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AUGUST 2019 NEWSLETTER

501 WEST BROADWAY, SUITE 700
SAN DIEGO, CALIFORNIA 92101-3563
TELEPHONE: (619) 239-7777
FAX NUMBER: (619) 238-8808

MMPPH Attorney Bradford N. Dewan is giving a presentation titled "IRAs: Pre-Mortem & Post-Mortem Planning" to the North County Estate Planning Council on September 3, 2019 @ 7:30 am at Fairbanks Ranch Country Club, 15150 San Dieguito Rd, Rancho Santa Fe, CA 92067. For more information, go to https://ncepc-sd.org/meetinginfo.php?id=71.

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ARE YOU (REALLY) PREPARED?

By DeEtte L. Loeffler, J.D., LL.M., Taxation

The Scout motto is "Be Prepared." As a former Scout leader, and an estate planning attorney, I spend much of my time helping others to prepare for life's unexpected events, like accidents, illness and death, and dealing with their aftermath. I am a vocal advocate for having college students sign health care and financial powers of attorney before going off to college, so that their parents can continue to help them with unexpected life events. I work with seniors to ensure they have similar documents in place in case of future diminished capacity or illness. I now have one more life situation to add to my list – the "accident."

This spring my husband slipped on ice while backpacking on the Pacific Crest Trail and tumbled about 175 feet down the side of a mountain. Fortunately he survived, but he suffered significant injuries. I am grateful to the Riverside County Sheriff's Department, Idyllwild Fire Department, and the Desert Regional Medical Center for their invaluable help.

In the aftermath of his fall, our lives were disrupted. He required surgery, and was unable to work for months. I missed work (and sleep) to provide care, schedule and take him to medical appointments, obtain special equipment, etc. We received shockingly high medical bills for his rescue, emergency treatment and surgery. Despite all of this, many things went right.

First, when I was notified of his accident, I already had an Advance Health Care Directive, Authorization to Release Medical Information and a financial Power of Attorney in place. I

was able to take those documents with me to the hospital, which simplified many issues for us both. For example, I was able to obtain copies of his medical records (including the CT scans, x-rays, etc.) from the hospital without a fight, while he lay sleeping in a hotel room nearby. I was also able to pick up his prescriptions (including narcotic pain killers) from a pharmacy in the middle of the night when the hospital unexpectedly discharged him at midnight without any "take with you" pain killers.

Second, we had medical insurance in place, along with supplemental insurance. So far, the insurance companies have dealt with and negotiated down more than $200,000 in medical bills and we have had only a small cost share to pay out of pocket.

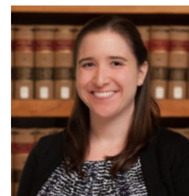
Third, my husband had purchased short term disability insurance through his employer. This coverage has allowed him to take more time to heal before having to go back to work full time. That has hastened his recovery and allowed him (and me) to not stress over paying our bills during his convalescence.

This experience also caused me to take a hard look at my own situation and I did not like what I saw. Although I have the same good medical insurance and emergency documents as my husband, our working situations are not entirely alike. Like most attorneys, I am essentially self-employed, so I am not covered by workers' compensation and there is no one to pay me a salary or benefits if I am temporarily out of commission. Although I have purchased life insurance to provide for my family if I die, I had not purchased disability insurance for myself. I have now researched both short- and long-term disability insurance and purchased appropriate coverage through a professional association to which I belong.

If you are the sole (or a major) income provider in your family, I encourage you to take time to review your own personal situation. You should have an Advance Health Care Directive and a financial Power of Attorney to allow someone else to act on your behalf if you are ever unable to do so for yourself. If your employer, or a professional association to which you belong, offers disability insurance, I recommend you consider it carefully. Unless you have enough money to "self-insure" in case of an accident, this insurance can mean the difference between financial ruin and being able to take the time your body needs to recover. Finally, you need to plan for the possibility that you will not survive your accident. Life insurance could help your family to retain their home or prevent your spouse from having to immediately get a job to make ends meet. In addition, you should also have a Will, and a trust if appropriate, to ensure that if you die, your estate will be distributed to the persons you want to benefit.

Our family story is ending much better than it could have. While my husband's full recovery will take some time yet, he is on the mend and our family was not financially devastated by this experience. Most importantly, we have reviewed our health care and financial powers of attorney and made some updates to them, and I now have disability insurance. We are now as Prepared as we can be for anything that might go wrong on our next family vacation… or trip to the store.

If you do not yet have an estate plan, or think this is a good time to update your existing plan, we would be happy to discuss how our firm could help you to Be Prepared as well.



SUPREME COURT RULES ON STATE TRUST TAXATION: IS CALIFORNIA'S TAXING SCHEME CONSTITUTIONAL?

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

On June 21, 2019, the U.S. Supreme Court unanimously held in *N.C. Dep't of Revenue v. The Kimberley Rice Kaestner 1992 Family Trust, U.S., No. 18-457,* that a trust beneficiary's mere residence in a state does

not establish sufficient nexus for the state to tax an out-of-state trust. The court held that income not distributed or required to be distributed to a beneficiary cannot be taxed in the beneficiary's resident state because it is uncertain where the beneficiary will live when the assets are actually distributed. It is worth noting that the case holding is very narrow, which leaves the status of some of California trust tax laws uncertain.

Basic Case Facts

The Kimberley Rice Kaestner 1992 Family Trust was formed by a New York Trustor, Joseph Lee Rice III. It was subject to New York laws, had a trustee who lived in Connecticut but worked and kept books and records in New York, and its assets were housed in Massachusetts. One of the beneficiaries, Kimberley Rice, lived in North Carolina during the period in question, but she never received any trust distributions and had no right to demand a distribution. The trustee had "absolute discretion" to make distributions and the trust would terminate when Kimberley Rice turned age forty. North Carolina's laws allowed the entire trust to be subject to taxation due to the presence of a beneficiary in the state since trust income potentially is "for the benefit of" a North Carolina resident.

The Court held that a minimum connection is needed under the due process clause of the U.S. Constitution before a state can tax a trust; mere residency of a beneficiary, who did not receive distributions, did not establish such a minimum connection. The court further held this is particularly so when the beneficiary's receipt of trust assets was "mere speculation" and not guaranteed. The court emphasized that the North Carolina beneficiary had no right to demand distributions, again, a narrow holding specific to the facts of the case.

Furthermore, the Court specifically noted that the holding does not address other state tax laws that may consider the residence of a beneficiary or the residency of the settlor as factors in levying tax on the trust. Justice Sotomayor wrote that, "we do not imply approval or disapproval of trust taxes that are premised on the residence of beneficiaries whose relationship to trust assets differs from that of the beneficiaries here." Further, the opinion stated in footnote 8 that the Court did not consider how greater beneficiary rights would affect the analysis saying, "we do not decide what degree of possession, control, or enjoyment would be sufficient to support taxation."

California Trust Taxation

The Court specifically did not address California's law which allows the state to impose tax on non-California source income attributed to, but not distributed to, a non-contingent beneficiary.[1] In California, such tax will be imposed on the income whenever distributed (a throwback tax), even if the beneficiary is outside of California when the income is received, if the beneficiary later returns to California within a certain period of time after receiving the income[2]. The amicus brief filed by the American College of Trust & Estate Counsel (ACTEC) noted that there are only four states which impose a tax on trusts based on the residence of a beneficiary. North Carolina and Tennessee impose this tax on contingent beneficiaries; California and Georgia only impose the tax on non-contingent beneficiaries. New York also imposes a similar throwback tax in certain circumstances. *See* N.Y. Tax Law §612(b)(40).

[1] In California, a contingent beneficiary is one whose interest is subject to a condition precedent. A non-contingent beneficiary is one whose interest is vested. *See* California Code of Regulations Title 18, Section 17742(b). A California beneficiary subject to a trustee's "absolute discretion," as in *Kaestner*, is a contingent beneficiary until receiving a distribution. *See* FTB Technical Advice Memorandum 2006-0002.

[2] *See* CA R&TC Section 17745. California also imposes a tax if there is a resident trustee, but this is not at issue in the case. A corporate fiduciary will be deemed to be a California resident if a major portion of the administration takes place in California. *See* CA R&TC Section 17742.

In footnote 10 the Court stated, "[w]e have no occasion to address, and thus reserve for another day, whether a different result would follow if the beneficiaries were certain to receive funds in the future. See, e.g., Cal. Rev. & Tax. Code Ann. §17742(a)." Therefore, California's trust taxation system was specifically not addressed by the Court and seems to remain in place currently, although its future is unclear.

California Implications

Commentators and experts, such as Georgetown University Law Center Professor Brian Galle, have expressed concerns after the holding that the result essentially approves the creation of tax shelters in high tax states, like California. According to Galle, a California resident beneficiary who receives trust distributions will of course be subject to tax on those distributions by virtue of being a resident. However, having a California beneficiary who does not control trust assets, with an out-of-state trustee, particularly in a low or no-tax state like Nevada, would not subject the trust to state taxation except for distributions actually paid. When ready for a large distribution, the beneficiary could move residency to nearby Nevada, allowing the trust to nearly escape all state taxation, unless the beneficiary returned to California within 12 months of receiving the distribution.[3]

Other experts, such as Jonathan Blattmachr, think the *Kaestner* holding will cause California's taxation based on beneficiary residence to be found unconstitutional.[4] Furthermore, the *Kaestner* case may also encourage other states to adopt a throwback tax similar to California's. It is worth nothing that the Kaestner trust would not be subject to tax in California under its taxing statutes, which is consistent with the holding by the Court.

The Court did not address what factors would justify trust taxation based on beneficiary residence, but due to the facts of the case, it would seem that possession, control, and enjoyment of the assets by the beneficiary would need to be present before a tax could be upheld. Estate planners should be careful in how they draft the trust language depending on whether state tax is a factor of consideration, and whether reduced control by the beneficiary is worth saving income taxes.

North Carolina has set a deadline of December 21, 2019 for trusts to seek a refund of tax paid to that state due to the *Kaestner* ruling. Non-California trusts that have been paying California taxes due to the residence of a beneficiary who did not receive distributions may want to consider filing a claim for refund, depending on the facts and circumstances in that trust. It seems trustees could make a sound argument based on *Kaestner* for a refund claiming that the California taxation scheme is unconstitutional. However, California also could make a strong case that distinguishes its taxing scheme from that adjudicated in *Kaestner*.

Conclusion

At this point, it is unclear whether California's tax levied on trusts based on the residence of non-contingent beneficiaries is constitutional. The U.S. Supreme Court specifically stated the taxation of trusts based on contingent beneficiaries is unconstitutional but declined to rule on taxation based on non-contingent beneficiaries. Experts have differing opinions about whether California's tax based on beneficiary residence is lawful in light of the *Kaestner* holding. However, until further notice, it remains valid law in California.

[3] *See* https://news.bloomberglaw.com/us-law-week/kaestner and *see* CA R&TC Section 17745(e).
[4] *See* webinar Slide 37 and comments at minute 50, available at https://shenkmanlaw.com/webinars-details/?id=2486

FEDERAL TAX UPDATE

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

and

*Marissa Wolfsheimer, Intern**

JCT Report on President's Budget Proposal. On March 11, 2019, President Trump submitted his fiscal year 2020 budget proposal to Congress, which includes provisions to make permanent the estate and gift tax provisions of the 2017 Tax Cuts and Jobs Act and to repeal certain health-care related taxes. On July 8, the Joint Committee on Taxation (JCT) released a report on the President's proposed budget which analyzes the Tax Cuts and Jobs Act in part and states that the Act "reduced the number of taxpayers electing to itemize deductions from 48.7 million in 2017 to 20.4 million in 2018." The JCT expects that making the estate and gift tax provisions permanent would reduce tax revenues by $44 billion by the year 2029, and making all of the Tax Cuts and Jobs Act provisions permanent would reduce tax revenues by $920 billion over 10 years.

Taxpayer First Act Signed into Law. On July 1, President Trump signed into law the Taxpayer First Act. The law aspires to modernize the IRS's customer service and establishes an Independent Office of Appeals to improve adjudicating appeals and to explain denials of referrals by Appeals. The Act expands the rights of whistleblowers and further enforces criminal tax violations. The new law also provides more safety measures for technology and taxpayers' personal information.

Ways and Means Supports Three Tax Bills. The Ways and Means Committee approved three tax bills, along partisan lines. First, the *Taxpayer Certainty and Disaster Tax Relief Act*, H.R. 3301, would extend tax provisions that are near expiration or have reached expiration into 2020. This act focuses on tax credits regarding biodiesel and alternative fuel, and extends disaster relief. These costs would be partially offset by reducing the estate and gift tax exemption amount in 2022 instead of 2025. Second, the *Economic Mobility Act*, H.R. 3300, would expand the Earned Income Tax Credit and make the child tax credit fully refundable. Finally, same-sex married couples could amend their filing status for income tax returns under the *Promoting Respect for Individuals' Dignity and Equality (PRIDE) Act*, H.R. 3299, even if the statute for past tax returns has already run. The House floor passed the PRIDE Act, but has not yet voted on H.R. 3301 or H.R. 3300; the Senate is not expected to pass these bills.

House Votes to Repeal Cadillac Tax. The House voted on July 17 to repeal the so-called "Cadillac Tax" on high-cost employer-provided health plans in H.R. 748, the *Middle Class Health Benefits Tax Repeal Act of 2019* sponsored by Representative Joe Courtney, D-CT. The bill has large bipartisan support and passed with a vote of 419-6. Without the repeal, a 40% excise tax is slated to go into effect in 2022 on the total value of employer and employee contributions towards certain employer-provided health plans. Opponents state the repeal would increase the federal deficit by approximately $200 billion over 10 years, according to projections by the Congressional Budget Office (CBO). A similar bill, S. 684, sponsored by Senator Martin Heinrich, D-NM, has been introduced in the Senate, but it is unclear whether the Senate will address S. 684 or H.R. 748.

States Again Challenge SALT Cap. In June, the IRS issued regulations that denied taxpayers a tax deduction for donations to a state-created charity if the donations reduced the taxpayers' state taxes. The purpose of the regulation was to stop the scheme offered by

some high tax states which set up "charities" to fund their state programs. On July 17, New York, Connecticut, and New Jersey sued the IRS claiming the agency exceeded its authority by issuing the regulation. The SALT cap continues to cause a controversy in Congress as well, with lawmakers arguing across the aisle at a House Ways and Means Select Revenue Measures Subcommittee on June 25.

IRS Semiannual Regulatory Agenda. The IRS released its regulatory agenda for the next 12 months, including plans to issue several proposed regulations relating to estate and gift taxes. Proposed regulations will address reporting transactions with foreign gifts and trusts, computing the present value for claims against an estate, and clarifying the deductibility of expenses for trusts and estates under Section 67(g) (relating to miscellaneous itemized deductions). Final regulations on several estate and gift topics are also forthcoming in the next year.

IRS Fiscal Year 2020 Budget. The House of Representatives passed the *Financial Services and General Government Appropriations Act*, H.R. 3351, on June 26 and allotted $12 billion to the IRS. The level of funding in the bill surpassed the President's request by $166 million and the 2019 fiscal year budget by $697.4 million. The bill would increase funds for Taxpayer Services, Enforcement, Operations Support, and Business Systems Modernization. However, the Senate has yet to indicate when it plans on visiting this legislation and the President has threatened a veto because the bill increases the national deficit.

Proposed PFIC Regulations. On July 10, the IRS issued proposed regulations affecting Passive Foreign Investment Companies (PFICs) under Internal Revenue Code Sections 1291, 1297, and 1298. The regulations aim to determine ownership using an income and assets test and provide guidance on corporate attribution.

STATE TAX NEWS

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

and

*Marissa Wolfsheimer, Intern**

CDTFA Tax Relief for July Earthquakes. The California Department of Tax and Fee Administration (CDTFA) is now offering relief to the counties of Kern and San Bernardino in light of the recent earthquakes that have affected business owners and feepayers. Tax relief, including extensions of filing and payment deadlines, is also included for counties affected by a winter storm in February and wildfires in November. Affected Californians can file for relief from interest and penalties online at the Relief Request website.

California Conformity to Tax Cuts and Jobs Act Legislation. On July 1, Governor Newsom signed AB 71, in which California conforms to several federal tax provisions enacted in 2017 under the Tax Cuts and Jobs Act. In addition to the expansion of the Earned Income Tax Credit and the creation of a refundable young child tax credit, California now conforms to partnership rules regarding technical terminations, Section 1031 like-kind exchanges, small business accounting method reforms, and net operating loss carrybacks.

CA Individual Mandate to Carry Health Insurance. Governor Newsom signed SB 78 on June 27, requiring most Californians to carry health insurance for themselves and their dependents beginning January 2020. The bill was modeled after the Affordable Care Act and Tax Cuts and Jobs Act amendments, even though the Affordable Care Act is currently under review in federal courts. Those not in

compliance will be subject to tax penalties. Insurance coverage must be reported by employers to the Franchise Tax Board by March 31 and employers will be subject to penalties for failure to report, though there are no employer penalties for failure to provide insurance. Tax exempt subsidies are available for low income taxpayers.

CA Bill Requires Presidential Candidates to Release Tax Returns. In July, the state Senate and Assembly both passed SB 27, the *Presidential Tax Transparency & Accountability Act,* which would require all candidates for President of the United States or Governor of the State of California to release to the California Secretary of State their last five years of income tax returns in order to be listed on the California ballot. Returns must be provided at least 98 days prior to the primary. Candidates may redact sensitive information such as social security numbers, the names of dependents, medical information, addresses, and telephone numbers. The bill has been presented to the Governor for signature.

Post-*Wayfair* Clarifications. Governor Newsom signed SB 92 on June 27, which clarifies that entities which merely advertise the sale of tangible personal property in California are not considered to be facilitating a sale under new nexus provisions. The CDTFA issued a new form, CDTFA-38-A, allowing "marketplace facilitators" to indicate their exemption under SB 92. Additionally, SB 92 provides sales and use tax exemptions for diapers and feminine hygiene products beginning January 2020.

Short Term Rental Bill Delayed. Assemblywoman Tasha Boerner Horvath, D-Encinitas, the author of AB 1731, decided to delay votes on the bill until next year. The bill would have disallowed short-term rentals of residential property for more than 30 days a year unless the owner lives on the property. Originally the bill was intended to apply to all California coastal cities, but later was directed specifically at San Diego. Proponents say the bill would allow for more rental and low-income housing to be available and point out that it only affects those with second homes. Opponents state that the regulations would reduce tourism and access to the beach while also discouraging investment in the city.

San Francisco Tax on CEO Wages. A proposal by San Francisco Supervisors titled the Mental Health Gross Receipts Tax will likely be a ballot measure in November. The bill proposes a 0.1% surcharge for each CEO doing business in the city of San Francisco who makes 100 times more than the median wage of his or her company's workers. The surcharge would increase accordingly to 0.2% should the CEO make 200% more than the median wage, increasing ratably up to 600%. Upon voter approval, the taxes collected from the proposal would fund "Mental Health SF," a program for accessible mental health and substance abuse treatment, which treatment currently costs the city over $70 million annually. If passed, the tax is expected to raise approximately $100 million annually.

**Marissa Wolfsheimer is interning with our office this summer. She just finished the second year of her undergraduate studies at UCLA and plans to major in political science.*

Disclaimer: This newsletter is provided to share knowledge and expertise with our colleagues with the goal that all may benefit. The content of this newsletter is for general information purposes only.

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DeEtte L. Loeffler, Esq.
Newsletter Editor

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