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DECEMBER 2017 CLIENT UPDATE

Dear Clients and Friends:

Since the enactment of the American Taxpayer Relief Act of 2012, we have had relative certainty in the federal estate, gift and generation-skipping transfer tax system. However, as this letter goes to print, we are awaiting the results of Congressional and White House efforts to overhaul much of the federal tax laws, including the estate, gift and generation-skipping transfer taxes.

In addition, 2017 saw a number of state-level changes in both transfer tax law and trusts and estates law, and some federal tax law decisions in the administrative and judicial arenas.

This letter will summarize some of the key federal and state changes most likely to be of interest to our clients, as well as briefly describe those areas of the proposed federal tax law changes that affect estate, gift and generation-skipping transfer taxes. If and when we have final federal tax legislation enacted, we will provide an update explaining the new tax laws in detail.

Federal Estate, Gift and GST Tax Exemptions and Exclusions in 2017 and 2018

The amount exempt from estate and gift taxes is $5,000,000 indexed for inflation (set at $5,490,000 for 2017 and expected to increase to $5,600,000 in 2018), and the taxes remain unified so that the entire exemption can be used during lifetime, or, if unused during lifetime, at death. The GST tax exemption also is now $5,000,000 indexed for inflation ($5,490,000 for 2017 and expected to increase to $5,600,000 for 2018).

In addition, the annual exclusion from gift tax, i.e., the amount that an individual can give to any number of people each year without using gift exemption or incurring a gift tax, is currently $14,000 but is scheduled to increase to $15,000 in 2018. The amount an individual can give to his or her non-US citizen spouse per calendar year is $149,000 in 2017 and is expected to increase to $152,000 in 2018.

Federal Tax Proposals

At the time this letter went to print, the U.S. House of Representatives had passed the Tax Cuts and Jobs Act and the United States Senate Finance Committee had sent the Senate version of the tax bill to the full Senate for consideration. Although the House and Senate versions of tax reform are similar in many respects, there are significant differences. If the Senate passes its tax bill, the House and Senate versions will have to be reconciled before a possible bill could be presented to President Trump for enactment.

While it remains to be seen what, if any, federal tax reform might be accomplished in 2017 or early 2018, below is a summary of some of the proposed changes to individual tax provisions:

Proposed Changes to Estate, Gift and Generation Skipping Transfer Taxes

Both the House and Senate are proposing increasing the amount exempt from estate, gift and generation-skipping transfer taxes to $10,000,000 (indexed for inflation), which would set the exemption amount at $11,200,000 per person as of January 1, 2018. In addition, the House proposal calls for the repeal of the estate and generation-skipping transfer taxes effective January 1, 2025 at which time the gift tax would remain but the rate of the gift tax would be lowered to 35%. The Senate proposal would retain all three taxes and actually has a sunset provision in 2025, meaning if no further action is taken to make the exemption increases permanent, the exemptions would revert back to $5,000,000 (indexed for inflation) on January 1, 2026.

Select Proposed Changes to Individual Income Taxes

The House proposal seeks to reduce the number of income tax brackets to 4 (12%, 25%, 35% and 39.6%) with a phase out of the lowest rate for individuals making in excess of certain thresholds. The Senate proposal retains 7 income tax brackets but lowers the tax rates of some brackets from existing levels (10%, 12%, 22.5%, 25%, 32.5%, 35% and 38.5%). As with the estate, gift and generation-skipping tax law changes, the Senate proposal includes a sunset for the changes in the individual tax rates so that they are set to expire on January 1, 2026.

The Senate bill also changes the rules for the taxation of stocks by applying a “first in, first out” (“FIFO”) requirement when stock is sold, gifted or donated. Essentially, the proposal would require that when individual investors transfer stocks (including interests in index funds, ETFs and individual stock holdings in managed and unmanaged accounts) of which they own various lots of the same stock purchased at different times, they will be required to treat the oldest lot they own as the lot being transferred, rather than being able to choose the lot with the most advantageous capital gains tax basis to transfer.

Both the House and Senate proposals call for: an increased standard deduction ($12,200 for individuals and $24,400 for joint filers); a repeal of the Alternative Minimum Tax ("AMT"); and the elimination of most itemized deductions, including State and Local Tax ("SALT") deductions (with the House proposal retaining a deduction for property taxes up to $10,000), medical expenses; student loan interest (in the House proposal), and most other itemized deductions. Both proposals also would make changes to the amount of home mortgage interest payments which would be deductible and would make changes to the capital gains exemption rules for gain on the sale of primary residences. Because the proposals differ in many respects and the potential changes, if enacted, may have different effects on clients based on their current and future tax and asset situations, it is difficult to provide any generalized guidance on how to best plan for possible changes. We encourage you to speak with your accountant or other tax professional to determine if you should take any action prior to the end of the year to either postpone income items and/or accelerate deduction items or otherwise prepare for potential changes to your tax situation.

Pass-Through Entity Income Taxes

Both the House and Senate proposals include changes to the taxation of income from pass-through entities. Currently, income earned by owners of pass-through entities (such as sole proprietorships, partnerships, LLCs taxed as partnerships, and S corporations) is taxed at the owners' individual tax rates, which is often higher than the corporate tax rate for other business entities. Both proposals seek to bring the tax rate for these pass-through entities more in line with other corporate tax rates. There are anti-abuse provisions in both proposals designed to limit the preferential tax treatment to "business income" and to prevent passive investors and others from utilizing pass-through entities to obtain lower tax rates on what is classified as non-business income.

Connecticut Makes Significant Changes to Estate and Gift Taxes

On October 31, 2017, Governor Malloy signed the new Connecticut State Budget for the Biennium Ending June 30, 2019. The new budget includes a change to the Connecticut Estate and Gift Tax Regime. Effective January 1, 2018, the Connecticut exemption from estate and gift tax will be increased from its current level of $2,000,000 per individual to $2,600,000. A further increase to $3,600,000 will take effect on January 1, 2019, and beginning January 1, 2020 the Connecticut estate and gift tax exemption will match the federal exemption ($5,000,000, indexed for inflation and scheduled to be $5,600,000 as of January 1, 2018). As the Connecticut legislature did not anticipate the potential doubling of the federal exemption or the potential repeal of the federal estate tax, it remains to be seen if the Connecticut estate and gift tax exemption will be capped in some way in 2020 and beyond if major changes to the federal tax system are enacted.

Finally, effective January 1, 2019, the estate and gift tax cap, the maximum amount an individual is liable to pay to Connecticut in combined estate and gift tax, will be reduced from $20,000,000 to $15,000,000 (which represents the tax due on an estate of roughly $129 million, meaning amounts in excess of that would not be subject to Connecticut gift or estate tax).

Connecticut Tax Amnesty Program

As part of the Connecticut State Budget, a "Connecticut Fresh Start Amnesty Program" was created. This program will allow qualified taxpayers who failed to file a tax return or failed to report the full amount of tax properly due on a previously filed return and who voluntarily come forward (prior to state notification of an audit or past due amount), to apply for amnesty from penalties and 50% of the interest on unpaid taxes for tax returns due on or before December 31, 2016. The tax amnesty program lasts until November 30, 2018. There are some exceptions and several additional criteria which must be met. If you would like more information on Connecticut's Fresh Start Amnesty Program, you should contact your accountant or your Cummings & Lockwood attorney.

New Jersey Repeals Estate Tax But Not Inheritance Tax

As reported in last year's update, New Jersey's estate tax is repealed effective January 1, 2018. New Jersey did not, however, repeal its inheritance tax, which is a separate tax, with a maximum 16% rate, on inheritances if the recipient is not a spouse, ancestor or descendant of the decedent.

Review and Current Status of New York Estate Tax Laws

In 2014, New York made significant changes to the New York estate tax laws. As a result, New York continues to have no state gift tax and New York's estate tax exemption continues to rise. New York's maximum estate tax rate remains at 16%. The estate tax is now essentially a cliff tax, however, in that the exemption is phased out for taxable estates that exceed the exemption amount, and taxable estates that are more than 105% of the exemption amount will be taxed in full as if no exemption existed. This means that any estate in excess of the exemption amount available for that estate by more than 5% will face a tax on the entire estate and not just the amount that exceeds the exemption. The New York estate tax exemption amount is currently $5,250,000 and is scheduled to increase to match the federal exemption as of January 1, 2019. However, the New York statute is tied to the federal tax law as it existed prior to the 2014 law, meaning the New York exemption is set at $5,000,000 as indexed for inflation from that year forward. If the federal estate tax laws are changed as discussed in the proposed legislation, New York's estate tax exemption will not equal the increased federal exemption amounts.

Florida Estate Tax

Florida does not have an estate tax as the state constitution prohibits the legislature from enacting a Florida estate tax on residents. However, Florida residents who own property in the District of Columbia or one of the 12 states which will continue to have an estate tax after January 1, 2018 may be subject to estate taxes at death. The 12 states that will continue to have an estate tax are Connecticut, Hawaii, Illinois, Maine, Maryland, Massachusetts, Minnesota, New York, Oregon, Rhode Island, Vermont and Washington.

How Your Assets are Titled Matters

When you developed your estate plan, you and your Cummings & Lockwood attorney worked to coordinate your asset ownership and beneficiary designations with that plan. It is extremely important that you review these items periodically to avoid accidentally undoing the dispositions in your Will and/or Revocable Trust. For example, if your Will creates equal trusts for your children, but you own stocks and bonds jointly with just one child, then your Will is rendered meaningless, because upon your death, that child will own all the stocks and bonds by operation of law. Your other children will receive nothing under the Will and any asset protection or tax benefits from the trust will be lost. Similar issues can arise with beneficiary designations for retirement plans and life insurance. Forms of ownership and distribution also can have a substantial impact on the amount of taxes due at your death, and may distort who is responsible for the taxes. Avoid unpleasant surprises for your heirs. Talk to your attorney about an estate plan "check-up" that includes a review of ownership and beneficiary designations.

Other Federal Tax Law Changes of Note

IRS Cancels Proposed Regulations to Restrict Estate and Gift Tax Valuation Discounts for Family-Owned Businesses and Entities

As you may recall, we reported in prior updates that the IRS was developing regulations restricting discounts for certain asset transfers to family members and/or trusts for their benefit. Last year the IRS issued proposed Regulations but their effective date was pushed off while the IRS heard testimony regarding their impact and advisability. These Section 2704 Regulations have been withdrawn by the IRS as of October 17, 2017. As of the date of this letter, there is no further word on potential changes or additional regulations in this area.

Estate of Powell v. Commissioner

The May 2017 Tax Court decision in the case of Estate of Powell v. Commissioner represents the most significant IRS success to date in its effort to discourage the use of family limited partnerships (FLPs), family limited liability companies (LLCs) and closely-held corporations as estate planning vehicles, particularly when used for "death-bed" planning. The element of the Tax Court holding that causes us concern is the court's conclusion that Section 2036(a)(2) of the Internal Revenue Code applied to cause 99% of the assets of a family limited partnership to be subject to estate tax in Mrs. Powell's estate even though her partnership interest was transferred prior to her death *because she retained an interest in the partnership which was not transferred more than three years prior to her death.* Of particular concern is the court's determination that because the decedent owned a 1% interest in the partnership at issue she had the ability to dissolve the partnership in conjunction with the other owners and therefore she had the ability to designate the persons who shall possess or enjoy the property or the income therefrom, within the meaning of Section 2036(a)(2).

Section 2036(a) of the Code is clear that it does not apply to a transfer which represents a "bona fide sale for an adequate and full consideration in money or monies worth." If we are correct, then as long as there is a clear business purpose for a client transferring assets to a family partnership, limited liability company or corporation in exchange for the partnership interest, membership interest or stock in such entity, the court's expansive interpretation of Section 2036(a)(2) in Powell should not apply at the death of such client to cause the partnership assets, rather than just the retained interest in the entity, to be subject to estate tax.

Where does the Powell decision now leave us with regard to sale and gift transactions that have been completed? As long as (i) the IRS agrees that there was a business purpose underlying the transfer of assets to the entity by a client and (ii) our interpretation of the Powell holding is correct, the Powell holding should not present a problem for such client's estate at death. On the other hand, there is a chance that a judge might construe the Powell decision more broadly than we do and there are certainly no guarantees that the IRS will agree that the business purpose exception to 2036(a)(2) applies to every client's situation, particularly with regard to the formation of family investment companies. There are many clients who, in light of Powell, should consider actions that might be taken now to further diminish or eliminate continuing risk with regard to a prior gift or sale. The appropriate means of reducing or eliminating risk will vary among families and transactions. Accordingly, this subject is best discussed in a detailed conversation with your Cummings & Lockwood attorney if you are concerned your estate might be facing this situation.

Private Foundations and Foreign Grants

The rules for making grants to foreign entities have changed. A private foundation can no longer rely on a foreign entity's Affidavit of Equivalency or on an opinion of foreign counsel to treat the foreign entity as equivalent to a U.S. public charity. Instead, current written advice from a qualified tax practitioner (a U.S. attorney, accountant or other enrolled agent licensed to practice in the U.S.) is now generally required unless a foundation director or officer with an understanding of U.S. charity tax law is able to make an equivalency determination for the foundation. Bottom line: If a foundation has or will have a long-term relationship with a foreign entity, it will probably want to determine and document the entity's equivalency to a U.S. public charity. For other foreign entities, a foundation will generally prefer to "exercise expenditure responsibility" over the grant.

In Closing

As this letter is being written, the news out of Washington with regard to the proposals and alternate proposals for tax law changes, as well as the final content and likelihood of success of permanent legislation, is changing by the hour. We continue to monitor all of the developments and will post alerts on our website (www.cl-law.com) with any major developments, as well as a summary of the relevant provisions of any final tax law that is enacted. We also remain cognizant that changes in state laws, taxes and fees can have as much or more of an effect on our clients, their estate plans and their families than federal tax laws and policies. We will, as always, endeavor to keep you informed of any major developments in future updates. Don't forget to check our website: www.cl-law.com.