HECKERLING* UPDATE 2014
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Top Ten Recent Developments and Other Hot Topics Discussed at Heckerling 2014

1. The New Marital Deduction Planning. Several presenters discussed the effect of the increase in and portability of the federal estate tax exemption, reduction of the federal estate tax rate, increased state and federal capital gains rates, and variance in state estate and income tax systems on testamentary marital deduction planning:

   a. Dennis Belcher noted a survey of practitioners asking for their typical marital deduction plan for an estate of $5 million to $10 million: 40% would include a formula credit trust; 30% would rely on portability; 20% would use a QTIP trust; 10% would rely on disclaimer planning.

   b. Need to elect portability on timely filed return. Section 9900 relief available? Tom Abendroth: "should be" available.

   c. Continued benefits of credit-shelter/formula planning: GST, remarriage (tax and non-tax), audit (credit trust not subject to detailed reporting).

   d. Complications in blended families – QTIP plan without use of exclusion at first death may cause both exemptions to benefit family of second spouse to die.

   e. Even in large estates, portability may be beneficial. Gift to grantor trust of DSUE amount could be more tax-efficient than funding of credit trust (assuming spouse need not be beneficiary).

   f. If client moves from Minnesota to state without estate tax (or if Minnesota repeals estate tax), credit trust could increase overall tax even with minimal appreciation.

   g. Flexibility is important – disclaimers and QTIP elections vs. formulas; and broad discretion by independent trustee of credit trust, disclaimer trust and QTIP trust.

2. The "Paradigm Shift" from Estate Tax Planning to Income Tax Planning. Many presenters discussed how the changes in the state and federal estate and income tax laws dramatically affect the long-standing goal of reducing clients' estates for the purpose of avoiding estate tax:

   a. For "gap" estates, estate tax avoidance can increase overall tax. In Minnesota, the estate tax rate is typically around 10% of excess over $1 million (e.g. $431,600 on $5.34 million taxable estate), while combined state and federal capital gain rates are around 33.7%.

   b. Even for large estates, difference between rates has shrunk dramatically – especially in certain states. In California, there is no state estate tax, so the maximum estate tax exposure is 40%, and the combined state and federal capital gains rate is up to 37.1%.

c. New importance of considering state of domicile of beneficiaries. For example, wealth transfer by Minnesota resident to California beneficiaries could avoid 10% estate tax but trigger up to 37.1% of income tax upon sale.

d. Importance of looking at particular assets – compare copyrights, fully appreciated stock to 401(k)s, loss stock, annuities.

e. Paul Lee of Bernstein: "Don't ever use the applicable exclusion." Instead used GRATs and sales and let the exclusion be used or pass to the spouse at death._Compares gift of $5 million with 10% of appreciation to non-gift sale of $7 million with same appreciation. Same wealth transfer with zero risk of wasted exemption (*e.g.*, if assets depreciate).

f. But consider last deceased spouse rule. Surviving spouse should use inherited DSUE prior to remarriage.

3. Possible Future Legislation. Presenters discussed the following items from the so-called "Greenbook," General Explanations of the Administration's Fiscal Year 2014 Revenue Proposals (April 10, 2013):

a. Elimination of zeroed-out GRATs and minimum ten-year term. The word is out that GRATs are a loophole in the transfer tax system. *See* Mider, Zachary, *Accidental Tax Break Saves Wealthiest Americans $100 Billion* (bloomberg.com Dec. 17, 2013): "The popularity of the shelter, known as the Walton grantor retained annuity trust, or GRAT, shows how easy it is for the wealthy to bypass estate and gift taxes. Even [Richard] Covey says the practice . . . makes a mockery of the tax code."

b. Grantor trusts (a) includible in estate and (b) subject to gift tax on distributions during life. Would not apply to GRATs, QPRTs, etc.

c. Maximum five-year "stretch" for non-spouse IRA beneficiaries (as under current law where owner dies prior to required beginning date and without qualifying beneficiary).

d. Maximum tax-deferred accrual in retirement plans subject to limit based on maximum annuity for defined benefit plan (currently would cap plans at $3.4 million). The "Romney Rule." *See* Cohan, William, *What's Really Going on With Mitt Romney's $102 Million IRA?* (theatlantic.com Sept. 20, 2012).

e. 90-year limit on GST exemption allocation. Trusts would have inclusion ratio of one after 90 years.

f. 2009 estate tax rates and exemptions. $3.5 million, portable, 45% Rate.

4. Possible Future IRS Action. The IRS has also given some indication of its priorities, in the Treasury-IRS Priority Guidance Plan (Nov. 20, 2013), setting forth "priorities for the allocation of the resources of our office" from July 2013 to June 2014; and Rev. Proc. 2013-3 (the IRS "no ruling list"):

a. IRS may issue guidance on Rev. Proc. 2001-38. Disregard of unnecessary QTIP election.

i. Still effective for reverse QTIP?

ii. Still effective for basis step-up at second death?

iii. Still effective for state purposes? See Minnesota Rev. Not. #12-05 (March 5, 2012).

b. IRS may issue final regulations under IRC § 67 (deductions of trusts and estates for investment advice). Proposed regulations require "unbundling."

c. Beneficiary defective trusts added to the IRS "No-Ruling List." Donor makes small gift to trust, subject to withdrawal right by beneficiary. Upon lapse, position is that the trust is a grantor trust as to the beneficiary. Beneficiary then sells property to trust. Presenters consider this a "shot across the bow" by the IRS.

5. Same Sex Marriage. More than one presenter discussed *Estate of Windsor*, 570 U.S. _____, 133 S. Ct. 2675 (2013), and state laws and cases addressing same sex marriage.

a. DOMA Section 3 (prohibiting federal government from recognizing same sex marriage) held unconstitutional. DOMA Section 2 (providing that states may refuse to recognize same sex marriages of other states) not addressed.

b. Rev. Rul. 2013-17 (IRS will recognize all same sex marriages, regardless of state of domicile).

c. 40% of U.S. population live in jurisdictions that allow same sex marriage.

d. Some states do not allow same sex marriage, but recognize marriages of other states (Colorado); some allow and recognize (Minnesota); others disallow and do not recognize (Alabama).

e. Some states that authorize same sex marriage, also allow divorce without domicile (Minnesota). Others do not, making it difficult to obtain a divorce.

f. Important to avoid probate in state that does not recognize.

g. Inconsistent federal agency treatment. Note that after Heckerling (February 8), Attorney General Holder announced Justice Department will recognize all same sex marriages.

6. State Fiduciary Income Tax. Two recent state fiduciary income tax cases call into question constitutionality of Minnesota-style trust income tax laws:

a. *Linn v. Department of Revenue*, No. 4-12-1055, 2013 WL 6662888 (Ill. App. Ct. Dec. 18, 2013) (Illinois statute imposing income tax on trust that no longer has connections to Illinois is unconstitutional under due process clause);

b. *McNeil v. Commonwealth of Pennsylvania*, Pa. Comm. Court, Nos. 651 F.R. 2010, 173 F.R. 2011 (May 24, 2013) (Pennsylvania fiduciary income tax

statute invalid under commerce clause, even with Pennsylvania-resident beneficiaries).

c. Compare Minn. Stat. § 290.01, subd. 7b (defining resident trust as including a post-12/31/95 trust that becomes a non-grantor trust while the grantor is domiciled in Minnesota).

7. Self-Cancelling Installment Notes. There was a long discussion in the Recent Developments session of *Estate of Davidson* Tax Court Docket No. 13748-13; Chief Counsel Advice 201330033 (Feb. 24, 2013).

   a. Sale to grantor trust for self-cancelling balloon note.

   b. Taxpayer position: under § 7520, as long as grantor is not terminally ill (greater than 50% chance of death within one year), SCIN must be valued based on § 7520 tables.

   c. IRS position: A SCIN is not valued under § 7520, because it is not an annuity, term interest or life estate. Rather, its value is based on the grantor's actual life expectancy. See Gen. Couns. Mem. 39503 (1986).

   d. Planning consideration: a private annuity is more clearly subject to § 7520.

8. Estate Reduction Strategies Using QTIP Assets Another important case discussed as some length was *Estate of Kite*, T.C. Memo 2013-43 (*Kite I*) and T.C. No. 6772-08 (unpublished Oct. 25, 2013) (*Kite II*) Wife creates lifetime QTIP for husband, husband dies, assets remain in trust for benefit of wife. QTIP contributes to FLP for LP units, units distributed to wife, wife sells units to children for deferred private annuity. Wife dies before receiving any payments.

   a. Basis step up at husband's death despite § 1014(e) (apparently the issue was not raised by the IRS, and that may be because the basis increase did not end up saving tax).

   b. The sale for a private annuity was not a gift.

   c. The distribution to the wife, coupled with her sale, was deemed to be an integrated transaction triggering § 2519. Even though she sold the property for full and adequate consideration, the court held in *Kite II* that the disposition of her interest in the QTIP triggers a gift of the entire trust property under § 2519.

   d. Professor Pennell: Decision is wrong and it not precedential.

   e. Planning tip: include broad distribution authority by independent trustee of QTIP to allow distribution out to spouse to engage in estate planning.

   f. Similar concept applies to discretionary trusts for descendants in case estate inclusion would reduce tax (e.g., with basis step-up).

9. The Medicare Surcharge. There was a lot of talk about planning to avoid the 3.8% Medicare Tax on net investment income, especially for trusts.

a. Section 1411 (part of Affordable Care Act) imposes 3.8% surtax on net investment income over certain AGI limits ($200,000 for individuals, $250,000 for couples and $12,150 for estates and trusts).

b. Material participation – TAM 201317010. Non-passive trade or business income is excluded from net investment income. A trust's material participation is determined with respect to the trustee. The participation must be as trustee, not as an employee (where the trustee is also an employee).

c. Service's position is contrary to *Mattie Carter Trust*, 256 F. Supp. 2d 536 (N.D. Tex. 2003), holding that a trust establishes material participation for purposes of IRC § 469 through activities of its fiduciaries, employees and agents.

d. Grantor trusts, QSSTs, and distributions from trusts may reduce or eliminate the tax.

10. Self-Settled Asset Protection Trusts. Finally, the *Huber* case and other asset protection trust cases and statutes were mentioned several times. Professor Pennell seems to take the position this type of planning is all but over. Presenters in private practice (*e.g.* Belcher and Harrington) were more circumspect in their assessments.

a. Ohio passed asset protection trust law in 2013, becoming 14th state to do so.

b. *In re Huber*, 201 B.R. 685 (Bankr. W.D. Wash. 2013). The court invalidated an Alaska asset protection trust created by a Washington resident.

c. Seven other cases in the last two years – all invalidating the trusts.

d. Implications for asset protection and estate tax planning.

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