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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.

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

I. 2023 FEDERAL GIFT & ESTATE TAX AMOUNTS

A. Gift Tax Annual Exclusion. The annual exclusion for gifts will increase to $17,000 per person to any recipient (up from $16,000 in 2022). The exclusion for gifts to a non-U.S. citizen spouse is increased to $175,000 per year (up from $164,000). 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 $12,920,000 (up from $12,060,000).

C. Generation-Skipping Transfer (GST) Tax Exemption (Lifetime). The exemption from the GST tax will also increase to $12,920,000 (up from $12,060,000).

D. Estate/Gift/GST Tax Rate. The tax rate on transfers in excess of the above exemptions continues to be 40%. California continues to have no state estate or inheritance tax.

II. FEDERAL LAW CHANGE

A. Corporate Transparency Act (CTA). The Corporate Transparency Act becomes effective as of January 1, 2024. This new law requires all "reporting companies" to file a report about the company, certain "beneficial owners" and company applicants with the U.S. Department of Treasury's Financial Crimes Enforcement Network (FINCEN). This will require people who control private LLCs, limited partnerships and corporations (but not general partnerships) to start filing reports disclosing to the federal government about their ownership, including personal information about the owners. For a more detailed explanation of this Act, please turn to Exhibit A attached to this letter.

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III. CALIFORNIA (AND LOCAL) LAW CHANGES

A. Non-Probate Transfer Value (Probate Code Sections 13050 et seq.). Effective April 1, 2022, the value of a decedent's estate that can pass without probate under the small estate provisions increased to $184,500 (from $166,250). Note that certain other figures under these Probate Code Sections have also changed.

B. Mansion Tax. Effective at various times in 2023, the Cities of Los Angeles, Santa Monica and Culver City will impose an additional transfer tax on the sale of certain valuable residential and commercial properties. (Other cities, such as Beverly Hills or Malibu, did not adopt this tax.)

1. City of Los Angeles (Measure ULA). Measure ULA takes effect on April 1, 2023 to levy an additional tax on the sale of certain real property (either residential or commercial). For properties sold for $5 million, but less than $10 million, the tax will be 4% of the total value; for properties sold for $10 million or more, the tax will be 5.5% of the total value.

2. Santa Monica (Measure GS). Measure GS takes effect on March 1, 2023 to levy an additional tax of 5.6% on the sale of certain real property (either residential or commercial) worth $8 million or more.

3. Culver City (Measure RE). Measure RE takes effect on April 1, 2023 to levy an additional tax on the sale of certain real property (either residential or commercial). For properties sold for at least $1.5 million, but less than $3 million, the tax will be 1.5% of the value; for properties sold for $3 million, but less than $10 million, the tax will be 3% of the value; and for properties sold for $10 million or more, the tax will be 4% of the value.

C. CA Pass-Through Entity Tax (PTET) Election. In general, the federal personal income tax no longer allows a deduction for state and local taxes beyond $10,000. However, the law allows states to impose income taxes on certain entities (such as partnerships, LLCs and S corporations) which otherwise don't pay income tax, and then the entity pays the tax which gives rise to a credit against taxes that can be taken by the individual owner, and thus effectively allow the state income tax to be deductible. Note that "disregarded entities" (such as single member LLCs) do not qualify for this election. California's Pass-Through Entity Tax election is effective for tax years beginning on or after January 1, 2021 and before January 1, 2026 for qualified entities required to file California returns. If you have any questions concerning this PTET election, please contact us or your accountant.

D. Prop 19 and Property Taxes. As we noted in last year's client letter, Proposition 19 causes property taxes on appreciated real estate to be adjusted upwards when the property (or, in certain cases, an interest in an entity owning property) is transferred to a child, unlike the situation in prior years. While there are some approaches that may avoid this result in certain cases with sufficient time and expense, and there may be a smaller increase if a home is transferred to a child who lives in it as his or her primary residence, in most cases the result is that transfers to children of long-held real estate are resulting in substantial property tax increases.

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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 some (or all) of the trust's fiduciaries are California residents, then a portion (or all) of the income will be subject to California tax; likewise, if some (or all) of the trust's non-contingent beneficiaries are California residents, then a portion (or all) of the income will be taxed by California. For a more detailed discussion on California income taxation, findings from a recent U.S. Supreme Court case, and the pros and cons of Incomplete Non-Grantor (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 (effective from 2017 through 2025) provides a unique and limited opportunity to reduce future transfer taxes. 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 2024), they will attempt to reduce the exemptions before 2026. A few "moderate Democrats" prevented this from happening in 2021 and 2022.

1. No "Clawback". The Treasury issued regulations indicating that an individual who makes gifts after 2018, but before 2026, and dies 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. Note, however, that the benefit only pertains to gifts of more than roughly $6 to $7 million per donor (depending on the final inflation adjustment).

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 (in 2023, $17,000 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 (5.2% for December 2022).

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 December 2022, the minimum interest rate will be 4.55% on loans (compounded annually) with a term up to 3 years; 4.27% on loans from 3 to 9 years, and 4.34% on loans over 9 years. These rates may allow the borrower (who can use the borrowed funds to make investments) to make a profit over the term of the loan (assuming the borrower can invest the borrowed funds at higher rates).

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 our 2020 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. This is no longer available since the holding period required for any elimination of the deferred gain can no longer be achieved. [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.

VI. ESTATE PLAN CHECK-UP. 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.

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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 2022 Edition of "Best Law Firms" for Trusts & Estates 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). Ms. Prouty is on the Transfer Tax Study Committee of ACTEC. Mr. Chae is on the Estate and Gift Tax Committee, Communications Committee and Transfer Tax Study Committee of ACTEC.

C. *Super Lawyers Magazine* listed Paul Gordon Hoffman, Alan S. Watenmaker, Erin L. Prouty, Chang H. Chae as "*Super Lawyers*" for 2023 and Mary Ramsden as "*Super Lawyer*" for 2021 and Garen L. Kirakosian as "*Rising Star*" for 2021.

D. The following attorneys have been selected for inclusion in the 2023 edition of *The Best Lawyers in America*:
   - Erin L. Prouty is named as 2023 Lawyer of the Year, Los Angeles, CA - *Trusts and Estates*
   - 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

- Corporate Transparency Act (CTA). The Corporate Transparency Act becomes effective as of January 1, 2024. This new law requires all "reporting companies" to file a report about the company, certain "beneficial owners" and company applicants with the U.S. Department of Treasury's Financial Crimes Enforcement Network (FINCEN). This will require people who control private LLCs, limited partnerships and corporations (but not general partnerships) to start filing reports with the federal government about their ownership.

  - "Reporting Company" Definition.

    i. For domestic (U.S.) companies, this definition includes any corporation, LLC, or other entity (such as LPs, LLPs and business trusts) created by the filing of a document with the Secretary of State or similar office.

    ii. For foreign companies, this definition includes any corporation, LLC, or other entity created under the laws of another country that is registered to do business in the U.S.

    iii. This definition does not include sole proprietorships, trusts (other than "business trusts"), public companies, tax exempt entities, pooled investment vehicles and the like. But, if such an entity owns an interest in a "reporting company," that ownership may trigger this reporting requirement (see below).

  - "Beneficial Owners" Definition. A beneficial owner is an individual who (a) directly or indirectly exercises substantial control over the entity, or (b) owns or controls 25% or more of the ownership interests in the entity.

    i. Substantial control includes an individual who is serving as a senior officer; who has authority to appoint or remove a senior officer or majority of the board; or who may direct or make substantial decisions over important matters.

    ii. 25% ownership includes total ownership interest in equity, capital, profit and options; direct and indirect interests; or joint ownership of undivided interests.

    iii. For trusts, a beneficial owner includes the grantor/settlor who has the right to revoke the trust or withdraw trust assets; a trustee or person holding authority to dispose of trust assets; or a beneficiary who is (a) the sole permissible recipient of income and principal, or (b) has the right to demand distribution or withdraw substantially all of the trust assets.

  - Information to Be Disclosed.

    i. For a reporting company, the following information must be disclosed: Legal name, trade name, address of principal place of business and tax identification number.

ii. For each <u>beneficial owner</u>, the following information must be disclosed: Legal name, date of birth, address, identification number (such as in a passport or driver's license) and an image of the identification document.

- <u>Effective Dates</u>. For companies existing as of January 1, 2024, forms must be filed between January 1, 2024 and December 31, 2025; a reporting company created on or after January 1, 2024 must file within 30 days after its creation. The filing requirement is a one-time form with FINCEN, plus an update within 30 days after any changes are made or inaccuracies are found.

- <u>Penalties</u>. If a reporting company fails to comply with the reporting requirements:

  i. There may be <u>civil</u> fines up to $500 per day (with a $10,000 maximum).

  ii. There may be <u>criminal</u> fines up to $10,000 and imprisonment up to two years.

EXHIBIT B

- 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.

    - 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.

    - 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.

    - 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.

    - 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.

- 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.

    - 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.

- 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.

- 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).

• 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.

- 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.

- 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.

- 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 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.

- 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.

EXHIBIT C

- 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.

- 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.]

- 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.

- 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 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.

- 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.

- 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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