LOEB & LOEB LLP

High Net Worth Families

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IRS Announces 2019 Gift and Estate Tax Exemption Amounts

The Internal Revenue Service recently announced the gift, estate and generation-skipping transfer (GST) tax limits for 2019:

- The combined lifetime gift tax/estate tax exemption amount and the GST tax exemption amount will each be $11,400,000 per individual ($22,800,000 for a married couple), up from $11,180,000 per individual (or $22,360,000 for a married couple) in 2018.
- The annual exclusion for gifts (which do not count against the lifetime gift tax exemption) remains at $15,000 per donee.

Use It or Lose It. The current gift, estate and GST exemption amounts were ushered in by the 2017 Tax Cuts and Jobs Act, which doubled the exemptions under prior law. The higher exemption amounts are temporary; on Jan. 1, 2026, they will revert to their prior amounts ($5.6 million per taxpayer, or $11.2 million for a married couple, plus inflation after 2018) absent further legislation. Even before then, it is possible that a new law could reduce the exemptions if there is a change in control of Congress or the White House.

There was some uncertainty as to whether gifts made using the additional exemption might be subject to estate tax in the estates of individuals who die after 2025, when the exemption amount will be lower. This technical concern was based on the mechanics of the estate tax calculation, which essentially applies the amount of the exemption in effect at the time of an individual's death against the value of the estate plus the individual's lifetime gifts. The IRS recently issued proposed regulations that would modify the estate tax calculation to avoid any such "clawback" at death. The proposed regulations confirm that while the higher gift tax exemption is in place, taxpayers have a unique window of opportunity to transfer significant amounts of wealth to younger family members and substantially reduce their future estate taxes.

There are many strategies for leveraging the gift tax exemption, which can be tailored to each taxpayer's individual circumstances. Although a detailed discussion of the various transfer techniques is beyond the scope of this report, a few key points bear mentioning.

First, there is a benefit to making gifts sooner rather than later, because all of the future income and appreciation in value of any transferred assets will be removed from the taxpayer's taxable estate. In addition, for those living in a state that imposes its own estate tax but no gift tax (such as New York and Illinois), a lifetime gift will shelter the gifted assets (and their appreciation and income) from the state estate tax. Additional leverage is possible in the case of a gift to a "grantor trust" that is treated as owned by the grantor for income tax purposes but not for estate tax purposes. Because the taxpayer pays the income tax on income generated by the trust, the assets in the trust can grow free of income tax; the grantor's payment of the trust's income tax in effect constitutes a tax-free gift to the trust's beneficiaries. Taxpayers can also allocate GST exemption to gifts to multigenerational trusts, thereby allowing the assets to pass from generation to generation free of estate and GST tax.

Any gifting strategy will need to be properly structured and should take into account potential trade-offs, including the potential loss of step-up in income tax basis for assets that are gifted during life.

Other Inflation Adjustments for 2019. Other inflation-adjusted amounts announced by the IRS for 2019 include the following:

- The top income tax rate of 37 percent will be reached by married couples filing jointly with taxable incomes greater than $612,350 and by single taxpayers with taxable incomes greater than $510,300.
- The Alternative Minimum Tax exemption will be $111,700 for married couples filing jointly (for whom the exemption will begin to phase out at $1,020,600) and $71,700 for single taxpayers (for whom the exemption will begin to phase out at $510,300).
- The standard deduction will be $24,400 for married couples filing jointly, $12,200 for single taxpayers and married individuals filing separately, and $18,350 for heads of households.

Guidance on Deductibility of Estate and Trust Expenses

The 2017 tax law eliminated all miscellaneous itemized deductions for estates and trusts as well as for individuals beginning in 2018 and running through 2025. It was initially unclear whether the typical expenses of administering an estate or trust — such as legal fees, accounting fees, fiduciary compensation, appraisal fees and the like — would remain deductible. The IRS provided some guidance on this question in Notice 2018-61.

The Notice states that the Treasury Department will issue regulations clarifying that estates and trusts may continue to deduct the expenses of administering an estate or nongrantor trust under the new tax provision, IRC Section 67(g). However, the application of the existing rules classifying what are miscellaneous itemized deductions for estates and trusts will effectively limit the types of expenses that are deductible.

Under prior law, the IRS had split estate and trust expenses into two categories. Expenses that are unique to estates and trusts (such as fiduciary compensation and fees for estate and trust accountings) were fully deductible, while expenses that could be incurred even if property were not held in an estate or trust (such as investment management fees) were classified as miscellaneous deductions and were subject to the 2 percent floor. Under the new law, that distinction continues to be relevant, as IRC Section 67(g) essentially eliminates deductibility for those estate and trust expenses that are characterized as miscellaneous itemized deductions. As a result, investment management and advisory

fees are no longer deductible against estate and trust income while IRC Section 67(g) remains in effect.

It still will be necessary for estates and trusts to segregate bundled fees such as those charged by corporate trustees, which generally include some component for investment advice. Each fiduciary will be responsible for determining what portion of compensation would not have been incurred outside an estate or trust, and only that portion will be deductible.

While the Notice has provided certainty as to which expenses may be deducted by an estate or trust, the deductibility of excess deductions by beneficiaries on the termination of an estate or trust remains to be determined. Under prior law, if estate or trust deductions exceeded income in the final year, those excess deductions passed out to the beneficiaries and could reduce their personal income tax. The Treasury Department has requested public comments as to whether excess deductions should be available to beneficiaries under the new law. Regulations to resolve that question are targeted for completion in June 2019.

If excess deductions are no longer deductible for beneficiaries, fiduciaries will need to carefully monitor the timing of income and the payment of deductions to maximize the benefit of the deductions. Often the bulk of administration expenses are paid at the end of an estate or trust. If the deductibility of those expenses would be lost to the extent they exceed income in the final year, a premium will be placed on matching up income and expenses during the entire duration of an estate or trust.

California Franchise Tax Board's Interpretation of Trust Tax Law is Overturned

It has been the long-standing position of the California Franchise Tax Board (FTB) that a nongrantor trust is subject to current income tax on all of its California-source income, while other income is apportioned to California based on the number of California resident fiduciaries and noncontingent beneficiaries. In March 2018, in *Paula Trust v. California Franchise Tax Board*, the California Superior Court in the County of San Francisco ruled in favor of the taxpayer and rejected the FTB's regulation providing for the current taxation of all California-source income. The court held that under the state tax statute, all trust income, including California-source income, is subject to apportionment. The upshot of the court's decision is that a nongrantor trust with at least one trustee or one noncontingent beneficiary outside California may be able to defer California tax on all or some of its California-source income until the income is distributed to the trust's beneficiaries.

In 2007, the Paula Trust recognized capital gain from the sale of its interest in Century Theaters. All of the trust's income for 2007 was California-source income. In 2007, the Paula Trust had two trustees, one of whom was a resident of California. The Paula Trust had only one beneficiary, who was a California resident. The beneficiary was a contingent beneficiary for purposes of the tax rules because the trust agreement provided that the trustees had the sole and absolute discretion to make distributions to the beneficiary. No distributions were made to the beneficiary in 2017.

On its originally filed 2007 California tax return, the trust reported and paid tax on all of its income. In 2012, the trust filed an amended tax return and a claim for refund, taking the position that only 50 percent of the income was subject to California tax under the apportionment formula in Revenue and Taxation Code Section 17743, which apportions income to California pro rata based on the number of resident and nonresident fiduciaries. The Paula Trust took the position that the apportionment statute applied to all income, including California source-income, and that the portion of the FTB's regulation (under California Code of Regulations, Title 18, Section 17743) providing that California-source income is not subject to this apportionment rule is invalid.

After failing to secure a refund from the FTB or on appeal from the Board of Equalization, the trust filed suit in California Superior Court. The Superior Court granted summary judgment in favor of the trust, holding that all of the trust's income, including its California-source income, is subject to the apportionment formula in Revenue and Code Section 17743. Not surprisingly, the FTB has appealed this decision. The FTB's opening brief in the appeal is due in January 2019.

Trustees of nongrantor trusts that are potentially subject to California taxation should consider the impact of this decision based on their California-source income and the residency of the trustees and beneficiaries. Trustees should consider filing protective claims for refund for prior years open under the statute of limitations (generally four years from the filing of a return) in order to preserve a trust's right to any refund if the pending appeal is resolved in favor of the taxpayers.

Not a US Citizen or Green Card Holder? Here Is the Day- Count Test That You Need to Know

Under the Internal Revenue Code, individuals who are either U.S. citizens or U.S. residents are subject to U.S. federal income tax on their worldwide income. If you hold a green card, you automatically are a U.S. resident for these purposes. But what if you are a non-U.S. citizen who does not have a green card? In that case, you will be a U.S. resident if you meet the "substantial presence" test under IRC Section 7701(b)(1)(A)(ii).

The substantial presence test looks at the number of days that an individual has spent in the U.S. during the current calendar year and the preceding two years. This test is satisfied if the individual spends

(i) at least 31 days in the U.S. during the current year, and

(ii) at least 183 days in the U.S. during the current year and the preceding two years, as counted under a weighted formula.

For purposes of the 183-day test, one counts the number of days present in the U.S. for the current year, one-third of the days present in the U.S. during the immediately preceding year and one-sixth of the days present in the U.S. during the year before that. Some practitioners also call this the "120-day test" because under the formula, a noncitizen who does not have a green card can safely stay in the U.S. for 120 days each and every year without triggering income tax residency.

For example, suppose an individual is physically present in the U.S. for 120 days in each of 2016, 2017 and 2018. For purposes of the substantial presence test for tax year 2018, one counts all the days that the individual was present in 2018 (120) plus one-third of the days that the individual was present in 2017 (40) plus one-sixth of the days that the individual was present in 2016 (20). Because the total number of weighted days is 180, the individual will not be considered a U.S. resident in 2018.

If an individual spends any time during a particular day in the U.S., that day generally is counted for purposes of the substantial presence test. If an individual arrives in the U.S. one evening and leaves the U.S. the next morning, for example, two days would be counted.

Notwithstanding the general rule described above, exceptions exist for certain categories of individuals, including teachers, students and certain foreign government-related individuals (such as diplomats and employees of certain international organizations). In addition, an individual who meets the substantial presence test but stays in the U.S. fewer than 183 days in a particular year may qualify for treatment as a nonresident if the individual can show that he or she has a tax home and closer connections in another country. If the U.S. has an income tax treaty with the individual's home country, that may provide another

option to make a claim of nonresidency even when the substantial presence test has been met. In either case, an affirmative filing with the IRS is required to make a claim of nonresidency.

Each individual's particular facts and circumstances must be reviewed in order to determine how the rules apply in his or her case. Please feel free to contact our International Trust & Estate Planning team for more information.

Michigan Upholds Smartphone Note as Eelectronic Will

The Michigan Court of Appeals recently affirmed that a smartphone note was a valid electronic will in *In re Estate of Duane Francis Horton II (Mich. App. (2018) WL 3443383)*, applying an unusual state statute that allows evidence of a testator's intent to overcome formal defects. Most states — including California, Illinois and New York — require wills to satisfy at least some formal requirements set by statute. *Horton* reveals the outer edge of recent efforts to adapt and reinterpret these requirements to fit an increasingly digital world.

Duane Francis Horton II committed suicide in 2015, leaving an undated, handwritten journal entry directing his friends to "My final note, my farewell" on his phone's Evernote application. The note, which existed only in electronic form, included apologies, personal messages, funeral arrangement requests and directions for the distribution of Horton's estate. Horton left most of his money to his half sister and his belongings to other family members and friends. He also specified that his mother should not receive any money as a result of his death. In lieu of a signature, Horton typed his full name at the end of the note.

Horton's court-appointed conservator submitted his "farewell" note for probate as his will. Horton's mother, Lanora Jones, countered that her son died intestate and that she was his sole heir. The Probate Court admitted the note to probate as Horton's electronic will, leading Jones to appeal.

The Michigan Court of Appeals upheld the probate court's determination, citing a state statute that allows formal defects to be disregarded if clear and convincing evidence shows that a document was intended by the decedent as a last will. Such statutes, sometimes called "harmless error" statutes, are far more liberal than the holographic will statutes in many states, including Michigan and California, which generally excuse formal deficiencies if a will is signed, dated and in the testator's handwriting.

Horton's unwitnessed, undated electronic note clearly failed to meet Michigan's requirements for even a holographic will. But state law recognized it as a will because of evidence that it was "distinctly testamentary in character" — that is, intended by Horton to transfer property at and by reason of his death. Horton left handwritten instructions for accessing a note that was clearly intended to be read after his death, since it contained explanations for his suicide, final farewells and funeral arrangement requests, along with instructions for the postmortem distribution of his property. Testimony about Horton's strained relationship with his mother supported the conclusion that he wrote the note at least in part to prevent her from inheriting after his death. Under Michigan law, the fact that Horton wrote the note "in anticipation of his imminent death by his own hands" and intended it to govern the posthumous disposition of his property was enough to qualify it as an electronic will.

Michigan's harmless error statute and the *Horton* ruling represent the far edge of a much more limited national trend toward accommodating nontraditional wills, including electronic wills. Currently, just three states — Nevada, Indiana and Arizona — have enacted laws that expressly authorize electronic wills, and none is nearly broad enough to have led to the result in *Horton*. Rather, these statutes aim to translate core formal requirements into digital form. Nevada was the first

state to authorize electronic wills, in 2001, enacting a statute that requires a date, the testator's e-signature, electronic notarization or the e-signatures of two witnesses, and a unique "authentication characteristic" for the testator, such as a retinal scan or fingerprint. More recent electronic will statutes in Indiana and Arizona likewise require the testator to electronically sign in the presence of two witnesses.

Even absent such statutes, courts can interpret existing laws to accommodate electronic wills. In 2013, for example, an Ohio probate court in *Estate of Castro (Lorain County Probate Div., Case No. 2013ES001400)* accepted a printed copy of a will written and signed on a tablet.

The result in *Horton* represents a significant break with American legal tradition, disregarding all of the formalities otherwise required by state law to focus exclusively on the testator's intent. Nevada, Indiana, Arizona and Ohio have pursued the less radical course of translating traditional will formalities into digital forms through legislation or judicial interpretation. But even that relatively conservative approach outpaces most states, where no steps have been taken to integrate electronic wills into the probate code. For the time being, the best way to use your smartphone for estate planning is still to call a lawyer.

California Allows Trust Modifications Via Decanting

In September 2018, California enacted the Uniform Trust Decanting Act. Similar to wine decanting, trust decanting is a method by which a trustee may remove or modify trust provisions in an irrevocable trust by distributing the trust assets from an old trust into a new trust.

The ability of the trustee to modify the trust depends on the discretion afforded the trustee under the trust instrument. The more discretion the trustee has over the principal distributions, the more options the trustee has for modifying the trust through decanting. The provisions regarding what can be modified through decanting fall into two categories: (1) the rules that apply to fiduciaries with "limited distributive discretion" and (2) the rules that apply to fiduciaries with "expanded distributive discretion."

A trustee with limited distributive discretion is a trustee whose discretion to distribute trust principal is limited to an ascertainable standard. For example, a trust may provide a trustee with the power to distribute principal for the beneficiary's health, education, maintenance or support. A trustee with limited distributive discretion may exercise the decanting power to modify administrative provisions of the trust, including the successor trustee provisions or the powers of the trustee. However, the trustee may not materially change the dispositive provisions of the trust.

A trustee with expanded distributive discretion is a trustee whose discretion to distribute trust principal is not limited to an ascertainable standard or reasonable support standard. For example, a trust may give the trustee sole discretion to make or not to make distributions of principal for any purpose. A trustee with expanded distributive discretion may exercise the decanting power to modify both administrative and certain dispositive provisions of the trust. However, generally speaking, a trustee may not add a new beneficiary (except perhaps indirectly by granting a power of appointment whereby a beneficiary can direct the distribution of trust assets to another individual during his or her lifetime or at death).

Before exercising the decanting power, a trustee must give at least 60 days' notice to a long list of interested parties, including beneficiaries. If minors are beneficiaries, it may be necessary to have a court appoint a guardian ad litem to represent the interests of the minors and receive the notice on their behalf.

If you have any questions regarding California's decanting statute or its applicability to a particular irrevocable trust, please do not hesitate to contact us.

Review Your Fiduciaries

As we have noted in prior news alerts about the 2017 tax law, we recommend that clients review or contact us to review their current estate planning documents to determine whether modifications are necessary to address the dramatic increase in the estate and GST tax exemptions.

This is also a good opportunity to review the appointments of the executors of your will and trustees of your revocable and irrevocable trusts to make sure that the individuals or organizations named are still appropriate. You should also consider whether suitable mechanisms are in place to name successors in the event named individuals or organizations cannot serve. Ideally, each estate plan should have in place a structure that allows successors to be appointed without court intervention. We are happy to discuss options for appointing successors if your named fiduciaries are unable to serve.

If you see anything in these reports that you believe may have application to your own situation, please contact any member of our Tax or Trusts and Estates practice. We hope you feel free to pass on the report to other family members, friends and colleagues.