Is There a Salve for the SALT that was Rubbed into Our Wounds?

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Effective 2018, individual and married taxpayers filing jointly may deduct only up to $10,000 for their combined state and local (i) real and personal property taxes, and (ii) income taxes or sales taxes (herein together called "SALT"). For married taxpayers filing separately, each taxpayer is limited to a $5,000 deduction. The $10,000 limit is not indexed for inflation. Absent a cataclysmic change in the body politic, we will awake from this nightmare on January 1, 2026. Coupled with this change, and closely related thereto, is the increase in the standard deduction from $12,700 to $24,000 for married taxpayers filing jointly, making moot for many taxpayers the issue of itemized deductions. This, too, carries with it the same limited window of applicability expiring on December 31, 2025. See, An Act to Provide for Reconciliation Pursuant to Titles II and V of the Concurrent Resolution on the Budget for Fiscal Year 2018 (the "2017 Tax Act" or "Act"), Pub. L. No. 115-97, § 11042, 131 Stat. 2054 (2017) (H.R. 1).

The two questions for planners like us are: (i) is there one or more viable strategies that can be implemented to circumvent this limitation and (ii) is the effort, both in terms of cost and complexity, worth the tax savings that could be derived from any such strategy? In the nine months since enactment of the Act (as of this writing), any number of commentators have begun to publish ideas on such planning. This article is an attempt to shed some more light on those ideas.

Basic Structure of Plan. The structure most often appearing in tax journals and other publications reporting on such matters involves some combination of (i) a limited liability company ("LLC"); (ii) multiple non-grantor trusts, with either an incomplete transfer ("INGs") or a completed transfer of assets; and/or (iii) a spousal limited access trust ("SLAT")(the latter, together with a non-grantor trust, being called a "SALTy SLAT"). How it works is as follows: A personal residence, whether primary or a secondary/vacation residence, with an annual property tax well in excess of $10,000 is transferred to an LLC. The client makes a gift of the LLC membership interests into separate non-grantor trusts. The LLC and trusts do not have to be created in the same jurisdiction, but preferably in one that has no state income tax. There are currently eight states with no state income tax.[1] An investment portfolio, or a business interest, generating enough income to offset that member's share of the property tax deduction is also gifted to the trusts. Each trust should qualify for its own $10,000 property tax deduction.[2] The entire property tax is deductible, and there is no loss of the tax deduction arising from the annual SALT cap of $10,000. Mission accomplished.

First hurdle: IRC Section 643(f). This section states as follows: "For purposes of this subchapter, under regulations prescribed by the Secretary, 2 or more trusts shall be treated as 1 trust if— (1) such trusts have substantially the same grantor or grantors and substantially the same primary beneficiary or beneficiaries, and (2) a principal purpose of such trusts is the avoidance of the tax imposed by this chapter. For purposes of the preceding sentence, a husband and wife shall be treated as 1 person."

Obviously, if all of the separate trusts created under this plan design are treated as one trust, the plan fails. But, quick to point out by some commentators (prior to August 8, 2018 – See *Postscript* below), no regulations have ever been issued by Treasury since §643(f) was enacted in 1984. Ergo, the provision should have no enforcement power. I have yet to see any real authority for that proposition, although two commentators have cited the same recent Tax Court case for same.[3] However, upon my own review of that case, it is clear that there was no such holding. To the contrary, I would proffer that the rule set forth in *Estate of Neumann v. Commissioner*, 106 T.C. 216 (1996) is the better authority.[4]

Also relevant, I suggest, is the legislative history of the statute, which states that §643(f) was the result of congressional decision to overrule a case that had

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invalidated earlier Treasury regulations on the subject.[5] That regulation was intended to reverse a defeat sustained by the IRS in *Estelle Morris Trusts v. Comm*[6], which held against a background of silence in the Code and Regs that 20 separate trusts created by 10 virtually identical instruments should be treated as separate taxpayers. Almost immediately that Regulation was attacked in *Stephenson Trust v. Comm.*[7], and the Tax Court invalidated it, stating, in part, that it added restrictions not contained in the statute nor contemplated by Congress. Section 643(f) was designed to overrule *Stephenson*. The legislative history indicates that Congress wanted Treasury to issue new regulations, somewhat different from those held invalid under *Stephenson*. The committee reports include two examples that illustrate the congressional intent. There also exists a number of private letter rulings that have addressed §643(f), one that concluded multiple charitable lead trusts created under one instrument would not be consolidated under §643(f)[8]; and another where multiple trusts were created to settle intrafamily litigation, with the Service ruling, in part, that §643(f) would not apply because a primary purpose was not the avoidance of income tax within the meaning of §643(f)(2)[9].

Why have I taken off on so long a tangent about §643(f), when others have paid it very short shrift? Because I believe this is a real issue that we cannot avoid discussing with our clients if we are going to be so bold to suggest this type of planning to save income taxes. As the old saying goes, "Do you want to make your client famous?" The good folks at the Service read the same journals as we read. Navigating around the prohibition of "substantially the same primary beneficiary or beneficiaries" ought not to be too difficult. [Think reciprocal SLAT's that are designed not to be reciprocal.] But one may be hard pressed to argue, with a straight face, that one of the purposes for engaging in any derivation of the transaction described herein is not to avoid a tax imposed by Chapter 1 of the Code. So, at best, you may be arguing that it was not "a principal purpose" for doing so, which is different from arguing, and more difficult to sustain, than arguing it was not the only purpose for doing so. Moreover, seeking a private letter ruling will not be a solution to resolve the issue of intent. As was stated in *PLR 200220012*, "Determining whether avoidance of income tax is a primary purpose…is a question of fact, the determination of which must be deferred until the federal income tax returns of the parties involved have been examined by the office of the District Director…"

Second hurdle: Jurisdiction and Plan Design. Assuming we, and our clients, are intrepid enough to turn a blind eye to §643(f), or can create another principal purpose for engaging in this type of planning other than to avoid paying income tax, what do these multiple trusts look like? They come in two flavors: incomplete transfers and completed transfers. In either case, for the most part, each trust will have the following characteristics:

- The trust must be located in a state that does not tax trust income [See Footnote 1].
- The trust cannot be subject to tax in the grantor's state of residence. Many states,[10] Pennsylvania included, label trust "resident trusts", and therefore subject to state taxation, simply by virtue of the grantor being a resident of that state, regardless of where the trust is located. Query, whether such statutes are subject to challenge.[11]
- The trust cannot be a grantor trust [More about eliminating the "strings" below].
- The trust will look to allow for discretionary distributions to the grantor. This is certainly not a requirement, but if desired, it will trigger other design requirements. Distributions to trust beneficiaries (children and other descendants) should also be discretionary, if for no other reason than asset protection.
- The grantor maintains enough control over the transferred assets to avoid making it a completed gift. On the other hand, with the lifetime exemptions doubled under the Act to $11.18M, there may be plenty of gifting capacity left for many clients so as not to be concerned with this. But keep in mind that the new higher exemptions are also scheduled to sunset and return to about $5.6M after 2025. So, this may become a "use it or lose it" proposition to be taken into consideration.

The Grantor Trust Strings.

a. Section 677. What may be a first line of inquiry with our clients is whether they anticipate needing the income that will be generated inside the trusts, or if they are prepared to give it up. If the former, then in order to avoid grantor trust status, each trust agreement must include a provision that the income can only be distributed to, or held and accumulated for future distribution to, the grantor or the grantor's spouse with the approval or consent of an adverse party. IRC §677(a)(2). Thus, one best have a very friendly "adverse party", as defined in §672(a), willing to play along.

b. Section 674. Any power to control the beneficial enjoyment of corpus or income exercisable by the grantor or a non-adverse party, or both, without the approval or consent of an adverse party will cause grantor trust status under §674(a). This power is rarely used in creating an "intentionally defective" grantor trust, because such power also

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results in estate tax inclusion of trust assets under §2036 and/or §2038. So, even in those instances when we are looking for "incomplete transfers" to trigger estate tax inclusion, this is not the provision that should be included in the trust agreement; because you then lose non-grantor trust status for income tax purposes. On the other hand, if the goal is to make a completed transfer, although there are eight exceptions to grantor trust status in §674(b), that is, one or more of these eight powers can be included in the trust agreement without undermining non-grantor trust status, one needs to be careful as to which one may also result in an incomplete transfer, and concomitantly estate tax inclusion.

c. Section 675. The administrative powers in this section of the Code have been the darlings of the grantor trust world of planning for years, because they result in the grantor being treated as the owner of the trust for income tax purposes, facilitating gift tax free additions to a trust by a grantor when he or she pays the income taxes that otherwise would be payable by the trust; yet for the most part, the retention of such powers does not result in estate tax inclusion. The most common of these powers is the "swap" power in §675(4)(C), and the power to borrow from the trust without adequate interest in §675(2), with the "swap" generally being favored because it allows the grantor to recapture appreciated assets inside the trust and subject those assets to inclusion in grantor's estate in order to get a step up in basis at death. So, clients will have to understand that they cannot retain any of these popular powers if they want to create the non-grantor trust required

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for SALT planning purposes.

The Incomplete Transfer Strings. As suggested above, one can carefully select from the exceptions to §674(b) to create an incomplete transfer, yet maintain non-grantor trust status. But further consideration should be given to Treas. Reg. §25.2511-2 (c), which provides, in part, that a gift is incomplete if and to the extent that a reserved power gives the donor the power to name new beneficiaries or to change the interest of the beneficiaries as between themselves unless the power is a fiduciary power limited by a fixed or ascertainable standard. A careful examination of this regulation, as compared to the exceptions in §674(b)(2), (3), and (5), is required. The inclusion in the trust agreement of a testamentary special power of appointment should accomplish both goals of incomplete transfer and non-grantor trust status [(b)(3)].[12] But, for example, the retention of a power to distribute corpus to a beneficiary needs to be, at the same time (i) not a fiduciary power limited by a fixed or ascertainable standard (to accomplish incomplete transfer), and (ii) limited by a reasonably definite standard (to accomplish non-grantor status). Good luck trying to thread that needle.

Third Hurdle: Cost/Benefit Analysis. If a client walks in the door, who is paying $150,000 in property taxes, are you going to suggest he set up fifteen (15) trusts, none of which can have "substantially the same primary beneficiary"? One would need to have an investment portfolio, assuming a 5% annual return, equal to $3,000,000 to cover that much in property taxes, and be prepared to give it away. Other than the ultra-high net worth client (i) this will likely require the incomplete transfer design of trust, and (ii) some access to same by the grantor during his or her lifetime. I won't venture to guess what any attorney will charge to put a plan like this together, other than to suggest a range anywhere between low to mid five figures to north of six figures. Beyond the fees/costs of creating multiple trusts, not to be overlooked are those for creating the LLC, preparing an operating agreement for the LLC, a lease between the grantor and the trusts, annual filing of multiple income tax returns, and retaining separate counsel for the various parties to the plan. Will the tax benefit justify all of these costs?

Example: Client, a resident of Pennsylvania, has an investment portfolio generating a 5% annual return of $325,732, a home with a property tax of $60,000, and is paying federal tax at the highest marginal rate of 37%. The state income tax on the portfolio income at 3.07% is $10,000. Assuming his total itemized deductions exceed the standard deduction of $12,700, this tax will be fully deductible for federal income tax purposes, and reduce his federal tax by $3700 ($10,000 x .37), making the net cost of the state tax $6300. The real estate tax will not be deductible for federal income tax purposes because of the $10,000 SALT limitation, making the net cost of the property tax $60,000. Total net cost of both deductions is $66,300 ($6300 + $60,000). Client has two children and four grandchildren. He is prepared to set up six separate non-grantor trusts (not in Pennsylvania and hopefully not subject to PA tax as a result of the *McNeil v. Commonwealth* decision) for each descendant as the primary beneficiary in order to be able to deduct, for federal income tax purposes, both his state income tax and his property tax. He can choose to move either the entire portfolio or the home, or some combination thereof, to each of the six trusts. Assume he wants to transfer just enough of his portfolio to create $60,000 of income ($10,000 per trust). The total value of the transfer to the trusts will be $1,200,000 of portfolio assets (assuming the 5% annual return) plus the value of the home. Assume further that this will be an incomplete transfer to avoid utilizing any more of Client's exemption amount or paying gift taxes. How much in taxes will Client save?

Client's portfolio income is now $265,732 ($325,732 - $60,000). State income tax on portfolio income at 3.07% is $8158, which is fully deductible. This reduces his federal tax by $3018, making the net cost of the state tax of $5,140. The property tax deduction of $60,000 will now be fully deductible against the portfolio income now inside the trusts, which will reduce federal taxes by $21,000 (assuming each trust's marginal federal tax rate of 35%), making the net cost of the property deduction of $39,000. Total cost of both deductions is $44,140 ($5140 + $39,000). After tax savings with the six trusts are $22,160 per year ($66,300 - $44,140).

Conclusion: Some planning ideas look a whole lot better on paper than they do when time comes to implement them. The economics of the SALT deduction are not particularly impressive on a standalone basis. But there can be meaningful income tax savings when leveraged over multiple trusts that stay in place over the remaining seven-year window under the Act. While the structure described is ostensibly legal, Section 643(f) cannot be ignored. The calculation of savings in the example above is just that – one example. It cannot be considered indicative of the savings in every case. The transaction costs always need to be considered. In short, do the math.

Post Script.

a. States Concocting Their Own Salve. Some states are not sitting around allowing their residents to succumb to this new tax regime. They are taking the

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fight to their state legislatures and to the courts. On July 17, 2018, four states (Connecticut, Maryland, New Jersey, and New York) filed a lawsuit to strike down the cap on SALT deductions under the Act. The case is *State of New York, State of Connecticut, State of Maryland and State of New Jersey v. Steven T. Mnuchin et al* (S.D.N.Y., Civil Action No. 18-cv-6427). The plaintiffs are seeking "declaratory and injunctive relief" to eliminate the cap, citing the Sixteenth Amendment and the Tenth Amendment, arguing that the SALT cap disregards states' rights and the "distinct and inviolable role in our federalist scheme." The complaint also alleges, "as many members of Congress transparently admitted, it deliberately seeks to compel certain states to reduce their public spending." That, the complaint argues, is unconstitutional.

Three states, Connecticut, New York, and Pennsylvania, have enacted legislation, each of which have as its goal, a "workaround" to the new $10,000 SALT deduction. New York has a new optional payroll tax, referred to as the Employer Compensation Expense Tax ("ECET"), and a charitable contribution workaround. The intention of both is to shift the state tax burden from the individual (subject to the cap) to either a charitable deduction or a business entity. Connecticut came up with a new pass-through entity tax ("PTE"), where individual partners and corporate partners are entitled to a credit equal to 93.01% of the pro rata share of the tax paid by the PTE, the intention being to shift the tax burden to the PTE, and converting the tax paid into a business expenses; yet the state receives substantially the same amount of Connecticut tax. And in Pennsylvania, a business entity can make a charitable contribution through the Pennsylvania Educational Improvement Tax Credit Program ("EITC"). While not a new program in this state, the tax benefits may provide individuals with a vehicle to turn a non-deductible tax into a deductible contribution.

b. <u>Proposed Regulations</u>. Between the date this article was first drafted and the date it went to press, Treasury has already issued two sets of proposed regulations that will have to be monitored carefully and taken into account before engaging in the planning ideas discussed in this article, or if one hopes that a new state law may be the salve that cures the sting. The first set, released on August 8, 2018, is the long anticipated proposed regulations for new IRC §199A. But buried at the very end of the 184 pages is new *Section 1.643(f)-1*. Apparently, Treasury felt that the use of "multiple trusts" might be considered by our brethren in circumventing the new §199A rules. So, it included this new "anti-abuse" regulation. And, lo and behold, all of the discussion above as to whether IRC §643(f) can be safely ignored (or not) because of there being no regulations just became academic. This new regulation includes only two paragraphs: (a) and (b), and also includes two examples: one good, and one bad. Paragraph (a) is the "General rule", which is pretty much the statute copied verbatim. However, Paragraph (b), titled "A principal purpose", reads as follows: "A principal purpose for establishing or funding a trust will be presumed if it results in a significant income tax benefit <u>unless there is a significant non-tax (or non-income tax) purpose that could not have been achieved without the creation of these separate trusts."</u> (emphasis added).

The second set of regulations, issued on August 23, 2018, is proposed regulations to counteract the state legislation counteract, with a revision to *Section 1.170A-1*, which deals with charitable contributions. This new regulation provides that a taxpayer who makes payments or transfers property to an entity eligible to receive tax deductible contributions must reduce their charitable deduction by the amount of any state or local tax credit the taxpayer receives or expects to receive.

Query, whether new *Section 1.643(f)-1* just blew out the entire planning ideas described in this article. Maybe not, but at a minimum, it significantly reduced the window of opportunity to do so; as the proposed regulations have no force or effect until finalized, which could be late this year or early next year. In the interim, planners best don their most creative bonnet in documenting the "significant non-tax (or non-income tax) purpose" for the multiple trusts needed to accomplish the workaround of the SALT limitation. Perhaps, we will need to dust off our "legitimate business or non-tax purposes" that we used in the context of defending FLPs in order to satisfy the bona fide sale exception to Section 2036(a). It was not easy, but it was not impossible. [See e.g., *Estate of Stone v. Comm*., T.C. Memo. 2003-309; *Estate of Kimbell v. U.S.*, 371 F.3d 257 (5th Cir. 2004); and *Estate of Church v. U.S.*, 85 AFTR2d 2000-804 (W.D. Tex. 2000)]. That task in the context of defeating a §643(f) attack on our SALT planning is not likely to be any easier.

Notes:

1 AK, FL, NV, NH, SD, TX, WA, WY

2 The $10,000 limit on deducting state and local taxes under the Act applies to trusts, as made clear in footnote 171 of the Joint Explanatory Statement. There is no standard deduction for a non-grantor trust.

3 SIH Partners LLLP v. Comm. 150 T.C. No. 3 (Jan. 2018)

4 The test laid out by the Tax Court for determining whether the issuance of regulations is a precondition to the application of the statute draws a distinction between regulations that explain "how" the tax is collected and regulations that dictate "whether" the tax is collected. It may

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be open to debate as to whether the regulation referred to in §643(f) deals only with how, and not whether, the tax is to be applied. Count me as one on the "how" side.

5 Treas. Reg. §1.641(a)-0(c).

6 51 TC 20 (1968), aff'd per curiam 427 F.2d 1361 (9th Cir. 1970)

7 81 TC 283 (1983)

8 PLR 200149016

9 PLR 200209008

10 CN, DC, IL, LA, ME, MD, MI, MN, NE, OH, OK, PA, UT, VT, WV and WI

11 In McNeil v. Commonwealth, 67 A.3d 185 (2013), two intervivos trusts were created by a Pennsylvania resident, governed by Delaware law, with sole trustee located in Delaware, none of the trusts' assets located in Pennsylvania, and no income from Pennsylvania sources. However, all of the trusts' discretionary beneficiaries were residents of Pennsylvania. Commonwealth Court found that the Commerce Clause of U.S. Const. art. I, § 8, cl. 3 was violated by the imposition of PIT in the circumstances.

12 But, see, e.g., PLR 201650005 where the Service consistently rules that a testamentary special power of appointment reserved by a grantor acts to make the transfer of principal, only, incomplete for gift tax purpose, but not with respect to the income of the trust .

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