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Hoffman, Sabban & Watenmaker strives to keep its clients and friends informed of important developments affecting their estate, gift and tax planning. This letter summarizes some of those developments.

Due to Governor Gavin Newsom's March 19, 2020 Executive Order (N-33-20) to stay home, many of our lawyers and paralegals are working remotely from home. However, as we consider much of our services to be "essential" as described by Governor Newsom, we continue our efforts to serve our clients to the best of our ability, while maintaining the edicts of social distancing to ensure the safety and well-being of our clients, advisors and everyone in our firm. Accordingly, we wanted to provide our annual letter to update you on recent legislation passed to deal with the nationwide (and global) pandemic, and also to describe techniques having general application that extend beyond the recent crisis.

Our thoughts and well wishes go out to all of you and your family and we hope that everyone is safe and well.

I. 2020 FEDERAL GIFT & ESTATE TAX AMOUNTS

A. Gift Tax Annual Exclusion. The annual exclusion for gifts remains at $15,000 per person to any recipient. The exclusion for gifts to a non-U.S. citizen spouse is increased to $157,000 per year (up from $155,000). As before, the annual exclusion for gifts to a U.S. citizen spouse is unlimited.

B. Estate and Gift Tax Exemption (Lifetime). The estate and gift tax lifetime exemption is increased to $11,580,000 (up from $11,400,000).

C. Generation-Skipping Transfer (GST) Tax Exemption (Lifetime). The exemption from the GST tax will be the same as the estate and gift tax lifetime exemption ($11,580,000).

D. Estate/Gift/GST Tax Rate. The tax rate on transfers in excess of the above exemptions continues to be 40%.

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E. Tax Return Due Dates Extended. As a result of the COVID-19 pandemic, due dates for all Federal and California income, gift and estate tax returns have been extended to July 15, 2020. Note that this extension applies to most all returns due on or after April 1, 2020 and before July 15, 2020. For exact details, please see IRS Notice 2020-66.

II. FEDERAL LAW CHANGES

A. CARES Act. The Coronavirus Aid, Relief and Security (CARES) Act became effective March 27, 2020. This new law was intended to provide significant economic stimulus to both individuals and small businesses. However, it also provided certain estate planning benefits for clients in 2020.

1. No Charitable Deduction Limitation for Certain Charitable Contributions. The CARES Act eliminated the deduction limitation (currently 60% of the donor's adjusted gross income [AGI]) for charitable gifts of *cash* to *public charities* (but not donor advised funds) in 2020. Thus, donors can now deduct these qualifying gifts against 100% of their AGI on their 2020 income tax returns.

2. No Required Minimum Distributions for IRAs in 2020. Participants or beneficiaries of IRAs (defined below) are not required to take any required minimum distribution for 2020. It appears that the IRA charitable rollover (described below) remains available in 2020. Thus, clients who wish to make charitable gifts out of their IRAs in 2020 should consult their advisors to maximize their charitable and income tax benefits.

B. SECURE Act. Effective January 1, 2020, the Setting Every Community Up for Retirement Enhancement (SECURE) Act made significant changes to individual retirement accounts and qualified retirement plans, such as 401k plans (collectively referred to below as "IRAs"). The following rules don't apply if the IRA owner died last year or earlier.

1. Extend Age of RMDs. The age at which required minimum distributions (RMDs) begins is moved from 70½ to 72 years for people attaining age 70-1/2 after 2019. Also, there is no longer any maximum age for contributing to traditional IRAs.

2. Stretch Out Limited to 10 Years. The Act generally requires inherited IRA benefits to be fully distributed to all non-spouse beneficiaries within 10 years of the IRA owner's death. There is an exception for a limited class of beneficiaries (described below).

    i. The rules for non-designated beneficiaries (like charities or non-qualified trusts) remain the same: If the IRA owner wasn't receiving RMDs, then the IRA benefits must be taken within five years of the owner's death; if the IRA owner was receiving RMDs, then the IRA benefits may be taken

over the IRA owner's life expectancy based on his or her age at the time of his or her death.

ii. Only "eligible designated beneficiaries" (EDBs) may continue to elect to take their inherited IRA benefits over their own life expectancies. All other designated beneficiaries must receive their entire IRA benefits no later than 10 years after the IRA owner's death. Thus, for example, a person who is not an EDB could take no distributions for the first nine years and then the entire balance in year 10. These EDBs include (a) the IRA owner's surviving spouse, (b) disabled or chronically ill beneficiaries, (c) individuals who are not more than 10 years younger than the IRA owner and (c) the IRA owner's minor children (but not minor grandchildren). For minor children, the 10-year rule will apply once they attain the age of majority (in most cases, age 18, but the Act provides for a postponement of this majority age for children who are students, including college, until as late as age 25).

3. $100,000 Charitable Rollover. The age at which qualified charitable distributions from IRAs ("charitable rollovers") is permitted remains 70½, not 72. Although an income tax charitable deduction is not received, IRA owners do not recognize income on these charitable rollovers (so it affects the amount of the owner's "adjusted gross income" which has implications for other tax purposes). Also, these rollovers are not limited to the IRA owner's required minimum distributions (RMDs); thus, even if the IRA owner is not receiving any RMDs, he or she may still make a charitable rollover starting at age 70½. However, charitable rollovers cannot be made to a private foundation, donor advised fund or supporting organization.

4. Estate Planning Impact. It is not completely known at this time how these new rules will impact certain trusts designated as IRA beneficiaries. In particular, we do not know fully how these rules affect conduit provisions in trusts, which were originally designed to allow trust beneficiaries to stretch out the IRA benefits for their lifetimes. For example, although our conduit language does not restrict the IRA beneficiary from receiving any IRA benefits until the end of the 10-year period, other firms' provisions may result in such a restriction. Also, if the intended IRA beneficiary is "disabled or chronically ill," then the conduit provisions may negatively impact the beneficiary's entitlement to government benefits. Thus, clients should examine their IRAs and beneficiary designations, and review how this new Act may affect their intentions with respect to their designated beneficiaries.

III. CALIFORNIA LAW CHANGES

A. Non-Probate Transfer Value (Probate Code Sections 13050 et seq.). Effective January 1, 2020, the value of a decedent's estate that can pass without probate under the

small estate provisions will increase to $166,250 (from $150,000). Note that certain other figures under these PC Sections have also changed.

B. Limitation on Use of Independent Contractors (AB 5). Effective January 1, 2020, new rules will govern the classification of workers as employees or independent contractors. For more information concerning this new law and its potential impact, please turn to Exhibit A attached to this letter.

C. Rent Control. A statewide rent control law was recently enacted, to be effective January 1, 2020, that limits certain residential landlords' ability to increase rent and evict tenants. If you own residential rental properties, you should consult a real estate lawyer to determine whether or not the new rent control law applies to you and how to comply with the new legal requirements. Evictions are limited during the current pandemic.

IV. INCOME TAXATION OF OUT OF STATE TRUSTS

A. California Income Taxation of Non-Grantor Trusts. California taxes income of an irrevocable, non-grantor trust, wherever situated, if (a) there is California source income, (b) there is a trustee or other fiduciary who is a California resident, or (c) there is a "non-contingent" beneficiary who is a California resident. Unlike many other states which tax based on the residence of a settlor, California ignores this consideration. Thus, if all of the trust's fiduciaries are California residents, then all of the income will be subject to California tax; likewise, if all of the trust's non-contingent beneficiaries are California residents, then all of the income will be taxed by California. For a more detailed discussion on California income taxation, finding from a recent U.S. Supreme Court case and the pros and cons of ING trusts, please turn to Exhibit B attached to this letter.

V. ESTATE AND TAX PLANNING

A. Utilizing Higher Exemptions. As discussed in last year's letter, the doubling of the gift, estate and GST tax exemptions provides a unique and limited opportunity to reduce future transfer taxes. As noted previously, the Tax Cuts and Jobs Act ("Tax Act") providing for the higher exemptions is set to expire on January 1, 2026. Further, Congressional Democrats have made it clear that if they win control of the presidency and both houses of Congress earlier (say, in 2020), they will attempt to reduce the exemptions before 2026.

1. No "Clawback". The Treasury issued regulations indicating that individuals who make gifts between 2018 and 2026, but die after 2025 (when the exemptions return to the 2017 levels), will not be penalized by having to pay estate tax on gifts in excess of his or her exemption at the time of his or her death (but, which were within the legal limits when the gifts were made).

2. Use It Before You Lose It. Assuming that you can afford to make gifts in excess of the old limit ($5 million, plus inflation, per person, or over $10

million per couple), we recommend making gifts utilizing these higher exemptions as soon as possible.

B. Tax-Free Gifting. The following approaches can be valuable when a client has assets in excess of the estate tax exemption and wants to pass assets to others free of gift tax (and estate tax).

1. Annual Exclusion. An annual exclusion gift (currently $15,000 per person to anyone) is a "free" gift with neither IRS reporting nor gift tax implications.

2. Payments of Tuition and Medical Bills Directly to Providers. Payments of tuition directly to educational institutions (from preschool to graduate school) and medical bills directly to doctors or hospitals do not count against the annual exclusion amount or lifetime exemption. Note that this is not applicable if someone else pays the bills and you reimburse him or her.

3. Irrevocable Grantor Trust. An "intentionally defective grantor trust" (or IDGT) is a device that allows you to give away assets (so that any income and asset growth is out of your estate), but you continue to pay income tax on the income and capital gain. This is essentially a gift tax-free gift of the income tax payments.

   Because the IDGT is deemed to be the same taxpayer as the grantor for income tax purposes, any sale of appreciated property between the two will not realize capital gains taxes. In addition, any rent paid to the IDGT by the grantor (because the grantor occupies a home that was transferred to the IDGT) or any interest paid to the grantor by the IDGT (for a loan made by the grantor to the IDGT) is not subject to income taxes.

   Also, any post-sale appreciation in the sold asset will pass to the purchaser (likely the grantor's descendants) free of gift and estate taxes.

4. GRAT. A "Grantor Retained Annuity Trust" (or GRAT) is a device that allows you to make a tax-free gift of appreciation in assets contributed to the GRAT in excess of the interest rate set by the IRS (1.2% for April 2020 and 0.8% for May 2020).

C. Intra-Family Loans. The IRS allows you to charge interest on a loan to a related person (i.e., a child or a trust for a child) using an interest rate set by the IRS in the month the loan is made. For May 2020, the minimum interest rate will be 0.25% on loans (compounded annually) with a term up to 3 years; 0.58% on loans from 3 to 9 years, and 1.18% on loans over 9 years. These historically low rates will likely allow the borrower (who can use the borrowed funds to make investments) to make a significant profit over the term of the loan.

D. Income Tax and Basis Planning. Given the doubling of the gift and estate tax exemptions, there are fewer estates that may be subject to estate taxes. Further, the gap

between the estate tax rate (40%) and the combined federal and California capital gains tax rate (37.1% if the Medicare surtax is included) has narrowed considerably, such that obtaining a step up in income tax basis may be just as important, if not more, than reducing one's taxable estate (although there could be a step down).

This is especially true for married couples in California holding community property, as the income tax basis in 100% of that property (including the surviving spouse's one-half share) will be stepped up to its fair market value on the death of the first spouse. As a result, if the surviving spouse inherits the deceased spouse's share and soon thereafter sells that property, he or she will incur no estate tax and no capital gains tax. For a more detailed discussion on how the above facts, along with *portability*, may have changed how we structure estate and tax planning for married couples, please turn to Exhibit C attached to this letter.

E. Qualified Opportunity Zones. As detailed in last year's letter, the Tax Act created unique investment opportunities called Qualified Opportunity Zones (QOZs). There are basically three tax benefits of QOZs:

1. Deferral of Capital Gains Tax. Individuals may elect to defer recognition of capital gain from certain sales or exchanges of capital assets by investing the gain in a QOZ, if it is invested within 180 days of the date of the sale or exchange. Unlike Section 1031 exchanges for real estate, this deferral is not limited to real properties; it can apply to most capital assets (including interests in businesses and publicly traded stocks). Also, unlike real estate exchanges, the individual only has to invest the gains, not the entire proceeds from the sale of the capital asset; thus, the individual may keep the sale proceeds equal to his or her basis in the sold capital asset.

2. Elimination of Part of Deferred Gain. If the individual holds the newly invested QOZ for five years, 10% of the deferred gain on the sold capital asset will be eliminated entirely; if the QOZ is held for seven years, an additional 5% of the deferred gain (or 15% total) will be eliminated. The remaining 85% of the deferred gain will be subject to capital gains tax when the QOZ is sold or on December 31, 2026, whichever occurs earlier. Thus, if a client wanted to maximize this elimination of certain portion of the gain, he or she would have had to sell the capital asset and invest in a QOZ by December 31, 2019.

3. No Tax on Appreciation in QOZ Investment. If the QOZ investment is held for 10 years, any and all appreciation in the QOZ will not be subject to further capital gains tax whenever it is sold (even for gain arising after the 10-year holding period).

There are numerous rules related to QOZs, including certification of the zones and the portion of the investment that counts towards the deferral. Please consult us if you are interested in learning more about these QOZs.

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VI. <u>ESTATE PLAN CHECK-UP</u>. This might be a good time to review your trust and other estate planning documents to see if they still accomplish your goals.

A. Change in Circumstances. Remember that changes in your circumstances, such as a marriage or divorce, a change in your financial situation or liquidity, retirement, births and deaths, might necessitate revisions to your estate plan. Your life insurance needs might have also changed.

B. Old Formula Clauses. You might have an older estate plan that makes gifts based on a formula tied to an exemption amount that has changed, such as gifts to grandchildren, children from a prior marriage, charity or others. The amount of those gifts may be drastically different under current law than what you had envisioned. You should review these formulas and determine whether they still make sense, especially in light of the increased exemptions.

C. Beneficiary Designations. Check your beneficiary designations of retirement accounts and life insurance policies, and consider whether they need to be changed.

D. Avoiding Probate. Make sure your assets are titled in the name of your living trust. If you have refinanced your home or other real property, the lender might have had you take your property out of your trust to process the loan. Be sure to put title back into your trust. Also, for married couples, how you hold title (i.e., joint tenancy, as opposed to community property) may affect the extent of the basis adjustment upon the first death. You should check to see how title is held, so this may be changed before an untimely demise.

E. People Left in Charge. Check your estate planning documents to make sure that the people you have named to hold certain positions are still the individuals you wish to serve (e.g., the guardians for minor children, trustees of your trusts, executors under your wills, financial agents under your durable powers of attorney and health care agents under your advance health care directives).

F. Fixing Outdated Plans. For revocable trusts, wills, powers of attorney for finances and advance health care directives, you may make changes as you wish. This also applies to some irrevocable trusts (for example, if you have the power to change the trustees, or if you have a "power of appointment" to change distribution provisions of the trust). However, it is more difficult to change irrevocable trusts when you don't have any power to make these changes. Nevertheless, California law and certain estate planning techniques allow for the ability (under prescribed circumstances described below) to change these seemingly permanent plans.

1. Modification Allowed by Law. California law allows changes to and early termination of irrevocable trusts in certain circumstances.

    i. Without Court Involvement. The creator of the trust and all of the beneficiaries may modify or terminate the trust by written agreement without a court petition. If not all of the beneficiaries agree to the

modification, the creator and the other beneficiaries may petition the court for the change.

ii. All Beneficiaries Agree. If the trust creator is not available (deceased or incompetent) and if all of the beneficiaries agree, they may petition the court for modification or termination of the trust (with some limitations).

iii. Change in Circumstances. Any trustee or beneficiary may petition the court to modify or terminate the trust, indicating that there are circumstances unknown and unanticipated by the trust creator which would "defeat or substantially impair" the purposes of the trust.

2. Decanting Statute. Under California's "decanting" statute, the trustee may transfer the assets of an existing irrevocable trust (with certain limitations) to another irrevocable trust with different provisions for the benefit of substantially similar beneficiaries. Much of the trustee's decanting power is dependent upon its distribution authority in the existing trust. There are other limits based on the tax consequences of the trust, but it does appear that the trustee may decant from a grantor trust to a non-grantor trust and vice versa. However, before decanting, the trustee must give at least 60 days notice to the trust creator, each "qualified beneficiary" and certain other interested parties. In certain circumstances (such as when there are minor beneficiaries), a guardian ad litem (GAL) will need to be appointed to represent those beneficiaries.

It appears that California's statute, especially with the stricter notice requirements, may be more limited than many other states' decanting laws, but it does give another avenue to change some outdated plans.

VII. FIRM RECOGNITION

We are pleased to have been recognized for the quality of our work by the following:

A. *U.S. News - Best Lawyers®* - Our firm received a Tier One (highest) Regional ranking in its 2019 Edition of "Best Law Firms" for both Trusts & Estates Law and Tax Law.

B. Paul Gordon Hoffman, Alan S. Watenmaker, Erin L. Prouty and Chang H. Chae are Fellows of the American College of Trust and Estate Counsel (ACTEC).

C. *Super Lawyers Magazine* listed Paul Gordon Hoffman, Alan S. Watenmaker, Erin L. Prouty, Chang H. Chae and Mary Ramsden as "*Super Lawyers*" for 2020 and Garen L. Kirakosian and Krista R. Hartwell as "*Rising Stars*" for 2020.

D. The following attorneys have been selected for inclusion in the 2020 edition of *The Best Lawyers in America*:

- Paul Gordon Hoffman, Alan S. Watenmaker, Erin L. Prouty, Chang H. Chae, Mary K. Ramsden and Eric M. Tokuyama - *Trusts and Estates*
- Paul Gordon Hoffman - *Tax Law*

We would be happy to discuss with you the best options for taking advantage of any of the opportunities described above. If you are interested in discussing these opportunities or in reviewing your estate plan to ensure that it meets your current objectives, please contact us.

EXHIBIT A

A. Limitation on Use of Independent Contractors (AB 5). Effective January 1, 2020, new rules will govern the classification of workers as employees or independent contractors.

1. Law's Impact. This new law will affect employer costs with respect to Social Security and Medicare taxes, unemployment and disability insurance, workers' compensation costs and coverage, sick leave, minimum wage, overtime and other items.

2. "ABC" Test to Determine Independent Contractor. The law codifies the "ABC" test for determining independent contractor status, which was adopted by the California Supreme Court in *Dynamex Operations West, Inc. v. Superior Court* (2018). Under this test, it is presumed that an individual is an employee unless the hiring entity demonstrates that **all three** of the following conditions are met for independent contractor status:

    i. Individual is free from the control and direction of the hiring entity in connection with the work (both under contract and in reality);

    ii. Individual performs work that is outside the usual course of the hiring entity's business; and

    iii. Individual is customarily engaged in an independently established trade, occupation, or business of the same nature as the work performed for the hiring entity.

3. Exempted Occupations. Some of the more significant occupations that are exempted from this law are listed below (this list is not exhaustive):

    i. Insurance agents;
    ii. Medical professionals (including doctors, dentists, psychologists and veterinarians);
    iii. Licensed professionals (including lawyers, architects, engineers and accountants);
    iv. Financial advisers;
    v. Licensed real estate agents; and
    vi. Construction contractors and trucking services.

4. Loanouts. It is not yet clear how the new law may affect entertainment clients with loanout companies. Those clients should consult their entertainment attorneys and business managers to determine the law's applicability.

5. Penalties. Both California and the IRS can levy penalties for misclassification, which can be severe. Additionally, any employee can file an independent cause

of action for misclassification (including for minimum wages, overtime, etc.) and may be entitled to attorneys' fees.

6. Consult Labor Lawyer. If you have any questions concerning the above, you should consult a labor or employment lawyer.

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EXHIBIT B

A. California Income Taxation of Non-Grantor Trusts. California taxes income of an irrevocable, non-grantor trust, wherever situated, if (a) there is California source income, (b) there is a trustee or other fiduciary who is a California resident, or (c) there is a "non-contingent" beneficiary who is a California resident. Unlike many other states which tax based on the residence of a settlor, California ignores this consideration. Thus, if all of the trust's fiduciaries are California residents, then all of the income will be subject to California tax; likewise, if all of the trust's non-contingent beneficiaries are California residents, then all of the income will be taxed by California. For a more detailed discussion on California income taxation, finding from a recent U.S. Supreme Court case and the pros and cons of ING trusts, please turn to Exhibit B attached to this letter.

1. Residence. An individual (whether a beneficiary or fiduciary) residing in California is considered a California resident, unless he or she is here on a temporary or transitory purpose. As a rule of thumb, an individual is presumed to be a California resident if he or she spends, in the aggregate, more than 9 months of the tax year in California.

2. Beneficiary. A beneficiary is vested (non-contingent) if his or her right to receive income from the trust is not subject to any contingency, except perhaps the passage of time (i.e., right to receive the income at a certain age). The beneficiary may also have a vested interest if the accumulated income will be distributed to the beneficiary's estate or if the beneficiary has a general power of appointment over the income at his or her death.

3. Throwback Tax. Where a non-resident trust was properly refraining from paying California income tax (such as when there is no California source income and no fiduciaries or vested beneficiaries reside in California), California may tax a resident beneficiary when that accumulated income is distributed to him or her. These rules are complex and have several limitations, so please contact us or your accountant for specific application.

4. Watch Out. A beneficiary who leaves California within 12 months before the date of distribution of accumulated income, only to return to California within 12 months after the distribution, is presumed to be a resident of California throughout the period of distribution. Thus, beneficiaries should carefully assess their connections to California before receiving accumulated distributions.

B. Kaestner Case. In *North Carolina Department of Revenue v. Kimberley Rice Kaestner 1992 Family Trust*, the U.S. Supreme Court recently held that North Carolina did not have the power to tax the income of a New York non-grantor trust where there were insufficient ties to North Carolina.

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1. Relevant Facts. The pertinent facts of the case are as follows: the trust was created by a New York resident and governed by NY law; the trustee was a Connecticut resident; the trust assets were located in Massachusetts; and the beneficiaries (of a particular subtrust) all moved to North Carolina. In addition, the trust income was from non-North Carolina sources, no distributions were made to any of the beneficiaries, and none of them had any power to demand any distribution.

2. Court's Decision. The U.S. Supreme Court agreed with the North Carolina courts that the above facts do not provide a sufficient constitutional basis for North Carolina to impose its income tax on the trust's accumulated income. The Court's decision is limited to the specific facts of this case and it did not give any indication as to what facts may alter the result of prohibiting taxation by the state taxing authority.

3. California Impact. Because of the above limitation, it is unclear what impact, if any, this case may have for California residents. As described above, the California Franchise Tax Board (FTB) would likely wait to tax on the accumulated income of an out-of-state non-grantor trust, at least until distributions are actually made to California resident beneficiaries (assuming there are no other contacts with California and no California source income).

C. ING Trusts. In recent years, one of the planning techniques touted by many advisors to avoid California income taxes is an "Incomplete Non-Grantor Trust" or ("ING" trust for short). Because these ING trusts are typically established in states with no state income taxes, such as Delaware, Nevada and Wyoming, they are at times referred to as DINGs, NINGs and WINGs.

1. Based on PLRs. These ING trusts are based on certain IRS private letter rulings in which grantors would establish irrevocable trusts in which contributions to them were considered to be "incomplete" gifts for federal gift tax purposes. They were incomplete gifts because under the trust, the grantor retained certain powers (though limited to ensure the grantor is not considered to be the trust's taxpayer) to change the eventual distribution of the trust assets.

2. Gift and Estate Tax Issues. To make distribution decisions, the ING trust appoints a distribution committee comprised in most cases the beneficiaries of the trust, as they are considered to be "adverse parties" (i.e., adverse to each other's interests). This is done so that the grantor may receive distributions without the trust being considered a grantor trust and so that the members of the distribution committee are not considered to have made gifts to the distribution recipients and so that the trust assets are not includible in the committee members' estates for estate tax purposes.

3. California Income Tax Issue. As indicated above, California will tax an out-of-state non-grantor trust's income if it has a California resident fiduciary. Thus, if

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the distribution committee of an ING trust is made up of a majority of California residents, it may be subject to California income tax. The ING trusts attempt to avoid this issue by indicating that the distribution committee is acting in a "non-fiduciary" capacity. However, the California Franchise Tax Board makes its own determination of "fiduciary" capacity and may override this non-fiduciary capacity argument.

In addition, due to the California "throwback" tax rules (described above), if the ING trust beneficiary (or grantor) receiving a distribution is then considered to be a California resident, then California may subject the distribution to California income tax.

4. Pitfalls. In assessing the advisability of creating one of these ING trusts, clients should consider all of the following:

    i. Whether distributions out of the ING trusts will subject the income to be taxed in California (or another state with state income tax) based on its other rules (such as the throwback tax, having California source income, etc.).

    ii. Despite the argument that the distribution committee may be acting in a "non-fiduciary" capacity, whether a majority of the committee members are residents of California. Please remember that some of the committee members must be beneficiaries of the ING trust to avoid certain gift and estate tax issues.

    iii. Be careful about the timing of a significant income tax event, such as capital gains tax upon a sale of an appreciated asset. The California FTB will likely scrutinize more closely a situation where the transfer to an ING trust is closely followed in time by a sale of the asset in an attempt to avoid California income taxes.

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EXHIBIT C

A. Income Tax and Basis Planning. Given the doubling of the gift and estate tax exemptions, there are fewer estates that may be subject to estate taxes. Further, the gap between the estate tax rate (40%) and the combined federal and California capital gains tax rate (37.1% if the Medicare surtax is included) has narrowed considerably, such that obtaining a step up in income tax basis may be just as important, if not more, than reducing one's taxable estate (although there could be a step down).

This is especially true for married couples in California holding community property, as the income tax basis in 100% of that property (including the surviving spouse's one-half share) will be stepped up to its fair market value on the death of the first spouse. As a result, if the surviving spouse inherits the deceased spouse's share and soon thereafter sells that property, he or she will incur no estate tax and no capital gains tax. Below is a discussion of how the above facts, along with *portability*, may have changed how we structure estate and tax planning for married couples.

1. Old Law Necessitating Bypass Trust. Before portability was enacted, a bypass (or credit shelter) trust was needed to preserve the first spouse's estate tax exemption. For example, when the estate tax exemption was $1 million, if the deceased spouse did not create a bypass trust, but rather left his or her assets to the surviving spouse outright, the first spouse's estate tax exemption was lost and the surviving spouse was left only with his or her own $1 million exemption. Thus, in that event, the couple needed to create a bypass trust in order to leave their children $2 million, estate-tax free.

   Portability changed this, as a surviving spouse can now utilize the deceased spouse's estate tax exemption (if any), even without creating a bypass trust, provided that a federal estate tax return is filed. [We discussed these requirements in our 2017 client letter.]

2. Disadvantage of Bypass Trust Planning. One disadvantage to creating a bypass trust is that the assets allocated to it do not receive a step up in income tax basis upon the death of the surviving spouse. While the appreciation in value in the bypass trust escapes estate tax, it will be subject to capital gains tax when the assets are sold. This trade-off can make sense to the extent that the surviving spouse's estate, plus the assets in the bypass trust, will exceed the survivor's estate tax exemption. But, if the value of the surviving spouse's estate, plus the assets in the bypass trust, is less than the survivor's estate tax exemption (taking into account the predeceased spouse's "portable" exemption), then the inability to claim a stepped-up basis on the bypass trust assets creates a real disadvantage.

3. Full Marital Trust Planning. Due to the higher exemptions and the enactment of portability, it may now be preferable for clients to avoid creating a bypass trust upon the death of the first spouse. As we indicated in last year's letter, the

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IRS now allows an irrevocable marital trust to be created without first having to establish a bypass trust. Thus, through this full marital trust planning (where all of the deceased spouse's assets are held in the marital trust), clients may achieve many of the benefits of the bypass trust (e.g., creditor protection, GST planning, locking in the deceased spouse's wishes as to the ultimate beneficiaries of the trust on first death, and avoiding property tax reassessment), while having the assets of the marital trust stepped up for income tax purposes on the surviving spouse's death.

4. Planning Going Forward. Clients should review their estate plans to determine the proper planning in this current higher exemption environment. If you are the surviving spouse and there is a bypass trust already in existence, and if the value of your assets, plus the assets in the bypass trust, is less than the estate tax exemption, you may want to explore options to terminate the bypass trust and have those assets included in your estate. This could avoid capital gains taxes when those assets are sold after your death.

5. Swapping Assets in Grantor Trusts. For clients who have created IDGTs in the past and have contributed assets with low income tax basis, you should consider doing a tax-free exchange or sale, using other assets (perhaps cash) with higher basis. That way, your beneficiaries will receive a step up in basis on those assets upon your passing.

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