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2017 Tax Cuts and Jobs Act

The most significant changes in tax law—since the 1986 tax reform—were enacted in December 2017. The following charts detail the provisions most relevant to high income and high-net-worth taxpayers.

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Significant provisions of the Act

Most of the provisions of the Act are effective for tax years beginning after 2017, with many of the individual income tax provisions expiring after 2025.

Individual Income Tax highlights

- The Act replaces the current seven individual tax brackets with rates ranging from 10% to 37%.
- The Act nearly doubles the standard deduction for taxpayers and eliminates personal exemptions.
- Itemized deductions are mainly limited to home mortgage interest; state and local income, sales, and property taxes; and charitable contributions.
  - The Act limits the deductions for state and local income, sales, and property taxes to $10,000.
  - The Act retains the home mortgage interest deduction for new mortgages for principal and second residences, but limits the interest deduction to a $750,000 mortgage. The deduction for home equity interest is eliminated.
  - The Act slightly increases the allowable deduction for cash contributions to public charities and otherwise retains the current charitable contribution deduction rules.
- For divorce decrees and separation agreements entered into after 2018, alimony would no longer be deductible by the payor and would not be taxable to the payee.
- The Act retains the individual alternative minimum tax (AMT) with increased exemption amounts.
- The Act contains many other provisions that affect numerous other deductions and credits for individuals.
- The Act repeals the individual mandate of the Affordable Care Act.
- The Act changes the method for calculating inflation indices so amounts indexed for inflation will grow more slowly.

Wealth Transfer Tax highlights

- The Act retains the estate, gift, and generation-skipping transfer (GST) tax and doubles the exemptions for the period 2018-2025.
- Heirs will continue to have a fair market value basis in inherited assets, and the gift tax remains in place.
- Portability of a deceased spouse's unused exemption is retained.

Corporate and Business Tax highlights

- The Act reduces the corporate tax rate to a flat rate of 21%.
- The Act provides a deduction of 20% of qualified business income from a partnership, S-Corporation, or sole proprietorship, which results in an effective top rate of 29.6%, subject to a phase-out.
- The Act allows a 100% first-year expensing of certain depreciable assets for assets placed in service by September 27, 2017, along with a limitation of interest expense deductions.
- The Act increases Section 179 expensing limits.
- The Act repeals the corporate AMT.
- The Act limits net operating loss deductions.
- The Act imposes a one-time repatriation tax of 15.5% on earnings and profits (liquid) and 8% on illiquid.
- The Act moves to a territorial tax system for the taxation of income.

Provisions with no changes

- No change made to the specific identification method for sale of stock (or donative transfers to family or charity), so transfers of stock are not required to be made on a first-in, first-out (FIFO) basis.
- The contribution limits for IRAs and 401(k) plans are unchanged.
- The Act does not change the capital gains tax, net investment income tax, or the Medicare surtax.

Strategic wealth planning under the new tax law

The Act is voluminous and complex, and attorneys, accountants, financial advisors, and taxpayers will be grappling with its impact for many months. But we do see some emerging themes and opportunities to consider in 2018.

Estate Tax Planning

For individuals with assets greater than the 2017 exemption amount ($5,490,000), the Act now creates an opportunity to shelter almost double that amount from the federal estate, gift, and GST taxes.

- For individuals who have already created an irrevocable trust, using the exemption can be as easy as adding to the existing trust.
- The additional exemption can be used to add to or create a variety of trusts, including long-term dynasty trusts, spousal lifetime access trusts, and life insurance trusts.
- In some cases the exemption can be used to fund a Delaware self-settled domestic asset protection trust.
- The Act particularly encourages lifetime gifts, as a way to take advantage of the increased exemption, as the increased exemption is scheduled under the Act to expire after 2025. In 2026, the exemption will drop to $5,490,000, as adjusted for inflation.
- The use of the additional exemption amount can be leveraged through techniques, such as sales to intentionally defective grantor trusts, taking advantage of the current low interest rate environment.
- Lifetime gifts that use the exemption amount can be made without any federal transfer tax cost, and they also have the advantage that future appreciation of the assets is also outside the taxable estate.

Income Tax Planning with Trusts

Although the Act lowered income tax rates, it also eliminated or limited many deductions, including the state and local income and property tax deduction (SALT). As taxpayers become more sensitive to the costs of state and local taxes (now limited to a $10,000 deduction), there may be some income tax planning opportunities.

- A Delaware Incomplete Non-Grantor Trust (“DING Trust”) can be an attractive vehicle to minimize state tax earned by the trust. The DING Trust provides for the taxation of some interest, dividends, and capital gains to be taxed in another jurisdiction that has no state income tax on trust assets. Delaware does not tax this type of income that is held in a DING Trust if the beneficiaries are not residents of Delaware. The creation and funding of the DING can be accomplished without using any of the gift tax exemption.
- Take a look at existing grantor trusts that were created so that the creator of the trust is taxed on the income of the trust. One way to reduce state income taxes is to “turn off” the grantor trust feature of a grantor trust. By removing this feature from an existing trust so that it becomes a non-grantor trust, the trust becomes its own taxpayer. With the new higher estate tax exemptions, some of the pressure on estate tax minimization may be relieved. If the trust is administered in a tax-friendly state such as Delaware, it may be possible to turn off payment of state taxes on the trust's income.
- Irrevocable trusts can be specifically drafted to grant an individual the power to swap assets of the trust with assets that the Grantor holds individually. Low cost basis trust assets can be substituted for high cost basis assets held by the Grantor individually. The low cost basis assets now held by the Grantor would be eligible for a step up in basis upon the Grantor's death.

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Strategic wealth planning under the new tax law continued

- With the reduction of the corporate tax rate and the enactment of a new deduction for pass-through entities, business owners should reexamine whether it is more beneficial to operate a C corporation than a pass-through entity. Owners should revisit their operating structures and, if appropriate, change their type of entity. They should also consider taking advantage of the increased gifting exemption to move assets into trust.
- Another way to reduce state income taxes would be to establish residency in a state that does not have a state income tax. This might be available to taxpayers who already spend a significant amount of time in a non-tax state such as Florida.

Charitable Planning

Although the Act eliminated or dramatically reduced most itemized deductions, it retained the charitable contribution deduction. The deduction for cash contributions to public charities was even enhanced, permitting cash contributions up to 60% of adjusted gross income, rather than 50% under prior law. However, for many donors the tax advantages of charitable giving will be impacted by rate reductions and other changes. As a consequence of the increased standard deduction and the elimination of many itemized deductions, many donors will no longer be able to itemize deductions, losing many (but not all) of the tax incentives for charitable giving. But for those donors who can still itemize, itemized deductions are no longer subject to the itemized deduction phase-out. And for very high-net-worth donors who are still subject to the federal or state estate tax, the charitable deductions from estate, gift, and generation-skipping transfer tax still apply.

For donors who still itemize

- Lifetime charitable gifts made outright to public charities, private foundations, and donor advised funds can provide both income and estate tax advantages.
- Gifts can also be structured to benefit both family and charity through charitable remainder and lead trusts, and for smaller gifts, charitable gift annuities.
- Gifts can be made even more tax efficient by donating appreciated property such as publicly traded stock, and in some cases, closely held businesses and collectibles.

For donors who can no longer itemize

- A donor over age 70½ can take advantage of the special rule permitting up to $100,000 of IRA distributions directly to a qualified charity. This has the same impact as a charitable deduction, because the amount of the IRA distribution to charity is not included in income.
- While not generating a deduction for non-itemizers, gifts of appreciated property still save the capital gains taxes that would have been due if the asset were sold. For low basis assets, that can still provide significant tax savings.
- Some donors will be able to bunch their deductions, making larger deductible gifts every few years, possibly into a donor advised fund.

Federal Income Tax—Individuals

	Law in 2017	Tax Cuts and Jobs Act *
Rates on ordinary income	Seven brackets: 10%, 15%, 25%, 28%, 33%, 35%, and 39.6% for income above $418,400 (single); $444,550 (head of household); $470,700 (married); $235,350 (married filing separate); Indexed for inflation	Seven brackets:10%, 12%, 22%, 24%, 32%, 35%, and 37% for income above $500,000 (single); $500,000 (head of household); $600,000 (married); $300,000 (married filing separate); Indexed for inflation after 2018 Reverts to current law after 2025
Standard deduction	$6,350 (single and married filing separately); $9,350 (head of household); $12,700 (married); Indexed for inflation Additional standard deduction for elderly and the blind	$12,000 (single and all other taxpayers); $18,000 (head of household); $24,000 (married); Indexed for inflation after 2018 Reverts to current law after 2025 Retains current additional standard deduction for elderly and the blind
Itemized deductions and personal exemption	• State and local property taxes fully deductible; state and local income tax or sales tax fully deductible • Home mortgage interest deduction for up to two residences, $1,000,000 debt limit; $100,000 debt limit for home equity • Charitable contribution deductions for cash gifts to public charities up to 50% of AGI • Allows medical expense deduction for expenses in excess of 10% of AGI • Allows student loan interest deduction • Personal exemption $4,050/person • Itemized deductions phase-out for adjusted gross income (AGI) over $261,500 (single); $313,800 (married)	• Limits combined deductions for state and local income, sales and property taxes to $10,000 • Limits home mortgage interest deduction for new purchases from 2018-2025 to $750,000 of indebtedness for first and second residences; repeals deduction for home equity interest • Increases charitable contribution deduction for cash gifts to public charities to 60% of AGI • Retains medical expense deduction for expenses in excess of 7.5% of AGI for 2017 and 2018 • Eliminates miscellaneous itemized deductions subject to 2% floor • Retains investment interest deduction • Eliminates personal casualty loss except for disasters • Eliminates tax preparation expense • Eliminates investment fees and expenses • Retains student loan interest deduction • Eliminates personal exemption • Eliminates the itemized deduction phase-out Reverts to current law after 2025

* Most provisions are effective for tax years beginning after 2017.

Federal Income Tax—Individuals continued

	Law in 2017	Tax Cuts and Jobs Act *
Alternative minimum tax (AMT)	26% and 28% rates, with exemption amount of $54,300 (single); $84,500 (married); $42,250 (married filing separately); $24,100 (Trusts); Indexed for inflation	Increases exemption amount to $70,300 (single); $109,400 (married); $54,700 (married filing separately) Exemption phases out at $1,000,000 (married); $500,000 (all others) Indexed for inflation after 2018 Reverts to current law after 2025
Trust income tax	15%, 25%, 28%, 33%, and 39.6% for estate or trust income over $12,500	10%, 24%, 35%, and 37% for estate or trust income over $12,500
Like-kind exchanges	Tax-deferred exchanges of like-kind property permitted for real property and tangible personal property held for use in a trade or business or investment	Tax-deferred exchanges of like-kind property limited to real property not held primarily for sale
Alimony deduction	Above-the-line deduction for payor; included in the recipient's income	Eliminates deduction for payor; not treated as taxable income to recipient; applies to divorce and separation agreements after 2018
Section 529 Plans	Allows 529 Plans for higher education; allows Coverdell savings accounts	Permits distributions of $10,000 per year for elementary and secondary schools Allows rollover to ABLE accounts
Affordable Care Act – individual mandate	2.5% of AGI up to $2,085 maximum	Eliminates after 2018

* Most provisions are effective for tax years beginning after 2017.

Federal Income Tax—Individuals continued

	Law in 2017	Tax Cuts and Jobs Act *
Accounting methods for sale and other transfers of stocks	Specific identification method allowed in computing capital gains on sale or transfer of part of a stock holding	No change
Retirement accounts – 401(k)	No limit on lifetime contributions; $18,000 maximum annual contribution; over age 50 may make annual catch up contribution of $6,000, as indexed for inflation	No change
Gain on sale of principal residence	May exclude gain on the sale of principal residence up to $500,000 (married); may be used every 2 years; must be principal residence for 2 of the 5 previous years	No change
Rates on capital gains / dividends	Top rate of 20% 1-year holding period	No change
Surtax on net investment income	3.8%, above $200,000 AGI (single); $250,000 (married); Trusts with income over $12,500	No change

* Most provisions are effective for tax years beginning after 2017.

Federal Transfer Taxes

	Law in 2017	Tax Cuts and Jobs Act *
Estate tax rate and exemption	Top tax rate of 40% $5,490,000, as adjusted for inflation	Retains estate tax Increases exemption to $10,000,000, indexed for inflation after 2011, approximately $11,200,000 for 2018 Reverts to current law after 2025
Lifetime gift tax rate and exemption	Top tax rate of 40% $5,490,000, as adjusted for inflation	Retains gift tax Increases exemption to $10,000,000, indexed for inflation after 2011 Reverts to current law after 2025
Generation-skipping transfer tax rate and exemption	Flat rate of 40% $5,490,000, as adjusted for inflation	Retains generation-skipping transfer tax Increases exemption to $10,000,000, indexed for inflation after 2011 Reverts to current law after 2025
Portability of estate and gift tax exemption	Unused exemption of deceased spouse available (with limitations)	No change
Basis of inherited assets	Stepped up to fair market value at death	No change
Gift tax annual exclusion	$14,000 per donee as indexed for inflation	No change in law $15,000 per donee for 2018 as indexed for inflation

* Most provisions are effective for tax years beginning after 2017.

Federal Income Tax—Business

	Law in 2017	Tax Cuts and Jobs Act *
Corporate income tax	Top rate of 35% Flat 35% rate for personal service corporations	Top rate of 21% beginning after 2017 Eliminates the special rate for personal service corporations
Pass-through business income from small businesses (such as Sole Proprietorships, Partnerships, LLCs, and S-Corporations)	Top rate of 39.6%	Allows a deduction equal to 20% of qualified business income which results in an effective top tax rate of 29.6%, with trusts and estates eligible for the 20% deduction Deduction limits based on specific service income and on W-2 wages and capital, phased in at $315,000 (married) Reverts to current law after 2025
Taxation of carried interests	Taxed as capitals gains; requires one-year holding for capital gain treatment	Requires three-year holding period for capital gain treatment
International tax	Worldwide tax system	Territorial tax system implemented through 100% exemption for certain foreign source dividends One-time tax on liquid (15.5%) and illiquid (8%) earnings and profits Tax imposed on base erosion payments

* Most provisions are effective for tax years beginning after 2017.

Federal Income Tax—Business continued

	Law in 2017	Tax Cuts and Jobs Act *
Business interest expense	Allowed as a deduction, subject to a number of limitations	Restricts to 30% of adjusted taxable income, business income interest, and floor plan financing interest Businesses with average annual revenue of $25,000,000 or less exempt from limit
Depreciation and expensing	May take additional depreciation in the year property is placed into service; 50% of the cost of qualified property in 2017	Immediately expense 100% of the cost of qualified property acquired after 9/27/2017 Bonus depreciation rates phase-out after 1/1/2023 by 20% per year
Corporate AMT	20% on income greater than the $40,000 exemption; exemption phase-out starting at income greater than $150,000 Corporations with average gross receipts of less than $7.5 million for the preceding three tax years are exempt	Eliminates
Net operating loss deduction	Deduction for losses in excess of income; may carry back two years and carry forward 20 years (with exceptions)	Limited to 80% of taxable income
Section 179	Allows immediate expense of $500,000; reduced for amounts in excess of $2,000,000	Allows immediate expense of $1,000,000; reduced for amounts in excess of $2,500,000

* Most provisions are effective for tax years beginning after 2017.

Federal Income Tax—Charitable

	Law in 2017	Tax Cuts and Jobs Act *
Deduction for cash gifts to public charities	Charitable contribution deduction for cash gifts to public charities up to 50% of AGI	Charitable contribution deduction for cash gifts to public charities increased to 60% AGI Reverts to current law after 2025
Private Foundations – excise tax on net investment income	2% excise tax on net investment income, which is reduced to 1% for years in which foundation distributions exceed historic level	No change
Private Foundations – excess business holding rules on business ownership	Private foundations are subject to an excise tax on ownership of more than 20% (35% if no control) of the voting stock, profits interest, or beneficial interest of a business enterprise	No change
Taxation of college and university endowments	Traditional endowment income such as interest, dividends, capital gains, rents, royalties, and annuities, exempt from tax	1.4% excise tax on net investment income of private colleges and universities meeting an assets and student tuition test

Sources: House of Representatives Committee on Ways and Means, H.R. 1 Tax Cuts and Jobs Act, Conference Report, December 15, 2017. Joint Explanatory Statement of the Committee of Conference, December 15, 2017.

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THE USE OF ASSET PROTECTION TRUSTS FOR TAX PLANNING PURPOSES

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I. Creating a Delaware Asset Protection Trust.

What follows is a summary of the relevant issues to consider when drafting a Delaware asset protection trust under the Delaware Qualified Dispositions in Trust Act, 12 Del. C. § 3570, et. seq., (the "Act"). Included are the requirements for creating a trust (a Delaware asset protection Trust) under the Act, prohibited powers which the grantor may not retain under the Act, permissible powers which the grantor may retain under the Act and who may defeat a Delaware asset protection trust.

A. Requirements To Create A Delaware Asset Protection Trust.

There are six requirements to create a Delaware asset protection trust under the Act. These requirements are as follows:

1. A disposition by a transferor by means of a trust instrument. 12 Del. C. § 3570(7).

2. The trust instrument must appoint a qualified trustee within the meaning of 12 Del. C. § 3570(8). 12 Del. C. § 3570(11).

3. The qualified trustee must maintain or arrange for custody in Delaware of at least some of the trust assets, maintain records for the trust on an exclusive or non-exclusive basis, prepare or arrange for the preparation of fiduciary income tax returns for the trust or otherwise materially participate in the administration of the trust. 12 Del. C. § 3570(8)b.

4. The trust must provide that Delaware law governs the validity, construction and administration of the trust. 12 Del. C. § 3570(11)a.

5. The trust must be irrevocable. 12 Del. C. § 3570(11)b.

6. The trust must contain a spend-thrift clause which should make reference to the Bankruptcy Code. 12 Del. C. § 3570(11)c.

B. Prohibited Grantor Powers.

There are several powers that are impermissible for the grantor to retain under the Act. These powers include:

1. The grantor may not serve as trustee of the trust. 12 Del. C. § 3570(8)a. & (8)c.

2. The grantor may not serve in an advisory position (including as a trust protector or distribution adviser) provided the grantor may serve as investment adviser for the trust. 12 Del. C. § 3570(8)d. & 12 Del. C. § 3571.

3. The grantor may not retain the power to direct distributions from the trust. 12 Del. C. § 3570(8)d. & 12 Del. C. § 3571.

4. The grantor may not demand a return of assets transferred to the trust. 12 Del. C. § 3571.

C. Permissible Powers Retained by Grantor.

1. The grantor may serve as investment adviser for the trust and as such retain the right to consent to or direct investment decisions. 12 Del. C. § 3570(8)d.

2. The grantor may retain the power to veto distributions of income or principal from the trust. 12 Del. C. § 3570(11)b.1.

3. The grantor may appoint advisers who have authority to remove and appoint qualified trustees or trust advisers, advisers who have authority to direct, consent to or disapprove distributions from the trust and advisers described in 12 Del. C. § 3313. 12 Del. C. § 3570(8)c.

4. The grantor may retain the power to remove and replace trustees or trust advisers. 12 Del. C. § 3570(11)b.7.

5. The grantor may retain a limited lifetime or testamentary power of appointment. 12 Del. C. § 3570(11)b.2.

6. The grantor may retain the ability to receive income or principal pursuant to broad discretion or a standard as determined by Delaware trustees, non-Delaware trustees and/or advisers. 12 Del. C. § 3570(11)b.6.

7. The grantor may retain the right to receive mandatory income distributions. 12 Del. C. § 3570(11)b.3.

8. The grantor may retain an interest in a CRT or a QPRT. 12 Del. C. § 3570(11)b.4.

9. The grantor may receive up to a 5% interest in GRAT, GRUT or total-return uni-trust. 12 Del. C. § 3570(11)b.5.

10. The grantor may retain the potential or actual use of real property held under a qualified personal residence trust or the possession and enjoyment of a qualified annuity interest within the meaning of Treasury Regulations § 25.2702-5(c)(8). 12 Del. C. § 3570(11)b.8.

11. The grantor may retain the right to receive income or principal from the trust to pay income taxes due on the income of the trust provided that the trust instrument expressly provides for the payment of such taxes and the potential or actual receipt of income or principal would be at the trustee's discretion, or pursuant to a mandatory direction in the trust instrument, or the discretion of an adviser. 12 Del. C. § 3570(11)b.9.

12. The grantor may retain the right to receive income or principal from the trust to pay, after the death of the grantor, all or any part of the debts of the grantor outstanding at the time of the grantor's death, the expenses of administering the grantor's estate, or any estate or inheritance tax imposed on or with respect to the grantor's estate. 12 Del. C. § 3570(11)b.10.

D. Who May Defeat An Asset Protection Trust?

There are four categories of creditors who may defeat a Delaware asset protection trust and as such reach the trust assets to satisfy a judgment. The Act requires that any action involving a Delaware asset protection trust be brought in the Delaware Court of Chancery. 12 Del. C. § 3572(a). The following four categories of creditors may defeat a Delaware asset protection trust:

1. A creditor whose claim arose before the creation of the trust provided the claim is brought within four years after the creation of the trust or, if later, within one year after the creditor discovered (or should have discovered) the trust and the claim is proven, by clear and convincing evidence, that the creation of the trust was a fraudulent transfer. 12 Del. C. § 3572(b)(1).

2. A creditor whose claim arose after the creation of the trust provided the claim is brought within four years after the creation of the trust and the creditor proves, by clear and convincing evidence, that the creation of the trust was a fraudulent transfer. 12 Del. C. § 3572(b)(2).

3. A person whose claim results on account of an agreement or court order for the payment of support or alimony for the grantor's spouse, former spouse or children, or for a division or distribution of property in favor of the grantor's spouse or former spouse. 12 Del. C. § 3573(1). Only a spouse who is married to the grantor before the trust was created may avail himself or herself of such right. 12 Del. C. § 3570(9).

4. A person who suffers death, personal injury or property damage on or before the date the trust was created for which the grantor is liable. 12 Del. C. § 3573(2).

II. Completed Gift Asset Protection Trusts.

On December 22, 2017, President Trump signed the Tax Cuts and Jobs Act of 2017 (the "2017 Act"). The 2017 Act increased the exemptions for federal estate tax, gift tax and generation skipping tax (GST) to approximately $11,200,000 per person. The exemptions are indexed for inflation. The tax rates on estates, gifts and GST transfers above the exemption is forty percent (40%).

As a result of the 2017 Act, clients are presented with an estate planning opportunity to transfer significant amounts of wealth out of their estate without the imposition of transfer taxes. However, even the wealthiest clients are often concerned with giving such large amounts of money away based on the fear that they may need to access the assets in the future.

One option that clients may have is to create a trust in a jurisdiction such as Delaware which allows for self-settled asset protection trusts. A client can make a transfer to a trust established in such a jurisdiction, to which the client allocates gift tax exemption, that provides that the trustee may distribute income and principal from the trust to a class of beneficiaries, that includes the client, in the sole and absolute discretion of the trustee. The client can also allocate GST exemption to the trust which would allow the trust to continue in perpetuity if established in a jurisdiction such as Delaware which has abolished the rule against perpetuities. See 25 Del. C. § 503. What follows is a summary of the relevant issues to consider when creating a completed gift asset protection trust.

A. Grantor's Retention of Control.

The first issue to address is whether the transfer of assets to the trust constitutes a completed gift for federal gift tax purposes.

1. **Is the Transfer to the Trust a Completed Gift?**

    (a) A transfer is incomplete for federal gift tax purposes if the grantor retains sufficient dominion and control over the property. Treas. Reg. § 25.2511-2(b).

    (b) If an individual creates a self-settled trust in a jurisdiction where his or her creditors may attach the assets, the grantor has retained sufficient dominion and control over the assets because under local law the grantor is able to relegate his or her creditors to the assets of the trust. See Rev. Rul. 76-103; Rev. Rul. 77-378; and Paolozzi v. Commissioner, 23, T.C. 102 (1954). As such, the trust must be established in a jurisdiction that allows for self-settled asset protection trusts thereby preventing the grantor from being able to relegate his or her creditors to the assets of the trust.

    (c) Revenue Ruling 76-103.

        (i) In Revenue Ruling 76-103, the grantor created an irrevocable trust which provided that during the grantor's lifetime the trustee could distribute income and principal of the trust in its sole and absolute discretion to the grantor. The trust further provided that upon the death of the grantor, the remaining principal of the trust was to be distributed to the grantor's issue. The trust was determined to be a discretionary trust under the laws of the state in which the trust was created and the entire property of the trust was subject to the claims of the grantor's creditors.

(ii) Revenue Ruling 76-103 concluded that as long as the trustee continues to administer the trust under the laws of the state subjecting the trust assets to the claims of creditors, the grantor retained dominion and control over the trust property. As such the grantor's transfer of the property to the trust does not constitute a completed gift for federal gift tax purposes.

(iii) Revenue Ruling 76-103 also concluded that if the grantor were to die before the gift becoming complete, the date of death value of the trust property would be includible in the grantor's gross estate for federal estate tax purposes under Section 2038 because of the grantor's retained power to, in effect, terminate the trust by relegating the grantor's creditors to the entire property of the trust.

(d) Revenue Ruling 77-378.

(i) In Revenue Ruling 77-378, the grantor created an irrevocable trust which provided that the trustee was empowered to pay to the grantor such amounts of the trust's income and principal as the trustee determines in its sole and absolute discretion. Under the applicable state law, the trustee's decision whether to distribute trust assets to the grantor was entirely voluntary. Furthermore, the grantor was prohibited from requiring that any of the trust assets be distributed to the grantor nor could the creditors of the grantor reach any of the trust assets.

(ii) Revenue Ruling 77-378 concluded that the grantor had parted with dominion and control over the property that the grantor transferred into the trust. Although the trustee had an unrestricted power to pay trust assets to the grantor, the grantor could not require that any of the trust assets be distributed to the grantor nor could the grantor utilize the assets by going into debt and relegating the grantor's creditors to the trust. Revenue Ruling 77-378 therefore concluded that the grantor's transfer to the trust was a completed gift for federal gift tax purposes.

2. **Sections 2036(a)(2) and Section 2038.**

Another concern relates to whether the trust assets will be includible in the grantor's estate under Sections 2036(a)(2) and Section 2038 of the IRC because of the grantor's retained power to terminate the trust by relegating the grantor's creditors to the entire property of the trust.

(a) Section 2036(a)(2) of the IRC provides that a decedent's gross estate includes property transferred in trust other than for full and adequate consideration if the decedent retained the right to designate the persons who shall possess or enjoy the property or income therefrom. IRC § 2036(a)(2).

(b) Section 2038 of the IRC provides that a decedent's gross estate includes property transferred in trust other than for full and adequate consideration if the decedent retained the right to alter, amend or revoke the trust. IRC § 2038.

(c) Both Sections 2038(a) and 2036(a)(2) have been used to cause a self-settled trust whose assets are subject to the claims of the grantor's creditors to be included in the grantor's estate. See Rev. Rul. 76-103; Estate of Paxton, 68 TC 785 (1986).

B. Grantor's Retained Beneficial Interest.

Another issue to address is whether the grantor's mere retention of a discretionary beneficial interest in the trust will cause the assets to be included in the grantor's gross estate under Section 2036(a)(1) of the IRC.

1. **Section 2036(a)(1).**

(a) Section 2036(a)(1) of the Internal Revenue Code provides that a decedent's gross estate shall include property transferred in trust other than for full and adequate consideration if the decedent retained the right to income from the property. IRC § 2036(a)(1).

(b) The use, possession, right to income or other enjoyment of the transferred property is considered as being retained by the decedent to the extent the use, possession, right to the income, or other enjoyment is to be applied toward the discharge of a legal obligation of the decedent. Treas. Reg. § 20.2036-1(b)(2).

(c) The right to the income need not be express but may be implied. Treas. Reg. § 20.2036-1(1)(i).

2. **Revenue Ruling 2004-64 (the "2004 Ruling").**

(a) The 2004 Ruling held that the grantor of a trust, which is taxed as a grantor trust for income tax purposes, is not treated as making an additional taxable gift to the trust by virtue of paying the trust's income tax liability.

(b) The 2004 Ruling also addressed the estate tax consequences if, pursuant to the governing instrument or applicable local law, the grantor of the trust may or must be reimbursed by the trust for the income tax.

(c) The 2004 Ruling held that assuming there is no understanding, expressed or implied, between the grantor and the trustee regarding the trustee's exercise of its discretion to reimburse the grantor for the income tax liability, the trustee's discretion to satisfy such obligation will not alone cause inclusion of the trust assets in the grantor's gross estate for federal estate tax purposes.

(d) However, the 2004 Ruling specifically states that the trustee's discretion to reimburse the grantor for the income tax liability combined with other factors including, but not limited to: (i) an understanding or preexisting arrangement between the grantor and the trustee regarding the trustee's exercise of its discretion; (ii) a power retained by the grantor to remove the trustee and name a successor trustee; or (iii) applicable local law subjecting the trust assets to the claims of the grantor's creditors may cause inclusion of the trust assets in the grantor's gross estate for federal estate tax purposes.

(e) The 2004 Ruling seems to address the concern raised in the completed gift asset protection trust context regarding whether the grantor's mere retention of a discretionary beneficial interest is sufficient to cause inclusion of the trust assets in the grantor's estate under Section 2036(a)(1) of the IRC. Following the rationale contained in the 2004 Ruling, the trustee's mere ability to distribute assets to the grantor should not alone cause inclusion of the assets in the grantor's gross estate for federal estate tax purposes.

C. The Private Letter Rulings.

Two Private Letter Rulings have been issued addressing the transfer tax consequences associated with self-settled asset protection trusts. See PLR 9837007 and PLR 200944002. Both Private Letter Rulings involved the use of Alaska trusts established by Alaska residents.

1. **PLR 9837007 (the "1998 PLR").**

(a) In the 1998 PLR the grantor created a trust for the benefit of herself and her descendants. The trustee could, but was not required to, distribute income and/or principal from the trust to any of the beneficiaries.

(b) The 1998 PLR concluded that the transfer to the trust would be a completed gift for federal gift tax purposes because a creditor of the grantor would be precluded from satisfying claims out of the grantor's interest in the trust. However, it expressly did not rule on whether the assets would be included in the grantor's estate for federal estate tax purposes.

2. **PLR 200944002 (the "2009 PLR").**

(a) In the 2009 PLR the grantor created a trust for the benefit of himself, his spouse and descendants. Distributions of income and principal could be made to the beneficiaries of the trust in the sole and absolute discretion of the trustee.

(b) The 2009 PLR again concluded that the transfer to the trust was a completed gift for federal gift tax purposes. However, the 2009 PLR also concluded that the trustee's discretionary authority to distribute income and/or principal to the grantor does not by itself cause the trust to be includable in the grantor's estate for federal estate tax purposes under Section 2036(a)(1) of the IRC.

(c) The analysis contained in the 2009 PLR is based primarily on the 2004 Ruling. Both the 2004 Ruling and the 2009 PLR conclude that the assets will not be included in the grantor's estate under Section 2036(a)(1) under the theory that the trustee's discretionary authority to distribute assets to the grantor will not by itself result in estate tax inclusion. However, neither the 2004 Ruling nor the 2009 PLR address whether Sections 2036(a)(2) or 2038 will cause inclusion in the grantor's estate under the theory that the grantor could terminate the trust by relegating the grantor's creditors to the entire property of the trust. For the reasons discussed in Section II Paragraph A of this outline, Sections 2036(a)(2) and 2038 should not cause the assets to be included in the grantor's estate as long as the trust is created in a jurisdiction allowing for self-settled asset protection trusts as the grantor will be prohibited from relegating his or her creditors to the assets of the trust.

D. Creditor Exceptions.

1. All states that have self-settled trust legislation, other than Alaska or Nevada, allow certain creditors to access the trust. For example, the Delaware Qualified Dispositions in Trust Act allows for certain family claims, including child support and alimony, provided that with respect to an alimony claim the spouse must have been married to the grantor before the trust was created. 12 Del. C. §§ 3573(1) and 3570(9).

2. A question has arisen as to whether the mere fact that a family creditor could reach the trust assets is enough to cause the transfer to the trust from being an incomplete gift or otherwise cause the trust assets to be included in the grantor's gross estate under Sections 2036(a)(2) and 2038.

3. The reason for this concern stems from language contained in the 2004 Ruling. The 2004 Ruling expressly states that the trustee's discretion to distribute trust assets to a grantor to satisfy the grantor's income tax liability combined with other factors, such as applicable local law subjecting the trust assets to the claims of the grantor's creditors, may cause inclusion of the trust assets in the grantor's estate for federal estate tax purposes.

4. Proponents of Alaska and Nevada law have argued that the mere existence of the family claim exception contained in statutes of other jurisdictions, such as Delaware, would be enough to cause the assets to be includible in the grantor's estate under Sections 2036(a)(2) and 2038 and therefore a grantor should only establish a trust in Alaska or Nevada if the grantor desires for the trust assets to be excluded from his or her estate.

5. However, what is overlooked in this argument is the theory of acts of independent significance, which is discussed in the next section of this outline.

E. Acts of Independent Significance.

1. The theory of acts of independent significance is applied when determining whether the grantor retained a power which rises to the level of a power which will cause inclusion in the grantor's gross estate under Sections 2036(a)(2) or 2038 of the IRC or otherwise result in an incomplete gift. If the retained power allows the grantor the ability to act in such a way so as to affect the beneficial interest of the trust, but the possibility of such action occurring is so de minimis and speculative, the power will be found to be an act of independent significance. See Estate of Tully, 528 F.2d 1401 (1976); Ellis v. Commissioner, 51 T.C. 182 (1968), judgment aff'd, 437 F.2d 442; Rev. Rul. 80-25; and PLR 9141027.

2. Courts have ruled that the possibility of divorce is an act of independent significance. See Estate of Tully, 528 F.2d 1401; PLR 9141027.

   (a) Estate of Tully.

      (i) In the Estate of Tully case the Court addressed whether death benefits paid directly to the decedent's widow by his employer should be included in the decedent's estate under Section 2038.

      (ii) The decedent and his business partner entered into an agreement which provided that upon the decedent's death the company would pay the decedent's widow a death benefit equal in amount to twice the annual salary which the company had paid to the decedent for the year immediately preceding the date of his death.

      (iii) One of the arguments made by the Internal Revenue Service was that the decedent retained a Section 2038 power to revoke or terminate the transfer of the death benefits to his wife by virtue of the possibility that he could have divorced his wife prior to his death.

      (iv) The Court held that the possibility of divorce is so de minimis and so speculative rather than demonstrative, real, apparent and evident that it cannot rise to the level of a Section 2038power.

3. Courts have also determined that acts of independent significance include failure to support a spouse as well as the ability to have or adopt children. Ellis v. Commissioner, 51 T.C. 182 (1968), judgment aff'd, 437 F.2d 442; and Rev. Rul. 80-255.

   (a) Revenue Ruling 80-255.

      (i) In Revenue Ruling 80-255, the decedent created an irrevocable trust which provided that the income was to be paid in equal shares to the decedent's children and principal was to be distributed twenty-one (21) years after the creation of the trust in equal shares to the decedent's children, per stirpes. The trust instrument also provided that the decedent's children, born or adopted after the creation of the trust, were to be additional beneficiaries.

      (ii) The issue addressed in Revenue Ruling 80-255 was whether the decedent retained a power to change the beneficial interest of the trust for purposes of Sections 2036(a)(2) and 2038 of the IRC because the trust provided that children born or adopted after the creation of the trust were to become beneficiaries and the decedent had the ability to bear or adopt additional children.

      (iii) Revenue Ruling 80-255 determined that the act of bearing or adopting children is an act of independent significance. Revenue Ruling 80-255 held that although the decedent's act of bearing or adopting children will automatically result in adding the child as a beneficiary to the trust, such result is merely a collateral consequence of bearing or adopting children and is not equivalent to the decedent's retention of a power to designate or change beneficial interest within the meaning of Sections 2036(a)(2) and 2038 of the IRC.

F. Conclusion.

1. Completed gift asset protection trusts present a unique planning opportunity for clients who want to utilize the increase in gift tax and GST exemption to transfer assets out of their estate but are concerned with the possibility of needing access to the funds in the future.

2. It is extremely important that in establishing a completed gift asset protection trust there is no implied understanding between the grantor and the trustee regarding distribution from the trust to the grantor.

3. Notwithstanding the fact that all states, other than Alaska and Nevada, allow for certain creditors to access the trust, the theory of acts of independent significance should allow a grantor to establish a completed gift asset protection trust in any jurisdiction allowing for self-settled asset protection trusts and have the assets excluded from his or her estate.

4. It should also be possible to leverage the gift made to the trust by having the trustee purchase a life insurance policy on the life of the grantor with the proceeds gifted to the trust. This will essentially allow the grantor to still benefit from the cash value contained in the policy (at the discretion of the trustee) and have the death benefit excluded from the grantor's estate upon his or her death.

III. Incomplete Gift Non-Grantor Trusts.

It is possible for a grantor to establish a trust in a jurisdiction that allows for the creation of self-settled asset protection trusts, retain a beneficial interest in the trust and have the trust treated as a non-grantor trust for income tax purposes. Typically the grantor will also want the trust to be an incomplete gift for transfer tax purposes. In Delaware we refer to these trusts as DING trusts. The acronym stands for Delaware Incomplete Gift Non-Grantor trust.

A. Tax Structure of Trust.

1. Section 677(a)(3) of the IRC provides that the grantor shall be treated as the owner of a trust for income tax purposes if trust income, without the approval or consent of any adverse party, may be distributed to the grantor or the grantor's spouse. IRC § 677(a)(3). Therefore, in order for the trust to be a non-grantor trust for income tax purposes, the consent of an adverse party must be obtained prior to distributing assets to the grantor or the grantor's spouse.

2. The trust also must be created in a jurisdiction which allows for self-settled asset protection trusts because if creditors of the grantor can reach the trust assets the trust will be a grantor trust. Treas. Reg. § 1.677(a)-1(d).

3. The trust is structured as an incomplete gift for federal gift tax purposes through the grantor's retention of a lifetime limited power of appointment pursuant to which the grantor can appoint trust corpus to or for beneficiaries of the trust provided that the power is limited by a reasonably definitive standard (i.e. health, education, maintenance and support), a testamentary limited power of appointment over the trust and through the grantor's retention of a veto power whereby a distribution directed by any one member of the distribution committee (as explained in more detail below) must be approved by the grantor. Treas. Reg. § 25.2511-2(b).

B. The Private Letter Rulings.

1. Several Private Letter Rulings (the "PLRs") confirm that under Delaware law a grantor can create a non-grantor trust, fund the trust with contributions that are not considered taxable gifts for federal gift tax purposes and still retain the right to receive discretionary distributions of trust income and principal from the trust. See PLR 200715005; PLR 200647001; PLR 200637025; PLR 200612002; and PLR 200502014.

2. In the PLRs, the grantor created a discretionary trust for the benefit of the grantor and others (the "permissible beneficiaries"). A Delaware corporate trustee is appointed as sole trustee of the trust.

3. A committee (the "Distribution Committee") consisting of two to four of the permissible beneficiaries of the trust, has the power, by unanimous consent, to direct the trustee to distribute trust assets to or among the permissible beneficiaries. In addition, any one member of the Distribution Committee, with the consent of the grantor, may direct the trustee to make distributions. If a member of the Distribution Committee resigns or otherwise ceases to serve, a permissible beneficiary other than the grantor or the grantor's spouse is appointed as a successor Distribution Committee member.

4. The grantor retains a limited testamentary power of appointment over the trust assets to appoint the remaining trust assets to any person or organization other than the grantor, the grantor's estate, the grantor's creditors or the creditors of the grantor's estate.

5. The PLRs conclude that the grantor has not made a completed gift upon establishment of the trust due to the retention of the grantor's limited testamentary power of appointment over the trust assets. However, the grantor will be treated as making a taxable gift when a trust distribution is made to someone other than the grantor.

6. The PLRs also conclude that the Distribution Committee members have a substantial adverse interest to each other for purposes of Section 2514 of the IRC and therefore

do not possess general powers of appointment over the trust. See IRC § 2514(c)(3)(B).

C. IR-2007-127 (the "2007 Notice").

1. In 2007 the IRS issued a notice calling into question the gift tax consequences to the members of the Distribution Committee. See IR-2007-127.

2. The 2007 Notice stated that the conclusions reached in the PLRs with respect to the gift tax consequences of the Distribution Committee members may not be consistent with Revenue Ruling 76-503 and Revenue Ruling 77-158 (the "Revenue Rulings"). See Rev. Rul. 76-503 and Rev. Rul. 77-158.

D. The Revenue Rulings.

1. The Revenue Rulings have facts that are identical. In the Revenue Rulings, three siblings, A, B and C owning equal one-third interests in their family business contribute their respective interests in the business to an irrevocable trust for the benefit of their descendants. The trust permits the trustees to distribute trust property to whomever they select, including themselves, in such proportions and at such times as they see fit. Each trustee has the ability to designate one of the trustee's relatives to serve as successor trustee upon the trustee's death or resignation. In the event a trustee fails to designate a successor, the oldest adult living descendant of a deceased or resigned trustee is to occupy the vacant trustee position.

2. The decedent, D, was selected by A to be one of three original trustees and D served in that position until D's death.

3. The Revenue Rulings address whether any of the trust assets are includible in D's gross estate under Section 2041 of the IRC under the view that D had a general power of appointment over the trust assets held jointly with the other two co-trustees. The Revenue Rulings conclude that one-third (1/3) of the value of the trust as of the date of D's death is includible in D's gross estate under Section 2041 of the IRC as property subject to a general power of appointment. In reaching the conclusion the Revenue Rulings focused on the language of Section 2041 of the IRC. Section 2041(b) of the IRC sets forth the definition for a general power of appointment. Section 2041(b)(1)(C)(ii) of the IRC provides that a power that is not exercisable by the decedent except in conjunction with a person having a substantial adverse interest in the property subject to the power is not a general power of appointment. IRC § 2041(b)(1)(C)(2).

4. The Revenue Rulings determined that the Section 2041(b)(1)(C)(ii) safe harbor did not apply to D because the remaining co-trustees did not have a substantial adverse interest to D. The terms of the trust provide that upon D's death a successor trustee is to be appointed in D's place. The remaining co-trustees do not receive the entire

power of appointment upon D's death. Instead, the surviving co-trustees must continue to share the power with D's replacement. The Revenue Rulings determined that this does not put the surviving co-trustees in a better economic position after D's death and as such their interest is not substantially adverse to D.

5. In reaching this conclusion, the Revenue Rulings also focus on the regulations under Section 2041 of the IRC. See Treas. Reg. § 20.041-3(c)(2) and (3). The Revenue Rulings state that had the trust been drafted so that upon D's death the power of appointment would vest solely in the remaining co-trustees, the co-trustees' interests would be substantially adverse to that of D and D would not have a general power of appointment resulting in the inclusion of one-third (1/3) of the trust assets in D's estate under Section 2041 of the IRC.

E. Comparing the PLRs to the Revenue Rulings.

1. The PLRs are similar to the Revenue Rulings in that upon the resignation of any Distribution Committee member, a permissible beneficiary is to be appointed as a successor Distribution Committee member in place of the resigning Distribution Committee member. Therefore, the distribution power does not vest in the remaining Distribution Committee members but instead must be shared with a successor Distribution Committee member. This does not put the remaining Distribution Committee members in a better economic position after the resignation of a Distribution Committee member.

2. However, there is an important fact which distinguishes the PLRs from the Revenue Rulings. The PLRs conclude that the transfer to the trust by the grantor is an incomplete gift and that a distribution from the trust to any person other than the grantor would be a completed gift. In the Revenue Rulings, A, B and C irrevocably transferred their interests in the family business to the trust upon its creation at which time they made a taxable gift to the trust. Distributions from the trust to the beneficiaries would not be considered taxable gifts by A, B or C.

3. If the rationale of the Revenue Rulings were applied to the PLRs, distributions from the trust would constitute completed gifts by the Distribution Committee members. This would produce unprecedented gift tax results. For instance, a distribution from the trust to the grantor would constitute a taxable gift to the grantor of property which the grantor is already treated for federal transfer tax purposes as owning. Furthermore, a distribution to any other person besides the grantor would constitute a taxable gift of the same property to the same person at the same time by both the grantor and the Distribution Committee members.

F. Recent Rulings Affecting Use of DING Trusts

1. CCA 201208026 (the "CCA").

(a) In 2012 the IRS issued an opinion relating to the gift tax ramifications associated with a transfer of property into a trust where the grantor retains a testamentary limited power of appointment.

(b) In the trust at issue in the CCA, parents transferred property in trust with Child A as trustee. The trust beneficiaries were Child A, Child B, spouses and other lineal descendants. The parents reserved a testamentary limited power of appointment. The trust provided that if the limited power of appointment was not exercised, the trust would terminate at the death of the survivor of the parents and the remaining trust assets would be distributed to Child A and Child B. The trust provided that the trustee had the discretion to distribute trust assets to the beneficiaries for broad purposes.

(c) The IRS determined that the gift into the trust should be severed into two components, the term interest and the remainder interest. The IRS further determined that the term interest was not subject to change by the exercise of the parents' retained testamentary power of appointment and therefore the gift of the term interest constituted a completed gift.

(d) The IRS did rule that the gift of the remainder interest was an incomplete gift due to the retention of the testamentary limited power of appointment, but that the gift was valued at zero (0) under Chapter 14 of the IRC meaning that the value of the gift was the full fair market value of the property transferred into the trust.

2. PLR 201310002 (the "2013 PLR").

(a) In the 2013 PLR the grantor created a trust for the benefit of himself and his issue. During the grantor's lifetime, the trustee is required to distribute such amounts of the net income and principal to the grantor and his issue as directed by the Distribution Committee and/or the grantor, as follows:

(i) At any time, the trustee, pursuant to a direction of a majority of the Distribution Committee members, with the written consent of the grantor, is required to distribute to the beneficiaries such amount of the net income or principal as directed by the Distribution Committee ("Grantor's Consent Power");

(ii) At any time, the trustee, pursuant to the direction of all of the Distribution Committee members, is required to distribute to the beneficiaries such amount of the net income or principal of the trust as directed by the Distribution Committee; and

(iii) At any time, the grantor, in a non-fiduciary capacity, may, but shall not be required to, distribute to any one or more of the grantor's issue, such amounts of the principal (including the whole thereof) as the grantor deems advisable to provide for the health, maintenance, support and education of the Grantor's issue ("Grantor's Sole Power").

(b) Upon the grantor's death, the remaining trust assets are to be distributed to or for the benefit of any person or persons or entity or entities, other than the grantor's estate, his creditors, or the creditors of his estate, as the grantor may appoint by his Last Will and Testament. In default of the grantor's exercise of his limited power of appointment ("Grantor's Testamentary Power"), the balance of the trust will be distributed, per stirpes, to the grantor's then living issue in further trust.

(c) The 2013 PLR concluded as follows:

(i) The grantor's retention of the Grantor's Consent Power caused the transfer of property into the trust to be wholly incomplete for federal gift tax purposes;

(ii) The grantor's retention of the Grantor's Sole Power also caused the transfer of the property into the trust to be wholly incomplete for federal gift tax purposes; and

(iii) The grantor's retention of the Grantor's Testamentary Power caused the transfer of property into the trust to be incomplete with respect to the remainder interest in the trust for federal gift tax purposes.

3. **PLR 201550005 (the "2015 PLR").**

(a) The 2015 PLR has similar facts to the 2013 PLR with a few important distinctions:

(i) In the 2015 PLR, the grantors (husband and wife) as co-grantors created a trust for the benefit of themselves, their issue, the spouses of their issue and a separate California irrevocable trust (the "Investment Trust") created for the benefit of their issue;

(ii) The grantors resided in a community property state (California) and all property contributed to the trust was community property;

(iii) The trust created a Power of Appointment Committee (the "Committee") initially consisting of the grantors' four minor children, the Investment Trust and the grantors;

(iv) The voting power of the minor children on the Committee is exercised during their minority by a "Guardian" appointed by the grantors, acting together, or by the survivor of them;

(v) As long as the Committee consists of two or more members, other than the grantors, the Committee by unanimous consent, including the grantors, can add a trust beneficiary who is not on the Committee to the Committee;

(vi) The Committee ceases to exist upon the death of the surviving grantor, the membership of the Committee falling to one member other than the grantors or the resignation of all of the Committee members whereupon the trustee has the power to make distributions to the grantors and the beneficiaries in its discretion;

(vii) At any time, the Trustee, pursuant to the direction of a majority of the Committee members, other than the grantors, with the written consent of either grantor, is required to distribute to the beneficiaries such amounts of the net income or principal as directed by the Committee ("Grantor's Consent Power");

(viii) At any time, the Trustee, pursuant to the direction of all of the Committee members, other than the grantors, is required to distribute to the beneficiaries, such amount of the net income or principal of the trust as directed by the Committee ("Unanimous Member Power");

(ix) At any time, either grantor, in a non-fiduciary capacity, may, but shall not be required to, distribute to any one or more of the grantors' issue, such amounts of the principal (including the whole thereof) as the grantor deems advisable to provide for the health, maintenance, support and education of the grantors' issue ("Grantor's Sole Power"); and

(x) Upon the death of each grantor, such grantor's half of the community property is to be distributed to or for the benefit of any person or persons or entity or entities other than the grantor's estate, the grantor's creditors or the creditors of the grantor's estate as the grantor may appoint by his or her last will and testament and in the event the grantor fails to exercise the testamentary limited power of appointment such grantor's share is distributed 10% to the Investment Trust and the balance to the issue of the grantors, per stirpes.

(b) The 2015 PLR reached the same conclusions as the 2013 PLR relating to the gift tax consequences to the grantors in contributing property to the trust. As such, the 2015 PLR concluded that the grantors' retention of the Grantor's Consent Power and the Grantor's Sole Power caused the transfer of property into the trust to be wholly incomplete for federal gift tax purposes. The 2015 PLR also concluded that upon the deaths of the grantors their respective interests in the trust would be includable in their gross estates for federal estate tax purposes.

(c) The 2015 PLR also analyzed whether the distribution of trust property by the Committee to any beneficiary of the trust, other than the grantors, would be treated as a completed gift subject to federal gift tax, by any member of the Committee and whether upon the death of any Committee member any portion of the trust property would be included in his or her estate because such Committee member is deemed to have a general power of appointment within the meaning of Section 2041 of the IRC. The 2015 PLR reached the following conclusions on these issue:

(i) The powers held by the Committee under the Grantor's Consent Power are powers that are exercisable only in conjunction with the creators of the trust (i.e. the grantors) and accordingly under Sections 2514(b) and 2041(a)(2), the Committee members do not possess general powers of appointment by virtue of holding the power. The powers held by the Committee members under the Unanimous Member Power are not general powers of appointment for purposes of Sections 2514(b) and 2041(a)(2) based on the examples in Sections 25.2514-3(b)(2) and 20.2041-3(c)(2) of the Treasury Regulations as the Committee members have substantial adverse interests in the property subject to the power. As such, any distribution made from the trust to a beneficiary, other than the grantors, pursuant to the exercise of the powers held by the Committee members are not gifts by the Committee members and instead are gifts by the grantors; and

(ii) The powers held by the Committee members are not general powers of appointment for purposes of Section 2041(a)(2) and accordingly the possession of these powers by the Committee members will not cause the trust property to be includable in any Committee member's gross estate under Section 2041(a)(2) of the IRC.

(d) Finally, the 2015 PLR reached an important conclusion relating to the income tax basis of the community property held in the trust. The 2015 PLR concluded that the basis of all community property (i.e., 100% of the property) in the trust on the date of death of the first grantor to die will receive an adjustment in basis to the fair market value of such property at the death of the first grantor assuming that the Committee is in existence at the time of the death of the first grantor, such that the trust is not treated as a grantor trust as to either grantor.

4. **Analysis.**

(a) The CCA called into question whether the mere retention of the testamentary limited power of appointment by a grantor will be sufficient to cause a transfer of property into a trust to be incomplete for federal gift tax purposes.

(b) The 2013 PLR and 2015 PLR offer additional guidance on what is required to cause a grantor's transfer of assets into a trust to be incomplete for federal gift tax purposes. It seems clear from the 2013 and 2015 PLRs that the retention of a testamentary limited power of appointment will only cause the transfer of property into a trust to be incomplete with respect to the remainder interest in the trust for federal gift tax purposes. As a result, a grantor is required to retain additional powers over a trust to cause the transfer of property into the trust to be wholly incomplete for federal gift tax purposes.

(c) The 2013 and 2015 PLRs provide that the retention of the Grantor's Consent Power and the Grantor's Sole Power are each sufficient, in and of themselves, to cause the transfer of property into a trust to be wholly incomplete for federal gift tax purposes.

(d) Some commentators have suggested that the retention of the Grantor's Sole Power is required in order to cause the transfer of trust property into the trust to be wholly incomplete for federal gift tax purposes. This would mean that the DING structure would no longer work in any self-settled asset protection trust jurisdiction which prohibits a grantor from retaining a lifetime limited power of appointment. At the time the 2013 PLR was issued Delaware's self-settled asset protection trust statute did not permit a grantor to retain a lifetime limited power of appointment. However, the statute was modified in February of 2014 to permit a grantor to retain a lifetime limited power of appointment. 12 Del. C. § 3570(11)b.2.

(e) As previously explained, the 2013 and 2015 PLRs clearly state that the grantor's retention of the Grantor's Consent Power is sufficient to cause the transfer of property into a trust to be wholly incomplete for federal gift tax purposes and as such the DING structure should work in any self-settled asset protection trust jurisdiction which permits a grantor to retain the right to consent to trust distributions. Notwithstanding, it is advisable for a client to establish the trust in a jurisdiction such as Delaware or Nevada, which permit the retention of a lifetime limited power of appointment, so as to cause the trust to squarely fall within the structure described in the 2013 and 2015 PLRs.

(f) The 2015 PLR provides additional guidance on the gift and estate tax consequences to the members of the Distribution Committee.

(g) The 2007 Notice called into question whether the members of the Distribution Committee were truly adverse to one another in which case the Distribution Committee members would possess general powers of appointment within the meaning of Sections 2514 and 2041 of the IRC. This would result in distributions from the trust to any of the beneficiaries, other than the grantor, being treated as taxable gifts by the members of the Distribution Committee and the trust assets being includable in the estates of the Distribution Committee members upon their deaths.

(h) The 2015 PLR confirms that the members of the Distribution Committee do not possess general powers of appointment for either gift or estate tax purposes notwithstanding the fact that in the event only two Distribution Committee members (other than the Grantor) are serving, the Distribution Committee members, by unanimous vote, could appoint other beneficiaries of the trust to the Distribution Committee.

(i) The 2015 PLR also clarifies that it is permissible to have minors serve on the Distribution Committee provided that their interest as Distribution Committee members is voted by a Guardian during their minority. It is important to note that the grantor or the grantor's spouse may not serve as the Guardian for the minor beneficiaries for purposes of voting their interest as the Distribution Committee members.

(j) Finally, the 2015 PLR provides guidance on the income tax consequences associated with a contribution of community property to a trust by husband and wife. The 2015 PLR clearly provides that upon the death of the first grantor to die all of the community property held in the trust will receive a full step up in basis.

G. Conclusion.

1. Incomplete gift non-grantor trusts present a unique opportunity for individuals residing in states such as California, New Jersey, Kentucky, Massachusetts, Michigan and Missouri to minimize or avoid state income tax.

2. The 2013 and 2015 PLRs further substantiate the use of DING trusts.

3. The 2013 and 2015 PLRs clearly state that the grantor's retention of the Grantor's Consent Power causes the transfer of property into the trust to be wholly incomplete for federal gift tax purposes, meaning a grantor should not be required to retain a lifetime limited power of appointment in order to cause the transfer of property into the trust to be wholly incomplete for federal gift tax purposes. However, it is

advisable for clients to establish DING trusts in jurisdictions such as Delaware or Nevada which allow for the retention of a lifetime limited power of appointment so as to model the structure contained in the 2013 and 2015 PLRs.

4. The 2015 PLR also confirms that the members of the Distribution Committee are truly adverse to one another and as such do not possess general powers of appointment within the meaning of Sections 2514 or 2041 of the IRC and therefore distributions from the trust to beneficiaries other than the grantor will not result in the members of the Distribution Committee making taxable gifts and the assets of the trust will not be includable in the estates of the Distribution Committee members upon their deaths.

The Qualified Business Income ("QBI") Deduction

How it is determined and what it means to business entities

Presented by:

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Jordon N. Rosen, CPA, MST, AEP® is a Director and shareholder in the Wilmington, Delaware CPA firm of Belfint, Lyons & Shuman, where he heads the firm's estate and trust practice. Jordon also provides tax consulting and compliance services to the firm's higher net worth clients and business owners. He is the Past President of the National Association of Estate Planners and Councils (NAEPC) and has served as president of the Delaware Estate Planning Council and the Chester County, PA Estate Planning Council. Mr. Rosen is also a member and past chair of the Delaware State Chamber of Commerce tax committee, is a member of the AICPA Trust, Estate and Gift Tax Technical Resource Panel, and is a member of the editorial board of Thomson Reuters Focus publication.

Jordon is a licensed CPA in Delaware and Pennsylvania and is a member of the Pennsylvania Institute of CPAs, Delaware Society of CPAs and the AICPA Tax Section. He also holds the designation of Accredited Estate Planner ® and has been recognized as a 5-Star Wealth Manager by Philadelphia Magazine and Delaware Today.

Mr. Rosen is a frequently sought out speaker both locally and nationally on tax planning and related issues and has published more than 100 articles. He has been a frequent television and radio guest and a past host of Money Talk on 1450-WILM. He received his undergraduate degree in Accounting from Temple University and his Master's degree in Taxation from Widener University.

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Qualified Business Income Deduction (2018 - 2025)

Overview

- Applies to non-corporate taxpayers, including estates and trusts, who have QBI from an S Corp., schedule E real estate rentals, partnerships or sole proprietors
- Applies only to QBI effectively connected with the conduct of a trade or business within the U.S.
- QBI includes items of income, gain, deduction and loss
- No distinction between passive and active income

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QBI Deduction Equals

- (1) The lesser of "combined QBI income amount" or 20% of the excess, if any, of taxable income of taxpayer for the year over the sum of net capital gains and cooperative dividends, PLUS.
- (2) The lesser of 20% of cooperative dividends or taxable income (reduced by capital gains).

NOTE : QBI deduction taken in computing taxable income, not AGI, regardless of whether taxpayer itemizes deductions.

- "Combined QBI income amount" -
  - 20% of QBI, subject to W-2 limit for each trade or business, plus
  - 20% of aggregate REIT dividends **AND** qualified PTP income for the year.

NOTE: **IF** net QBI amount is less than zero, the amount is treated as a loss in the succeeding tax year.

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QBI Does Not Include:

- Certain investment income
- Reasonable Compensation paid to the taxpayer
- Guaranteed payments paid to the taxpayer

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QBI - W-2 Limitation

- Wage Limitation does not apply if taxable income does not exceed $315,000
  - Limitation phases in when taxpayer's taxable income exceeds $315,000 for MFJ ($157,500 for others).
  - Phase-in is over the next $100,000 of taxable income for MFJ ($50,000 for others).
- If taxable income > $415,000 - MFJ ($207,500 for others) - the deduction cannot exceed the greater of:
  - 50% of (allocated share of) W-2 wages of the trade or business, or
  - 25% of (allocated share of) W-2 wages of the trade or business, **PLUS** 2.5% of the unadjusted basis of all qualified property held by and available for use in the T/B at the close of the year

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QBI Deduction for Specified Service Industry

- Generally does not apply
- Exception if taxable income of individual does not exceed \$315,000 (MFJ), \$157,500 (for others).
- Exception is phased-out over the next \$100,000 (MFJ), \$50,000 (for others)
- QBI deduction does not apply to the business of performing services as an employee.
- Specified services include, but not limited to accounting, law, healthcare and consultants (but not engineers and architects).

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QBI Examples: Example #1

- Basic Rule: Combined QBI deduction cannot exceed taxable income (net of capital gains) x 20%
- John is a married accountant with business income of $150,000
  - QBI Deduction: $150,000 x .20 = $30,000
  - Net Taxable Income: $200,000
  - $200,000 x .20 = $40,000
  - QBI deduction is not limited
- Mary is a married accountant with business income of $250,000
  - QBI Deduction: $250,000 x .20 = $50,000
  - Net Taxable Income: $200,000
  - $200,000 x .20 = $40,000
  - QBI deduction is limited to $40,000

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QBI Examples: Example #2

For Non-Specified Service Businesses:

- When taxable income exceeds $415,000 (MFJ), the QBI deduction is limited to the greater of:
  - 50% of Wages or
  - 25% of Wages **PLUS** 2.5% of unadjusted basis of property
- Bruce is married and has a yard cleaning company and has taxable income of $600,000 and the QBI amount from the company is $100,000. The company pays wages of $50,000 and has nominal assets
- Lesser of:
  - $100,000 x .20 = $20,000
  - Limited to: $50,000 (wages) x .50% = $25,000
  - Bruce's QBI deduction is not limited

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QBI Examples: Example #3

- Bruce also owns a rental property that generates $8,000 of QBI. Assume the property is fully depreciated and there are no employees.
- The QBI deduction is $0

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QBI Examples: Example #4

- Same as EXAMPLE #3 except the building is not fully depreciated and was purchased for $250,000, which includes land cost of $50,000.
  - QBI deduction is $8,000 x .20 = $1,600
  - ($0 wages x .25) **PLUS** $200,000 (net of land) x .025 = $5,000
  - QBI deduction of $1,600 is not limited

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QBI Examples: Example #5

- Jordon is married and has a widget producing business that generates $100,000 of QBI. His taxable income is over $415,000. In addition, he paid wages of $30,000 and has qualified property of $50,000.
  - $100,000 x .20 = $20,000
  - Wage Test 1: $30,000 x .50 = $15,000
  - Wage Test 2: ($30,000 x .25) + ($50,000 x .025) = $8,750
  - QBI deduction is limited to $15,000 (the greater of $15,000 or $8,750)

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QBI Examples: Example #6

- Valerie is an attorney and has business income of $200,000 after paying wages of $100,000 to employees. She files a joint return which shows taxable wages of $375,000.
- QBI = $\left(1 - \dfrac{\$375{,}000 - \$315{,}000}{\$100{,}000}\right) \times \$200{,}000 = \$80{,}000$
- Includible wages = 40% x $100,000 = $40,000
- QBI deduction = $80,000 x 20% = $16,000
- Wage limitation = $40,000 x 50% = $20,000
- Deduction of $16,000 is not limited.
- If taxable income were greater than $415,000, the deduction would be **zero**.

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QBI Examples: Example #7

- Same as EXAMPLE #6 except that the trade or business is a widget retailer that paid wages of $50,000 and had no assets.
- The Wage Limitation Test would apply on a phase in basis since taxable income exceeds $315,000, but less than $415,000
- QBI Deduction: $200,000 x .20 = $40,000
- Wage Limit: $50,000 x .50 = $25,000
- Deduction: $25,000 + [50% x ($40,000 - $25,000)] = $32,500

NOTE: If VALERIE'S TAXABLE INCOME WERE GREATER THAN $415,000, THE WAGE TEST LIMIT WOULD BE FULLY PHASED IN AND HER DEDUCTION WOULD BE LIMITED TO $25,000.

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Quick Reference Chart - The QBI Deduction

(Net) Taxable Income	Specified Services	Other Businesses
< $315,000	QBI x 20%	QBI x 20%
$315,000-$415,000	Phase-out of Deduction (W-2 / Asset Limitations Apply)	Phase-in of W-2/Asset Limitation Rule
>$415,000	No Deduction	Full W-2/Asset Limitation Rule APPLIES

The new 21% flat rate eliminates any opportunity to benefit from a run through lower rate brackets

- The basic structure of the corporate tax system remains the same – corporate earnings are taxed twice, once when earned and again when distributed. Even with the preferential rate on qualified dividends, the C corporation structure may be less tax-efficient than pass-through entity choices
    - For an individual taxpayer whose dividend income is taxed at the 15% rate and the 3.8% Net Investment Income Tax applies, $100 of distributed C corporation earnings nets $35.86 after tax – a 35.86% combined tax rate
    - If a QBI deduction is available, the C corporation structure is decidedly less attractive
    - Earnings left within the corporation won't be subject to the shareholder level tax, creating an incentive to accumulate earnings instead of distributing
    - The tax code contains two provisions which function as a disincentive – the accumulated earnings tax and the personal holding company tax, both of which generally impose a second level of tax on targeted corporations
    - Deemed dividends provide a relief valve for avoiding the taxes – but they can be an expensive cure
    - These taxes have been dead letters for a long time but may regain importance under the new C corporation tax regime

- Reasonable compensation may take on added significance, particularly for pass-through entities. There are several reasons:
  - Even if all of an S corporation's pass-through income is subject to tax at the same income tax rate, compensation is subject to payroll taxes as well, giving the IRS some incentive to assure that a stockholder/employee is being compensated adequately for services provided to the corporation.
  - Regardless of the choice of entity, QBI doesn't include reasonable compensation or, in the case of a tax partnership, guaranteed payments. If a QBI deduction is in play, the IRS again has incentive to assure that the owner/employee is being compensated properly.
  - In a C corporation structure in which the taxpayer can demonstrate a reasonable need to accumulate earnings (and thus avoid the accumulated earnings tax), the IRS has incentive to assure that as much corporate income as possible is exposed to payroll taxes and as little as possible qualifies for the low C corporation tax rate.

- For many businesses organized as pass-through entities, converting to C corporation status for the presumed benefit of a lower rate won't make sense
  - In any case, a careful analysis of the business's assets is important – for example, it might be tax-advantageous to leave some assets, such as real property, within the pass-through entity even if the decision is made to conduct business operations through a C corporation.

- What about converting a C corporation to an S corporation to take advantage of the QBI deduction?
    - Some owners might not qualify to hold stock in an S corporation
    - A corporation with two classes of stock can't make an effective S election
    - A corporation with substantial accumulated earnings may not be able to maintain an S election. A deemed dividend distribution may be a fix, but not necessarily inexpensive
    - A change in the method of accounting for inventory may rule out such an election

Choice of Entity Example #1

- Paul owns an HVAC business. Paul performs $120,000 worth of services for the business annually, by reasonable compensation standards. The business pays out $250,000 in W-2 wages to individuals other than Paul and owns no qualified property. The business earns $315,000 in annual profit, before attributing any compensation to Paul for his services.
- Paul is married, and he and his wife file a joint income tax return.

	C Corporation	S Corporation	Partnership/LLC
W-2 Wages	**$120,000**	**$120,000**	**$ 0**
Qualified Business Income	**$ 0**	**$195,000**	**$315,000**
QBI Deduction	**--**	***($ 39,000)***	***($ 58,200)****
Dividends (Net of 21% Corp. Tax Paid)	**$154,050**	**--**	**--**
Tax on Wages and QBI	**($ 18,280)**	**($ 54,820)**	**($ 50,210)**
Tax on Dividends	**($ 23,110)**	**--**	**--**
Net to Paul	**$232,660**	**$260,180**	**$264,790**

* If these figures represent the total income of Paul and his wife, and they take the standard deduction of $24,000, their QBI deduction will be capped at 20 percent of their taxable income (without regard to the QBI deduction itself), which would be 20 percent of ($315,000 minus $24,000).

Choice of Entity Example #2

Same facts, except the business earns $600,000 in annual profit, before attributing any compensation to Paul for his services.

	C Corporation	S Corporation	Partnership/LLC
W-2 Wages	**$120,000**	**$120,000**	**$ 0**
Qualified Business Income	**$ 0**	**$480,000**	**$600,000**
QBI Deduction	**--**	***($ 96,000)***	***($115,200)****
Dividends (Net of 21% Corp. Tax Paid)	**$379,200**	**--**	**--**
Tax on Wages and QBI	**($ 18,280)**	**($127,780)**	**($121,060)**
Tax on Dividends	**($ 66,960)**	**--**	**--**
Net to Paul	**$413,960**	**$472,220**	**$478,940**

* If these figures represent the total income of Paul and his wife, and they take the standard deduction of $24,000, their QBI deduction will be capped at 20 percent of their taxable income (without regard to the QBI deduction itself), which would be 20 percent of ($600,000 minus $24,000).

Choice of Entity Example #3

Same facts, except the business earns $600,000 in annual profit, before attributing any compensation to Paul for his services, ***and***

(i) the business is a specified service business; or

(ii) the business utilizes independent contractors instead of employees and therefore pays no wages.

	C Corporation	S Corporation	Partnership/LLC
W-2 Wages	**$120,000**	**$120,000**	**$ 0**
Qualified Business Income	**$ 0**	**$480,000**	**$600,000**
QBI Deduction	**--**	***Not eligible***	***Not eligible***
Dividends (Net of 21% Corp. Tax Paid)	**$379,200**	**--**	**--**
Tax on Wages and QBI	**($ 18,280)**	**($161,380)**	**($161,380)**
Tax on Dividends	**($ 66,960)**	**--**	**--**
Net to Paul	**$413,960**	**$438,620**	**$438,620**

Choice of Entity Example #4

Same facts, except the business earns $550,000 in annual profit, before attributing any compensation to Paul for his services, ***and***

(i) the business is a specified service business; or

(ii) the business utilizes independent contractors instead of employees and therefore pays no wages.

Also, Paul wishes to maintain a reserve of $200,000 annually to allow for future flexibility in growth.

	C Corporation	S Corporation	Partnership/LLC
W-2 Wages	**$120,000**	**$120,000**	**$ 0**
Qualified Business Income	**$ 0**	**$430,000**	**$550,000**
QBI Deduction	**--**	***Not eligible***	***Not eligible***
Dividends (Net of 21% Corp. Tax Paid)	**$139,700**	**--**	**--**
Tax on Wages and QBI	**($ 18,280)**	**($143,880)**	**($143,880)**
Tax on Dividends	**($ 21,320)**	**--**	**--**
QBI Taxed but Not Distributed	**--**	**($200,000)**	**($200,000)**
Net to Paul	**$220,100**	**$206,120**	**$206,120**

Questions

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