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Transfer Tax Considerations Under the Tax Cuts and Jobs Act

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HIGHLIGHTS

- The U.S. House of Representatives and Senate ushered HR 1, 115th Cong (2017-2018), the Tax Cuts and Jobs Act (the Act), through conference committee, and President Donald Trump signed the Act into law on Dec. 22, 2017.
- Most of the Act's provisions are effective as of Jan. 1, 2018.
- Because the Act doubles the estate, gift and generation-skipping transfer (GST) tax exemptions, it is important for clients to review their existing estate plans, reconsider current strategies and explore new planning opportunities.

1. Introduction

Republicans in Congress passed the Act in just less than two months, achieving sweeping tax reform. Although clients will surely benefit from many modifications to the existing transfer tax regime, the changes may produce unintended results when applied to estate plans implemented before 2018. The Act was passed in the U.S. Senate along party lines and did not garner the required 60-vote supermajority required by the Byrd Rule, which prohibits legislation that increases the deficit after the time period covered by the budget resolution; therefore, its duration is limited to 10 years. Further, due to budget considerations, a number of the Act's provisions with respect to transfer taxes – including, but not limited to, the increased estate, gift and GST exemptions – are effective only until Dec. 31, 2025. If Congress takes no further action, these provisions will sunset and prior law will be reinstated as of Jan. 1, 2026.

Highlighted below are the key transfer tax provisions of the Act. Additionally, potential revisions that should be made to many clients' core estate planning documents are noted and additional planning opportunities that should be considered are summarized.

2. The Tax Cuts and Jobs Act

The Act makes the following modifications to the current federal transfer tax regime.

- It doubles the exemption for gift, estate and GST taxes from $5 million to $10 million per person, indexed for inflation occurring after 2011.[1] Though there was a technical change in the index used to calculate inflation, the adjustments have proven to closely match the figure previously announced by the IRS for 2018: $5.6 million per person. Accordingly, as of Jan. 1, 2018, a married couple can shield roughly $22.4 million from the transfer tax. The change is effective through Dec. 31, 2025.

1 *See* HR 1, § 11061 (amending IRC § 2010(c)(3)).

In This Issue

1 Transfer Tax Considerations Under the Tax Cuts and Jobs Act
3 The Tax Cuts and Jobs Act: Selected Issues for Individuals
8 International Estate Planning: Estate Tax Planning Issues Involving a Non-Citizen Spouse
10 Events Calendar
10 Advance Directive Legislative Update

- None of the estate, gift or GST taxes are repealed by the Act. The transfer tax regime will continue, but it will apply to fewer estates due to the significantly increased exemption amounts.
- Taxpayers will continue to receive a full step-up in basis for inherited property included in the decedent's taxable estate.[2]
- The estate, gift and GST tax rates remain at 40 percent.[3]

3. Impact Analysis and Planning Considerations

The Act presents obstacles and opportunities that must be considered. Headlines trumpet the substantially expanded exemption amounts, but for clients with existing estate plans, the increased exemptions could produce unintended consequences that may result in costly post-death disputes. At the same time, the proposed changes present a once-in-a-generation opportunity to significantly minimize, and potentially eliminate, the impact of federal transfer taxes. All of this can be approached with the view that federal tax reform is opening a window, not removing a wall. The transfer tax benefits terminate within eight years. Meanwhile, the U.S. Department of the Treasury has not yet addressed how the scheduled contraction of the exemption amount will be handled. Moreover, if the balance of power shifts in Congress and/or a subsequent presidential administration, Democrats may revisit the changes sooner than 2025. Thus, clients should not delay in availing themselves of the Act's many benefits.

Formula Funding Concerns:

Many existing estate planning documents include what is known as a "formula funding clause," which divides assets between a "bypass trust" (also known as a "Credit Shelter Trust") and a "marital trust" upon the death of the first spouse. A formula funding clause can take many forms but often is structured to retain in the bypass trust the "greatest amount that can pass free of federal estate tax," with the balance passing to the marital trust. For clients executing estate plans prior to 2018, they likely intended to fund the bypass trust with the deceased spouse's $5.6 million exemption, with the balance passing to the marital trust.

Given the significantly increased estate tax exemption provided by the Act, if clients take no action to revise existing estate plans, significantly fewer assets will pass to the marital trust in those plans where a formula funding clause has been utilized. As a result, the surviving spouse might receive less than his or her mandatory statutory minimum inheritance, possibly even resulting in the surviving spouse being disinherited entirely. For example, consider a married couple with a combined potential estate of $20 million, with $10 million owned by each spouse. Based upon the new law, this couple can avoid all federal estate taxes due to the increased exemption. If, however, the couple has a pre-2018 estate plan with a formula funding clause, the formula funding clause would direct the deceased spouse's entire $10 million estate to the bypass trust. In this scenario, no amount would pass to the marital trust. This unintended result is reason for significant concern, especially where there are second marriages and/or "blended families."

Deductible Bequests:

Clients should consider the purpose and nature of certain deductible bequests in light of the potential changes. Certain techniques – such as "charitable lead" or "charitable remainder" trusts – minimize estate tax by splitting the interests in a trust between charitable and non-charitable beneficiaries. Those techniques often were incorporated into estate plans based on a conscious decision by clients to shift assets that would otherwise have gone to the U.S. Treasury to one or more charities. Clients should revisit such plans and consider whether the size and nature of those bequests are still appropriate, especially in plans where the interests of their heirs might be unnecessarily delayed.

Planning Opportunities:

For clients who have already used their lifetime exemptions, the Act presents an incredible opportunity to further advance such wealth planning. Additional planning considerations include the following:

- **Plan Now to Hedge Against the Scheduled Sunset or Potential Repeal of the Act.** Since the Act does not repeal the estate tax, ultra-high-net-worth clients should continue to aggressively plan for an estate tax. Even taxpayers with a more "moderate" net worth should consider expanding existing gift planning in the event that the transfer tax exemptions revert to pre-2018 amounts – or lower – in the future.
- **Engage in New Transfer Tax Planning Strategies.** Clients whose estates will be subject to the estate tax even at the increased exemption amount should take advantage of the expanded exemption in leveraged transactions to maximize their wealth transfers. For example, sales to irrevocable grantor trusts outside of the grantor's estate will continue to be a popular planning mechanism, particularly where there is an opportunity to further leverage the increased exemption amount. Further, because the IRS withdrew the proposed Internal Revenue Code section 2704 Treasury Regulations, additional discounting of the transferred assets may be possible, thereby increasing the efficiency of such wealth transfer techniques.
- **Revisit and Refine Existing Tax Planning.** For existing planning transactions that were accomplished with promissory notes of relatively modest value, clients should consider whether it is advantageous to use the additional exemption to lower or eliminate the

2 IRC § 1014(a).
3 IRC § 2001(c).

promissory note through a gift. For promissory notes that exceed the available increased exemption amount, it may be beneficial to give additional assets to the purchaser trust to increase that trust's asset base to assist that trust's repayment of the note.

- **Maximize GST Planning.** Continued and expanded use of GST exempt trusts for gift-giving should be considered. This strategy can take the form of a current allocation of GST exemption to existing trusts that have not yet received an allocation of GST exemption. Alternatively, the increased exemptions provide an opportunity to further expand the advantages of multi-generational wealth transfer planning. For clients with funded non-GST exempt trusts, there is an opportunity to move assets from the non-exempt GST trust to an exempt GST trust structure. For example, a gift could be made of the increased exemption amount to a new GST exempt trust, and that new trust could then acquire the assets from the old non-GST exempt trust.
- **Consider New Basis Planning.** Clients will be required to balance the use of the increased exemption applicable to gift transactions against the loss of a step-up in basis in transferred assets at death. While this has long been a concern for clients with "borderline" taxable estates, the Act dramatically, albeit temporarily, refocuses that issue. Ultra-high-net-worth clients will need to consider whether it is feasible to use the newly increased exemption amount to give away high-basis assets, while retaining low-basis assets in their estates. The Act's sunset – and potential for early repeal – adds to the difficulty of this calculation.
- **Consider Alternative Planning Techniques.** Clients should consider alternative uses of the increased exemption, such as forgiving existing loans to family members and terminating unworkable split-dollar life insurance agreements. For example, an economic benefit split-dollar arrangement that has become prohibitively expensive based upon the insured's age may be terminated by using the donor's increased exemption to give away the split-dollar receivable.

4. Oregon Transfer Taxes

The changes under the Act described in this article apply only to federal transfer taxes. As Oregon estate planning lawyers know, Oregon has its own estate tax, with an exemption amount of $1 million per taxpayer. Oregon has no gift tax. The changes to federal transfer taxes under the Act will not change the type of planning that is done to minimize Oregon estate tax. Credit Shelter Trust planning, for instance, remains a technique that can be useful for preserving a predeceased spouse's $1 million exemption from Oregon estate tax, even though it is no longer necessary for federal transfer tax purposes.

Further, as has been noted several times in past Newsletters, planning for both federal and Oregon income tax reduction also remains important. This could include, for example, terminating Credit Shelter Trusts that are no longer needed so that the trust assets are included in the surviving spouse's estate and obtain a stepped-up basis for income tax purposes upon his or her death. It also might include modifying trusts to add general powers of appointment, so that trust assets are includable in the beneficiary's estate at death (also resulting in a stepped-up basis).

A discussion of these techniques is beyond the scope of this article, but it is important to remember that just because a client may no longer have federal transfer tax exposure does not mean that he or she has no tax planning needs at all.

5. Conclusion

The Act significantly lessens the burden of federal transfer taxes on most families. Ultra-high-net-worth clients that will continue to have a taxable estate with the increased exemption amounts should immediately engage in additional planning to take full advantage of the Act's transfer tax benefits. Even those clients with more modest estates should consider taking swift action to avail themselves of the increased exemption amounts and expanded planning opportunities now available before the Act's transfer tax provisions sunset at the end of 2025.

The Tax Cuts and Jobs Act: Selected Issues for Individuals

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On December 22, 2017, President Trump signed into law the Tax Cuts and Jobs Act, the most sweeping change to the Internal Revenue Code since 1986. The marquee change made by the Act was the significant reduction in the tax rate paid by corporations. However, the Act had a significant impact on the way taxes will be paid by individuals as well.

These materials will provide an introduction and overview to what we feel are the most important changes affecting individuals. They in no way provide a comprehensive discussion, and the impacts of the Act are still being discussed and considered. Nevertheless, we hope they provide a good starting point.

But before getting into the details, we need to mention one point. A Senate rule, known as the "Byrd Rule," requires, in effect, that any law that has a negative fiscal impact beyond 10 years requires at least 60 votes. Because the Republicans had only a bare majority, they had to pass a bill that, from a long-term perspective, was revenue-neutral. For that reason, a number of the changes, and most of the changes to personal taxes, made by the Act sunset at the end of 2025.

Unless otherwise stated, rates and exemptions presented in this article are for married couples filing jointly, and references to the "Code" are to the Internal Revenue Code.

I. Rates.

Rates for individuals went from 10, 15, 25, 28, 33, 35, and 39.6 percent last year to 10, 12, 22, 24, 32, 35, and 37 percent. This change sunsets after 2025. Capital gains rates stay at 15% and 20%, but the threshold pushing you into the higher rate is now indexed for inflation. Code section 1(j).

Personal exemptions, which previously were scheduled to be $4,150 per person in 2018, have been suspended through 2025. Code section 151(d)(5)(A).

The rates for trusts and estates are still 10, 24, 35, and 37 percent. The top rate of 37% kicks in after $12,500 of income. Code section 1(j).

The "Kiddie Tax" previously taxed a child under the age of 19 (or 24 if a full time student) at the parents' rates, if their rates were higher. Under the Act, a child's earned income is taxed under rates for single individuals, and unearned income is taxed the same as trusts and estates. Code section 1(j).

And while we're on the subject of children, under prior law the maximum child tax credit was $1,000 and was phased out if modified adjusted gross income ("AGI") exceeded certain amounts. If the credit exceeded the tax liability, the child tax credit was refundable up to 15% of the amount of earned income in excess of $3,000 (the earned income threshold). The Act increases the credit to $2,000. A nonrefundable credit of $500 is available for qualifying dependents other than qualifying children. The maximum refundable amount of the credit is $1,400, indexed for inflation. The amount at which the credit begins to phase out is increased to $400,000, and the earned income threshold is lowered to $2,500. The changes to the credit sunset and revert to pre-existing law after 2025. Code section 24(h).

The benefit to these rate changes is not clear without looking as well at the changes in deductions. As will be clear, many taxpayers whose rates will go down will nevertheless pay more tax in 2018 because their deductions will go down even more.

II. Deductions.

Perhaps the most important change for individuals is the increase in the standard deduction. Before the Act, the deduction was to be $13,000 in 2018. Under the Act, this deduction increases to $24,000 until 2026. This is important, because taxpayers are allowed to deduct either the standard deduction or the sum of all their itemized deductions. Code section 63(c)(7). By increasing the standard deduction (and reducing certain itemized deductions, below), the Act will make it more beneficial for many taxpayers NOT to itemize. This could have a significant impact, for instance, on the number of taxpayers who deduct charitable contributions.

The next important change, especially for Oregonians, is the limitation on deducting state and local taxes. Previously, state and local income, property, and sales taxes were deductible against federal income tax. Under the Act, however, through 2025 the total amount of such state and local taxes that can be deducted is $10,000. Code section 164(b)(6). This limitation does not apply to property taxes paid or accrued in the carrying on of a trade or business under Code section 212.

Mortgage deductions also are affected. The deduction for mortgage interest is limited to $750,000 of underlying indebtedness. This limitation does NOT apply to debts incurred before December 15, 2017 and reverts back to the prior $1 million limitation starting in 2026. Further, deductions for home equity indebtedness (typically home equity lines of credit, or HELOCs) where the proceeds are not used to buy, build, or substantially improve the residence secured by the loan (for example, when the proceeds are used to pay for a vacation or tuition) are suspended for the same period. Code section 163(h)(3)(F)(i)(I).

One deduction that becomes more useful under the Act is for medical expenses. Before the Act, such expenses were deductible only to the extent that they exceeded 10% of the taxpayer's AGI. Under the Act, that threshold is reduced to 7.5% of AGI. This change goes away even earlier than most, and is only available for the next two years. Code section 213(f)(2).

The charitable deduction under the Act remains largely unchanged except in one respect. Previously, contributions to a charity were limited to 50, 30, or 20 percent of modified AGI, depending upon the type of charity to whom the property was donated, and the type of property donated. Under the Act, the 50% limitation is increased to 60%. This increase also ends after 2025. Code section 170(b)(1)(G)(i).

The miscellaneous itemized deduction, which includes fees for investment advice and which is subject to the 2% of AGI floor, has been suspended through 2025. Code section 67(g). This has led to a question about the extent to which it applies to trustee fees (discussed below).

In good news to higher income taxpayers, the limitation on itemized deductions (known as the "Pease" limitation), under which such deductions are reduced by 3% of a taxpayer's AGI if it exceeded a stated threshold, has been eliminated through 2025. Code section 68(f).

The Alternative Minimum Tax ("AMT") was intended to prevent high income taxpayers from avoiding tax liability through the use of various deductions, exclusions, and credits. Unfortunately, the exemption amount used to eliminate certain deductions was not indexed for inflation,

so that an increasing number of taxpayers were affected over the years. The AMT was not eliminated under the Act as had been initially proposed but instead has been retained with a higher exemption amount: from $86,200 to $109,400. Although a discussion of how the exemption works and how the AMT is calculated is beyond the scope of these materials, this exemption change will take a great number of taxpayers out of the AMT regimen. Code section 55(d)(4).

The interplay of these provisions will produce interesting results. For example, a retired but still high-earning Oregonian who has paid off her mortgage may find herself with only $10,000 of itemized deductions (that is, the cap on state and local tax). This means that her charitable contributions would have to exceed $14,000 (if she was married filing jointly) in order for her itemized deductions to exceed the amount of her standard deduction. And, in this case, it would only be the charitable contributions in excess of $14,000 that would produce a benefit over the standard deduction (in other words, this taxpayer would have to donate $15,000 in order to see a benefit of a $1,000 deduction over the standard). This analysis would change significantly if that taxpayer had medical costs in excess of 7.5% of her AGI and still had a mortgage. In other words, it's no longer clear who will and will not benefit from charitable deductions from a tax perspective.

Hot Tip: Maybe the most useful planning recommendation deals with charitable contributions by older clients. Those clients who have significant retirement plan or IRA balances must start taking "required minimum distributions" (RMDs) after they reach age 70 ½. Wealthier clients may not need those distributions, but are required to take them into income anyway. By making a "charitable rollover" of some or all of those distributions, a client is not entitled to a charitable deduction, but simply does not have to take the portion given to charity into income if the client has attained age 70 ½ . Code section 408(d)(8)(B). This is an excellent way to make charitable gifts in a tax-efficient way, and still take advantage of the higher standard deduction (bearing in mind that the charitable rollover is limited to $100,000 per year).

Less Hot Tip: Another way to think about getting as much income tax benefit from a client's charitable contributions is for the client to consider "bunching" her contributions into a single year. For example, assume a client gives $10,000 per year to her favorite charity and has paid off her home. Her total itemized deductions might only equal $20,000, which is $4,000 less than her itemized deductions (assuming she's married). She would get no tax benefit from her contributions because she would never itemize. On the other hand, if she made no charitable contributions in years one and two, and instead made $30,000 of gifts in year three, she would still get the standard deduction in the first two years, but would get $40,000 of itemized deductions in year three. Put another way, this client would get an additional $16,000 of income tax deduction over three years by saving up all her charitable contributions. This approach may be of limited usefulness, however, as many clients probably will not choose to give in this way.

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III. Deferred Income.

Several more minor changes were made to retirement plans and deferred compensation, but are worth discussing.

First, taxpayers can no longer recharacterize contributions to Roth IRAs as contributions to a regular IRA within the same taxable year. This limits the flexibility of making a Roth contribution but keeping your options open if your tax situation changes. Code section 408A(d)(6)(B)(iii).

Second, taxpayers who have certain stock options exercised starting on January 1, 2018 can elect to defer income recognized on the transfer of qualified stock. Code section 83(i). The rules regarding this deferral are beyond the scope of these materials.

Third, the amount that can be contributed to ABLE accounts has increased. An ABLE account is essentially a tax-deferred plan that benefits individuals with disabilities. Code section 529A. Further, in some cases amounts from 529 plan accounts can be rolled over into ABLE accounts. This might be a way to redirect over-funded 529 plans into accounts for disabled family members. Code section 529(c)(3)(C)(i)(III).

Finally, 529 plan funds can now be used to pay private elementary and secondary school tuition, up to a $10,000 annual limit. Previously such funds could be used only for college expenses. Code section 529(c)(7).

> ***Warning:*** Oregon does provide an additional deduction to Oregon taxpayers of $4,660 (in 2017) for contributions to the Oregon 529 plan. However, Oregon House Bill 4080, awaiting the Governor's signature, will require Oregon taxpayers to add back to their state income any amount of a 529 plan distribution that covers K through 12 private school tuition, if the contribution from which the distribution was made received an Oregon state income tax deduction. Additionally, those taxpayers also will have to add earnings to such a 529 plan back into their taxable income.

IV. Pass-Through Income.

The Act provides a significant benefit to individuals with trade or business income from an S corporation, partnership, LLC taxed as a partnership, or sole proprietorship. The individual is entitled to a deduction of 20% of qualified business income ("QBI") from such an entity. Investment income is generally not included in QBI, nor are reasonable compensation or guaranteed payments. Taxpayers earning more than $415,000 (with a phase-out starting at $315,000) are unable to take the deduction for income generated from the following trades or businesses: health, law, consulting, athletics, financial or brokerage services, or where the reputation or skill of an owner or employee is its principal asset. So, for example, a lawyer in a partnership who is just starting out and whose income is lower might be able to take advantage of this provision, but if she becomes successful, she can't. *See generally* Code section 199A.

There are many limitations and computational complexities involved in determining the amount of this deduction, which are beyond the scope of these materials, so the owner of a pass-through entity who wants to take advantage of the deduction should consult with her accountant.

As with most of the rest of the Act, this deduction is only available through 2025.

V. Taxes on Nonprofits.

The Act made three changes to the taxation of nonprofits that won't have wide-ranging effects, but could have significant impacts on a few nonprofits.

First, nonprofits are subject to tax at the corporate rate on compensation paid to a "covered" employee (i.e., one of the five highest paid) in excess of $1 million, as well as on excess parachute payments. Code section 4960.

Second, certain private colleges and universities have to pay a 1.4% excise tax on net investment income if they have assets of at least $500,000 per student. Code section 4968.

Finally, unrelated business taxable income (UBTI) is now calculated differently: losses from one unrelated tax or business cannot be used to offset gains from another. Rather, gains and losses have to be calculated separately for each trade or business. Code section 512(a)(6).

VI. Trustee Fees.

As discussed earlier, miscellaneous itemized deductions (those that are only deductible to the extent they exceed 2% of the taxpayer's AGI) are suspended through 2025. Personal representative and trustee fees are miscellaneous itemized deductions, and therefore also subject to the 2% floor, except to the extent that those fees "would not have been incurred if the property [generating the tax] were not held in such trust or estate." Code section 67(e)(1). Trustee fees attributable to investment advice, which is an expense individuals incur as well as fiduciaries, are subject to the 2% floor, but administrative expenses are not.

This leads to the question of whether trustee fees as a whole are no longer deductible, or only those fees subject to the 2% floor. Several large financial institutions, as well as prominent ACTEC Fellows on national presentations, have opined (without apparent support) that the administrative portion of trustee fees will remain deductible.

However, this position violates the plain language of Code section 67(b), which states that a "miscellaneous itemized deduction" is any deduction other than those described in a long list of specifically enumerated exceptions. Trustee fees (both administrative and investment) are not included in that list, and therefore are miscellaneous itemized deductions. Code section 67(g) says that all miscellaneous itemized deductions are suspended through 2025. It makes no mention of those deductions that are subject to the 2% floor.

There's no clear answer; respected professionals and institutions have come down on both sides of the question (or have refused to take a position).

VII. Charts.

The following charts illustrate some of the changes described above.

Individual income tax rates

Income Bracket Thresholds					
Tax Rate	**Single**	**Married Filing Jointly/ Surviving Spouse**	**Married Filing Separately**	**Head of Household**	**Trust/Estate**
10%	$0	$0	$0	$0	$0
12%	$9,525	$19,050	$9,525	$13,600	N/A
22%	$38,700	$77,400	$38,700	$51,800	N/A
24%	$82,500	$165,000	$82,500	$82,500	$2,550
32%	$157,500	$315,000	$157,500	$157,500	N/A
35%	$200,000	$400,000	$200,000	$200,000	$9,150
37%	$500,000	$600,000	$300,000	$500,000	$12,500

Standard deduction, itemized deductions, and personal exemptions

Personal and Dependency Exemptions (you, your spouse, and dependents)		
	Pre-existing law	**New law**
Exemption	$4,150	No personal exemption

Standard Deduction		
	Pre-existing law	**New law**
Married filing jointly	$13,000	$24,000
Head of household	$9,550	$18,000
Single/married filing separately	$6,500	$12,000
Additional aged/blind		
Single/head of household	$1,600	$1,600
All other filing statuses	$1,300	$1,300

Itemized Deductions		
	Pre-existing law	**New law**
Medical expenses	Yes, to extent expenses exceed 10% of AGI floor	Yes, 10% AGI floor reduced to 7.5% for 2017 and 2018
State and local taxes	Yes, income (or sales) tax, real property tax, personal property tax	Yes, limited to $10,000 ($5,000 for married filing separately)
Home mortgage interest	Yes, limited to $1,000,000 ($100,000 for home equity loan), one-half those amounts for married filing separately	Yes, limited to $750,000 ($375,000 for married filing separately), no home equity loan; the $1,000,000/$500,000 limit still applies to debt incurred before December 16, 2017
Charitable gifts	Yes	Yes, 50% AGI limit raised to 60% for certain cash gifts
Casualty and theft losses	Yes	Federally declared disasters only
Job expenses and certain miscellaneous deductions	Yes	No

Child tax credit

Child Tax Credit		
	Pre-existing law	New law
Maximum credit	$1,000	$2,000
Non-child dependents	N/A	$500
Maximum refundable	$1,000	$1,400 indexed
Refundable earned income threshold	$3,000	$2,500
Credit phaseout threshold		
Single/head of household	$75,000	$200,000
Married filing jointly	$110,000	$400,000
Married filing separately	$55,000	$200,000

Alternative minimum tax (AMT)

Alternative Minimum Tax (AMT)		
	Pre-existing law	New law
Maximum AMT exemption amount	$86,200 (MFJ), $55,400 (Single/HOH), $43,100 (MFS)	$109,400 (MFJ), $70,300 (Single/HOH), $54,700 (MFS)
Exemption phaseout threshold	$164,100 (MFJ), $123,100 (Single/HOH), $82,050 (MFS)	$1,000,000 (MFJ), $500,000 (Single, HOH, MFS)
26% rate applies to AMT income (AMTI) at or below this amount (28% rate applies to AMTI above this amount)	$191,500 (MFJ, Single, HOH), $95,750 (MFS)	$191,500 (MFJ, Single, HOH), $95,750 (MFS)

International Estate Planning: Estate Tax Planning Issues Involving a Non-Citizen Spouse

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Entire books could be written on estate tax planning for non-citizens. Here is a short analysis of some of the most relevant issues involved with an estate plan for a non-citizen when married to a U.S. citizen. The examples in this analysis involve a husband who is an Oregon resident and a U.S. citizen with a taxable estate for federal tax purposes, and whose wife is a non-citizen.

Issues Regarding a Green Card Holder Serving as Trustee of a Revocable Trust

If a non-citizen serves as trustee, the Internal Revenue Service ("IRS") may deem the trust a foreign trust. When a trust becomes a foreign trust, each asset in the trust is subject to a capital gains tax on the excess of the fair market value of the asset over its adjusted cost basis. The IRS will also impose a special tax on any accumulated undistributed net income.

A trust is considered domestic if (i) a U.S. court can exercise primary supervision over trust administration (the "court test"), and (ii) U.S. persons control all substantial trust decisions (the "control test"). 26 CFR § 301.7701-7(a)(1). The term "U.S. person" means any U.S. citizen or alien admitted for permanent residence in the United States. IRC § 6010.

As long as the non-citizen spouse maintains her green card status and continues to live in the United States, there are no issues with her serving as trustee or co-trustee of a typical revocable trust. However, if she moves back to her home country and continues to serve as trustee, the trust will become a foreign trust, resulting in very unfavorable tax consequences.

Practice Tip – If the non-citizen spouse is named as trustee or co-trustee of a revocable trust, the trustee resignation provisions should be drafted so that she will be deemed to have immediately resigned as trustee if she ceases to be a U.S. resident taxpayer (or U.S. person).

General Background Regarding Death Taxes

Oregon residents are potentially subject to both the federal estate tax and the Oregon estate transfer tax. Under current law, the federal estate tax comes into play if a decedent passes away with more than approximately $11.18 million in assets (adjusted for inflation). The Oregon estate transfer tax comes into play when a decedent passes away with over $1 million in assets.

Gifts Involving a Non-Citizen Spouse

Gifts to U.S. citizen spouses qualify for the unlimited marital deduction and gifts of less than $15,000 per year to other beneficiaries can qualify for the gift tax annual exclusion. However, gifts to a non-citizen spouse do not qualify for the unlimited marital deduction but may qualify for a $152,000 annual exclusion. This allows a U.S. citizen spouse to make a gift of up to $152,000 annually (adjusted for inflation) to a non-citizen spouse without utilizing his unified credit or needing to file a gift tax return.

When a U.S. citizen spouse's wealth is disproportionately large compared to the wealth of the non-citizen spouse, one option is for the U.S. citizen to gift a substantial amount of assets to the non-citizen spouse. The goal is to drop the taxable estate of the U.S. citizen spouse below $11.18 million. However, the estate would likely still be taxable for Oregon purposes. In other words, even if the wealth is equalized between the spouses and there's no federal estate tax exposure, the estate will likely still be subject to Oregon estate transfer taxes if the couple remains in Oregon. In addition, if the couple ceases to reside in Oregon but continues to own real estate or tangible personal property in Oregon, the estate will still be subject to Oregon estate transfer taxes.

Practice Tip – If a U.S. citizen spouse adds his non-citizen spouse's name to a deed and the amount gifted to his spouse exceeds $152,000, the U.S. citizen must file a gift tax return to report the transfer. The unified credit may be available to cover any taxes resulting from this transfer.

Federal Issues Regarding the Marital Deduction

Married couples who are both U.S. citizens have an unlimited marital deduction available upon the death of the first spouse. IRC § 2056(a). This unlimited marital deduction is not available if the surviving spouse is a non-citizen. The U.S. government is concerned that the property transferred to the non-citizen spouse will escape the deferred federal estate tax because of the possibility that the property may be removed from the jurisdiction of the U.S. estate tax before the death of the non-citizen surviving spouse.

An exception to the marital deduction limitation is available if the property passes to the surviving non-citizen spouse in a qualified domestic trust ("QDOT"). IRC § 2056A. There are three requirements for a QDOT:

(1) At all times, at least one trustee must be either an individual U.S. citizen or a domestic corporation (the "domestic trustee");

(2) No distribution (other than income) may be made unless the domestic trustee may withhold taxes and the QDOT must meet the requirements of regulations prescribed by the IRS to ensure the collection of any such taxes (the tax rate is the same as the federal estate tax); and

(3) The trustee must file an appropriate election for the trust to be treated as a QDOT. *Id.*

Practice Tip – If a non-citizen is named as a trustee on a revocable trust and it's expected that a QDOT will be created upon her spouse's death, the trust provisions should require that at least one trustee of the QDOT must be an individual U.S. citizen or a domestic corporation and that no distribution may be made from the trust unless the domestic trustee has the right to withhold from such distribution the taxes imposed on the distribution.

Oregon Issues Regarding Marital Deductions

In Oregon, $1 million can pass free of the estate transfer tax. At the death of the first spouse, the surviving non-citizen spouse would likely take an Oregon Special Marital Property ("OSMP") election on the amount in excess of $1 million. There is no requirement that the surviving spouse be a U.S. citizen to make an OSMP election. This has the same effect of deferring estate transfer taxes until the surviving spouse passes away.

ORS 118.013 allows property transferred outright to a spouse to qualify for the OSMP election. If a couple's assets are all jointly owned or will pass via transfer-on-death or beneficiary designations, then an OSMP election may be taken on these assets. As a reminder, if all of the assets pass to the surviving spouse and an OSMP election is taken on all the assets, the estate of the surviving spouse will have to pay taxes on any amount in excess of $1 million.

Ideally, joint assets should be transferred to a trust so that the surviving spouse can disclaim $1 million to avoid estate transfer taxes on these assets at the surviving spouse's death. Alternatively, the trust can be set up as an A-B split so that half of the joint assets are placed into an irrevocable trust and not included in the surviving spouse's taxable estate.

Issues Regarding Assets Located Outside of the United States

We can only give legal advice pertaining to assets located in states in which we are licensed to practice. Clients should be advised to obtain legal counsel in the jurisdiction in which the non-citizen spouse has assets in and other countries in which that spouse is a citizen.

Conclusion

When one spouse is a non-citizen, there can be a lot of unfavorable tax consequences if the U.S. citizen spouse passes away first. However, with careful estate tax planning, there are measures the married couple can take to effectuate beneficial tax planning.

Advance Directive Legislative Update

Hilary A. Newcomb, Attorney at Law

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House Bill 4135 (the Bill), which modifies both the statutes and the form of Advance Directives, was recently passed. The Bill accomplishes these tasks:

1. Establishes a diverse, elected 13-member Advance Directive Adoption Committee (Adoption Committee) for purposes of proposing and adopting changes to the current Advance Directive form on a four-year cycle (changes will not take effect unless they pass the Legislative Assembly);
2. Modifies the present statutory form (for example, it is simpler and the principal's notarized signature is sufficient for execution);
3. Maintains the nomination of health care representatives in statute; and
4. Directs the Adoption Committee's future proposed forms through legislation.

This is the first time the Advance Directive form has been changed in 25 years, so naturally there are many questions surrounding the Bill. Here are some common ones:

Q. #1: When is the effective date of the Bill?

A. #1: It awaits signature by the Governor.

Q. #2: When do the new statutes go into effect?

A. #2: The new statutes and modified statutory form (in the Bill, not from the Adoption Committee) would become operative on January 1, 2019.

Q. #3: When does the modified statutory form sunset?

A. #3: The modified statutory form of the Advance Directive sunsets on January 1, 2022, because the Adoption Committee is expected to have a newly proposed form by that time.

Q. #4: Are Advance Directives that were executed prior to January 1, 2019 invalid?

A. #4: No. A savings clause in the Bill addresses previously signed Advance Directive forms. It clarifies that as long as an Advance Directive was validly executed under the laws in effect at the time of signing, it will remain valid.

Q. #5: How often can the Adoption Committee propose a new Advance Directive form to the legislature?

A. #5: The Adoption Committee may propose and adopt changes to the current Advance Directive form on a four-year cycle, yet this proposed form would still need to go through the legislative process.

The full text of the Bill can be viewed at:
https://olis.leg.state.or.us/liz/2018R1/Downloads/MeasureDocument/HB4135

Events Calendar

Central Oregon Estate Planning Council Meeting
May 8th, 2018 at 5:30 PM
at the Awbrey Glen Golf Club in Bend.
Reservations can be made through
cpuddy@oregoncf.org or (541) 382-1170

18th Annual Oregon Tax Institute
June 7th, 2018 – OSB CLE Event
Multnomah Athletic Club

Advanced Estate Planning Seminar/Webcast
June 22, 2018 – OSB CLE Event
Multnomah Athletic Club

Seattle Estate Planning Seminar
November 12-13, 2018
at the Washington State
Convention Center in Seattle

The Editors want to include announcements of upcoming events that are open to the public and may be of interest to our readers. If you know of an event, please send basic information, including point of contact information to Chris Cline at *chriscline@riverviewbank.com* for inclusion in the next issue of the Newsletter.