner to prepare an affidavit for the client to sign, evidencing the factors supporting domicile (or non-U.S. domicile) and the client's present intention at the time the U.S. estate plan is created. While self-serving, the affidavit may be helpful to support a certain position taken on the domicile rules in an audit and, importantly, support the practitioner's basis for preparing the estate plan the way he or she did." Some planners do this for clients on an annual basis.

c. **Non-Resident Non-Citizens Subject to Estate Tax on U.S. Situs Assets**. Persons who are not U.S. citizens or domiciliaries are nevertheless subject to U.S. estate taxation on U.S. situs assets. The tax is assessed at the same rates as for citizens and residents, but with only a $60,000 exemption, which is not adjusted for inflation (but the exemption may be increased by treaty, and indeed the exemption is increased under the U.S./Canada treaty based on the portion of worldwide assets that are U.S. assets, as discussed in Item 45.b below). §§2101(a)-(b), 2102(b). Worldwide debts and expenses of administration can be deducted, but prorated based on the ratio of the value of taxable U.S. assets to the value of worldwide assets owned by the decedent. §2106 (b). The proportional limit does not apply, however, to a qualified charitable deduction for bequests to U.S.-based charities or if the property is to be used only within the United States.

Practice tip: A nonresident may want to forgo any deductions on the U.S. estate tax return to avoid disclosing the value of all worldwide assets.

U.S. Situs Assets. U.S. situs assets include the following.

- Real property located in the United States
- Tangible personal property such as antiques, jewelry, vehicles, and artwork (unless the art is in transit or on loan for an exhibition) located in the United States
- Currency located in the United States (cash located outside the United States is not U.S. property)
- Deposits held at banks located in the United States in a custodial capacity or deposits held at brokerage firms or other financial institutions that are not banks
- U.S. mutual funds (including money market funds) organized in corporate form
- Shares of stock issued by U.S. corporations
- Debt obligations of a U.S. person or US governmental entity
- Interests in a partnership or limited liability company that either does business in the United States or owns assets in the United States are probably U.S. property. Interests in trusts and estates are generally looked through to the situs of the underlying assets.

Various exceptions apply, and the following are non-U.S. situs assets.

- Deposits with corporations or other persons carrying on banking business, including deposits with a domestic branch of a foreign corporation
- Depository bank accounts maintained with U.S. savings institutions, including checking and savings accounts, time deposits, and certificates of deposit
- Qualified portfolio debt obligations, which include government and publicly traded bonds
- Life insurance proceeds (not the cash surrender value) paid by a U.S. insurer on a policy owned by a nonresident on the life of the nonresident
- Interests in a foreign partnership or LLC that does not do business in the United States or own assets in the United States are probably non-U.S. property
- U.S. real property encumbered with a nonrecourse mortgage, for the amount subject to the encumbrance.

d. **NRAs Subject to Gift Tax on U.S. Situs Assets**. A noncitizen nonresident is subject to U.S. gift tax only on transfers of real estate and tangible property located in the United States, but not on intangible property (such as stocks or interests in partnerships or LLCs) even if located in the United States. The same rates apply as for U.S. citizens or residents. Nonresidents qualify for the annual gift tax exclusion, regardless of who the donee is, but does not qualify for the $60,000 estate tax exemption. (The U.S./Canada treaty affords no relief with respect to being able to make use of any of the $11.4 million gift exclusion amount.)

Practice Tips:

- A nonresident may want to make gifts of U.S.-based intangible assets during lifetime in order to avoid their inclusion in the U.S. estate tax base at death.
- A gift of currency on deposit in bank accounts constitutes tangible property. Nonresidents making gifts through wire transfers or checks drawn on a U.S. bank account will probably be subject to U.S. gift tax.
- While a nonresident is not subject to the federal gift tax on the transfer of intangibles, foreign counsel should be consulted to determine whether any tax consequences in the home country will apply to the gift.

e. **Application of Generation-Skipping Transfer Tax for NRAs**. A transfer by a nonresident will be subject to the GST tax only if it is subject to federal estate or gift tax. Although subject to debate, a nonresident is likely allowed a GST exemption equal to that available for U.S. citizens and residents.

44. Canadian Income Tax

a. **Scope of Taxation**. Canadian residents (whether or not they are Canadian citizens) are taxable on their worldwide income. For example, if a Canadian resident sells or gives a capital asset, including U.S. real estate, the resident would generally be subject to Canadian income tax on that disposition.

Nonresidents of Canada are subject to Canadian income tax to the extent they carry on business in Canada, are employed in Canada, or dispose of taxable Canadian property. Nonresidents are also subject to Canadian withholding tax on certain forms of income derived from Canadian sources such as interest, royalties, management fees, rents, and dividends.

b. **Nonresidents Taxed on Dispositions of "Taxable Canadian Property**."
Nonresidents are taxed on the dispositions of "taxable Canadian property." The statute lists a number of assets treated as taxable Canadian property. Some of those assets include real property situated in Canada, property used in a business in Canada, stock in a corporation (other than a mutual fund), an interest in a partnership or trust (other than a unit of a mutual fund trust) if more than 50% of the fair market value of the share or interest is derived from certain property located in Canada, an income interest in a trust that is resident in Canada, and a life insurance policy in Canada.

c. **Residency**. Two alternative tests apply to determine who is a Canadian resident, and a person who is a Canadian resident is subject to Canadian tax on worldwide income for the entire taxation year. The first is a "Sojourner Test," applicable if a person is in Canada for at least 183 days during the taxable year even though the sojourning is transient in nature. The second test is referred to as the "Facts and Circumstances Test." It can apply even if the individual is physically present in Canada fewer than 183 days. The prevailing test is whether the person has settled in Canada and in the ordinary routine of his or her life, regularly, customarily and ordinarily lives in Canada.

d. **Deemed Disposition; Spousal Rollover**. As described above, the Canadian income tax applies to a disposition of capital assets by Canadian residents and to a disposition by nonresidents of taxable Canadian property. Special rules provide that a deemed disposition applies (resulting in a capital gains tax) if a capital asset (for a Canadian resident) or taxable Canadian property (for a nonresident) is sold, gifted (even to a family member), transferred to a U.S. resident trust (even a revocable living trust), transferred to a non-Canadian corporation or partnership (generally), or transferred on death (but special exceptions apply for transfers on death to a spouse, discussed below regarding the spousal rollover).

   Practice Tip: A transfer of Canadian real estate to a U.S. trust (even a revocable trust) will trigger the deemed disposition tax. **A common planning strategy in the U.S. is to transfer out-of-state real property to a revocable trust. Be very wary of doing that with Canadian real property.**

   Spousal Rollover. A special spousal rollover exception applies to transfers on death – if the property is transferred to a surviving spouse who is a Canadian resident or to a Canadian resident trust for the Canadian surviving spouse. A treaty provides relief for a transfer to a U.S. spouse. If the individual was a United States resident immediately before death, for purposes of the spousal rollover provision, both the individual and the individual's spouse will be deemed to have been a resident in Canada immediately before the individual's death. Also, a trust will be treated as resident in Canada if it would have been so treated had the trustees been Canadian residents, to the extent allowed by Canadian authorities.

e. **LLCs**. In the U.S. most owners elect to have LLCs taxed as a partnership, resulting in flow-through income tax treatment, with tax being paid at the indivdiaul level. Canada, however, taxes LLCs as corporations, with an effective tax rate exceeding 60% for income passing out to the owners. The United States–Canada Income Tax Treaty, discussed below, provides relief for U.S. residents who have Canadian assets in LLCs, but provides no relief for Canadian residents with interests in LLCs. This is a common problem for persons who move to Canada with family assets in LLCs, and also for Canadian who buy U.S. real estate (because the local advisors typically advise that the real estate be acquired in an LLC, not knowing that it will be taxed as a corporations for Canadian purposes.

45. United States–Canada Income Tax Treaty

a. **Overview; Purpose is to Mitigate Double Taxation**. The United States–Canada Income Tax Convention (the "Treaty") arguably provides Canadians with the most favorable estate tax treatment of any U.S. tax treaty. The Treaty mitigates double taxation by providing for a deduction of Canada's equivalent of an estate tax (the deemed disposition tax). The Treaty has been amended five times, so be sure to look at all of the amendments in determining how the Treaty applies to a particular situation.

b. **U.S. Estate Tax Exemption Available**. Canadians can make use of the U.S. estate tax exemption, prorated based on the ratio of the value of taxable U.S. assets to the value of worldwide assets owned by the decedent. The executor must file a Form 706 or 706NA to claim the credit, even if no tax is due.

c. **Marital Transfers**. An additional credit is allowed for certain marital transfers, similar to the unlimited marital deduction available for transfers to U.S. citizen spouses or to qualifying trusts for spouses. Canadians do not get a marital deduction, but get a "marital credit" that essentially doubles the exemption for Canadians if the estate passes to a surviving spouse. If the decedent is a U.S. citizen, the marital credit is equal to the U.S. estate tax credit amount. If the decedent is not a U.S. citizen, the marital credit is equal to the prorated estate tax credit allowed to non-citizens (described in subparagraph b immediately above). As a result, qualified domestic trusts (QDOTs) are typically not used for Canadian residents if the exemption and marital credit would result in the estate paying no estate tax. (If the estate is large enough that an estate tax would, or may, still be due at the first spouse's death, an alternative to requiring that assets pass to a QDOT is to leave open the flexibility for the surviving spouse to create a QDOT and have the assets pass to the QDOT after the decedent's death. If the surviving spouse is an NRA the QDOT will be a foreign trust and will not be taxable in the U.S. if it has no U.S. source income. That is an advanced [and complex] planning alternative.)

d. **Canadian Residents Get Credit If U.S. Estate Tax Also Applied**. The estate of a Canadian resident decedent receives a credit on any deemed disposition tax due to Canada if the U.S. estate tax also applied on U.S. situs property. The Treaty relief does not apply, however, to the gain that is recognized on the deemed disposition at the death of the owner of an alter ego trust or at the death of the surviving partner of a joint partner trust (these trusts are discussed in Item 47.b below). If the trust owns U.S. real property, the **individual** decedent's estate would be subject to the U.S. estate tax as to the value of the U.S. property, and the **trust** would be subject to the deemed disposition tax on capital gains. They are not the same taxpayer, and the credit again the deemed disposition tax under the Treaty would not apply.

e. **U.S. Residents Get Credit for Deemed Disposition Tax Paid to Canada**. U.S. citizens or residents similarly receive a credit for the deemed disposition tax paid on taxable Canadian property, computed as if it were a credit for foreign death taxes (but the Canadian deemed disposition tax cannot otherwise be claimed as a debt deduction).

f. **Treatment of Gifts under Treaty**. The Treaty does not permit Canadian residents to make any use of the U.S. gift exemption amount.

Gifts may result in a mismatch of the recognition of capital gains, which could lead to double taxation. For example, if a U.S. resident makes a gift of Canadian real property, a deemed disposition (with resulting capital gain) results for Canadian purposes. For U.S. purposes, however, no gain is recognized and the donee simply takes the donor's basis (with an adjustment for loss purposes) and a gain would occur when the donee later sells the property, thus resulting in a timing mismatch and the possibility of double tax. The same thing could happen if a Canadian resident makes a gift of U.S. situs property, which would result in a Canadian tax at the time of the gift, with low basis in the donee for U.S. income tax purposes and with gain being recognized when the donee later sells the asset, resulting in double tax. The Treaty permits the donor to elect to accelerate U.S. tax on the amount of the Canadian capital gain, and the taxpayer could use foreign tax credits to eliminate double taxation.

If a gift results in the payment of U.S. gift tax, the Treaty does not provide a credit in the amount of the U.S. gift tax against the Canadian capital gains tax arising from the gift.

g. **No Treaty Relief for Trusts**. The Treaty provides tie-breaker rules for individuals to avoid double tax, but no tie-breaker rules apply for trusts, and double tax in both countries is a possibility for a trust.

46. General Canadian Estate Planning Issues

a. **Forms of Ownership**. Common forms of ownership in Canada include tenancy in common and joint tenancy (with right of survivorship). In addition, the Supreme Court of Canada recognized a new form of ownership in *Pecore v. Pecore*, 2007 SCC 17. Under this decision, an individual can transfer property to the joint names of the individual and others but still retain the whole of the beneficial interest in that property during his or her lifetime, while giving the right of survivorship to the other joint owner. A subsequent case recognized that the survivorship interest may be in trust for one or more beneficiaries.

b. **Canadian Entities**. Commonly used Canadian entities include companies, partnerships, and not-for-profit societies.

c. **Multiple Wills**. Multiple wills are often used in Canada to avoid probate tax in high tax jurisdictions (in Ontario it is about 1.5% and in B.C. it is about 1.4%), to facilitate the administration of assets in a different province or other jurisdiction, to appoint an executor with special skills or experience to deal with a certain asset, and to afford greater privacy with respect to worldwide assets. Each of the multiple wills applies only as to certain assets, and the relevant court is asked to probate only the one will that is relevant for assets requiring probate for title passage of property in that jurisdiction. The probate tax for that jurisdiction would not be imposed on assets passing under a second will that is not being probated in that jurisdiction.

d. **Pourover Clauses**. Pourover clauses (pouring over assets to a revocable trust) have been invalidated by a case in B.C. Be wary of using them in other provinces as well.

e. **Variation Legislation in British Columbia**. Statutory provisions in British Columbia allow any surviving of a decedent to allege that the decedent's will does not make adequate provision for them and apply to the court to vary the terms of the will. This is a facts and circumstances issue, and the results in any particular court proceedings are very difficult to predict. British Columbia has more estate litigation than any of the other provinces in Canada. The variation claim by children can be avoided with respect to assets that have been transferred to a trust and do not pass under the decedent's will.

47. Trust Planning and Trust Taxation in Canada

a. **Trust Planning in Canada**. Trusts are recognized in Canada. Commonly used trusts include inter vivos trusts, discretionary trusts, and spousal trusts (qualifying for the spousal rollover for a deemed disposition and not subject to the 21-year deemed disposition that general applies to trusts (discussed below)).

b. **Alter Ego Trusts and Joint Partner Trusts**. Alter ego trusts and joint partner trusts qualify for special tax breaks.

   Alter ego trusts can be created by a 65 year or older Canadian resident in which the grantor is the only beneficiary for his or her life and must receive all of the trust income.

   Joint partner trusts can be created by a 65 year or older Canadian resident if the spouse or common law partner is also a Canadian and the income must pass to the contributor and the spouse/common law partner and they are the only permissible beneficiaries during the contributor's life.

   Tax breaks for these trusts include: (1) tax deferred transfer of capital assets to the trust (the deemed disposition tax is deferred until the death of the owner of the alter ego trust or the death of the surviving partner of the joint partner trust), (2) the 21-year deemed disposition rule for trusts will not apply during the life of the contributor for an alter ego trust or the joint lives of the contributor and spouse/common law partner for a joint partner trust, (3) the probate tax does not apply to the value of assets contributed to the trust, and (4) qualification for a significant exception that can eliminate or significantly reduce the capital gains tax on the disposition of a principal residence (most other trusts would not qualify for the primary residence exception).

c. **Trust Residency in Canada**. Trust residency depends on the facts and circumstances of each case, and is located where the "mind and management" of the trust is located, but that is generally based on the residence of the trustees. U.S. persons are strongly warned not to name a Canadian resident as sole trustee of the U.S. person's trust (and especially of revocable trusts).

   In addition, deemed residency rules apply if (1) a Canadian resident has made a contribution to the trust, or (2) a Canadian resident is a beneficiary of the trust and someone related to the Canadian beneficiary was a resident of Canada within 60 months before or after making any contribution to the trust.

d. **Canadian Taxation of Non-Resident Trusts**. Non-resident trusts are not subject to Canadian tax other than on Canadian source income (on a gross-based withholding basis) or on the disposition of taxable Canadian property (described below). Distributions of income (but not corpus) from a non-resident trust to a Canadian resident will be subject to Canadian tax by the recipient.

   If a non-resident trust disposes of taxable Canadian property or is deemed to do so, 25% of the gross sale proceeds will be withheld (unless the trust is Treaty-protected) and the trust must file a tax return to have a portion of the withheld proceeds returned to the trust.

e. **Taxation on Settling a Canadian Trust**. Transfers to a trust, other than transfers by a Canadian resident to joint spousal trusts, alter ego trusts, and other self-benefit rusts, are taxable events. The transfer is likely also subject to a local property transfer tax or land transfer tax, depending on the region.

A U.S. resident that is subject to such a Canadian tax on settling a trust under the Treaty may elect to recognize gain for U.S. purposes, and a foreign tax credit may be allowed against the U.S. tax. This would result in a matching Canadian and U.S. basis. For example, this could apply when a U.S. resident transfers U.S. real property to a revocable trust.

f. **21-Year Deemed Disposition Rule for Trusts**. Canadian trusts are deemed to have disposed of capital assets for their fair market value every 21 years, and are therefore subject to capital gains tax. To avoid that tax, trust assets are typically distributed to beneficiaries before the end of the 21-year period, and a distribution to a Canadian resident-beneficiary of any trust can occur on a tax-deferred basis. Similarly, a distribution to a non-resident of Canada can be on a tax-deferred basis if the distribution is a share of the capital stock of a non-resident owned investment corporation or certain types of Canadian property.

Non-Canadian trusts with taxable Canadian property (as modified by the Treaty) are subject to this same deemed disposition rule.

g. **Traps and Tips for U.S. Trusts with Canadian Beneficiaries**. Revocable trusts will be grantor trusts for U.S. tax purposes, with taxes paid by the grantor, but a Canadian beneficiary will be taxed on a distribution of income from the U.S. trust, even if the grantor paid U.S. income tax on the trust income.

- A distribution of capital is not taxed to the beneficiary. If income is not distributed in the year of receipt, and is not distributed until a subsequent year after the trustee has accrued income to capital, the distribution will be treated as a capital distribution and not taxed to the beneficiary.
- If a U.S. non-grantor trust makes the distribution in the first 65 days of year 2, after the income has been accrued to principal, even if the trustee makes the 65-day rule election to treat the distribution as if had been made in year 1 for U.S. tax purposes, the Canadian authorities will still recognize the distribution as a distribution in year 2 of capital and therefore non-taxable to the Canadian recipient. Judicious use of the 65 day-rule election can be very useful.

48. U.S. Trust Becoming Foreign Trust, Subject to Complex Rules

a. **Complexities for Foreign Non-Grantor Trusts**. The Code has a clear bias in attempting to force foreign trusts created by U.S. persons to be treated as grantor trusts (during the life of the grantor). §679. Upon termination of grantor trust status, §684 imposes a tax on the unrealized appreciation.

A foreign trust created by a non-U.S. person is treated as a non-grantor trust unless it meets several exceptions described in §672(f). Various complexities apply, including a harsh throwback tax on accumulations distributions (increased by an interest charge) that applies when distributions are made to U.S. beneficiaries and including various reporting requirements.

As a result, U.S. persons creating trusts typically want to avoid having the trust treated as a foreign trust (and particularly as a foreign non-grantor trust).

b. **Determining Trust Residency for U.S. Tax Purposes**. A trust is a foreign trust unless both of the following tests are satisfied: (1) courts in the U.S. must be able to exercise primary supervision over the trust; and (2) one of more U.S. persons have the

authority to control all substantial decisions of the trust. §§ 7701(a)(30)(E) & (31)(B). A foreign person is someone who is not (among other things) a U.S. citizen or resident, or a U.S. domestic corporation. If a foreign person has control over only one "substantial decision," foreign trust status results. "Substantial decisions" are defined in the regulations to mean "all decisions other than ministerial decisions." Reg. § 301.7701-7(d)(1)(ii). Examples are included that are very expansive, including not only the power to determine the timing, amount and selection of beneficiaries, but other administrative actions such as making income/principal allocations, investment decisions, and compromising claims. The definition even includes the power to appoint a successor trustee (unless it is restricted so that it cannot change the trust's residency) and the power to remove, add, or replace a trustee. The control test considers powers held by the trustee as well as by other advisors or "trust protectors."

If a change in control causes a trust to become a foreign trust, regulations allow a twelve-month period to make changes so that the trust satisfies the control test, but no grace period exists for failing the court test.

49. Migrating Clients

a. **Inbound to Canada**.

(1) **Basis Bump When Move to Canada**. If a non-Canadian resident moves to Canada, all of the person's assets, other than taxable Canadian property, are deemed to have been sold immediately prior to the move, resulting in a basis bump to fair market value upon the move to Canada.

(2) **Canadian Documents**. The client should have a Canadian will dealing with Canadian assets, a power of attorney, and health care document satisfying the requirements in the relevant Canadian province. Draft them carefully not to revoke the U.S. documents unless they will be operative as well as to U.S. assets. Consider not using a revocable trust-pour over will approach for the estate plan because of the Canadian income tax effects of transfers to revocable trusts.

(3) **Alter Ego or Joint Partner Trust**. Consider using an alter ego trust or joint partner trust if **the clients are 65 or older.**

b. **Inbound to U.S**.

(1) **Determine and Document Appropriate Domicile Status**.

(2) **U.S. Situs Assets if NRA**. If the person remains an NRA, for estate tax purposes, many of the client's assets, other than real estate in the U.S., may not be subject to U.S. estate tax. Monitor what types of assets the client will own. U.S. real estate, shares of stock in U.S. corporations, or interests in businesses that do business in the U.S. are U.S. situs assets, but many other types of assets would not.

(3) **Marital Deduction Planning**. Even though the spouses are not U.S. citizens, because of the Treaty provisions (discussed in Item 45.c above), a QDOT may not be required to avoid estate tax problems depending on the size of the estate.

(4) **Transfer Planning**. If the individuals are NRAs, gifts of intangibles will not result in gift tax liability. Gifts of "taxable Canadian property," however, will be subject to the deemed disposition tax in Canada. A gift by an NRA to a long-term dynasty trust of non-U.S. situs assets that is not subject to the U.S. gift tax will not be subject to the GST tax.

Items 50-60 are observations from a Seminar at the Summer Meeting: Critical Cross Border Considerations for Clients Who Travel and Live Internationally by Professor David M. English, Deborah J. Tedford, and Gail E. Mautner

50. Power of Attorney – Recognition of Validity

a. **Multiple Powers of Attorney**. Consider executing powers of attorney in multiple states or jurisdictions if the client moves between those jurisdictions.

b. **Reasons Given for Refusing to Accept Powers of Attorney from Another Jurisdiction**. (1) The form doesn't look familiar. (2) Different terminology may be used. (3) Some states mandate that the statutory form or a "substantially" equivalent form be used. (4) In some states, powers of attorney are durable unless stated otherwise, and in other states, the power of attorney must state that it is durable before it will be survive incapacity. (5) The rules of construction may differ (for example, whether a health care agent can withhold nutrition and hydration).

51. Powers of Attorney – Uniform Recognition of Substitute Decision-Making Documents Act

a. **Description**. The Uniform Recognition of Substitute Decision-Making Documents Act resulted from a joint task force of the U.S. Uniform Law Commission and the Canadian Law Conference. The U.S. version was approved in 2014, and the substantively similar Canadian counterpart was approved in 2016. The Act addresses the validity and administration of powers of attorney in cross-border situations (either (i) across jurisdictions within a country or (ii) between the two countries).

The name of the Act was chosen instead of "Power of Attorney" because of the variety of terms used to label a document that appoints a person to make decisions on another's behalf. The Act applies to health and personal care documents as well as powers of attorney.

b. **Recognizes Powers of Attorney Executed in Another Jurisdiction**. The Uniform Act applies to powers of attorney signed anywhere outside the state or province (whether in another state or province of the same country or in the other country).

c. **Three Major Tenets**.

(1) **Validity**. The document is valid if it complies with the governing law indicated in the documents, or, if no governing law is indicated, with the law where the document was executed. A health care document is also valid if it satisfies the law of the place where implemented.

(2) **Interpretation**. The document is interpreted in accordance with the law under which it was created.

(3) **Third Party Reliance**. Third parties are protected for good faith reliance that the document is valid. (This is especially important.)

d. **Enactments**. The Uniform Act has been adopted in full in only three states (Alaska, Connecticut, and Idaho), but the 2006 Uniform Power of Attorney Act includes similar provisions, and it has been adopted in 31 states in the U.S. Interestingly, all of the states that have adopted the Act are northern states, but the issues are more likely to arise with southern states, as Canadians escape to southern states for the winter, or southerners escape to Canada for the summer.

52. Powers of Attorney – Other State Law

a. **2006 Uniform Power of Attorney Act**. As indicated immediately above, the Uniform Power of Attorney Act has been adopted in 31 states. It includes the basic tenets of the Uniform Recognition of Substitute Decision-Making Documents Act, but the Uniform Power of Attorney Act applies only to powers of attorney.

b. **Other State Health Care Statutes Vary as to Recognition**. State health care statutes take one of three approaches regarding recognition: (1) valid if valid where executed; (2) valid if valid in the state where treatment is provided; or (3) the provider may presume validity of an out-of-state document absent knowledge to the contrary.

c. **Conflicts of Law**. Absent a statute, conflicts of law principles are unclear, but the law of the place of execution is more likely to apply to property powers of attorney than health care documents. Also, the law of the place of execution is more likely to apply to validity and interpretation than to implementation.

53. Powers of Attorney – Hague Convention

a. **Enactment**. Many separate conventions have been approved under the Hague Convention over the years. The Hague Convention on International Protection of Adults was completed in 2000. It has been ratified by 12 countries, all in Europe. While it has not been ratified in the U.S. or Canada, it provides useful guidance about important issues.

b. **Choice of Law**. Section 15 of the Convention addresses choice of law issues.

- Propriety of the agent's exercise of powers is determined by the law where the power is implemented.
- Validity and interpretation are determined by the law designated in the document or if none, by the law of the principal's habitual residence.

The law designated by the principal must have a connection to the principal (i.e., country where the principal is a national, former habitual residence, or country where property is located as to that property).

54. Guardianship – Uniform Acts

a. **Uniform Child Custody and Enforcement Act (1997)**. This uniform act, addressing custody of children, uses a priority list of factors for determining the appropriate jurisdiction. Number one on the list is the "home state," which is based on physical presence or the duration of physical presence.

This uniform act provides that the United States court must honor a custody order issued by a foreign country court if the order was issued under factual circumstances in substantial conformity with the jurisdictional standards of the Act. Enforcement of the foreign order is excused only if the foreign child custody law violates fundamental principles of human rights.

b. **Uniform Adult Guardianship and Protective Proceedings Jurisdiction Act (2007)**. This act addresses jurisdictional issues regarding adult guardianships. The Act has been enacted in all but four states (Florida, Kansas, Michigan, and Texas).

The highest jurisdictional priority is granted to the ward's home state, followed by a state with a significant connection, followed by other states. The "home state" determination is based on continuous physical presence of a least six consecutive months, other than temporary absences. A number of factors are listed for determining if a state has a significant connection.

In addition, a jurisdiction where the ward is located can take emergency action, and a jurisdiction where property is located can take action as to that property.

Other provisions include the transfer of a case to another jurisdiction, and registration of an out-of-state guardianship/conservatorship order.

Section 103 of the Act addresses international cross border issues by stating generally that "A court of this state may treat a foreign country as if it were a state for the purpose of applying this article and Articles 2, 3, and 5." The Act is less definitive in requiring the recognition of foreign orders than the Uniform Child Custody Jurisdiction and Enforcement Act (discussed above). A comment to § 103 explains: "Because guardianship regimes vary so greatly around the world, particularly in civil law countries, it was concluded that under this Act a more flexible approach was needed. Under this Act, a court may but is not required to recognize the foreign order." Apparently, during the discussions about the Act, some were concerned in particular about Iran.

55. Guardianship – Hague Convention

The Hague Convention on International Protection of Adults has not been ratified in the U.S., but it is useful to a court considering whether and how to take jurisdiction of an international case under § 103 if the Uniform Adult Guardianship and Protective Proceedings Jurisdiction Act.

Article 3 describes a broad range of "measures" that a country with jurisdiction may take relating to the guardianship.

Article 5 provides that proper jurisdiction is in the country of the adult's "habitual residence." That term is not defined but it is used without definition in a variety of the Hague Conventions. Habitual residence focuses on the duration of present and past locations instead of on present intention.

Article 8 provides that the country with jurisdiction may request another country to take measures of protection. Article 9 allows a country where the adult is located to take emergency action, and Article 11 allows a country where property is located to take action as to that property.

56. Practice Notes – Cross Border Guardianship Issues

Gail Mautner provides an excellent list of issues that planners should consider in connection with cross border guardianship issues:

1. What can a foreign guardian/conservator/trustee do in your state if he or she does not seek to be appointed as a guardian or conservator in the U.S. jurisdiction, but instead seeks to enforce his or her foreign appointment and orders?
2. What if the foreign country guardian/conservator is seeking only to marshal assets, rather than attempting a full guardianship of the person or the estate?

3. What type of notice is necessary to interested parties when a foreign country guardian or conservator seeks to be appointed as guardian of the person or the estate in your state?
4. How will the court know whether the petitioner has provided appropriate notice? How will the court know whether the procedures and protections of the foreign country have been followed?
5. What information should the court obtain to determine whether to grant comity to a foreign country's protective orders and guardianship appointments?
6. Should the court's concern about comity and "treating a foreign country as a state" increase or decrease depending on whether your state allows enforcement of foreign country orders by registration pursuant to Article 4 of the UAGPPJA?

57. Health Care Issues – Persons Inbound to U.S.

a. **U.S. Has Most Expensive Health Care**. The bad news for inbound persons is that the U.S. health care industry is the most expensive in the world. The most recent increase has been caused by cost increases in administrative jobs, not primary health services.

b. **Employees in U.S**. The Affordable Care Act applies to those legally in the U.S. on work visas as well as citizens. Employees of large employers (50 or more employees) must be covered by company plans. Employees of small employers (less than 50 employers) are not required to provide health insurance. The mandate to purchase health insurance was removed but these persons are eligible to obtain coverage on the exchanges (including with subsidies depending on the person's income).

c. **Retirees in U.S. (Including U.S. Citizens Who Have Not Worked in U.S.)**. Possibilities include the following.

(1) **Private Health Coverage**. Health insurance is expensive in the U.S., especially for retirees since they are older and will likely need more health care. Possible providers are GeoBlue, a Blue Cross/Anthem company and Cigna Global Medical, an international division of Cigna. Both of these provide global coverage. The premium cost is based on the country involved, the age of the person, and the level of coverage.

(2) **Medicare for Those Over 65**. A person who has worked in the U.S. and has paid into the Social Security system for at least 10 years can obtain Medicare coverage. Furthermore, a person who is at least age 65 and is either a U.S. citizen or has resided in the U.S. for at least the last five years (paying for private coverage) may "buy in" to Medicare. That coverage is known as Premium Medicare, or in Social Security parlance, Premium HI.

The premium costs of Premium HI in 2019 are:

(1) Part A - **$437** per month (lower with 30 quarters or more of work in the U.S. with payments to the U.S. payroll tax system) plus

(2) Part B coverage **$135.50** or higher based on income or on penalty (for example $271 with a ten year, 100% penalty); plus

(3) Part D prescription **($30-$50** per month or more), plus any Part D penalty for late sign up (generally 10%/year for every year past age 65 without coverage); plus

(4) Medigap coverage, possibly an additional **$150-220** per month depending on availability and level of coverage.

The cost of Medicare should be compared to private coverage, but a benefit of Medicare is that it is readily accepted throughout the U.S.

58. Health Care – Persons Outbound to Foreign Countries

a. **Cheaper**. The good news is that any place other than the U.S. has cheaper health care. However, if the individual pays for foreign coverage and also maintains his or her Medicare coverage, the person may be paying twice.

b. **Medicare Not Recognized in Foreign Countries But Consider Retaining Medicare Coverage**. Medicare insurance will not be recognized by foreign health care providers. Even so, outbound persons should consider retaining their Medicare coverage. If they later return to the U.S., penalties can apply for years that they dropped out of Medicare coverage. (For example, many persons who move to the U.K. end up moving back to the U.S. before 17 years have elapsed, because after residing in the U.K. for 17 years, the U.K. tax system applies fully to the individual.)

59. Travel and Evacuation Insurance

Some reputable companies that provide short term medical care coverage while abroad include Allianz Global Assistance, Amex Assurance, Generali Global Assistance, Seven Corners, Travelex, and Travel Guard.

Evacuation insurance pays to have a patient in a foreign country transported in a plane with medical staff back to the U.S.

60. Dual Social Security Coverage

a. **The Problem—Double Payroll Taxes**. Most countries impose payroll taxes for the social security systems based on the location of the worker, but the U.S. Social Security rules apply to U.S. citizens and resident aliens working abroad for American employers, regardless of where the employee is located, how long the assignment is, or whether the employee is covered by the foreign system. This can result in double Social Security payroll taxes.

b. **Tax Equalization**. Some companies offer "tax equalization" programs to reimburse the employee for the additional taxes.

c. **Detached Worker**. The U.S. has agreements with selected foreign countries to eliminate dual Social Security taxation and coverage for shorter term or temporary employees. The "detached worker" designation can apply to employees of a U.S. company who are temporarily transferred abroad for five years or less. The U.S. company may present a "certificate of coverage" to the foreign authorities for an exemption from that country's payroll tax system for any detached workers they employ.

d. **Totalization**. Workers who work in various countries may not qualify for retirement benefits under any of the countries' systems. For that situation, some countries have created a "totalization" system that allows the workers to combine or totalize coverage credits from both countries for prorated benefits.