

Restructuring Existing Trusts to Work Under New Tax Law

Key Tax Reform Provisions Affecting Trusts, QBI Thresholds, and Allocations; Managing the Legal Processes of Modifying Old Trusts

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Today's Panel

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New Tax Law Changes Impacting Trusts

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Estate and Gift Tax Exemption

- Temporary doubling of the estate and gift tax basic exclusion amount
- Treas. Reg. § 20.2010-1(c)
 - “Special rule in the case of a difference between the basic exclusion amount applicable to gifts and that are applicable at the donor’s date of death”
 - Ordering Rule
 - DSUE

Tax Rates and Brackets

- New tax law combines the 25% and 28% tax brackets into one 24% tax bracket

INCOME TAX RATES FOR 2020			
TAX RATE	SINGLE TAXPAYER	MARRIED FILING JOINTLY	ESTATE OR TRUST
10%	\$0 to \$9,875	\$0 to \$19,750	\$0 to \$2,600
12%	\$9,876 to \$40,125	\$19,751 to \$80,250	not applicable
22%	\$40,126 to \$85,525	\$80,251 to \$171,050	not applicable
24%	\$85,526 to \$163,300	\$171,051 to \$326,600	\$2,601 to \$9,450
32%	\$163,301 to \$207,350	\$326,601 to \$414,700	not applicable
35%	\$207,351 to \$518,400	\$414,701 to \$622,050	\$9,451 to \$12,950
37%	over \$518,400	over \$622,050	over \$12,950

References: IRC [§1\(e\)](#), [§1\(i\)\(2\)](#), [§1\(j\)\(2\)\(E\)](#), as adjusted for inflation; [Pub. L. No. 115-97, §11001](#); [Rev. Proc. 2019-44](#), §3.01.

Deductions

- State and local income and property taxes are maxed out for trusts and estates at \$10,000. Treas. Reg. § 20.2010-1(c).
- TCJA eliminated the ability of individuals to claim miscellaneous itemized deductions under §67(a). IRC §67(g)
 - Treas. Reg. §1.67-4.
 - Concern that IRC §67(g) would block all deductions for a trust or estate other than those that an individual would be able to deduct in computing adjusted gross income or which were listed as *not* miscellaneous itemized deductions in the list found at IRC §67(b).
 - Notice 2018-61 provides that IRC §67(g) does not block deductions that are allowed under IRC §67(e)(1) and Reg. §1.674-4.
- Investment advisory fees
- QBI deduction (discussed later)

Electing Small Business Trusts

- IRS finalized regulations (modifying the allocation rules under Treas. Reg. §1.641(c)-1) regarding the addition of nonresident aliens (“NRAs”) to the class of permissible potential current beneficiaries of an electing small business trust (“ESBT”)
- Regs require that the ESBT’s S corporation income be included in the S portion of the ESBT if that income otherwise would have been allocated to an NRA deemed owner under the grantor trust rules
- Accordingly, if the deemed owner is an NRA, the grantor portion of net income must be reallocated from the grantor portion of the ESBT to the ESBT’s S portion

Situs and Governing Law Considerations

- What is the situs of the trust?
 - Specified in Trust Instrument
 - Place of Administration
- What law governs administration?
 - Specified in Trust Instrument
 - General principles of state law (See, e.g., 12 Del. C. § 3332(b): “the laws of [the State of Delaware] shall govern the administration of the trust while the trust is administered in this State unless the governing instrument expressly provides [otherwise]”)

Situs and Governing Law Considerations

- Migration of trust situs, change/designation of law governing administration.
 - Look to language of governing instrument:
 - Ability to modify situs/law governing administration (ex. Trustee or trust protector may designate situs/law governing administration).
 - Remove/replace trustees to add trustee located in favorable jurisdiction
 - “Pitch and Catch” concerns: Does current jurisdiction require action to relinquish jurisdiction/change situs?

Modification Techniques

- Generally five options (depending on jurisdiction)
 - Decanting
 - Merger
 - Modification by Consent
 - Non-Judicial Settlement Agreement (“NJSA”)
 - Judicial Settlement Agreement (a/k/a “Consent Petition”)

Decanting

- Decanting is the exercise of discretion by a trustee to distribute (“decant”) the principal or income of a trust to the trustee of another trust with the same dispositive provisions as the first trust. See, e.g., 12 Del. C. § 3528.
- Requirements (varies by state – these are DE)
 - Beneficiaries of the second trust must also be beneficiaries of the first trust.
 - Second trust must comply with any standards of distributions under the first trust.
 - Written instrument must be signed and acknowledged by the trustee and filed with the records of the trust.
- Note: Decanting is an exercise of trustee discretion – no consent of the beneficiaries may be required - but may be advisable. Consider implications of trustee “action” vs. “beneficiary” action.

Merger

- Combining first trust with (or “into”) second trust that has similar (but not necessarily identical) dispositive provisions or differing (and perhaps more advantageous) administrative provisions. See, e.g., 12 Del. C. § 3325(29).
- Generally permitted without judicial involvement.
- Generally permitted so long as the merger does not result in a material change of the dispositive provisions of the trust defining a beneficiary’s interest in the principal or income of the trust.
- Generally can be used to modify administrative provisions in the same way as decanting, NJSA, modification by consent or judicial modification.
- As with decanting, merger is an exercise of trustee discretion. Consent of the beneficiaries generally is not required - but may be advisable. Consider implications of trustee “action” vs. “beneficiary” action.
- See, e.g., 12 Del. C. § 3341 for consequences of merger.

Modification by Consent

- Several states have adopted some version of UTC 411, authorizing modification of trusts with the consent of the grantor, all then-serving fiduciaries and all beneficiaries. See, e.g., 12 Del. C. § 3342.
 - Requirements (varies by state – these are DE)
 - Written consent (or non-objection) of: (i) trustor(s); (ii) all then-serving fiduciaries; and (iii) all beneficiaries.
 - New provisions or modified provisions must be provisions that would otherwise have been permitted in the original governing instrument on the date of creation.
 - Important distinctions versus other forms of modification:
 1. Modification permitted even if modification violates a material purpose of the trust, with consent of trustor.
 2. Trustee (fiduciaries) may not have a duty to consent to proposed modification.
- Distinction between providing consent and merely acknowledging and not objecting?
- Warning: Be aware of tax consequences of modification since: (i) trustor and beneficiaries may be deemed to have “consented” or affirmatively agreed to the modification and (ii) this may be a modification of a material purpose (such as limitations on distribution of income or principal, charitable purpose, etc.).

Non-Judicial Settlement Agreements, Non-Judicial Modifications and Judicial Modifications

Non-Judicial Settlement Agreements (“NJSA”)

General Requirements: §111 of the UTC

- Consent of all “interested persons” whose consent would be required in order to achieve a binding settlement were a court to approve it;
- Change “does not violate a material purpose of the trust” and
- Can only include terms and conditions that would be properly approved by a court.

Non-Judicial Settlement Agreements (“NJSA”)

Interested Persons

- Must be parties to the agreement
- Determination depends upon the nature of the modification
 - “[b]ecause of the great variety of matters to which a nonjudicial settlement may be applied, this section does not attempt to precisely define the ‘interested persons’ whose consent is required to obtain a binding settlement...”
- Representation of Interested Persons
 - UTC § 302 – Representation by Holder of General Testamentary Power of Appointment
 - UTC § 303 – Representation by Fiduciaries and Parents
 - UTC § 304 – Representation by Person having Substantially Identical Interest
 - UTC § 305 – Appointment of Representative (e.g., a guardian ad litem)

Non-Judicial Settlement Agreements (“NJSA”)

Matters that may be resolved by a NJSA: UTC §111(d)

- Interpretation or construction of the terms of the trust;
- Approval of a trustee’s report or accounting;
- Direction to a trustee to refrain from performing a particular act or the grant to a trustee of any necessary or desirable power;
- Resignation or appointment of a trustee and the determination of a trustee’s compensation;
- Transfer of a trust’s principal place of administration; and
- Liability of a trustee for an action relating to the trust.

Non-Judicial Modifications

Key Elements

- Non-judicial action
- Settlor must be alive, competent, and willing to participate in the modification or termination
- Modification or termination does not have to be consistent with the material purpose of the trust
- All beneficiaries must participate in the agreement

Non-Judicial Modifications

Consent Modifications with Consent of Settlor and Beneficiaries: UTC §411(a)

- Require the consent of all beneficiaries as well as the settlor.
 - Trustee consent, however, is not generally required.
- All types of modifications are allowed – even those inconsistent with material purpose of the trust

Judicial Modifications

Key Elements

- Judicial action required
- Broader modification authority than all other alternatives
- Attorney ad litem may be appointed to represent minor or unborn beneficiaries
- Beneficiary consent may be required in some states for some types of judicial modifications

Judicial Modifications

UTC Provisions

- UTC §411(b) – Consent of all Beneficiaries.
- UTC §411(e) – No Consent of All Beneficiaries But Beneficiaries Adequately protected.
- UTC §412 – Unanticipated Circumstances or Inability to Administer Trust Effectively.
- UTC §413 – Cy Pres Doctrine for Charitable Trusts
- UTC §414 – Uneconomic Trust.
- UTC §415 – Reformation to correct mistakes.
- UTC § 416 – Tax Objectives
- UTC § 417 – Combination and Division of Trusts

Who Has to Agree to Modification?

- Decanting and Merger: Exercise of trustee discretion. Beneficiaries do not necessarily have to consent, but may acknowledge or indicate non-objection.
- Modification by Consent: Generally, trustor, trustee and all beneficiaries must provide written consent or written statement of nonobjection. See, e.g., 12 Del. C. § 3342(a).
- Non-Judicial Settlement Agreement: “Interested Persons” or “Qualified Beneficiaries” – Definition varies by state.
 - UTC 111(a) defines “interested persons” as “persons whose consent would be required in order to achieve a binding settlement were the settlement to be approved by the court”.
 - 12 Del. C. § 3338(a) defines “interested persons” as those persons “whose interest in the trust would be affected by the proposed [NJSA] . . .” which may include the trustees, beneficiaries, trustor and any other persons having an interest in the trust (such as holders of powers of appointment, powers to remove/appoint fiduciaries, or any other powers held in a nonfiduciary capacity. This might include advisers, such as investment advisers or trust protectors.

Who Has to Agree to Modification?

- What if required persons (typically the beneficiaries) are unborn, unknown or unascertained?

- Many states have “virtual representation” statutes. See, e.g., 12 Del. C. § 3547 (“a minor, person who is incapacitated, or unborn person, or a person whose identity or location is unknown and not reasonably ascertainable . . . may for all purposes be represented by and bound by another who has a substantially identical interest”).

- Some states have “designated representative” statutes. See, e.g., 12 Del. C. § 3339 (permitting a person to be authorized or directed by the governing instrument to “represent or bind 1 or more beneficiaries in connection with a judicial proceeding or nonjudicial matter . . .”).

Summary of Modification Provisions by State

An excellent summary (as of 03/11/2019) of what states permit modification of irrevocable trusts, and using what methods, can be found at:

https://www.actec.org/assets/1/6/Overview_of_State_Statutes_Permitting_Modification_of_Irrevocable_Trusts.pdf

QBI Deduction

QBI Deduction

Eligibility

- Trusts and estates are entitled to deduction
- **Threshold amount of taxable income of trust or estate equals that of a single filer**
- Deduction can be taken by:
 - Grantor of grantor trust (grantor treated as directly conducting activities of the trust **with respect to portion of trust treated as owned by the grantor**);
 - Non-grantor trust or estate; or,
 - Beneficiary(ies) (non-grantor trust or estate treated as **relevant pass-through entity** (“RPE”))

Qualifying Trusts for the QBI Deduction

Treas. Reg. § 1.199A-6(d)(3)(iv).

- The Threshold Amount applicable to a trust or estate is \$157,500 for any taxable year beginning before 2019.
- Thereafter, the Threshold Amount is \$157,500 increased by the cost of living adjusted provided in Regulations § 1.199A-1(b)(12).

QBI Calculation at Entity Level

Treas. Regs. § 1.199A-6(d)(1)

- A trust or estate must calculate its QBI, W-2 wages, UBIA of Qualified Property, Qualified REIT Dividends, and Qualified PTP Income.
- The QBI of a trust or estate must be computed by allocating qualified items of deduction described in Section 199A(c)(3) in accordance with the classification of those deductions under Regulations § 1.652(b)-3(a), and deductions not directly attributable within the meaning of Regulations § 1.652(b)-3(b) are allocated in a manner consistent with the rules of Regulations § 1.652(b)-3(b).
- Any depletion and depreciation deductions described in Section 642(e) and any amortization deductions described in Section 642(f) that are otherwise properly included in the computation of QBI are included in the computation of QBI of the trust or estate, regardless of how those deductions may otherwise be allocated between the trust or estate and its beneficiaries for other purposes of the Code.

Allocation Among Trust or Estate and Beneficiaries

Treas. Reg. § 1.199A-6(d)(3)(ii).

- The QBI, W-2 wages, UBIA of Qualified Property, Qualified REIT Dividends and Qualified PTP Income of a trust or estate are allocated to each beneficiary and to the trust or estate based on the relative proportion of the trust or estate's distributable net income ("DNI") for the taxable year that it is distributed or required to be distributed to the beneficiary or is retained by the trust or estate.
- The trust or estate's DNI is determined with regard to the separate share rule of Section 663(c), but without regard to Section 199A.
- If the trust or estate has no DNI for the taxable year, any QBI, W-2 wages, UBIA of Qualified Property, Qualified REIT Dividends and Qualified PTP Income are allocated entirely to the trust or estate.
- *See comprehensive example of the allocation of DNI and calculation of the 199A deduction with respect to trusts, estates and beneficiaries under Treasury Regulation Section 1.199A-6(d)(3)(viii)*

Special Rules – Electing Small Business Trust (“ESBT”)

- 3 Requirements to qualify as ESBT:

1. All of the beneficiaries (a person to whom a distribution of income or principal may be made) of the trust must be individuals or estates eligible to be S shareholders. Beneficiaries are counted as shareholders for purposes of determining whether a corporation is an S corporation. IRC § 1361(c)(2)(B)(v).
2. No interest in the trust was acquired by purchase (i.e., gift, bequest, etc. only).
3. The trust must *affirmatively elect* to be treated as an ESBT under IRC § 1361(e).

Special Rules – Electing Small Business Trust (“ESBT”)

- Tax Treatment of ESBT: Two “portions”:
 - “S Portion” – Consists solely of S corporation stock.
 - To the extent the trust owns S-stock, that portion of the trust is treated as a separate trust when computing items of income tax. If all or a portion of the ESBT is a grantor trust – ESBT pays tax at trust level except for the amount that is taxed to the owner of the grantor trust portion. *Grantor trust rules override ESBT provisions.*
 - “Non-S Portion” – Everything else owned by the trust. Can be grantor or non-grantor.
- Administrative Note: An ESBT is treated as a *single trust for administrative purposes* – i.e., one EIN, one tax return. Treas. Reg. § 1.1361-1(m).

Items of Income and Deduction

- S-Portion:
 - QBI Deduction (IRC § 199A) attributed to assets of the S-portion.
 - QBI and other tax items from S-corporation allocated to S-portion.
- Non-S Portion:
 - All other items of income and deduction not allocated to S-portion.
- Note: For purposes of calculating the threshold amount (for 2018, \$315,000 for a married couple filing a joint return, and \$157,500 for all other taxpayers), S-portion and Non-S portion are treated as one trust.

Anti-Abuse Rules and Multiple Trust Rule

- General purpose of anti-abuse and multiple trust rules is to prevent the use of multiple trusts that have substantially the same grantor and beneficiaries and have a principal purpose of tax avoidance.
- IRC § 199A Anti-Abuse Rules.
 - “A trust formed or funded with a *principal purpose* of avoiding, or of using more than one, threshold amount for purposes of calculating the deduction under section 199A will not be respected as a separate trust entity for purposes of determining the threshold amount for purposes of section 199A.” (*emphasis added*). Treas. Reg. § 1.199A-6(d)(3)(vii).

Anti-Abuse Rules and Multiple Trust Rule

- IRC 643(f) Multiple Trust Rule.

- “[T]wo or more trusts will be aggregated and treated as a single trust if such trusts have substantially the same grantor . . . And substantially the same primary beneficiar[ies], and if a *principal purpose* for establishing . . . such trusts is the avoidance of Federal income tax.”) (*emphasis added*). Treas. Reg. § 1.643(f)-1(a).

Anti-Abuse Rules and Multiple Trust Rule

- 3-Step Analysis – Do the trusts have:
 - Substantially the same grantor(s);
 - Substantially the same “primary” beneficiar(ies);
 - A principal purpose of avoidance of federal income tax.
- Ambiguities:
 - “Principal Purpose” – Undefined.
 - “Primary Beneficiary” – Undefined.
 - When are grantors and beneficiaries “substantially” the same?
- Look to non-tax purposes for creation of trusts.