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Subject: Ed Morrow on the Introduction of the “Death Tax Repeal Acts of 2017” – How the Proposed Bills Differ, in their Attack on INGs of All Things, and Threats to CRTs

“Practitioners should consider writing their Senator and representative, perhaps through trade groups, urging them to simply leave §2511(c) in the dustbin of history, or at the very least to protect transfers to charitable remainder trusts from its application. Why complicate the gift tax even further? Just axe it. While they’re at it, Congress should clarify in any repeal that Section 1014 applies as if there were still an estate tax, to protect those widows and widowers with QTIP trusts from a denial of step up in basis at the surviving spouse’s death. Those in community property states will want a similar clarification vis-a-vis the surviving spouse’s half of community property.

For those practitioners and taxpayers considering ING trusts, perhaps for a future sale of a substantial asset, it may be wise to start the drafting process earlier rather than later, enabling the trust to be quickly funded should it look likely for a new §2511(c) to be reenacted as part of any estate tax repeal. This would lock in the ability to later shift income, take advantage of better charitable strategies and avoid state income tax on subsequent sales of appreciated property, depending on the state in question.”

We close the week with **Ed Morrow**’s analysis of the “Death Tax Repeal Acts of 2017” and how they could potentially impact INGs and CRTs.

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Now, here is Ed Morrow's commentary:

EXECUTIVE SUMMARY:

On January 24, 2017, five Republicans and one Democrat introduced H.R. 631, the "Death Tax Repeal Act of 2017," and Senator Thune, with 31 Republican Senators co-sponsoring, introduced very similar legislation with the same title, S.B. 205, in the Senate.[1] In the weeks prior, three much simpler estate tax repeal bills were introduced in the House, H.R. 30, H.R. 451 and H.R. 198, the latter also being referred to as the "Death Tax Repeal Act of 2017."[2]

This by itself is not surprising news to any readers of this newsletter – or the news in general. Republican leadership and President Trump have long vowed to kill the "death tax," and these bills are merely revivals of ones introduced in years past, albeit with greater likelihood of passage this time.

There are a few omissions of interest in the bills introduced so far in this session. There is no mention of any "mark to market" or modified carry-over basis regime in any of the bills, which was proposed by Donald Trump as part of his campaign.[3] The only exception being that H.R. 431 is specifically described as "REPEAL OF ESTATE TAX AND *RETENTION OF BASIS STEP-UP*."

Both S.B. 205 and H.R. 631 retain the gift tax at 35% while eliminating the estate and GST tax, and have some provisions to continue taxation of preexisting qualified domestic trusts (QDOTs) for ten years. H.R. 30 and H.R. 198 are much simpler – in a few bare sentences they would simply eliminate estate, GST and gift tax altogether, including on QDOTs.[4] H.R. 431 would only eliminate the estate tax and touches neither GST nor gift tax.

Notably, none of these bills protect QTIP trusts from the loss of a step up in basis at the surviving spouse's death.[5] Many, but not all, of Section 1014's triggers to adjust the basis at death require estate inclusion. Query whether the super-generous "double" step up in basis afforded to the surviving spouse's portion of community property is also at risk, since it too requires *estate inclusion*.[6]

How and when the sausage-making factory of Congress will ultimately reconcile all these to create something for the President to sign into law remains to be seen – much will be negotiated in the House Ways and Means and Senate Finance committees and there is yet the complicated drama of reconciliation and 60-vote hurdles in the Senate to play out.

This newsletter, however, will focus on a more obscure difference between H.R. 631 and S.B. 205 – the revival of Section 2511(c) of the tax code from the EGTTRA graveyard (S.B. 205 adds it, H.R. 631 omits it). This section was not originally designed to attack DING/NING trusts, but it would eliminate them nonetheless. The technique that it claimed to target has largely been eliminated by subsequent rulings.

COMMENT:

Should those taxpayers considering incomplete gift, non-grantor trusts (INGs) in the near future act sooner to save their opportunity? Unlike IGTs, GRATs, SLATs and the like that will likely continue if the estate tax is repealed and gift tax retained (and perhaps even skyrocket if the gift tax is also eliminated), INGs would be completely eliminated by S.B. 205.[7]

Put another way, if the passage of §2511(c) saves so much income tax that even some Republicans in Congress want to close the supposed loophole, should we be considering strategies that exploit it for some of our clients? The paradigm shift from estate tax to income tax planning forces us to consider the use of trusts for income tax shifting.[8]

Let's start by quoting and explaining S.B. 205's provision to add §2511(c) back into the code:

> (c) TREATMENT OF CERTAIN TRANSFERS IN TRUST.—Notwithstanding any other provision of this section and except as provided in regulations, a transfer in trust shall be treated as a taxable gift under section 2503, unless the trust is treated as wholly owned by the donor or the donor's spouse under subpart E of part I of subchapter J of chapter 1.

This is identical to the original EGTTRA provision, not even updated for the later technical corrections that had changed "treated as a taxable gift under section 2503" to "treated as a transfer of property by gift."[9]

Presumably this would eventually be changed again to clarify that charitable and marital deductions are permitted against such gift, as well as common and benign “gifts” to oneself that would typically occur in a charitable remainder trust (CRT), since such trusts are outside of the grantor trust rules (“subpart E of part I of subchapter J of chapter 1”).

Taking the above literally may cause massive gift tax exposure for a garden variety CRUT, which is probably not intended.[10]

Imagine a benevolent donor, age 50, establishing a 9% lifetime CRUT with $10 million. Our handy **NumberCruncher** software says that when the §7520 rate is 2.4%, this leads to a $1,149,300 charitable income (and gift tax) deduction. If §2511(c) were passed into law, this may mean that the taxable gift, however, is $8,850,700! **Say goodbye to the charitable remainder trust**. It’s one thing to deny a deduction, but quite another to put a 35% gift tax on transfers made in part to charity!

To explain this nonsense, let’s excavate the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) from the vaults of ancient history. In describing the effect of this section and its clarification, the Joint Committee on Taxation had this to say:[11]

> 9. Transfers in trust. The provision clarifies that the effect of section 511(e) of the Act (effective for gifts made after 2009) is to treat certain transfers in trust as transfers of property by gift. The result of the clarification is that the gift tax annual exclusion and the marital and charitable deductions may apply to such transfers. Under the provision as clarified, certain amounts transferred in trust will be treated as transfers of property by gift, despite the fact that such transfers would be regarded as incomplete gifts or would not be treated as transferred under the law applicable to gifts made prior to 2010. For example, **if in 2010 an individual transfers property in trust to pay the income to one person for life, remainder to such persons and in such portions as the settlor may decide, then the entire value of the property will be treated as being transferred by gift under the provision, even though the transfer of the remainder interest in the trust would not be treated as a completed gift under current Treas. Reg. sec. 25.2511–2(c)**. Similarly, if in 2010 an individual transfers property in trust to pay the income to one person for life, and makes no transfer of a remainder interest, the entire value of the

> property will be treated as being transferred by gift under the provision.[12] [emphasis added]

Even with their "clarification," it's hardly encouraging for our typical CRT scenario. Certainly Congress was not aiming at CRTs, but some amorphous fear of "tax shifting." Section 2511(c) aims to kill a gnat but strikes the golden goose. Moreover, since this original description and example of §2511(c) was written, the IRS issued a well-researched and considered memorandum on the very scenario bolded in the above paragraph, wherein it concluded that such a transfer is a taxable gift on the entire amount *without the need to resort to a statute like §2511(c)*![13]

In CCA 2012-08026, the IRS concluded that when a settlor retains a testamentary limited power of appointment over the principal, but retains no power to control the lifetime income interest, the settlor has made a completed taxable gift of the lifetime income interest even if the gift of the remainder interest is incomplete. Furthermore, thanks to Chapter 14, when *valuing* the portion of the gift that is complete, the *entire value* of the transfer is subject to gift tax, under the following syllogism:

> Generally, under § 2702(a)(2), the value of any retained interest which is not a qualified interest shall be treated as being zero. Section 25.2702-2(a)(4) provides that an interest in trust includes a power with respect to a trust if the existence of the power would cause any portion of a transfer to be treated as an incomplete gift. Accordingly, under § 25.2702-2(a)(4), the Donors' retained testamentary powers are interests, and the value of their retained interests is zero. **Therefore, the value of the Donors' gift is the full value of the transferred property**.[14] [emphasis added]

Thus, at least for the examples originally highlighted and discussed by Congress and the Joint Committee on Taxation, there is hardly any need for them to bother adding §2511(c) back into the Code, in light of CCA 2012-08026. Of course, an IRS Chief Counsel Memorandumis not law, it's simply the IRS' interpretation of it, but there is certainly enough authority and logic cited therein for the IRS to win a court case, or for Treasury to issue a binding regulation to the same effect.

Even if the CCA were incorrect and ineffective, what is it Congress *wants* to prevent by passing §2511(c), and, of course, retaining the gift tax at all? Aren't ING trusts primarily for *state* income tax avoidance?

Income Tax Shifting, Preferential Deductions and Deferral with INGs

Jumping off from the above Joint Committee example, assuming CCA 2012-08026 did NOT apply, a grantor could establish a trust using minimal lifetime gift tax exclusion (only the income interest being a taxable gift, not the value of the remainder), yet permitting the income from the trust to be shifted to various beneficiaries under Subchapter J, Parts A-D. Such a trust might very well be a grantor trust as to principal (e.g. capital gains), but not as to income.[15]

Shifting income to individual beneficiaries in lower brackets creates a tax rate arbitrage, and in the case of qualified dividends for a beneficiary in lower tax brackets, perhaps even outright elimination, since the tax rate may be 0%. Subchapter J non-grantor trust rules for partially or fully incomplete gift trusts override the "fruit and the tree" analogy wherein usually taxpayers have to give away the entire asset (the tree) to shift the income from it (the fruit) to others. Of course, this income shifting is completely useless to the uber-wealthy, whose children or even grandchildren are in equally high tax brackets as well.

More valuable to them would be the much more advantageous charitable tax deduction available to non-grantor trusts under §642(c), which permits a de facto above the line deduction unshorn by Pease limitations (often achieving better state results as well as federal), reduction from income subject to the 3.8% net investment income tax, no AGI limitations, and more advantageous lookback election provisions.

More intriguing still is the use of distributions to charitable remainder trusts, which do not qualify for the §642(c) deduction, but come under ordinary trust distribution deduction principles.[16]

But no one today would draft a trust like the one in the Joint Committee of Taxation example above, because of CCA 2012-08026. More likely, they would establish a *fully* incomplete gift, non-grantor trust, which lead us to DINGs and NINGs, which is even more efficient from a gift tax and tax shifting perspective than the cruder example in the EGTRRA

explanation, since no gift tax exclusion is used at all until a distribution is ultimately made to someone other than the settlor.

Modern DINGs

Since CCA 2012-08026 was issued, practitioners have adapted to create the modern incomplete gift, non-grantor (ING) trust.[17] These trusts get around the problem in CCA 2012-08026 by the settlor retaining certain powers as part of the distribution committee unless overridden by unanimous consent of the committee and retaining a non-fiduciary lifetime limited power of appointment capped by ascertainable standards. These are enough to help make the gift incomplete without triggering a grantor trust provision.

Primarily, INGs have caught the attention of practitioners in states with high state income tax rates such as California, Oregon, New York and New Jersey (and bank and trust companies in states such as Delaware, Nevada, South Dakota and Ohio with strong self-settled asset protection trust statutes), rather than for their potential use for federal income tax planning. Eventually, their popularity in New York led to that state passing a strictly targeted tax law against such trusts.[18]

Few, if any, Senators sponsoring S.B. 205 care about such trusts' ability to avoid *state* income tax. More troublesome to them *should* be the provision's potential effect on charities if the new Section 2511(c) is not clarified to exempt transfers to charitable remainder trusts (CRTs). However, they may still include it as is, in part by accidental holdover and misunderstanding of its current application.

In conclusion, practitioners should consider writing their Senator and representative, perhaps through trade groups, urging them to simply leave §2511(c) in the dustbin of history, or at the very least to protect transfers to charitable remainder trusts from its application. Why complicate the gift tax even further? While they're at it, Congress should clarify in any repeal that Section 1014 applies *as if there were* still an estate tax, to protect those widows and widowers with QTIP trusts from a denial of step up in basis at the surviving spouse's death. Those in community property states would surely want a similar clarification vis-a-vis the surviving spouse's half of community property.

For those practitioners and taxpayers considering ING trusts, perhaps for a future sale of a substantial asset, it may be wise to start the drafting process earlier rather than later, enabling the trust to be quickly funded should it look likely for a new §2511(c) to be reenacted as part of any estate tax repeal. This would lock in the ability to later shift income, take advantage of better charitable strategies and, depending on the state and asset in question, even avoid state income tax on subsequent sales of appreciated property.

HOPE THIS HELPS YOU HELP OTHERS MAKE A *POSITIVE* DIFFERENCE!

Ed Morrow

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CITATIONS:

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[1] The House bill and any updates on its passage can be tracked here: https://www.congress.gov/bill/115th-congress/house-bill/631/text?q=%7B%22search%22%3A%5B%22H.R.+631%22%5D%7D&r=1. The Senate bill and any updates on its passage can be tracked at https://www.congress.gov/bill/115th-congress/senate-bill/205/text?q=%7B%22search%22%3A%5B%22Thune+Estate+Tax+Repeal+2017%22%5D%7D&r=2.

[2] H.R. 198, also called the "Death Tax Repeal Act of 2017", with 56 co-sponsors, trackable at https://www.congress.gov/bill/115th-congress/house-bill/198?q=%7B%22search%22%3A%5B%22Death+Tax+Repeal%22%5D%7D&r=2 and H.R. 30, the "Farmers Against Crippling Taxes Act", which is essentially the same as H.R. 198, but has no co-sponsors. Perhaps the name was just not as catchy. H.R. 431, "Permanently Repeal the Estate Tax Act of 2017" (didn't they get the marketing memo to relabel it a "death tax"?) is trackable at https://www.congress.gov/bill/115th-congress/house-bill/451/text?q=%7B%22search%22%3A%5B%22H.R.+451%22%5D%7D&r=1.

[3] "The Trump Plan will repeal the death tax, but capital gains held until death and valued over $10 million will be subject to tax to exempt small businesses and family farms. To prevent abuse, contributions of appreciated assets into a private charity established by the decedent or the decedent's relatives will be disallowed." https://www.donaldjtrump.com/policies/tax-plan.

[4] In fact, it's so short we may as well include it here: "SECTION 1. SHORT TITLE.This Act may be cited as the "Death Tax Repeal Act of 2017".
SEC. 2. REPEAL OF ESTATE AND GIFT TAXES.
(a) In General.—Subtitle B of the Internal Revenue Code of 1986 (relating to estate, gift, and generation-skipping taxes) is hereby repealed.
(b) Effective Date.—The repeal made by subsection (a) shall apply to estates of decedents dying, gifts made, and generation-skipping transfers made after the date of the enactment of this Act."

[5] Adjustment of basis to fair market value at the date of death, colloquially and optimistically known as the "step up in basis", is governed by IRC §1014. Many planners have turned to overuse of QTIPs as the go-to solution for married clients who wish their beneficiaries to receive the step up at the death of the surviving spouse, despite all the other negatives of QTIP trusts. But if (when!) there is no estate tax, there would be no estate inclusion for QTIPs under §2044, which is a prerequisite for QTIPs to be "stepped up" under §1014(b)(10) ("Property includible in the gross estate of the decedent under section 2044"). By contrast, a trust containing a

testamentary general power of appointment could still be governed by §1014(b)(4) and obtain the step up ***regardless*** of whether there is estate inclusion under §2041, and could even be formulated to prevent a "step down". Why this is never discussed at CLEs or by the numerous advocates of exclusive QTIP plans is baffling. For a comparison chart of various trust design options and features for married couples, see pages 213-214 of the PDF of white paper at https://ssrn.com/abstract=2436964.

[6] IRC §1014(b)(6) "***property which represents the surviving spouse's one-half share of community property held by the decedent and the surviving spouse under the community property laws of any State, or possession of the United States or any foreign country, **if** at least one-half of the whole of the community interest in such property was includible in determining the value of the decedent's gross estate". How would courts interpret this if there were no such inclusion? Of course, QTIPs and community property may ultimately be stepped up the same as always if the estate tax is repealed, through either liberal IRS or court interpretation or ideally a technical correction, but would anyone guarantee that result for a client until then? Where is the authority to report contrary to the plain language of the statute, which requires inclusion? If you had a decedent client with significant LOSS property, wouldn't you feel comfortable taking the position that those paragraphs in §1014 no longer applied once the estate tax is repealed?

[7] For recent **LISI** newsletters on the continued importance of such planning in light of potential estate tax repeal, see distinguished **LISI** authors such as Steve Oshins, (Estate Planning Newsletter #2511), Alan Gassman Christopher Denicolo, Kenneth Crotty & Brandon Ketron (Estate Planning Newsletter #2500), Matt McClintock (Estate Planning Newsletter #2488), Marty Shenkman and Jonathan Blattmachr (Estate Planning Newsletter #2491).

[8] Of course, the *main* focus of estate planning is ALWAYS non-tax, but anyone who ignores taxes as part of the equation is begging for a malpractice suit. LISI has published many pieces over the years about the increased focus away from estate tax to income tax planning. From this author, the LISI article The Optimal Basis Increase Trust, originally published in March 2013, has been updated and is available at https://ssrn.com/abstract=2436964. An article on exploiting the

constitutional limits of taxing state “source income” and planning for business sales is *Ed Morrow on Corrigan v. Testa: Avoiding State Income Tax on Source Income,* LISI Income Tax Planning Newsletter #93.

[9] This clarification was probably not needed, since §2503(a) starts by defining taxable gifts as being reduced by the marital and charitable deductions of §2522 and §2523.

[10] Treas. Reg. § 1.664-1(a)(4).

[11] JCX-03-01 at http://www.jct.gov/s-1-03.pdf, pages 249-250.

[12] Treas. Reg. §25.2511(c): “A gift is incomplete in every instance in which a donor reserves the power to revest the beneficial title to the property in himself. A gift is also incomplete if and to the extent that a reserved power gives the donor the power to name new beneficiaries or to change the interests of the beneficiaries as between themselves unless the power is a fiduciary power limited by a fixed or ascertainable standard. Thus, if an estate for life is transferred but, by an exercise of a power, the estate may be terminated or cut down by the donor to one of less value, and without restriction upon the extent to which the estate may be so cut down, the transfer constitutes an incomplete gift. If in this example the power was confined to the right to cut down the estate for life to one for a term of five years, the certainty of an estate for not less than that term results in a gift to that extent complete.”

[13] IRS CCA 2012-08026 at https://www.irs.gov/pub/irs-wd/1208026.pdf.

[14] IRS CCA 2012-08026, page 7.

[15] Treas. Reg. §1.671-3(b)(2), Treas. Reg. 1.677(a)-1(g) example 2.

[16] For an extensive presentation on these issues, see “ING Trusts – Not *Just* for State Tax Avoidance”, available at http://ultimateestateplanner.com/programs/dings-nings-technical-planning-issues/. There is also some discussion as well in Part VIII of the Optimal Basis Increase Trust white paper linked to above. I refer to any ING that establishes a CRUT as a DING-CRUT.

[17] See various **LISI** newsletters by attorney William Lipkind who obtained the first post-2012 PLR, e.g., *Bill Lipkind on PLR 201310002: DING Redux*,

Estate Planning Newsletter #2076 (March 12, 2013). See also *Eliminate State Tax on Trust Income: A Comprehensive Update on Planning With Incomplete Gift Non-Grantor Trusts*, by Kevin Ghassomian, ACTEC Law Journal Winter 2013 and for a shorter summary see *Incomplete Gift, Non Grantor Trusts (aka DINGs, NINGs)*, by Edwin Morrow, Wealth Counsel Quarterly, Vol. 9, #3 2015, or *New Private Letter Ruling Breathes Life into Nevada Incomplete Gift Non-Grantor Trusts,* Trusts and Estates, *b*y Steve Oshins and Peter Melcher at https://media.wix.com/ugd/b211fb_fe418b3aa13d48908bc315e8c1a9601a.pdf*.*

[18] NY CLS Tax § 612(b)(41).