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**NYSBA: Trusts and Estates Law Section Spring Meeting**  
Recent Developments

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## Hypothetical

Deborah died on March 1, 2014, survived by her wife, Wendy. At the time of Deborah's death, Deborah and Wendy resided in Buffalo, New York, with their son, Scott. Deborah's Will created a credit shelter trust ("CST") for Wendy's and Scott's benefit, which was funded with \$3.5 million, the amount of Deborah's remaining exclusion amount. The CST names Wendy's accountant as Trustee, giving her the right to pay income and principal to the beneficiaries in her absolute discretion. The trust allows the trustee to be paid commissions at half the statutory rate, and Wendy's accountant has asked that this be changed to the full statutory rate. The CST has skyrocketed in value to \$7 million. Wendy is disappointed that the CST will have to pay income taxes on the gain, especially since it appears that she will not have an otherwise taxable estate.

Wendy has two other noteworthy financial interests. Along with her siblings, all of whom reside in the France, she is a discretionary beneficiary of a foreign trust that owns all of the stock of a foreign corporation, which manages the trust's financial holdings and produces largely passive income. Additionally, she owns a non-voting limited partnership interest in a domestic partnership with which she hopes to do some planning.

On February 1, 2018, Wendy and Scott move to Florida.

***How have the changes in the law over the past year impacted the estate-planning advice we could give to Wendy?***

## **FEDERAL UPDATES**

1. Withdrawal of Proposed Section 2704 Regulations
2. Addition of Section 199A (Qualified Business Income from Pass-Through Entities) to the Code
3. Temporarily Increased Exemption Amounts
4. Deduction by Trusts and Estates of Trustee Commissions under the New Miscellaneous Itemized Deductions Rules
5. Expanded Definition of U.S. Shareholder of Controlled Foreign Corporation under Section 951(b)
6. *Estate of Powell* and the Application of Section 2036(a)(2) to Limited Partnership Interests
7. Retroactive Tax Relief for Same-Sex Couples under Notice 2017-15
8. Increased Tax Deductibility for Cash Contributions to Public Charities

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### **1. Withdrawal of Proposed Section 2704 Regulations**

These regulations, which proposed eliminating certain perceived abuses of certain valuation discounts for family-owned entities, were officially withdrawn late last year; therefore, the rules and regulations regarding restrictions on liquidation for valuation purposes for estate, gift, and GST taxes remain as it did prior to the proposed regulations.

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## 2. Section 199A: Qualified Business Income from Pass-Through Entities

A new complex provision was added to the Code under section 199A, which provides for a deduction of up to 20% of business income from pass-through entities (sole proprietorships, partnerships, limited liability companies, or S corporations).

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## 199A: A Mouthful

The deduction is limited to the greater of (1) 50% of the W-2 wages with respect to the trade or business, or (2) the sum of 25% of the W-2 wages, plus 2.5% of the unadjusted basis immediately after acquisition of all qualified property (generally, tangible property subject to depreciation under section 167). The deduction also may not exceed (1) taxable income for the year over (2) net capital gain plus aggregate qualified dividends.

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## Section 199A: Definitions and Exception upon Exception

- The deduction is capped at 50% of the taxpayer's pro rata share of the total W-2 wages paid by the business.
- The deduction is allowed only for "qualified business income," which is generally the amount of net income, gain, deduction, and loss from an active trade or business within the United States.
- Qualified business income does not include, among other items, capital gain, dividends, or interest.
- A qualified business does not include specified service businesses in the fields of health, law, accounting, actuarial sciences, performing arts, consulting, athletics, financial services, brokerage services, or any other business where the principal asset in the skill or reputation of one or more of its employees.

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## Section 199A: More caveats

- The wage and specified service business limitations do not apply if a taxpayer has taxable income below \$315,000 (for married joint filers), and the deduction is phased out by a complex formula for the next \$100,000 of business income.

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## Problem

In 2018, Susan, who is married, has \$100,000 of income from her business, where she operates a hot dog stand in Central Park as a sole proprietor. The hot dog stand generates \$100,000 of income in 2018. Susan also recognizes \$100,000 of capital gain income, along with \$30,000 of deductions. **What is Susan's 199A deduction?**

- a) Susan is not entitled to any 199A deduction because she does not operate a qualified business.
- b) Susan is not entitled to the 199A deduction, because her income is too great.
- c) Susan is entitled to a deduction, which is \$20,000 (20% of her qualified business income).
- d) Susan is entitled to a deduction, which is \$14,000 (20% of \$70,000, the excess of taxable income of \$170,000 over net capital gain).

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## 3. Temporarily Increased Exemptions: A new section 2010

### PART VI—INCREASE IN ESTATE AND GIFT TAX EXEMPTION SEC. 11061. INCREASE IN ESTATE AND GIFT TAX EXEMPTION.

(a) IN GENERAL.—Section 2010(c)(3) is amended by adding at the end the following new subparagraph:

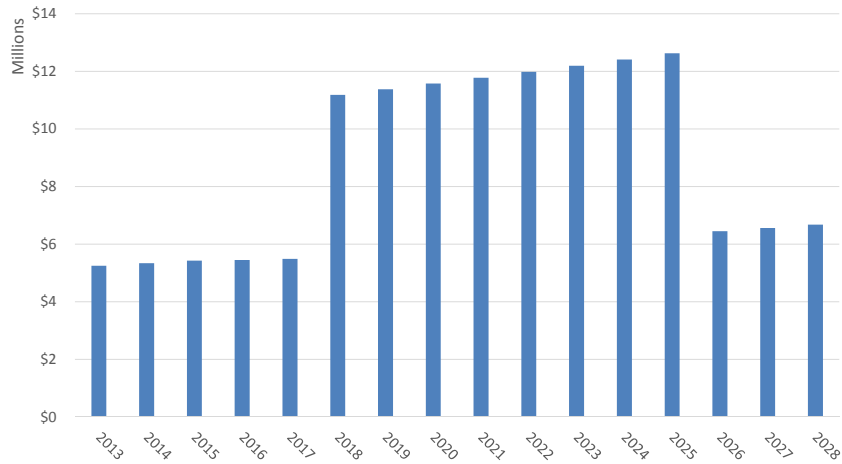
“(C) INCREASE IN BASIC EXCLUSION AMOUNT.—In the case of estates of decedents dying or gifts made after December 31, 2017, and before January 1, 2026, subparagraph (A) shall be applied by substituting ‘\$10,000,000’ for ‘\$5,000,000’.”.

- Treasury puts the inflation-adjusted figure at \$11,180,000 for 2018.
- Because the GST exclusion amount is tied to the basic exclusion amount, the GST exemption has also nearly doubled.
- These numbers are set to sunset at the end of 2025 and go back to \$5 million, adjusted for inflation.

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# Exclusion Amounts

Where They've Been and Where They're Going



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## Planning with the New Exemptions:

Flexibility is Key

- Nontaxable Powers of Appointment
- Broad distribution standards by independent trustees
- Substitution powers to settlor
- Basis adjustment planning
  - Giving nonfiduciary power to include POA to grantor to cause inclusion under §2036(a)(2) and 2038
  - Nonfiduciary grant GPOA to beneficiary
- Trust Protector Adding Grantor as Beneficiary
- Toggling of Gross Estate Inclusion
- Spousal Lifetime Access Trusts (SLATs)

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## Planning with the New Exemptions: Portability Takes a Front Seat

### reas. Reg. § 20.2010-2(c) Computation Of The DSUE Amount—

**Treas. Reg. § 20.2010-2(c)(1) General Rule.** — Subject to paragraphs (c)(2) through (4) of this section, the DSUE amount of a decedent with a surviving spouse is the lesser of the following amounts—

**Treas. Reg. § 20.2010-2(c)(1)(i)** — The basic exclusion amount in effect in the year of the death of the decedent; or

**Treas. Reg. § 20.2010-2(c)(1)(ii)** — The excess of—

**Treas. Reg. § 20.2010-2(c)(1)(ii)(A)** — The decedent's applicable exclusion amount; over

**Treas. Reg. § 20.2010-2(c)(1)(ii)(B)** — The sum of the amount of the taxable estate and the amount of the adjusted taxable gifts of the decedent, which together is the amount on which the tentative tax on the decedent's estate is determined under **section 2001(b)(1)**.

**Problem:** Husband and Wife have made no prior gifts when husband dies in 2025 when the exemption is \$12 million per individual. Exemption amount decreases per sunset provisions in 2026 to \$6 million. **What is wife's DSUE amount in 2026?**

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## Planning with the New Exemptions: Is Clawback Risk Real?

- What happens when a client uses the higher exemption amounts prior to the sunset in 2026?

“(2) MODIFICATIONS TO ESTATE TAX PAYABLE TO REFLECT DIFFERENT BASIC EXCLUSION AMOUNTS.—The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out this section with respect to any difference between—

“(A) the basic exclusion amount under section 2010(c)(3) applicable at the time of the decedent's death, and

“(B) the basic exclusion amount under such section applicable with respect to any gifts made by the decedent.”.

- In the history of the estate tax, the exemption amount has never decreased!
- What are we left to tell our clients?

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## 4. Miscellaneous Itemized Deductions: The 2%-of-AGI Limitation

### IRC § 67(a)

***In the case of an individual***, the miscellaneous itemized deductions for any taxable year shall be allowed only to the extent that the aggregate of such deductions exceeds 2 percent of ***adjusted gross income***.

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## What are Miscellaneous Itemized Deductions?

### IRC § 67(b)

For purposes of this section, ***the term 'miscellaneous itemized deductions' means the itemized deductions other than—***

- (1) the deduction under section 163 (relating to interest),
  - (2) the deduction under section 164 (relating to taxes),
  - (3) the deduction under section 165(a) for casualty or theft losses described in paragraph (2) or (3) of section 165(c) or for losses described in section 165(d),
  - (4) the deductions under section 170 (relating to charitable, etc., contributions and gifts) and section 642(c) (relating to deduction for amounts paid or permanently set aside for a charitable purpose),
  - (5) the deduction under section 213 (relating to medical, dental, etc., expenses),
  - (6) any deduction allowable for impairment-related work expenses,
  - (7) the deduction under section 691(c) (relating to deduction for estate tax in case of income in respect of the decedent),
  - (8) any deduction allowable in connection with personal property used in a short sale,
  - (9) the deduction under section 1341 (relating to computation of tax where taxpayer restores substantial amount held under claim of right),
  - (10) the deduction under section 72(b)(3) (relating to deduction where annuity payments cease before investment recovered),
  - (11) the deduction under section 171 (relating to deduction for amortizable bond premium),
- and
- (12) the deduction under section 216 (relating to deductions in connection with cooperative housing corporations).

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## What About Trusts and Estates?

### IRC § 67(e)

For purposes of this section, the adjusted gross income ***of an estate or trust shall be computed in the same manner as in the case of an individual, except that***

- (1) the deductions for costs which are paid or incurred in connection with the administration of the estate or trust and which would not have been incurred if the property were not held in such trust or estate, and
- (2) the deductions allowable under sections 642(b), 651, and 661, shall be treated as allowable in arriving at adjusted gross income.

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## Recap So Far

1. Individual taxpayers can deduct all miscellaneous itemized deductions (“MIDs”) in excess of 2% of AGI.
2. MIDs are all *itemized* deductions other than the deductions listed in Section 67(b).
  - The above-the-line deductions in Section 62(a) are also not MIDs.
3. Trusts and estates compute AGI in same manner as individuals except that the 2%-of-AGI limitation does not apply to the following MIDs:
  - Deductions (1) incurred in connection with the administration of trust/estate and (2) that would not have been incurred if the property not held by the trust/estate (i.e., fiduciary fees).
  - The personal exemption (IRC § 642(b)) and distribution deduction (IRC §§ 651 or 661).

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## Tax Cuts and Jobs Act: Adding the Confusing Section 67(g)

“Notwithstanding subsection (a), ***no miscellaneous itemized deduction shall be allowed*** for any taxable year beginning after December 31, 2017, and before January 1, 2026.”

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## Problem

In 2018, a trust pays its trustee a commission computed under SCPA 2309. The trust has taxable income well in excess of the amount of the commission.

***Can the trust deduct the commission against its taxable income?***

- a) Yes and in full because of the exception in Section 67(e)(1).
- b) Yes, but only to the extent the amount of the commission exceeds 2% of the trust's AGI.
- c) No, because under Section 67(g) until 2026, a trust and individual can't deduct expenses classified as a MID.

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## Two Indications Signal Section 67(g) Does Not Trump Section 67(e)

(i.e., continued deductibility of commissions)

1. The Joint Explanatory Statement on the Tax Cuts and Jobs Act states Congress added Section 67(g) to “suspend[] all miscellaneous itemized deductions *that are subject to the 2% floor under present law.*”
  - Section 67(e) excepted fiduciary fees from the so-called 2% floor, thus the deduction is outside the scope of what Congress intended to eliminate.
2. Section 67(e)(2) effectively permits the quasi-conduit regime of taxation of Subchapter J.
  - Section 67(e)(2) provides trusts/estates can take a distribution deduction in full despite it being a MID.
  - The distribution deduction is essential to avoid double taxation of trusts/estates and beneficiaries.

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## 5. Expanded Definition of “U.S. Shareholder” Section 951(b): Former vs. Current

### Former Section 951(b)

For purposes of this title, the term “United States shareholder” means, with respect to any foreign corporation, a United States person (as defined in section 957(c)) who owns (within the meaning of section 958(a)), or is considered as owning by applying the rules of ownership of section 958(b), 10 percent or more of the total combined voting power of all classes of stock entitled to vote of such foreign corporation

### Current Section 951(b)

For purposes of this title, the term “United States shareholder” means, with respect to any foreign corporation, a United States person (as defined in section 957(c)) who owns (within the meaning of section 958(a)), or is considered as owning by applying the rules of ownership of section 958(b), 10 percent or more of the total combined voting power of all classes of stock entitled to vote of such foreign corporation, **or 10 percent or more of the total value of shares of all classes of stock of such foreign corporation**

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## Problem

The beneficiaries of foreign trust consist of three U.S. citizens. The governing instrument gives the trustee absolute discretion to distribute income and principal to the beneficiaries. Under the law governing the trust, the trustee holds all voting rights to the trust's stock. The trust's sole asset is stock in a foreign corporation, which has significant earnings and profits every year.

***Does the IRS have a stronger argument to classify the U.S. discretionary beneficiaries as "United States shareholder[s]" under the current definition in Section 951(b)?***

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## 6. *Estate of Powell v. Comm'r*

- Many commentators have state that Powell is the most important tax court case addressing FLPs and LLCs in at least a decade. Why?
- Powell is the first case of its kind to apply section 2036(a)(2) analysis when the decedent owned merely a limited partnership interest. Prior cases, such as Strangi, found estate inclusion when the decedent owned the LP interest and a portion of the GP interest.
- The Court noted that the decedent, in conjunction with the other partners, could easily dissolve the partnership pursuant to the partnership agreement.
- However, the case is a great example of bad facts making bad law: decedent died a week after the transfer, and the transfer was made pursuant to an invalid transfer under a power of attorney.

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## 7. Notice 2017-15:

### Retroactive Relief for Same-Sex Couples

- Same-sex couples may now retroactively claim marital deductions and recalculate DSUE amounts and GST exemptions by filing a new or amended return, even if the statute of limitations has run.
- Same-sex marriage became legal in New York in 2010, so the notice will apply only to those gifts made between spouses after that time.

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## 8. Increased Tax Deductibility of Cash Contributions to Public Charities

### IRC § 170(b)(1)(G)(i)

In the case of any contribution of cash to an organization described in subparagraph (A), the total amount of such contributions which may be taken into account under subsection (a) for any taxable year beginning after December 31, 2017, and before January 1, 2026, shall not exceed 60 percent of the taxpayer's contribution base for such year.

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## NEW YORK STATE UPDATES

1. *In re Hoppenstein* and ability to decant New York trusts outside the provisions of EPTL 10-6.6
2. Proposed legislation that would make it easier to include capital gain in DNI for New York trusts
3. *In re Blecher* and modification of New York Wills to achieve tax results

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### 1. *In re Hoppenstein*

- NY Surrogate's Court dealt a potentially devastating blow to the necessity of EPTL section 10-6.6 for trust decantings.
- Court blessed power of trustees to decant under the document itself, which provided that they had the power "to pay such sums out of principal of the trust (even to the extent of the whole thereof) to the settlor's descendants, living from time to time, in equal or unequal amounts, and to any one or more of them to the exclusion of the others, as the Trustees, in their absolute discretion, shall determine."
- Note that "to or for the benefit of" language excluded
- Questions remain regarding how far practitioners can take this power beyond section 10-6.6.

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## 2. Inclusion of Capital Gain in DNI of NY Trusts Proposed Amendment to EPTL 11-A-4.4(2)

A trustee shall allocate to principal:  
money or other property received from the sale, exchange,  
liquidation, or change in form of a principal asset, including realized  
profit, subject to this part; ***provided, however, that a trustee may  
vary this allocation as provided in clause 11-2.3(b)(5)(A), and  
provided further, that a trustee who has an unlimited discretionary  
power to distribute principal, as defined in subparagraph 10-  
6.6(s)(9), may allocate to income part or all of the realized gain from  
the sale, exchange or other disposition of specified principal assets.***

New York Assembly Bill Number A09765 (proposed additions in ***bold italics***)

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## EPTL 11-A-4.4(2) In Plain English

- Money or property received from sale, exchange or liquidation of assets allocated to principal (not fiduciary accounting income)
- Under proposed addition, a trustee with unlimited discretion to distribute principal, may instead allocate these amounts to fiduciary accounting income
- At plain meaning, the statute is about allocation of receipts under state accounting rules
- ***But is there a federal income tax implication to the statute?***

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## Capital Gain and DNI

### Treas. Reg. § 1.643(a)-3

(a) *In general.* Except as provided in § 1.643(a)-6 [relating to foreign trusts] and paragraph (b) of this section, **gains from the sale or exchange of capital assets are ordinarily excluded from distributable net income** and are not ordinarily considered as paid, credited, or required to be distributed to any beneficiary.

(b) *Capital gains included in distributable net income.* Gains from the sale or exchange of capital assets are included in distributable net income to the extent they are, **pursuant to the terms of the governing instrument and applicable local law, or 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*

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## Treas. Reg. § 1.643(a)-3

### In Plain English

- Under Treas. Reg. § 1.643(a)-3(a), capital gain excluded from distributable net income (DNI)
  - DNI used to determine income tax obligations of trust/estate and beneficiaries
- However, exception in Treas. Reg. § 1.643(a)-3(b)(1) provides that capital gain will be included in DNI if allocated to FAI
- However, the IRS will only respect the allocation to capital gain to FAI in two instances:
  - Mandatory allocation pursuant to governing instrument AND applicable local law
  - Discretionary allocation pursuant to local law OR governing instrument (if not prohibited by local law)

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## Problem

Trust governed under NY law silent on allocation of capital gain to income or principal. For the year, trust recognizes large amount of capital gain income. Sole beneficiary, who is entitled to all trust income every year, resides in Florida, a state with no income tax.

***Would it be better if the trust or beneficiary paid the capital gains tax? Why?***

***Under current NY law, is there an action the trustee of this trust could take for the capital gain to be included in DNI?***

***Would the answer differ if Assembly Bill AO9765 passes?***

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## 3. *In re Blecher*

- Surrogate's Court allowed will modification to a 27-year old will in order to avoid NY state estate tax
- Modification was a reformation of a marital deduction formula to reflect changes in the tax laws.
- Court noted that modification would protect testator's intent from being thwarted by a change in the tax laws

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## Introductory Hypothetical

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