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AUGUST 2018 NEWSLETTER

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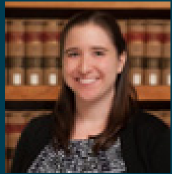
FIRM NEWS

DeEtte Loeffler will be speaking at the upcoming *National Business Institute's* seminar titled Trusts: The Ultimate Guide on August 20 and 21, 2018, at the Hampton Inn, Downtown San Diego. She will be covering Grantor Trusts and Tax Deduction with Trusts. Click the link below for more information!
NBI Seminar



In June, Katie Lepore, Esq., CPA, was a guest speaker at the monthly meeting of the San Diego Outback Real Estate Investors Network, focusing on entity formation and other legal aspects applicable to real estate investors. She also was a guest on the podcast "Close Up on America's Business: Where Business, Finance, and Technology Connect" to discuss current trends and common issues in estate planning. To listen to the podcast click the link below:
Listen Podcast Here

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WHO WOULDN'T PREFER A SIMPLER, LESS EXPENSIVE, ESTATE PLAN?

by DeEtte L. Loeffler, CPA, J.D., LL.M., Taxation

Federal law now makes it possible for most people to greatly simplify their estate plans while still avoiding gift and estate taxes. Simplifying your plan has the added benefit of preserving more assets for your heirs by saving on income taxes and trust administration expenses, including legal and accounting fees.

Simpler Trusts Should Pay Less in Income Taxes

The Tax Cuts and Jobs Act, enacted in December 2017, increased the exclusions for estate, gift and generation-skipping taxes to $11,180,000 and indexed them for inflation (until 2026 when these return to $5 million). A married couple in 2018 will be able to transfer up to $22,320,000 in lifetime gifts, or at death, without having to pay federal transfer taxes. The majority of people no longer need to worry very much about these taxes.

Income tax rates, however, are still relatively high, and taxes on complex trusts and passive

income are now the real threat to accumulated wealth. The highest federal income taxes rates are at 37%, plus a possible 3.8% Net Investment Income Tax ("NIIT") and a 0.9% Medicare Tax which applies to taxpayers earning (jointly) $250,000. In addition, California applies tax rates of up to 13.3% on top earners. Trusts reach the top federal tax rate at $12,501 of income. As a result, higher income taxpayers in California, and irrevocable trusts, now pay income taxes at a rate of over 50%.

Those with the ability to amend their plans to postpone the date when a trust becomes irrevocable, or to avoid the creation of irrevocable trusts in the future, may prevent the application of some or all of these taxes to their assets, thus preserving more for themselves and their heirs.

Why Simplification is Possible

The increase in tax exclusions is not the primary reason trusts can now be simpler, although it certainly helped. Under pre 2010 law, those with estates of less than twice the exclusion amount needed to use complex planning to minimize the tax bite. Spouses often could not leave all of the assets to the surviving spouse because that could cause the surviving spouse's estate to exceed his or her exemption and result in payment of an estate tax at the second death.

Fortunately, Congress enacted "portability" in 2010. While not a solution to all estate planning needs, portability does allow trusts to now be much less restrictive. Before portability, for example, a decedent's estate tax exemption had to be used upon death or the benefit was lost forever. As a result, most estate plans required the trust to divide upon the death of the first spouse into two or three different trusts, with one trust to hold the assets of the surviving spouse and the other trust(s) to hold the assets of the deceased spouse. The latter trusts, which were irrevocable, normally placed restrictions on the uses that could be made of those assets by the surviving spouse. The survivor was also required to administer the marital assets in more than one trust, leading to increased trust administration expenses (for tax returns, management and legal fees) after the first death.

With portability, the executor of the deceased spouse can elect (on a properly filed estate tax return for the first spouse) to claim any exclusion that was not used by the first spouse to die. The surviving spouse can therefore receive up to all of the marital assets and still shield them (up to the combined exclusion amount) from estate tax at the survivor's death.

Retaining the marital assets in a single, revocable trust in the name of the surviving spouse not only simplifies the management of those assets, it allows the assets to be taxed at the survivor's income tax rate, which will likely be lower than that of an irrevocable trust. It also avoids the expenses of maintaining more than one trust, including accounting and legal fees.

Shouldn't Everyone Have a Simple Plan?

Not everyone can or should have such a simple estate plan, but more people may want to consider one. People in second marriages, or with different beneficiaries, may still want to retain a multi-trust plan. In addition, people who have significant amounts of real property in addition to a personal residence (i.e., property with a combined assessed property tax value of over $1 million) may be better off maintaining a multi-trust plan in order to take advantage of Proposition 13 (the parent/child exclusion on reassessment) since this exclusion is still a "use or lose" benefit.

People who may not want a simple plan also include: (1) those who want to provide asset protection to a surviving spouse; (2) those who want to ensure their share of the assets go to certain beneficiaries; or (3) those whose estates will or may be subject to an estate tax at the second death. This last category includes couples whose gross estate exceeds $10 million and who may live past the year 2025.

New Flexibility Can Benefit All Estates

Couples who want to retain asset protection or other features of their current trusts can still benefit from making changes to take advantage of portability. One benefit of retaining assets in a single revocable trust is that those assets will receive a step-up in income tax basis at the death of the surviving spouse. The basis step-up can eliminate capital gains in the trust assets when they are later sold. For example, if the trust includes a house purchased for $100,000 that is worth $500,000 at the second death, the capital gain tax payable on the $400,000 increase in value will be eliminated at the death of the trust owner.

That same basis adjustment benefit is available to assets held in a qualified terminable interest trust (a "QTIP" or "marital" trust). Traditional trust funding would result in the assets of the deceased spouse being used to first fund a bypass trust (up to the exemption amount), with any extra going to fund a marital trust. However, if a trust is amended to require the marital trust to be funded first, or to give the surviving spouse the power to choose which trusts to fund (bypass, marital, or both) at the first death, the opportunities for maximizing income tax savings increase significantly. While such planning can be complex, and should be thoroughly discussed before adoption, the benefits of making a change to incorporate portability in your planning can provide significant income tax benefits for most estates.

Complex trusts are not a thing of the past, but many people can now have simpler, more income tax efficient plans. If you have questions about how your current plan operates or would like to discuss amending your plan to take advantage of the new laws discussed above or to avoid higher income tax rates imposed on irrevocable trusts, we would be happy to discuss these issues with you.

SOUTH DAKOTA V. WAYFAIR

By Katie Lepore, CPA, J.D., LL.M., Taxation

On June 21, 2018, the U.S. Supreme Court ruled in favor of South Dakota in *South Dakota v. Wayfair*, essentially giving states a greater right to collect sales tax from out-of-state sellers. The decision effectively overturned a 1992 Supreme Court ruling in *Quill Corp v. North Dakota* and a 1967 ruling in *National Bellas Hess, Inc. v. Department of Revenue of Illinois* which established a bright light physical presence standard that sellers needed to be present in a state in order to be required to pay sales tax to the state.

The ruling, however, leaves much still to be desired in that courts will need to determine on a case-by-case basis how to implement the ruling, since the only clear ruling is that a business does not need a physical presence in a state before being subject to that state's sales tax. States have a right to subject a taxpayer to paying tax when the taxpayer reaches a point called "nexus" with the state. When a taxpayer reaches nexus is based on state law and varies from state to state, so this new ruling will require sellers to track their sales to out-of-state purchasers and determine when the seller has reached the point of nexus with each state.

There are several items which are undecided and unclear at this point in time, and we expect states to enact rules and legislation following this major decision. Retailers can begin to ensure compliance with new laws by checking exemption certificates in each state or county where the business makes sales, and by beginning to track sales by state, if not already tracking in such a way. Retailers should also be on the lookout for rulings from any of the several states which already had nexus requirements enacted prior to the *South Dakota* decision, which may cause them to owe tax retroactively.

FEDERAL TAX UPDATE

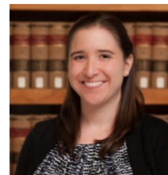
By Katie Lepore, CPA, J.D., LL.M., Taxation

Opportunity Zones Identified. The Tax Cuts and Jobs Act added a new code section, 1400Z-2, to the Internal Revenue Code, to incentivize development in low-income areas of the country. In late June, the IRS issued Notice 2018-48, which provided a complete listing of the areas (known as qualified opportunity zones) that would be eligible for such a credit. If a taxpayer develops in the areas identified, the taxpayer is allowed to defer gains on the sale of appreciated assets so long as the gains are rolled over into development in a qualified opportunity zone.

Social Security Wage Base May Increase. The wage base for Social Security could increase as of 2019, up to $132,300, as reported by the Social Security Administration's Office of the Chief Actuary (OCA). The current wage base for 2018 is $128,400. According to a June 8, 2018 article from RIA Checkpoint, "Actual annual increases to the wage base are announced in October of the preceding year and are based on then-current economic conditions… The OCA is also projecting that the Social Security trust fund will become insolvent in 2034, and that the Disability Insurance (DI) trust fund will become insolvent in 2032."

New Tax Bills on the Horizon. House Ways and Means Committee Chairman Kevin Brady (R-TX) announced that there would be a legislative draft of a second phase tax bill available for House members to review following the July 4 holiday. He further commented that a full agenda is expected for review by August, with votes tentatively scheduled for this fall. According to the Chairman, important topics he expects to be addressed are "making permanent or extending the individual tax cuts enacted as part of the Tax Cuts and Jobs Act…, which are set to expire by 2025. Areas under consideration include lower individual income tax rates, the expanded child tax credit, and the increased standard deduction... [and] retirement and education provisions."[1] A "Listening Session Framework" was released by the Ways and Means Committee on July 24, 2018.

Deductibility of Trust and Estate Expenses. The IRS issued Notice 2018-61 on July 13, 2018 indicating that the IRS will issue regulations clarifying that estates and non-grantor trusts may continue to deduct expenses described in IRC Sections 67(e), 642(b), 651 and 661, despite 67(a) relating to miscellaneous itemized deductions being suspended. Prior to the issuance of this notice, it appeared trusts would be unable to itemize these deductions. The deductions to be permitted include: costs 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, personal exemption, and the DNI deduction for simple and complex trusts.



STATE TAX UPDATE

By Katie Lepore, CPA, J.D., LL.M., Taxation

Trust Decanting. A bill authorizing trust decanting is making its way through the California legislature, SB 909, introduced by Senator Hertzberg (D-Van Nuys). The bill has passed the Senate and currently is in the second round of committee review in the Assembly. Decanting is a common tool used on the East Coast where a fiduciary can distribute the assets from one trust into a second trust without the approval of the beneficiaries.

[1] Thompson Reuters Checkpoint RIA https://checkpoint.riag.com/app/main/externalDoc?usid=411e33v285238&DocID=I1301d6461e434fd7a402a4cf5b106c98&feature=tnews&id=I1301d6461e434fd7a402a4cf5b106c98&lastCpReqId=321ff5&nlEmailId=&origResReq=%2Fapp%2Fdoc%3Ffeature%3Dtnews%26id%3DI1301d6461e434fd7a402a4cf5b106c98%26lastCpReqId%3D321ff3%26nlEmailId%3D&tabPg=4210

Currently, the California Probate Code allows for a trust to be modified with the consent of the settlor and all beneficiaries (Probate Code Section 15400). If the settlor is not alive, beneficiaries may ask for trust modification only with court approval under Probate Code Section 15403. Decanting would allow a trustee to distribute the trust assets to a new trust that has more updated terms, but is still consistent with the settlor's intent.

California conforming to new partnership audit rules. Senator Glazer (D-Orinda) has introduced SB 274, which among other things, would require partnerships to report to the FTB any federal audit adjustments or federal elections made within 6 months after federal examination. It also would require that any elections made at the federal level are binding for state tax purposes. A partnership would be able to request a different election for state tax purposes than federal tax purposes from the FTB, so long as a partnership can show the different election would not impede the collection of taxes by the FTB. The bill has passed the Senate and is in the second round of committee review in the Assembly.

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