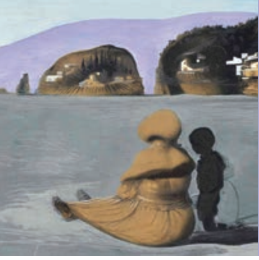

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TRUSTS & ESTATES

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By **Charles A. Redd**

Charting a New Course for Estate Planners in 2019

Recent developments from Congress and the courts

The Tax Cuts and Jobs Act (the Act) was signed into law on Dec. 22, 2017.[1] A number of the Act's provisions were important to trusts and estates professionals but none more so than that which increased the estate and gift tax basic exclusion amount for 2018 to $11.18 million,[2] a historically high figure by a large margin. The basic exclusion amount is scheduled to increase annually by virtue of inflation adjustments.[3] This component of the Act is, however, slated to expire on Jan. 1, 2026, at which time the basic exclusion amount will revert to amounts determined in accordance with pre-2017 Tax Act law.[4]

The comparatively enormous basic exclusion amount wrought by the Act should cause trusts and estates practitioners to reflect on the fact that a very sizable number of estate plans now in place (and, perhaps, still being designed) largely revolve around "formula" provisions to take effect at the death of the first spouse to die, which would cause property having a value equal to the smallest amount necessary to reduce federal estate tax to zero (or a fractional share of such property defined by a numerator equal to such smallest amount) to pass in a marital deduction disposition with the balance of the decedent's estate passing in a non-marital deduction disposition. There's always been a legitimate question regarding whether testamentary dispositions of property should be utterly dependent on whether the federal tax law in effect when an estate plan was assembled remains in place at the client's death.

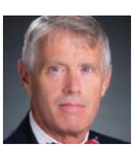
The Act accentuates this issue. Consider the following example: X has a will containing a formula provision of the type summarized in the preceding paragraph. X signed his will 10 years ago. X's non-marital deduction disposition is materially different from his marital deduction disposition. (There are innumerable clients across America in this estate-planning posture.) When X signed his will, his net worth was $5 million. Today, X's net worth is $8 million. Ten years ago, in 2008, the applicable exclusion amount (what we now refer to as the "basic exclusion amount") was $2 million. Today, it's $11.4 million.

Had X died in 2008, $3 million would have passed in the marital deduction disposition, and $2 million would have passed in the non-marital deduction disposition, a result of which X presumably approved. The applicable figures for 2009 would have been $1.5 million and $3.5 million. If X were to die today, his surviving spouse could receive *nothing* under his will (whether outright or in trust).

Clients with formula-based estate plans should carefully evaluate whether those plans would carry out their present intentions and, if not, take steps promptly to make changes needed to conform their plans to achieve the results they want. Furthermore, estate-planning advisors should seriously consider in what circumstances, if any, traditional zero-out-the-tax formula provisions make sense any longer (assuming they ever made sense).

Family Limited Partnerships

Estate of Streightoff v. Commissioner[5] involved a decedent (Frank) who on Oct. 1, 2008 formed a family limited partnership (FLP) with several family members as well as a revocable trust. Frank received an 89 percent limited partner interest, which he immediately assigned to the trustee of his revocable trust. The partnership agreement provided that limited partners owning a 75 percent or greater limited partner interest could,



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among other things, approve the admission of additional limited partners, remove the general partner (which would terminate the partnership), reconstitute the partnership and elect a new general partner.

In valuing the 89 percent interest for federal estate tax purposes, Frank's estate asserted that the 89 percent interest was an assignee interest and claimed a 13.4 percent lack of control discount and a 27.5 percent lack of marketability discount. The Internal Revenue Service countered by characterizing the 89 percent interest as a limited partner interest giving rise to no lack of control discount and an 18 percent lack of marketability discount.

The U.S. Tax Court opined that the 89 percent interest was a limited partner interest—both in form and in substance. Not only did the assignment paperwork indicate that the decedent had conveyed to his trust all of his 89 percent interest and "all and singular the rights and appurtenances thereto in anywise belonging," but also the decedent, up to the moment of his death, could have revoked his transfer to his trust of the 89 percent interest, which would have caused the 89 percent interest to be held by the decedent undeniably as a limited partner interest. Accordingly, the Tax Court ruled there was no valuation discount for lack of control.

Because Frank's estate had offered no evidence as to valuation of the 89 percent interest as a limited partner interest, the Tax Court accepted the IRS' valuation expert's conclusion that an 18 percent discount for lack of marketability should be allowed.

Though Frank's surviving family members were surely disappointed in the Tax Court's decision, clearly the estate could have suffered a much worse fate, and, indeed, it's surprising the estate fared as well as it did. In *Estate of Powell v. Comm'r*,[6] a reviewed Tax Court opinion and the most recent case addressing the estate tax consequences of FLP interests since *Streightoff*, the court ruled that the entire, undiscounted net asset value of an FLP was to be included in the decedent's gross estate under Internal Revenue Code Section 2036(a)(2) because the decedent, up to the moment of her death, could have joined with all the other partners and dissolved the FLP and, through her effective control of the general partner, could have controlled FLP distributions. One is left to wonder whether *Streightoff* is an anomaly in light of *Powell* or if the IRS and the Tax Court aren't prepared, after all, to use *Powell* as the standard against which all future cases involving estates holding FLP interests are to be judged.

State Income Tax on Trusts

Whether an irrevocable trust shall be subject to income tax imposed by a given state is generally determined by whether the trust is considered under that state's laws to be a "resident" for income tax purposes.[7] The analysis is sometimes complicated and often has nothing to do with the trust's situs or principal place of administration.[8]

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In *Fielding v. Comm'r of Revenue*,[9] a settlor formed four trusts in 2009 while domiciled in Minnesota. The original trustee was a Californian. The successor trustee was a Texan. All but one of the beneficiaries were non-Minnesota residents. All trust administration functions occurred outside Minnesota.

Initially, the trusts were grantor trusts for Minnesota income tax purposes. In 2011, the settlor relinquished the power to substitute trust assets, and the trusts then ceased to be "grantor type trusts" and became irrevocable within the meaning of Minnesota income tax law. Minnesota law defines a "resident trust," in part, as "an irrevocable trust, the grantor of which was domiciled in this state at the time it became irrevocable."[10] At the time the trusts became irrevocable, the settlor was domiciled in Minnesota.

In 2014, the trusts received income from investments as well as gains from the sale of stock. The Minnesota Commissioner of Revenue took the position that the trusts were "resident trusts" under Minnesota's statutory definition of "resident trust." The trustee's view was that Minnesota's statutory definition of "resident trust" violated the due process provisions of both the Minnesota Constitution and U.S. Constitution.

The Supreme Court of Minnesota observed that due process analysis imposes two constraints on state taxation. There must be both "a minimum connection" between the state and the person, property or transaction subject to the tax and a rational relationship between the income subject to the tax and the benefits conferred on the taxpayer by the state.[11] The court found that Minnesota's "resident trust" definition failed the due process analysis for three reasons.[12]

> The common theme in both *Fielding* and *Kaestner* is that, for a state statute defining or treating a trust as a "resident" for income tax purposes to be upheld, the required connection between the trust and the state must be current and direct and must involve a trust's purposefully availing itself of the legal benefits and protections flowing from operating in the state.

First, the court held that the settlor's residence at the time the trusts became irrevocable was "not relevant to the relationship between the trusts' income that Minnesota seeks to tax and the protection and benefits Minnesota provided to the trusts' activities that generated that income. The relevant connections are Minnesota's connection to the trustee, not the connection to the grantor who established the trust years earlier." Thus, the court looked largely to the trusts' independence as a legal entity, separate from the settlor or beneficiary.[13]

Second, the trusts owned no physical property in Minnesota that might serve as a basis of taxation.[14] The trusts owned stock of a Minnesota company and intangible property that was held outside Minnesota.

Third, the court didn't find significant any contacts with Minnesota by the settlor, the trusts or the beneficiaries that occurred prior to the tax year at issue. The court stated that the facts relevant to evaluating the sufficiency of a taxpayer's contacts are drawn from the tax year at issue.[15]

Kimberley Rice Kaestner 1992 Family Trust v. North Carolina Dept. of Revenue[16] involved a trust established in 1992 of which the settlor and the initial trustee were both residents of New York. The trust instrument provided that New York law was to govern. The successor trustee of the 1992 trust and initial trustee of three trusts resulting from a division, in 2002, of the 1992 trust was a Connecticut resident. In 1997, one of the beneficiaries, Kaestner, became a North Carolina resident. One of the trusts that came into existence in the 2002 division of the 1992 trust was for the benefit of Kaestner and her children, all of whom resided in North Carolina from 2005 to 2008, the tax years at issue.

From 2005 to 2008, the assets of the trust for the benefit of Kaestner and her children (the "Kaestner Trust") were held by a custodian in Boston. The ownership documents pertaining to all trust assets, along with all the trust's financial books and legal records, were located in New York. Tax returns and trust accountings were prepared in New York. All distributions from the Kaestner Trust were to be made, if at all, by the trustee in his discretion. Neither Kaestner nor her children received distributions from the Kaestner Trust between 2005 and 2008.[17] Kaestner and the trustee twice met in New York during the tax years in question to discuss trust investments and whether Kaestner wished to receive distributions. In 2009, following a request from Kaestner, the trustee transferred the Kaestner Trust's assets to a new trust, the KER Family Trust.

North Carolina law provides that the state may tax the income of a trust "that is for the benefit of a resident of [North Carolina]."[18] Accordingly, each year, from 2005 to 2008, the Kaestner Trust paid North Carolina income tax. In 2009, the trustee filed a claim for a refund of the taxes paid, which the North Carolina Department of Revenue denied in 2011. The Kaestner Trust then sued the Department of Revenue alleging the North Carolina statute imposing income tax on a trust for the benefit of a North Carolina resident[19] was unconstitutional under the due process and commerce clauses of the U.S. Constitution as well as Article I, Section 19 of the North Carolina Constitution.[20]

The Supreme Court of North Carolina noted that the due process clause requires "some definite link, some minimum connection, between a state and a person, property or transaction [the government] seeks to tax."[21] In addition, the court observed that "the income attributed to the State for tax purposes must be rationally related to values connected with the taxing State."[22] The court stated further that "it is essential in each case that there be some act by which the [party] purposefully avails itself of the privilege of conducting activities within the forum State, thus invoking the benefits and protections of its laws."[23] In its analysis, the court emphasized as "critical" that the Kaestner Trust and its beneficiaries had legally separate, taxable existences and that it was the beneficiaries, and not the Kaestner Trust, who were North Carolina residents and so reaped the benefits and protections of North Carolina's laws. The court therefore concluded that the beneficiaries' contact with North Carolina was insufficient to satisfy the requirements of due process and ruled that the statute at issue was unconstitutional as applied to the Kaestner Trust.[24]

The common theme in both *Fielding* and *Kaestner* is that, for a state statute defining or treating a trust as a "resident" for income tax purposes to be upheld, the required connection between the trust and the state must be current and direct (a connection between the state and the settlor or a beneficiary isn't enough) and must involve a trust's purposefully availing itself of the legal benefits and protections flowing from operating in the state.

IRC Section 642(c)

In *Green v. United States*,[25] a large irrevocable trust established in 1993 used ordinary business income it had received from a limited partnership of which it owned 99 percent to purchase various parcels of real estate. The purchases occurred in 2002 and 2003, and the total of the purchase prices was about $10.7 million. In 2004, the trust, pursuant to a provision in the governing instrument, contributed the real estate to a charitable organization described in IRC Section 170(b)(1)(A). At the time of the contributions to charity, the aggregate fair market value (FMV) of the contributed real estate was approximately $30.3 million. The trustee claimed a deduction, under IRC Section 642(c), in the amount of the full FMV of the donated property, $30.3 million. The IRS said the trust was entitled to a Section 642(c) deduction but only in the amount of the trust's basis in the property, $10.7 million.

Section 642(c) provides, in pertinent part, that a trust is entitled to deduct, in computing its taxable income, any amount of its gross income, without limitation, which pursuant to the terms of the governing instrument is, during the taxable year, paid for a purpose specified in Section 170(c).

There was no question that the trust made payments (in-kind distributions) totaling $30.3 million during the taxable year, 2004, for a purpose specified in Section 170(c). There was also no question that gross income was used in making such payments. The issue for determination was *how much* of the $30.3 million payments constituted gross income within the meaning of Section 642(c).

The U.S. District Court for the Western District of Oklahoma, siding with the taxpayer, held that the trust could deduct the full $30.3 million FMV of the properties contributed to charity.[26] The U.S. Court of Appeals for the Tenth Circuit reversed the district court, ruling that the trust's deduction was limited to $10.7 million, its basis in the donated properties.[27]

What really seemed to resonate with the Tenth Circuit were the IRS' arguments that: (1) Section 642(c) requires, as a condition for allowance of a deduction for a payment to charity, that such payment be made from "gross income," which as a matter of law can't include unrealized gain; and (2) allowing a full FMV deduction would permit the trust to deduct an amount not previously taxed. The first argument seems correct, although perhaps not as obviously correct as might first appear. The Tenth Circuit labored through 28 pages to reach its conclusion, and the opinion states that Section 642(c) is ambiguous and susceptible to four different interpretations. The second argument, standing alone, has no merit. Subject to applicable adjusted gross income limits, individual taxpayers have been allowed to deduct the full value of appreciated securities gifted to charity for as long as anyone can remember.[28]

Endnotes

1. An Act To Provide for Reconciliation Pursuant to Titles II and V of the Concurrent Resolution on the Budget for Fiscal Year 2018, Pub. L. No. 115-97 (the Act).
2. *See* Internal Revenue Code Section 2001(c)(3). Actually, the increase was to $10 million, but the cost-of-living adjustment mandated by IRC Section 2010(c)(3)(B) resulted in $11.18 million for 2018.
3. *See* Section 2010(c)(3)(B). The basic exclusion amount for 2019 is $11.4 million. *See* Revenue Procedure 2018-57.
4. *See* Section 2010(c)(3)(C).
5. *Estate of Streightoff v. Commissioner*, T.C. Memo. 2018-178 (Oct. 24, 2018).
6. *Estate of Powell v. Comm'r*, 148 T.C. No. 18 (May 18, 2017).
7. Even if the trust isn't a "resident," a state may nevertheless impose income tax on trust income derived from sources (for example, real estate; tangible personal property; a business, trade, profession or occupation carried on) within that state. *See, e.g.,* Section 143.181.2, RSMo.
8. *See* Charles A. Redd, "State Tax Stew," *Trusts & Estates* (July 2016).
9. *Fielding v. Comm'r of Revenue*, 2018 WL 3447690 (Minn. July 18, 2018), *aff'g*, 2017 Minn. Tax LEXIS 28 (Minn. T.C. 2017), *petition for cert. filed* (U.S. Nov. 21, 2018) (No. 18-664).
10. Minn. Stat. Section 290.01, subd. 7b(a)(2).
11. Quoting *Luther v. Comm'r of Revenue*, 588 N.W.2d 502 (Minn. 1999).
12. Note that the Supreme Court of Minnesota held that the Minnesota statutory definition of "resident trust" couldn't be applied constitutionally even to the one trust of which a beneficiary was a Minnesota resident. Could the *Fielding* rationale be invoked to attack the constitutionality of a state statute that defines "resident trust" as a trust whose settlor was domiciled in the state when the trust was created (or, if a revocable trust, when the trust became irrevocable) and of which there's at least one beneficiary residing in the state? *See, e.g.,* Section 143.331, RSMo.
13. Quoting *Greenough v. Tax Assessors of Newport*, 331 U.S. 486 (1947).
14. Citing *Westfall v. Dir. of Revenue*, 812 S.W.2d 513, 514 (Mo. 1991).
15. Quoting *Linn v. Dep't of Revenue*, 2 N.E.3d 1203, 1210 (Ill.App. 2013) and *Potter v. Taxation Div.*, 5 N.J. Tax 399, 404-05 (N.J. Tax Ct. 1983).
16. *Kimberley Rice Kaestner 1992 Family Trust v. North Carolina Dept. of Revenue*, 814 S.E.2d 43 (N.C. June 8, 2018), *aff'g*, 789 S.E.2d 645 (N.C. App. 2016).
17. Kaestner did receive proceeds of a loan from the Kaestner Trust in 2009, *petition for cert. filed* (U.S Oct. 9, 2018) (No. 18-457).
18. N.C. Gen.Stat. Section 105-160.2.
19. *Ibid.*
20. The commerce clause argument wasn't addressed by the Court of Appeals of North Carolina and therefore wasn't addressed in the Supreme Court of North Carolina decision.
21. Quoting *Quill Corp. v. North Dakota*, 504 U.S. 298, 306 (1992).
22. *Ibid.*
23. Quoting *Skinner v. Preferred Credit*, 361 N.C. 114, 123 (N.C. 2006).
24. The court acknowledged two cases in other jurisdictions cited by the Department of Revenue. In *Chase Manhattan Bank v. Gavin*, 249 Conn. 172 (Conn. 1999), *cert. denied,* 528 U.S. 965, the Supreme Court of Connecticut held that Connecticut's taxation of the income of an inter vivos trust didn't violate due process because the trust's beneficiary was a Connecticut domiciliary. The court pronounced *Gavin* unpersuasive and declined to follow it. In *McCulloch v. Franchise Tax Board*, 390 P.2d 412 (Cal. 1964), the Supreme Court of California ruled that California could tax the income of a trust in part because the beneficiary was a California resident. The court found *McCulloch* distinguishable from *Kaestner* because an important fact in *McCullough*, that the trustee was domiciled in California, wasn't present in *Kaestner*.
25. *Green v. United States*, 880 F.3d 519 (10th Cir. Jan. 12, 2018).
26. *Green v. United States*, No. CIV-13-01237-D (W.D. Okla. Nov. 4, 2015).
27. *Supra* note 25.
28. IRC Sections 170(a) and (b).