THE TOP 40 TAX PLANNING OPPORTUNITIES FOR 2020

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Robert S. Keebler, CPA/PFS, MST, AEP (Distinguished) is a partner with Keebler & Associates, LLP and is a 2007 recipient of the prestigious Accredited Estate Planners (Distinguished) award from the National Association of Estate Planners & Councils. He has been named by CPA Magazine as one of the *Top 100 Most Influential Practitioners in the United States* and one of the *Top 40 Tax Advisors to Know During a Recession*. Mr. Keebler is the past Editor-in-Chief of CCH's magazine, *Journal of Retirement Planning,* and a member of CCH's Financial and Estate Planning Advisory Board. His practice includes family wealth transfer and preservation planning, charitable giving, retirement distribution planning, and estate administration. Mr. Keebler frequently represents clients before the National Office of the Internal Revenue Service (IRS) in the private letter ruling process and in estate, gift and income tax examinations and appeals.

In the past 20 years, he has received over 200 favorable private letter rulings including several key rulings of "first impression." Mr. Keebler is nationally recognized as an expert in estate and retirement planning and works collaboratively with other experts on academic reviews and papers, and client matters. Mr. Keebler is the author of over 100 articles and columns and editor, author, or co-author of many books and treatises on wealth transfer and taxation, including the Warren, Gorham & Lamont of RIA treatise Esperti, Peterson and Keebler/Irrevocable Trusts: Analysis with Forms.

Mr. Keebler is a member of the editorial board of the Society of Financial Service Professionals "Keeping Current" series. He is a featured columnist for CCH's *Taxes Magazine* – "Family Tax Planning Forum," Steve Leimberg's "News of the Week Newsletter" and the Bureau of National Affairs Tax Division. Bob is also a contributing author to the American Bar Association's *The ABA Practical Guide to Estate Planning.* He also had his article "Is That Your 'Final' Answer?" published in *Tax Management Compensation Planning Journal*. Bob frequently is quoted in national publications such as *New York Times, Chicago Tribune, Baltimore Sun, Barrons, Bloomberg Wealth Manager, Financial Advisor*, *Forbes*, *Kiplinger*, *Lawyer's Weekly*, *On Wall Street, The Wall Street Journal, USA Today, Wealth Manager* and *Worth* in addition to many local and regional newspapers.

He is a frequent speaker for legal, accounting, insurance and financial planning groups throughout the United States at seminars and conferences on advanced IRA distribution strategies, estate planning and trust administration topics including the AICPA's Advanced Estate Planning, Personal Financial Planning Conference and Tax Strategies for the High Income Individual Conference.

Mr. Keebler graduated (cum laude) from Lakeland College with a degree in Accountancy and the University of Wisconsin - Milwaukee with a Masters in Taxation. Before practicing in Northeastern Wisconsin, he practiced with Price Waterhouse where he concentrated in taxation.

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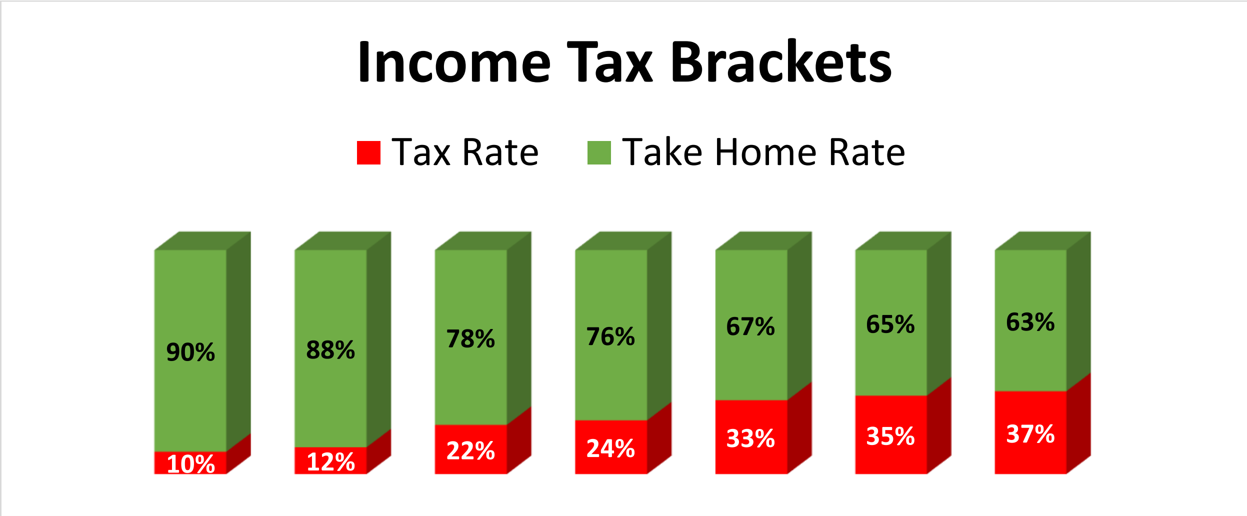
Chapter 1: Bracket Management Strategies

#1: Bracket Management

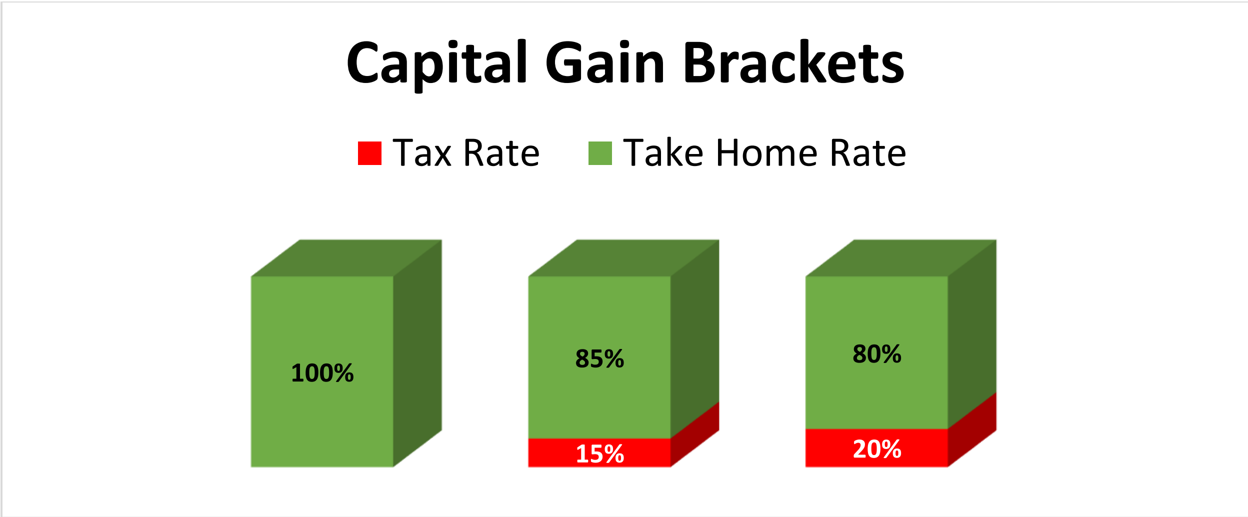
To begin with, there are a number of bracket management issues to consider:

- Capital gains tax rates
- Ordinary income tax rates
- Income should at least equal deductions
- Tax liability should at least equal tax credits available
- Non-refundable/non-carry forward credits
- Non-refundable carry forward credits
- Refundable credits

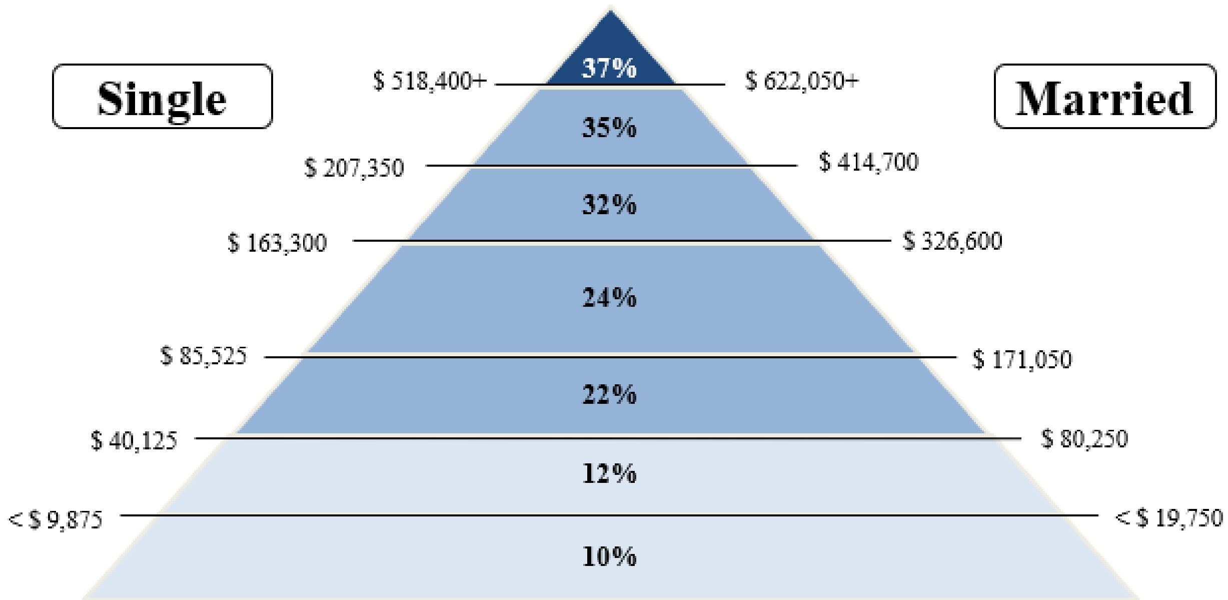
Following the 2017 Tax Cuts and Jobs Act, there are seven different ordinary income tax brackets – 10%, 12%, 22%, 24%, 32%, 35%, and 37% – and three different capital gains tax brackets – 0%, 15%, and 20%.[1] If you combine these tax brackets with the 3.8% net investment income tax (NIIT), there are even more possible tax brackets; i.e., high income taxpayers will be subject to a 40.8% tax rate on ordinary income and a 23.8% tax rate on long-term capital gains. The large number of tax brackets and the steep cliffs between some of them make tax deferral and income smoothing strategies a must.



[1] Note that there are two additional tax brackets for special income - a 25% bracket for unrecaptured IRC §1250 gain and a 28% bracket for collectibles gain.



2020 Federal Income Tax Rates and Brackets



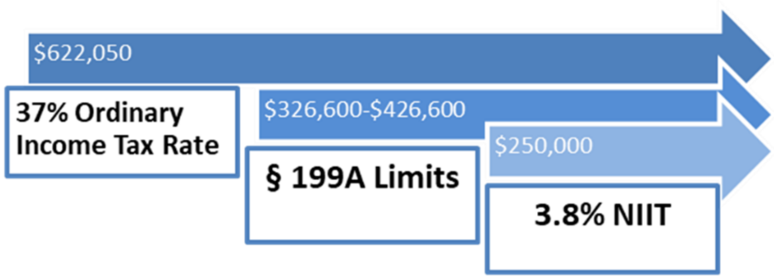
The first step in tax planning is to estimate the amount of taxable income over a five to fifteen year horizon. Once the amount of taxable income is estimated, planning to avoid the higher tax brackets and the NIIT can begin. There are many different specific tax planning strategies that can be implemented depending on the situation. Some of these include:

(1) Harvesting losses in high income years;
(2) Harvesting gains in low income years;
(3) Contributing to traditional IRAs in high income years;
(4) Contributing to Roth IRAs in low income years;
(5) Investing in tax deferred annuities;
(6) Creating different types of charitable remainder trusts;

(7) Creating charitable lead trusts;
(8) Engaging in installment sales;
(9) Engaging in life insurance strategies;
(10) Implementing Roth IRA conversions; and
(11) Creating family trusts.

These strategies, and more, are covered in detail in other sections of the book.

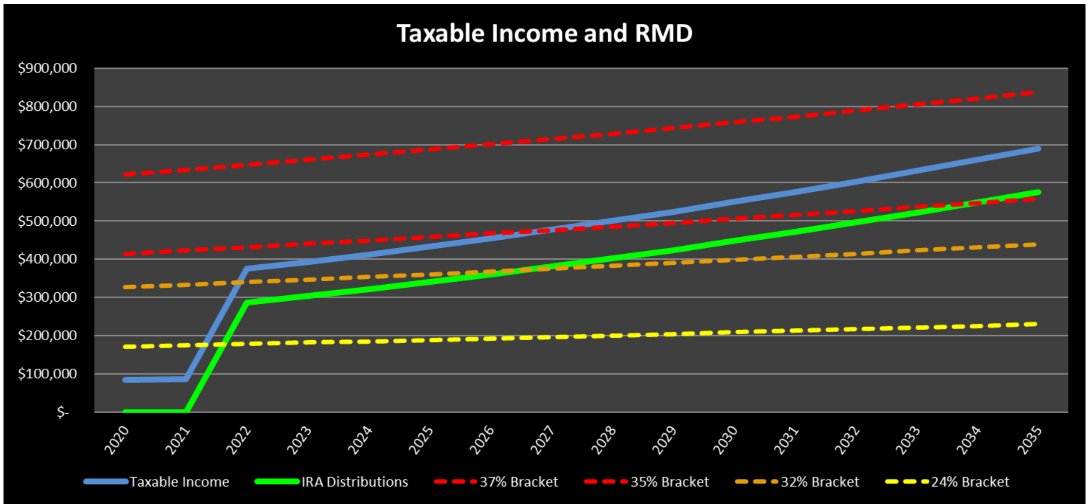
While some of those tax planning strategies may be quite complicated, the basic idea is simple – use income smoothing to obtain the maximum benefit of tax rate arbitrage. Basically, income smoothing strategies involve: (1) reducing taxable income in high income years by maximizing deductions and shifting income to lower income years; and (2) increasing income in low income years by deferring deductions and increasing taxable income to fill-up the lower tax brackets. Put another way, the idea is to keep taxable income below the highest tax rates and thresholds at which the effective tax rate increases.

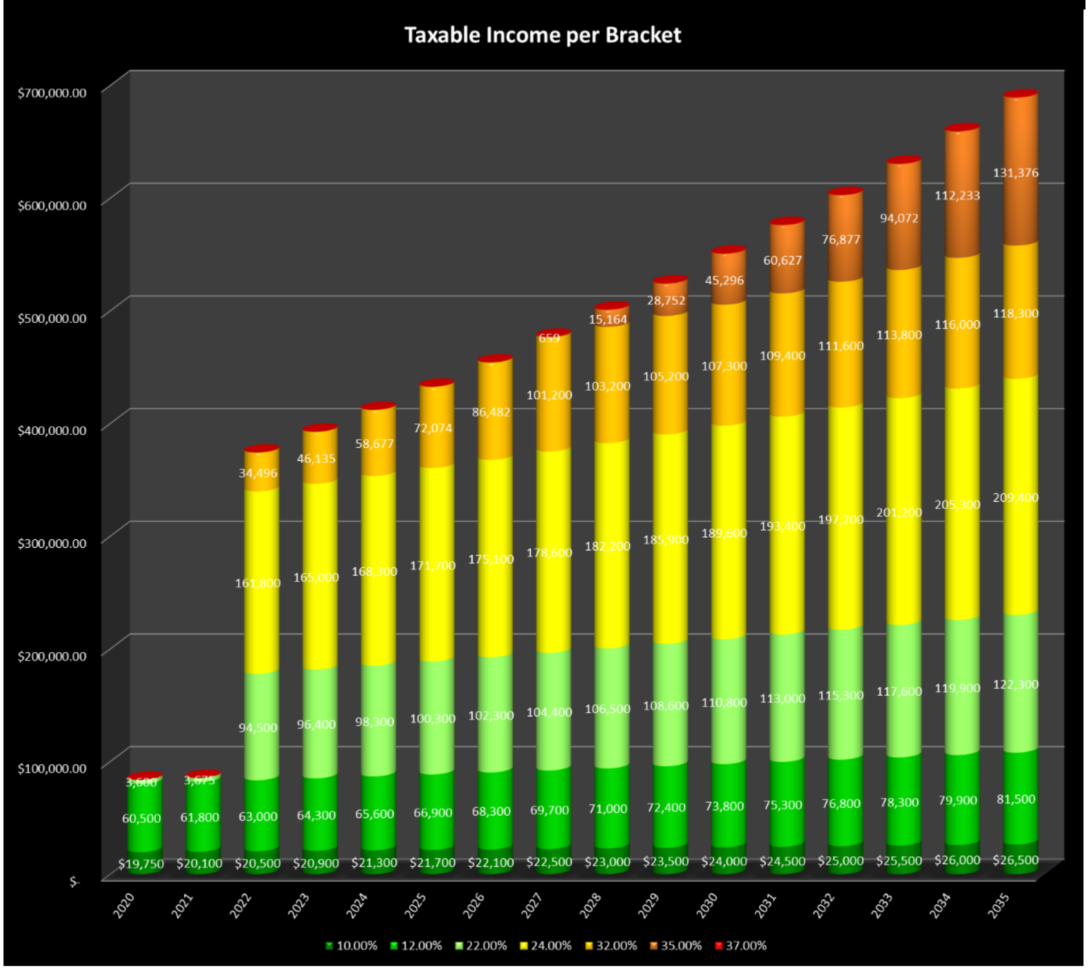


Thresholds for married filing jointly.

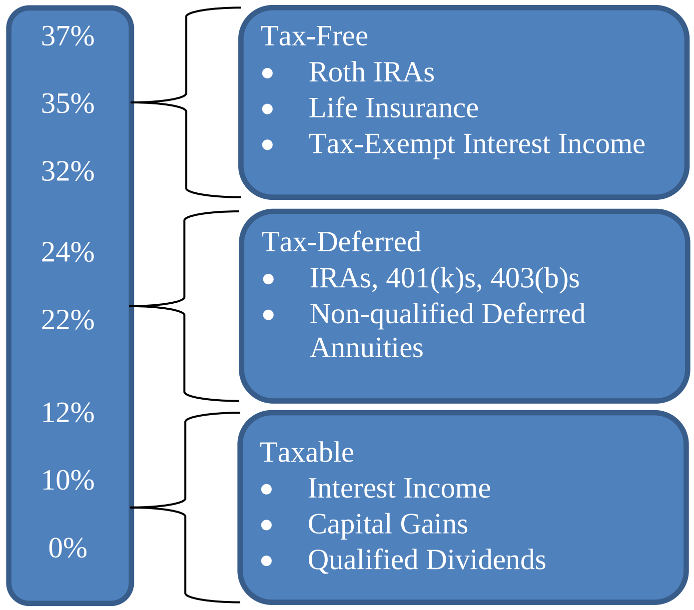
Below are some illustrations of poor bracket management: Suppose that your client's current taxable income is about $100,000 per year. He and his wife are reciently retired and think they are doing extremely well managing their tax obligations. However, you point out that soon they will be 70 and will need to start taking Social Security and Required Minimum Distributions (RMDs).[2] Without proper bracket management, their taxable income spikes by nearly $300,000 and only grows thereafter:

[2] The SECURE Act changed required beginning date for RMDs from age 70 ½ to age 72.


Taxable Income and RMD
$900,000
$800,000
$700,000
$600,000
$500,000
$400,000
$300,000
$200,000
$100,000
$-
2020 2021 2022 2023 2024 2025 2026 2027 2028 2029 2030 2031 2032 2033 2034 2035
Taxable Income
IRA Distributions
37% Bracket
35% Bracket
32% Bracket
24% Bracket


Taxable Income per Bracket
$700,000.00
$600,000.00
$500,000.00
$400,000.00
$300,000.00
$200,000.00
$100,000.00
$-
2020 2021 2022 2023 2024 2025 2026 2027 2028 2029 2030 2031 2032 2033 2034 2035
10.00% 12.00% 22.00% 24.00% 32.00% 35.00% 37.00%

Depending on the tax bracket one falls into, the strategy will be different.



Some of the top tax planning ideas include:

1. "Filling-up" the 10% or 12% bracket;
2. Doing Roth conversions by asset class and Roth conversions to manage tax brackets;
3. Spending from the "outside non-qualified" portfolio first once you have "filled-up" the 12% bracket;
4. Positioning bonds in IRAs because of the annual tax burden; and
5. Using life insurance as a supplement to existing pensions.

Furthermore, the appropriate strategies to use are different for different stages in a taxpayer's life, as shown in the following charts:

Early Accumulation Years (Ages 25-45)

- Maximize qualified retirement savings
- Maximize IRAs
- Position some funding in Roth IRAs or Roth 401(k)s
- Deferral via annuities
- Low-risk oil & gas transactions
- Low-risk real estate transactions
- Focus on low-return strategies

Core Accumulations Years (Age 46-Retirement)

- Continue to apply key concepts from early accumulation years
- Aggressively manage taxation of wage earnings
  - Retirement plans

    - ➢ Deferred compensation
- ❖ Aggressively manage taxation of investments

<u>At Retirement</u>

- ❖ Evaluate rollover of pensions and profit sharing plan
- ❖ Evaluate asset protection issues
- ❖ Manage net unrealized appreciation (NUA) opportunities
- ❖ Monitor the 10% IRC § 72(t) penalty
- ❖ Manage basis in both IRAs and qualified plans
- ❖ Manage qualified Roth distributions

<u>Early Retirement Years (Retirement-Age 70)</u>

- ❖ Manage the 10% and 12% tax brackets
- ❖ Generally defer IRA distributions taxed at 22% or greater
- ❖ Draw upon "outside non-qualified" assets and deferred compensation first
- ❖ Draw upon traditional IRA assets second
- ❖ Draw upon Roth IRA assets last
- ❖ Review Roth conversions to manage tax brackets

<u>Later Retirement Years (After Age 70)</u>

- ❖ Manage the 10% and 12% tax brackets
- ❖ Take all Required Minimum Distributions (RMDs)
- ❖ Spend down high basis outside assets
- ❖ Draw additional funds from IRA to manage tax brackets
- ❖ Update estate planning

Many of the income smoothing strategies above not only produce tax rate arbitrage, but also create tax deferral. The longer the period of time that tax can be deferred, the smaller the present value of the tax owed. Below is a chart showing the present value of a dollar of tax paid for various deferral periods, assuming a discount rate of 5%:

Yrs. Deferred	Discount Rate	Present Value Dollar
0 years	5%	$1.0000
1 year	5%	$0.9524
5 years	5%	$0.7835
10 years	5%	$0.6139
15 years	5%	$0.4180
20 years	5%	$0.3769

Unfortunately, deferring the entire amount of tax for a certain period of years as shown in the chart above may not be possible. Even if the full amount of tax payable cannot be deferred until the end of the period, impressive tax savings can still be achieved by spreading the payments out over the applicable time period rather than paying all the tax at the beginning of the period. To illustrate, suppose at the end of the tax year $100,000 in tax is owed because there was no tax planning. In the alternative, assume there was good tax planning and the same $100,000 in taxes owed is spread out over five, ten, fifteen, or twenty years. For example, if the tax payable is spread out over 5 years, $20,000 is paid each year and if the tax payable is spread out over 10 years, the tax payable each year is $10,000 per year. Below is a chart showing the present value of the $100,000 paid over the different time periods assuming different discount rates:

<u>5 Years</u>:

Discount Rate	Present Value
0%	$100,000
4%	$89,036
6%	$84,247
8%	$79,854

<u>10 Years</u>:

Discount Rate	Present Value
0%	$100,000
4%	$81,109
6%	$73,601
8%	$67,101

<u>15 Years</u>:

Discount Rate	Present Value
0%	$100,000
4%	$74,126
6%	$64,752
8%	$57,066

<u>20 Years</u>:

Discount Rate	Present Value
0%	$100,000
4%	$67,952
6%	$57,350
8%	$49,091

As shown above, with effective bracket management, tax savings are significant. While there are many ways to achieve good bracket management, the most important thing to recognize is that because of the new NIIT and higher tax brackets, bracket management is more important than ever, and, therefore, it is a must do tax planning strategy.

#2: Capital Gain Harvesting

Gain harvesting is a great year-end strategy that could potentially save the taxpayer substantial amounts of capital gains tax. The strategy applies to taxpayers who expect to be in a higher tax bracket in the future than in the current year. If this is the case, the taxpayer will sell the assets this year, pay tax on the gains at the lower current tax rate and step-up the basis of the assets to the sale price. Then the taxpayer will immediately repurchase the assets and sell them whenever he or she would have sold them if the gain harvesting strategy had not been used.[3] By doing so, the taxpayer shifts recognition of part of the capital gain from the higher bracket future tax year to the lower bracket current tax year.

The first consideration in deciding whether to use this strategy is determining what the taxpayer's expected tax brackets are over the coming years. In 2020, for married taxpayers filing jointly, the long-term capital gains rates are as follows:[4]

Amount of Income	Capital Gains Tax Rate
Less than or equal to $80,000	0%
$80,001 to $496,600	15%
Greater than $496,600	20%

In addition, consider the net investment income tax (NIIT). The 3.8% NIIT applies to the lesser of (1) net investment income, or (2) the excess of a taxpayer's modified adjusted gross income (MAGI) over the applicable threshold amount. In most cases, unless the capital gain is from the sale of active business assets, it will be treated as net investment income. Since the applicable threshold amount for married taxpayers filing jointly is $250,000, any married taxpayers with capital gains and a MAGI of over $250,000 will usually be subject to the 3.8% NIIT on top of the capital gains tax rate. Thus, including the NIIT, the tax rates for most capital gains of married taxpayers filing jointly are as follows:[5]

Amount of Income	Capital Gains Tax Rate
Less than or equal to $80,000	0%
$80,001 to $250,000	15%
$250,001 to $496,600	18.8%
Greater than $496,600	23.8%

[3] Note that if gain harvesting is used, the taxpayer must hold the asset for an additional year and one day to avoid being subject to short-term capital gains rates on subsequent sales.

[4] In 2020, for single taxpayers, the long-term capital gains rates are as follows:

Amount of Income	Capital Gains Rate
Less than or equal to $40,000	0%
$40,001 to $441,450	15%
Greater than $441,450	20%

[5] The applicable threshold amount for single taxpayers is $200,000; therefore, any single taxpayers with capital gains and a MAGI of over $200,000 will usually be subject to the 3.8% NIIT on top of the capital gains tax rate.

It may be advantageous for taxpayers in a lower tax bracket to harvest gains in the current year if they expect to fall into a higher tax bracket in later years.

Seems simple enough, but it's not. The difficulty in deciding on whether or not to harvest gains comes when the taxpayer was not planning on selling the asset for two, three, or more years. It becomes a battle between two competing benefits: paying tax at a reduced rate and loss of tax deferral. The best way to analyze these competing benefits is to think about gain harvesting as an investment in the current year to buy tax savings in a later year. This allows for a calculation of the rate of return on this investment. Below are two scenarios. In order to hold the investment consequences constant, let's assume that the taxpayer sells his publicly traded stock in the current year, immediately repurchases the same stock with the after-tax proceeds and sells it again in the year in which he or she would have sold it originally, had there not been any gain harvesting.

Example 1. Taxpayer (T) owns ABC company growth stock with a basis of $50,000 and an FMV of $150,000. T plans on selling the stock on January 1, 2021. If T sells the stock in 2020 his capital gains tax rate will be 18.8%. If T waits until 2021 to sell the stock, he expects his capital gains rate to be 23.8%. Shown below are the economic consequences of two scenarios: 1) T decides not to harvest gains and sells the stock next year; or 2) T harvests the gains from the stock by selling the stock this year.

Scenario 1: No Gain Harvesting

	December 31, 2020	**January 1, 2021**
Stock Value	$ 150,000	$ 150,000
Less Basis		$ 50,000
Gain		$ 100,000
Tax @ 23.8%		$ 23,800
After-Tax Gain		$ 76,200
Total Value (gain + basis)	$ 150,000	$ 126,200

Scenario 2: Gain Harvesting

	December 31, 2020	**January 1, 2021**
Stock Value	$ 150,000	$ 0
Less Basis	$ 50,000	
Gain	$ 100,000	
Tax @ 18.8%	$ 18,800	
After-Tax Gain	$ 81,200	
Total Value (gain + basis)	$ 131,200	

Taxpayer ends up with $5,000 more in the gain harvesting scenario ($131,200 - $126,200). Thus, T's rate of return on the tax paid in the current year is 26.60% ($5,000/$18,800). Since this is presumably far above T's opportunity cost of capital, T should harvest his gains.[6]

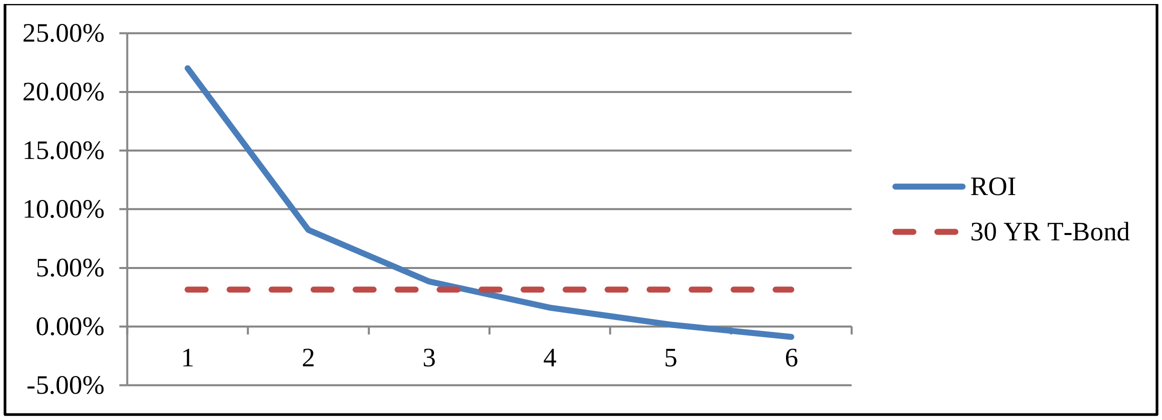
[6] Note that although there is only a one-day delay in selling the stock, the $18,800 of tax paid in the gain harvesting scenario is really invested for one year (April 15, 2020 to April 15, 2021, assuming no extension).

Usually if the taxpayers originally planned on selling the assets in the following year and they are in a lower tax bracket this year than they will be in next year, gain harvesting can be very beneficial. If the planned sale was farther in the future, however, loss harvesting may or may not be beneficial. The key variables to consider in deciding whether to harvest gains are:

- The time period between the gain harvesting sale and the sale of the repurchased assets (i.e., the period of time between the sale in the current year and the sale in the originally planned year);
- The difference in the taxpayer's tax rates between the two sales;
- The growth rate of the stock; and
- The taxpayer's opportunity cost of capital.

As stated above, the shorter the time period between the gain harvesting sale and the originally planned sale, the more favorable gain harvesting will be. The decision of whether to harvest gains will be based on the taxpayer's return on investment compared with his or her opportunity cost of capital (the return he or she could have earned on the best alternative investment of comparable risk). To illustrate, assume the same facts as in Example 2 above except that the time period between the sales will increase and the stock grows in value by 6% per year.

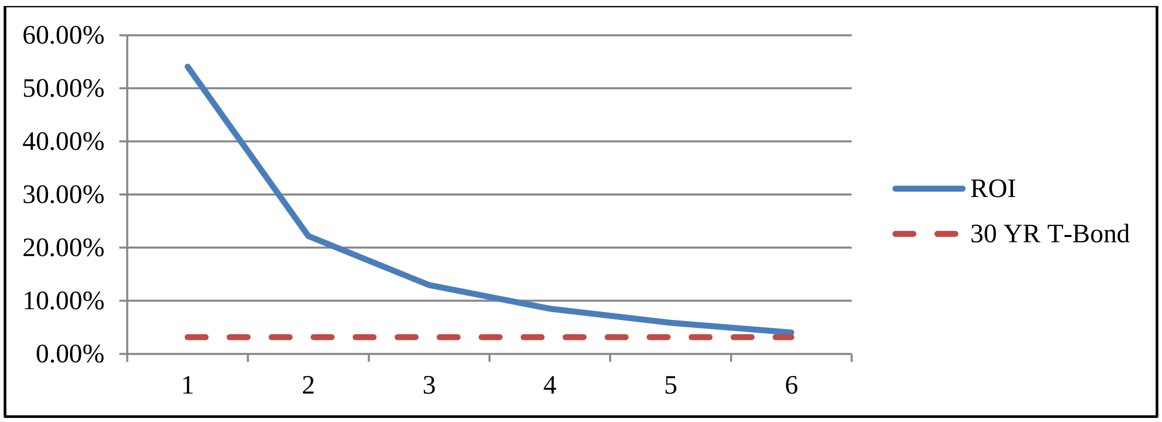
Time Period (Years)	**Return on Investment**
1	22.02%
2	8.25%
3	3.86%
4	1.61%
5	0.16%
6	-0.90%



As the above data shows, the advantages of gain harvesting quickly decline as the time period between the two sales increases.

Another important variable is the difference in tax rates for the two stock sales—the greater the differential in tax rates, the more favorable gain harvesting will be. In the above example, the tax differential was only 5%, below is a table with the return on investment for a tax differential of 8.8%; i.e., the taxpayers are in the 15% capital gains tax bracket in the current year and when they plan on selling the asset they will be in the 23.8% tax bracket.

Time Period (Years)	Return on Investment
1	54.09%
2	22.17%
3	12.95%
4	8.52%
5	5.85%
6	4.03%



Additionally, the higher the growth rate of the asset, the lower the return on investment will be. The last variable to consider is the taxpayer's opportunity cost of capital.[7] If the return on investment is higher than their opportunity cost of capital, then gain harvesting makes sense, if it is not, then it doesn't make sense to harvest gains.

Keebler & Associates, LLP developed a Gain Harvesting Return on Investment calculator that allows practitioners to quickly see what the return on investment of gain harvesting will be depending on the combination of the various variables mentioned above:

- The time period between the gain harvesting and the subsequent sale;
- The tax rate in the current year versus the tax rate in the year the asset will be sold;
- The asset's growth rate; and
- Any state tax rate.

Shown below is a sample screen shot of the results produced by the calculator.

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[7] A taxpayer's opportunity cost of capital is the return that could be earned on the next best use of the money invested. In other words, it is the expected return foregone by investing in the gain harvesting strategy.

Gain Harvesting Return on Investment (after-tax)

		2020	Future	2021	2022	2023	2024	2025	2026	2027
Growth Rate	4.0%	0.0%	15.0%	371.76%	116.42%	66.90%	46.55%	35.54%	28.66%	23.95%
State Tax	4.0%	0.0%	18.8%	466.91%	137.42%	77.62%	53.62%	40.80%	32.84%	27.43%
		0.0%	20.0%	496.96%	143.68%	80.75%	55.66%	42.30%	34.03%	28.42%
		0.0%	23.8%	592.11%	162.51%	90.01%	61.65%	46.70%	37.50%	31.28%
		15.0%	18.8%	16.91%	6.63%	3.34%	1.68%	0.65%	-0.08%	-0.64%
		15.0%	20.0%	23.28%	9.60%	5.32%	3.20%	1.90%	1.00%	0.33%
		15.0%	23.8%	43.43%	18.50%	11.15%	7.60%	5.50%	4.09%	3.06%

		2020	Future	2021	2022	2023	2024	2025	2026	2027
Growth Rate	8.0%	0.0%	15.0%	368.52%	114.83%	65.58%	45.31%	34.31%	27.39%	22.64%
State Tax	4.0%	0.0%	18.8%	448.78%	132.82%	74.88%	51.51%	38.98%	31.17%	25.83%
		0.0%	20.0%	493.92%	142.35%	79.70%	54.69%	41.35%	33.08%	27.43%
		0.0%	23.8%	589.22%	161.34%	89.10%	60.82%	45.90%	36.70%	30.47%
		15.0%	18.8%	13.82%	3.52%	-0.02%	-2.02%	-3.48%	-4.75%	-5.99%
		15.0%	20.0%	20.24%	6.62%	2.15%	-0.27%	-1.94%	-3.31%	-4.57%
		15.0%	23.8%	40.54%	15.89%	8.45%	4.73%	2.37%	0.65%	-0.76%

Most importantly, if the taxpayer is currently in the 0% capital gains tax bracket, gain harvesting will always be favorable because it gives the taxpayer a free basis step-up. Thus, always make sure to fill up the 0% capital gains tax bracket. Furthermore, if the taxpayer is nearing death and plans on keeping the asset until death to pass it on to his or her heirs, then there is no reason to harvest gains now because the taxpayer (or his heirs) will get a free stepped-up basis at the time of the taxpayer's death.

Lastly, before engaging in gain harvesting, be sure to take a look at the economic substance doctrine. IRC § 6662(b)(6) imposes a 20% penalty on any underpayment of tax due to a transaction that lacks economic substance. That penalty increases to 40% if the transaction is not adequately disclosed on the return. IRC § 7701(o) provides that a transaction has economic substance only if: (1) it changes the taxpayer's economic position in a meaningful way; and (2) the taxpayer has a substantial non-tax reason for entering into the transaction.[8]

From an investment perspective, the taxpayer would like to repurchase the asset as soon as possible after the gain harvesting sale to minimize the risk of the price increasing between the time of sale and the time of repurchase. When harvesting gains, it is difficult to see how either requirement above would be met if the sale and repurchase occurred on the same day or perhaps within a very short time period. If the time between the sale and repurchase is very short the IRS might take the position that the sale lacks substance. The seller has claimed a basis increase without really cashing out his or her investment or changing his or her economic position. However, gain harvesting would present a rather unusual situation for applying the economic substance doctrine. This is because there would be no understatement in the year the gain was harvested and you could not speculate in the current year how much might be saved later. Nevertheless, if the investor's tax rate was higher when the repurchased asset was later sold, the IRS might take the position that the penalty applied in the year of the second sale.

[8] IRC § 7701(o)(1).

> ***Example 3.*** Ken and Julie, married taxpayers filing jointly, own X Corporation stock with a basis of $10,000 and a fair market value of $40,000. In Year 1, when their other income is $43,800, they sell the stock, recognizing a gain of $30,000 and immediately repurchase the same stock. Because their total income for the year is less than $80,000, they are in the 0% capital gain bracket and they obtain a basis step-up without paying any capital gains tax. In Year 3, Ken and Julie's income has increased to $100,000 and the value of the X Corporation stock has increased to $50,000. They sell the stock, recognize a gain of $10,000 and pay capital gains tax of $1,500 (.15 x $10,000). It is not clear whether the IRS could (1) take the position that the Year 1 sale lacked substance, (2) deny the $30,000 basis increase, (3) claim an underpayment of $4,500 in Year 3 (.15 x $30,000), and (4) impose penalties on the understatement under IRC §§ 6662(b)(6) and 7701(o).

To be safe, taxpayers who harvest gains might wish to build substance into their sales. One way to do this would be to lengthen the time between the gain harvesting sale and the repurchase. For tax purposes, the longer the delay, the more likely it would be that the transaction would be treated as having economic substance because the taxpayer is subject to market risk during the intervening period. A longer time period would also make it easier for a taxpayer to show a non-tax motivation for the sale. If it turns out that the economic substance doctrine applies, taxpayers will want to make the delay as short as possible without taking a significant risk that IRC § 7701(o)(1) will apply. How long this period is will depend on all the facts and circumstances of the case and is difficult to determine. Another way to build substance into the transaction would be to repurchase assets that are similar, but not identical to the assets harvested.

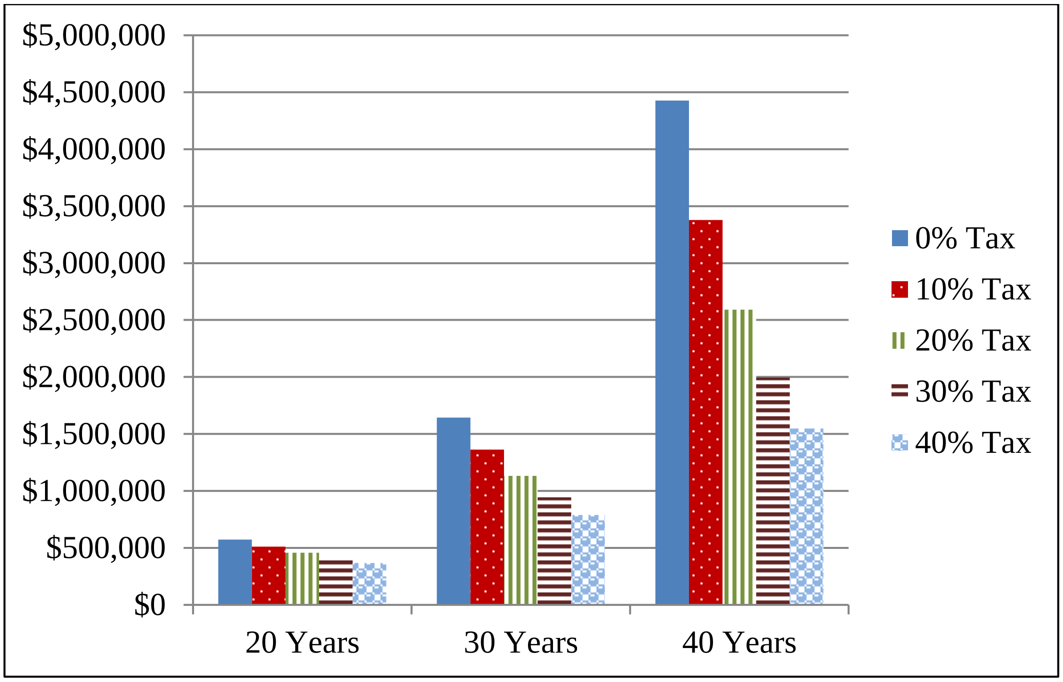
#3: Harvesting Capital Losses

There is a growing realization among investors that it isn't what you earn that counts, but what you keep after taxes. When the 3.8% tax on net investment income is added, the total tax rate on interest, rents, dividends, annuities, royalties, non-business capital gains and passive activities can be as high as 23.8% for long-term capital gains and 40.8% for ordinary income.

Over time, taxes can have a profound effect on the amount of wealth that can be accumulated. Consider the following example.

> ***Example 1.*** Taxpayer (T) invests $10,000 per year for 20, 30 or 40 years. The following chart shows the amount of wealth accumulated by the end of each period given a 10% pre-tax rate of return and various effective tax rates.

Tax Rate	20 Years	30 Years	40 Years
0%	$572,750	$1,644,940	$4,425,926
10%[9]	$511,601	$1,363,075	$3,378,824
20%	$457,620	$1,132,832	$2,590,565
30%	$409,955	$944,608	$1,996,351
40%	$367,856	$790,582	$1,547,620



The increased value created in an investment portfolio by using tax saving strategies is referred to as "tax alpha." Early researchers on tax-aware-investing assumed that the best way to create tax alpha was simply to minimize portfolio turnover. However, more recent research indicates that it

[9] Note that the 10% tax rate reduces the annual growth to 9.0% after tax (10.0 x (1 - .10)). The same equation applies to the growth rate when taxed at the 20%, 30% and 40% rate; i.e., (Growth Rate x (1 - Tax Rate)).

is not all turnover that reduces after-tax returns, but only net turnover (i.e., capital gains that could not be offset by capital losses).[10] This suggests that a multi-manager core and satellite approach might produce the best results. This strategy started with a passively managed, buy and hold, core portfolio and then added smaller satellite portfolios actively managed by other managers. The core portfolio maximized tax alpha and the satellite portfolios maximized pre-tax returns with active management, but aggressively harvested losses to minimize risk drag.

Quantifying the Tax Benefit of Loss Harvesting

Loss harvesting means selling assets at a loss and using those losses to offset capital gains realized on other assets. On the surface, it might appear that loss harvesting produces an economic benefit equal to the tax saved in the current year. It is important to recognize, however, that assuming tax rates stay the same, loss harvesting provides only a timing benefit. This is best understood by considering the overall transaction and not just the initial loss harvesting. Taxpayers who sell stocks to harvest losses typically wait 31 days to avoid the wash sale rules[11] and then reacquire the stock. While this reduces or eliminates current capital gain, it also gives the taxpayer a lower basis in the replacement shares and, thus, increases the gain recognized when these shares are later sold. The total gain recognized is the same, but loss harvesting creates tax deferral as shown in the following example.

> ***Example 2.*** Jill, a high income taxpayer in the 23.8% long-term capital gains tax bracket, recognizes $100,000 of long-term capital gain on Blackacre in 2020. To net out the gain, she sells 1,000 shares of ABC stock with a basis of $300,000 for $200,000. The $100,000 loss eliminates the capital gain and saves her $23,800 in 2020 (.238 x $100,000).
>
> Jill waits 31 days and repurchases 1,000 shares of ABC stock at $200/share, giving her a total basis of $200,000 in the shares. The value of the ABC stock increases to $500,000 in 2023 and Jill sells it. She recognizes a gain of $300,000 and pays tax of $71,400 ($300,000 x .238).
>
> If Jill had not harvested the loss in 2020 and sold the original shares in 2023 instead, she would have recognized a gain of $100,000 on Blackacre in 2020 and a gain of $200,000 on the ABC stock in 2024 ($500,000 sale price - $300,000 basis).
>
> Assume that Jill has a 7% opportunity cost of capital. Combining the tax consequences for 2020 and 2024, we get the following results.

[10] See, for example, Apelfeld, Fowler and Gordon, *Tax Aware Equity Investing*, Journal of Portfolio Management, 1996.
[11] See 26 U.S.C. § 1091.

A. NO LOSS HARVESTING

Year	Gain Recognized	Tax Payable	FV as of 2024 @ 7%
2020	$100,000	$23,800	$33,381
2024	$200,000	$47,600	$47,600
Total	$300,000	$71,400	$80,981

B. LOSS HARVESTING

Year	Gain Recognized	Tax Payable	FV as of 2024 @ 7%
2020	$0	$0	0$
2024	$300,000	$71,400	$71,400
Total	$300,000	$71,400	$71,400

By loss harvesting, Jill pays $9,581 less tax in future value terms than she would have paid without loss harvesting ($80,981 - $71,400). Note that the amount of the tax savings depends on (1) the time period between the two sales, and (2) the taxpayer's opportunity cost of capital. The longer the time period and the higher the opportunity cost of capital, the greater the economic benefit of tax harvesting will be.

It is also important to recognize that loss harvesting could backfire on a taxpayer if tax rates increase in the future. A higher tax rate might offset the timing advantage, depending on the magnitude of the rate increase and the length of the deferral period.

In general, capital losses are more tax efficient if they can be used to offset income taxed at higher tax rates (i.e., short-term capital gains and ordinary income). Thus, long-term losses used against short-term gains are more tax-efficient than short-term losses being used against long-term gains. The last thing you want to do is use a short-term loss carry forward and harvest long-term gain. That translates into using an asset that is potentially worth 40.8% to shelter a gain worth 23.8%. This results in a 17% negative arbitrage.

	Short-Term Gain	**Long-Term Gain**
Short-Term Loss	NEUTRAL	INEFFECTIVE
Long-Term Loss	EFFECTIVE	NEUTRAL

Caveat: Wash Sale Rules

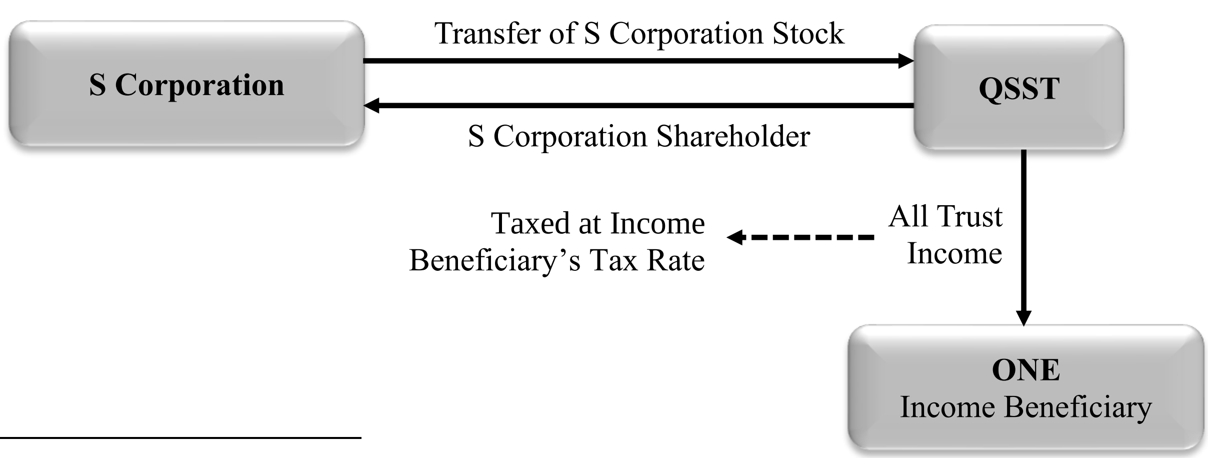
IRC § 1091 denies a deduction for losses incurred in a wash sale. A wash sale occurs when a taxpayer sells stock or securities at a loss and within thirty days before or after the sale buys substantially identical stock or securities. Thus, a taxpayer must wait at least 31 days before repurchasing the stock that was sold. This subjects the seller to the risk that the price of the stock or security could increase substantially during the time he or she is out of the market. There are a number of strategies that can be used to mitigate this risk, like purchasing similar but not identical stock after the sale.

#4: Trusts as S Corporation Shareholders: ESBT vs. QSST

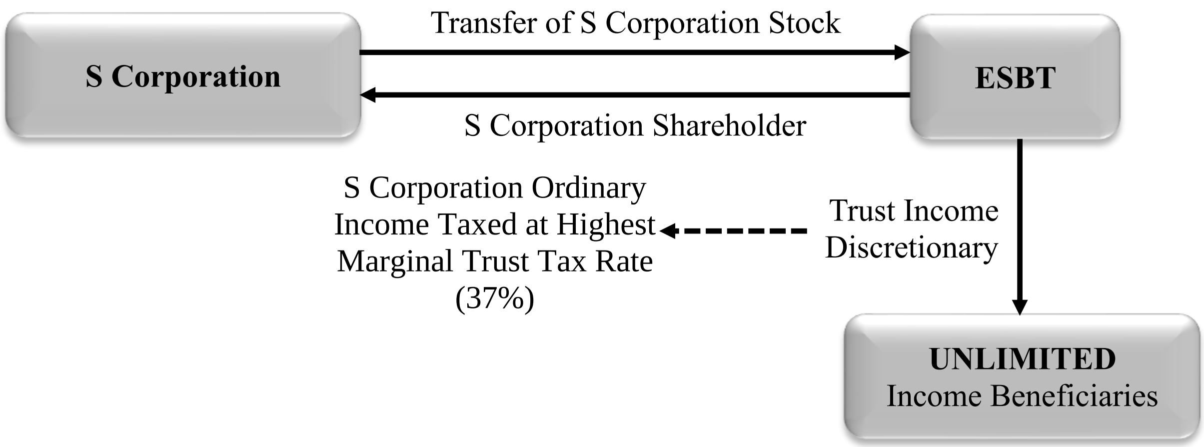
A corporation does not qualify as an S corporation if it has an ineligible shareholder. Eligible shareholders include only individuals, a decedent's estate, the estate of an individual in bankruptcy, certain tax-exempt organizations and certain trusts.[12] Eligible trusts include (1) grantor trusts, (2) IRC § 678 trusts, (3) qualified subchapter S trusts (QSSTs), (4) electing small business trusts (ESBTs), (5) certain testamentary trusts, and (6) voting trusts.[13] Taxpayers who wish to hold S corporation stock in a trust must frequently choose between a QSST and an ESBT. Perhaps the most common situation is one in which an individual held S corporation stock in a grantor trust, but grantor trust status terminated when the grantor died. The trust continues to be a qualified S corporation shareholder for two years after the grantor's death, but after that, the estate must choose between making the trust a QSST or an ESBT.

Important differences between the two often make the decision a difficult one. Overall, the main issue is: Would you rather have more restrictions (a QSST) or, in most cases, more taxes (an ESBT)? This tradeoff is shown in the following chart.

	QSST	**ESBT**
Trust Income Distribution	All trust income must be distributed	Discretionary
Trust Corpus	Must be distributed to the income beneficiary	No restriction on corpus distributions
Number of Current Income Beneficiaries	One (US citizen or resident)	Unlimited (only individuals other than nonresident aliens, estates, and charities)
Taxable Income	Passes through to the income beneficiary and is taxed at the beneficiary's tax rate	S corporation's income is recognized at the trust level and taxed at a flat rate equal to the highest marginal rate for trusts
Election	Made by the income beneficiary	Made by the trustee



[12] IRC § 1361(b)(1)(B).
[13] IRC § 1361(c)(2).



Since a QSST may only have one current income beneficiary, if you want to transfer stock to multiple beneficiaries, i.e., your children, you would need to set up a separate QSST for each beneficiary. While there can only be one income beneficiary, a QSST may designate successor beneficiaries. With an ESBT, you can set up one trust that includes all of the income beneficiaries. However, note that any ESBT designated beneficiaries must be an individual, estate or charity eligible to own S corporation stock. Additionally, the beneficiaries must not have acquired their beneficial interest through purchase.

Furthermore, with a QSST, all trust income must be distributed annually. With an ESBT, the trustee has discretion as to how much of the trust income is distributed and to whom the trust income is distributed. Therefore, with an ESBT, income can be left in the trust to accumulate.

With a QSST, the trust corpus must be distributed only to the income beneficiary during that beneficiary's life or on termination of the trust if prior to the death of the income beneficiary. However, after the beneficiary's death there is no restriction on corpus distributions. This is always the case with an ESBT – no restrictions on corpus distributions. Therefore, the trustee has discretion as to when and to whom distributions of trust corpus will be made. These factors give an ESBT much more flexibility for estate planning purposes.

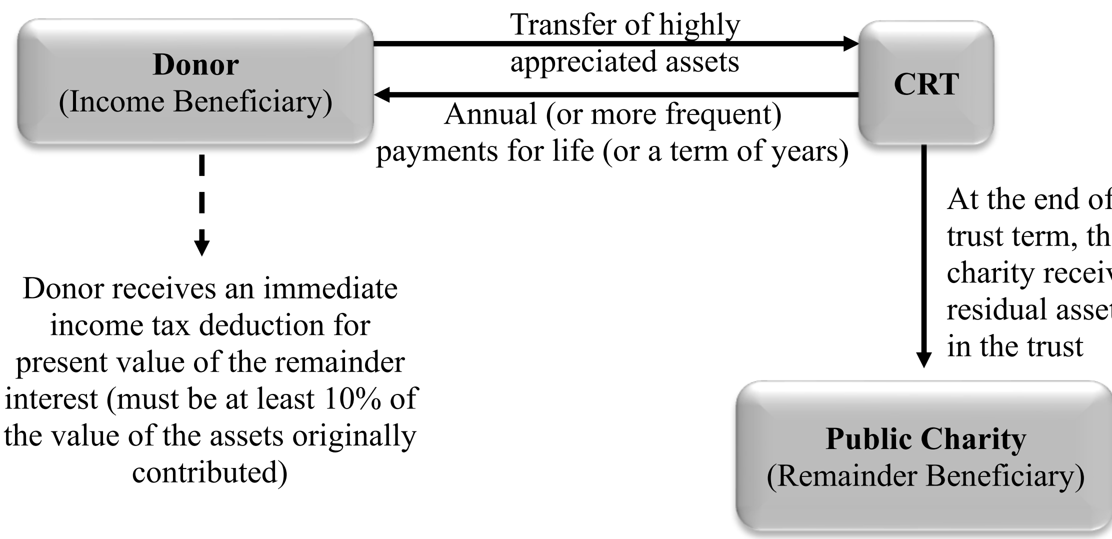
On the other hand, a QSST generally has better income tax consequences. A QSST is treated as an IRC § 678 trust owned by the trust beneficiary. Thus, trust income passes through to the income beneficiary and is taxed at that individual's current tax rate. Note, however, that all income of the trust is reported by the beneficiary, including the trust's share of S corporation income, even if the S corporation does not make a distribution to the trust. With an ESBT, the trust's income from the S corporation is recognized at the trust level and taxed at the highest marginal rate for trusts, which in 2020 is 37%. Because S corporation income is taxed at the trust level, there is no tax at the beneficiary level when income is distributed. Any other sources of trust income (i.e., anything other than S corporation income) are subject to the normal tax rules for trusts. The 37% ESBT rate is generally higher than the individual rate applicable to a QSST beneficiary.

As for eligibility to hold S corporation stock, with a QSST, the duration of eligibility depends on whether the income beneficiary dies prior to the end of the term of the trust. If the trust term ends during the beneficiary's life, the stock will be distributed to that person and the S corporation election will continue for at least as long as that person holds the stock. If, however, the beneficiary dies before the end of the trust term and there is no designated successor beneficiary, the trust remains an eligible S corporation shareholder during the two-year period beginning on the date of the beneficiary's death. Lastly, if a successor beneficiary has been designated, then the S corporation election continues unless the successor beneficiary affirmatively refuses to consent to the original QSST election. On the other hand, with an ESBT, the trust is an eligible shareholder until the ESBT election is terminated or until a person or trust that is ineligible to hold S corporation stock becomes a beneficiary.

Chapter 2: Income Smoothing Strategies

#5: Substantial Sale Charitable Remainder Trust (CRT)

An inter vivos charitable remainder trust (CRT) is an irrevocable trust created by a donor during the donor's life with a lead annuity or unitrust interest and a charitable remainder interest. The lead interest can be for life or a term of years (not to exceed twenty). The donor generally retains the lead interest and any property left in the trust at the end of its term passes to charity. The donor receives gift tax and income tax charitable deductions for the present value of the remainder interest. Assuming that the donor retains the lead interest, it is not subject to gift tax because the donor still owns it. The present value of the remainder interest must be at least 10% of the value of the assets transferred to the trust.



CRTs can be extremely useful for a taxpayer who has a large capital gain that pushes income for a tax year up into higher tax brackets and/or subjects the taxpayer to the net investment income tax (NIIT). Because CRTs are tax-exempt entities, they can sell assets without recognizing gain. Instead, the gain realized by the trust is taxed to the grantor, but only as the annuity or unitrust payments are received, allowing the gain to be spread out over many years, possibly subjecting it to lower tax brackets.

The character of these payments is determined under the "tier" rules of IRC § 664. The payments are first treated as ordinary income, to the extent the trust has realized current or accumulated ordinary income, then as capital gains, to the extent the trust has current or accumulated capital gains, then as other income (e.g., tax-exempt income), and finally as tax-free return of trust corpus. This enables taxpayers to spread gain recognition over a number of years as shown in the following examples.

> ***Example 1.*** Cindy, a single taxpayer age 51, has salary and interest income of \$150,000 net of deductions in 2020. Cindy sells Blackacre, vacant land with a basis of \$100,000, for \$800,000, recognizing a long-term capital gain of \$700,000. The gain is taxed as follows:

First $50,000 @ 15% (15% rate, no NIIT)	$7,500
Next $241,450 @ 18.8% (15% rate, 3.8% NIIT)	$45,393
Last $408,550 @ 23.8% (20% rate, 3.8% NIIT)	$97,235
Total Tax Paid on Gain	$150,128

Example 2. Now suppose that instead of selling the land herself, Cindy contributes it to a 20-year CRAT at a time when the § 7520 rate is 2%. She sets the value of the charity's remainder interest at the minimum 10% value allowed under the Tax Code, $80,000 ($800,000 x 10%), and retains the right to receive an annuity of $44,033 per year.

N	I	PV	PMT	FV
20 years	2%[14]	$720,000 ($800,000 - $80,000)	$44,033 (TVM)	$0

The CRAT subsequently sells the land and realizes a gain of $700,000 but none of the gain is recognized because the trust is tax-exempt. Assume that the trust assets are all invested in tax-exempt bonds so that the capital gain from Blackacre is the only taxable income flowing out to Cindy. The annuity payments to Cindy are taxable to her until the last of the $700,000 of capital gain realized on the sale of Blackacre has been distributed in Year 14. Because Cindy's income stays below her $200,000 applicable threshold amount for the NIIT and the $441,450 threshold amount for the 20% capital gains bracket, all payments are taxed at only 15%, making the total tax payable on the sale of Blackacre $105,000 (.15 x $700,000). Note that this is $45,128 less than the tax paid in the previous example ($150,128 - $105,000). The tax is not only lower, there is substantial tax deferral. Assuming a conservative 6% opportunity cost of capital, the present value of the tax payable is about $66,488, compared to the $150,128 without the CRT planning.[15]

The Net Investment Income Tax

The regulations for the NIIT allow a taxpayer to choose between two different accounting methods to determine the amount of NII distributed to a non-charitable beneficiary. A taxpayer may elect to use the "simplified method" as provided for in the 2012 Proposed Regulations or the "section 664 method" as provided for in the 2013 Final Regulations. Under the "simplified method," distributions from a CRT to a beneficiary for a taxable year consist of NII in an amount equal to the lesser of: 1) the total amount of the distributions for that year; or 2) the current and accumulated NII of the CRT. Under the "section 664 method," NII is categorized and distributed based on the existing section 664 category and class system.[16]

[14] Example Section 7520 Rate.
[15] Note that the full $50,203 annuity payment is treated as a capital gain to Cindy in years 1-13. In Year 14, only the first $47,361 is attributable to the $700,000 gain from the sale of Blackacre.
[16] See Reg. § 1.1411-3(d); 2013 Prop. Reg. § 1.1411-3(d); 2012 Prop. Reg. § 1.411-3(c)(2)(i).

Generally, if the taxpayer is not subject to the NIIT (i.e., their MAGI is below the ATA), then the "simplified method" should be used. This is because the "simplified method" accelerates distribution of NII; therefore, if the taxpayer's MAGI is below the ATA, they will not be subject to the NIIT on the distributed NII. On the other hand, if the taxpayer is subject to the NIIT (i.e., their MAGI is above the ATA), then the "section 664 method" should be used. This is because the "section 664 method" may defer distribution of NII because it "dips in to" the non-NII buckets even before all the NII is distributed; therefore, if the taxpayer's MAGI is above the ATA, deferring NII will provide the taxpayer with a better economic result. Note that taxpayers should always conduct their own analysis to determine which NII accounting method provides a better economic result under their specific facts and circumstances.

Caveat

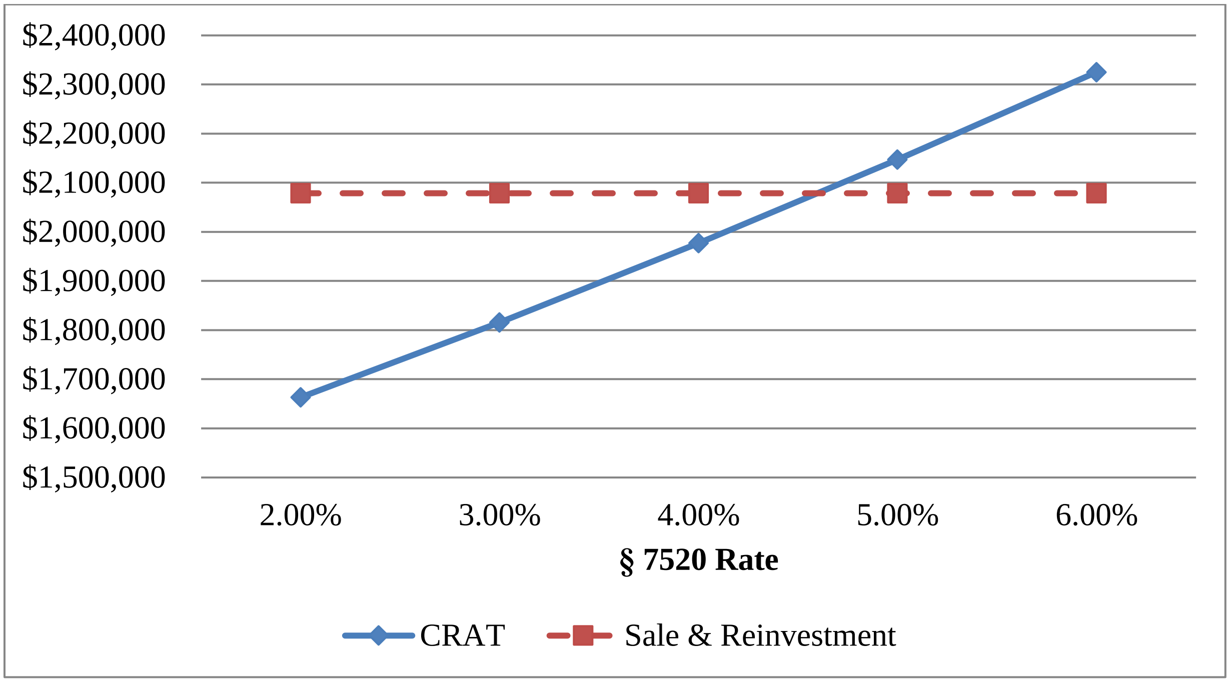
Notwithstanding the impressive income tax savings, given the relatively low current IRC § 7520 rates, this strategy is recommended only for taxpayers with strong charitable intent. There are two reasons for this. First, the taxpayer must give at least 10% of the amount transferred to a CRT to charity. In other words, the present value of the charitable remainder interest must be at least 10% of the value of the assets transferred to the trust. Second, the very low IRC § 7520 rates make the payouts from a CRAT very low. This is because the payouts reflect interest paid at the IRC § 7520 rate. In the following example we compare the total wealth taxpayers would have after twenty years if they simply reinvested the after-tax sale proceeds with the total wealth they would have if they used the CRAT strategy.

> ***Example 3.*** Assume the same facts as in Examples 1 and 2. If Cindy reinvested the after-tax sale proceeds, she would have $2,083,124 after 20 years ($649,528 appreciated @ 6% for 20 years). By contrast, if Cindy transferred Blackacre to the CRAT described above, she would receive the following payments after tax—

	Calculation	**After Tax**
Years 1-16:	$44,033 x 0.85	$37,428
Year 17	($15,475 x. 0.85) + $28,558	$41,712
Years 16-20:		$44,033
FV of payment stream:	TVM @ 6%	$1,402,937
FV of charitable deduction:	TVM: $80,000 @ 6%, 20 years	$256,571
Total wealth accumulation:		$1,659,508

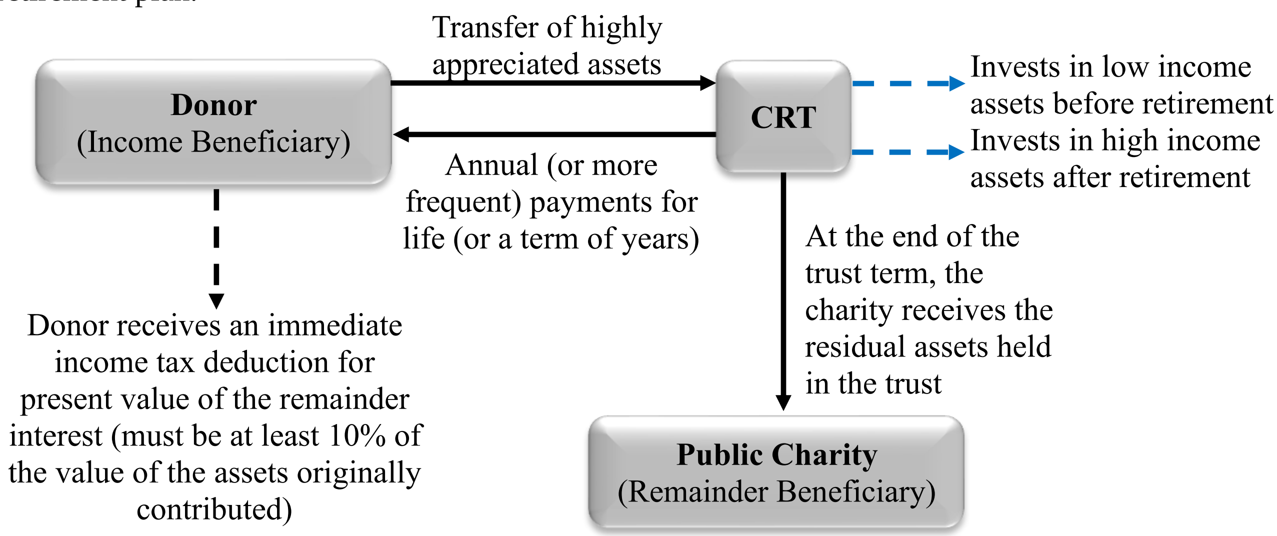
If IRC § 7520 rates increase in the future, the charitable remainder trust strategy might produce more total wealth than a sale and reinvestment, making it a desirable strategy even if the taxpayer has no charitable intent. The following chart compares the total wealth after twenty years from a sale and reinvestment with the total wealth from a CRAT after twenty years using various IRC § 7520 rates.

§ 7520 Rate	Annual Annuity	FV of Annuity after 20 years	Plus $256,571 from Charitable Deduction	Compared With Sale & Reinvestment
2.0%	$44,033	$1,406,562	$1,663,133	$2,091,628
3.0%	$48,395	$1,559,339	$1,815,910	$2,091,628
4.0%	$52,979	$1,720,835	$1,977,406	$2,091,628
5.0%	$57,775	$1,890,745	$2,147,316	$2,091,628
6.0%	$62,773	$2,068,698	$2,325,269	$2,091,628



#6: Retirement Charitable Remainder Trust

Other sections of this book describe how a charitable remainder trust (CRT) can be used to smooth out capital gains from a large sale (#12) and how a CRT can be used to shift income to family members in lower tax brackets (#5). A CRT can also be used as an alternative or supplement to a retirement plan.



Recall from the other CRT sections that the lead interest in a CRT can be either an annuity interest (CRAT) or a unitrust interest (CRUT). A retirement CRT is set up using a special kind of CRUT called a net income with make-up CRUT, or NIMCRUT. A NIMCRUT pays the settlor the lesser of a fixed percentage of the trust assets (recalculated annually) or the net trust income. It also includes a make-up provision providing that--"to the extent that trust income is less than the stated fixed percentage, the shortfall goes into a make-up account that can be paid out in later years to the extent the trust income exceeds the fixed percentage." It should be noted that in a NIMCRUT, the principal can never be invaded; therefore, the shortfalls in the make-up account may only be paid out later if trust income exceeds the fixed percentage.

> ***Example 1.*** For an illustration of how the make-up provision works, assume that after 5 years a 5% NIMCRUT, with a principal of $100,000 and a make-up account of $20,000, has the amounts of trust income shown below:

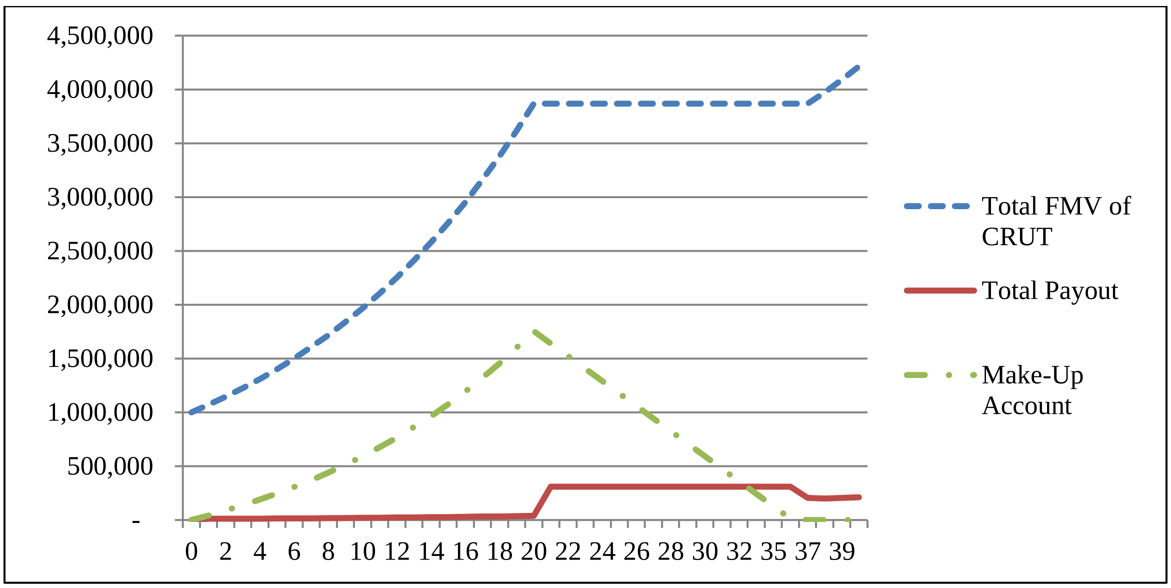
Trust Income	5% Unitrust Payout[17]	Make-Up "Payout"[18]	Actual Payout[19]	End. Bal. Make-Up Fund[20]	End. Bal. Trust
$ 4,000	$ 5,000	$ 0	$ 4,000	$ 21,000	$ 100,000
$ 5,000	$ 5,000	$ 0	$ 5,000	$ 20,000	$ 100,000
$ 6,000	$ 5,000	$ 1,000	$ 6,000	$ 19,000	$ 100,000

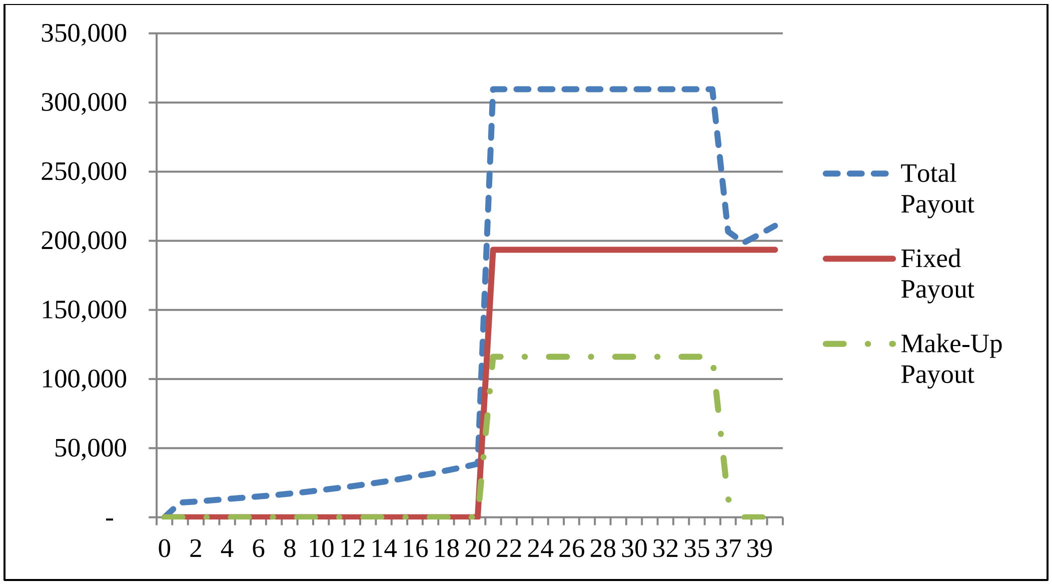
The CRT retirement strategy works by minimizing trust distributions before retirement and maximizing trust distributions after retirement. In the years before retirement, the NIMCRUT invests in assets that produce very low income, like growth stock. This activates the make-up provision, i.e., the trust income will be less than the fixed percentage so the shortfall goes into the make-up account to be paid out later when trust income exceeds the fixed percentage. Thus, in these years, the NIMCRUT makes few or no distributions, and accumulates gains tax-free. Then when the donor retires, the NIMCRUT invests in assets that will maximize trust income, like high dividend paying stock or high yield bonds. This will create trust income that exceeds the fixed percentage and will allow for not only the full amount of the fixed percentage to be paid out, but also the amounts in the make-up account. Thus, the retirement CRT allows for deferred growth of retirement funds without the restrictions on qualified retirement plans and relatively high payouts after retirement.

> ***Example 2.*** Taxpayer is currently 45 years old and plans to retire in 20 years. Before retirement, Taxpayer transfers low basis land to a 40-year NIMCRUT with a 5 percent payout. The NIMCRUT sells the land for $1,000,000 and invests the proceeds in growth stocks that appreciate in value at 7 percent per year and pay 1 percent in dividends. During these years, the amount of the fixed payout percentage that exceeds the net trust income goes into the make-up account to be paid out later. At the end of 20 years, there is $1,754,607 in the make-up account and the value of the stock has increased to $3,869,684. After retirement, the NIMCRUT sells the stocks and reinvests in high-yielding bonds, paying 8 percent interest annually. Taxpayer then begins to receive the full 5 percent annual payout from the NIMCRUT, $193,484 in Year 21 (.05 x $3,869,684). Taxpayer also receives a payment from the make-up account equal to the excess of the 8 percent return over the fixed payout percentage. This amount is $116,091 (.03 x $3,869,684). This reduces the make-up account to $1,638,517 ($1,754,607 - $116,091). This $1,638,517 is available for use in future years until it is used up (which happens in year 37). Once the make-up account is used up, the excess of net trust income over the fixed payout percentage is added to the NIMCRUT. Below is a summary of what the different amounts look like every 5 years.

[17] Calculated by taking the 5% interest rate times the $100,000 of trust principal.
[18] If the trust income exceeds the stated 5% payout and there is an accumulated amount in the Make-Up Fund, then the amount that the trust income exceeds the stated 5% payout will be a Make-Up Payout.
[19] The lesser of trust income or the stated 5% interest rate payout (plus any amount in the Make-Up Fund).
[20] If the trust income is less than the stated 5% interest rate payout, then that amount goes into the Make-Up Fund to be paid out later, when trust income exceeds the stated 5% interest rate payout.

Year	CRUT FMV	Trust Income	5% Unitrust Payout	Make-Up "Payout"	Total Payout	Make-Up Fund
1	$1,070,000	$10,700	$53,500	$0	$10,700	$42,800
5	$1,402,552	$14,026	$70,128	$0	$14,026	$246,132
10	$1,967,151	$19,672	$98,358	$0	$19,672	$591,344
15	$2,759,032	$27,590	$137,952	$0	$27,590	$1,075,522
20	$3,869,684	$38,697	$193,484	$0	$38,697	$1,754,607
RETIREMENT						
21	$3,869,684	$309,575	$193,484	$116,091	$309,575	$1,638,517
25	$3,869,684	$309,575	$193,484	$116,091	$309,575	$1,174,154
30	$3,869,684	$309,575	$193,484	$116,091	$309,575	$593,702
35	$3,869,684	$309,575	$193,484	$116,091	$309,575	$129,340
40	$4,214,453	$337,156	$210,723	$0	$210,723	$0





> Therefore, at the end of the 40-year NIMCRUT, $4,214,453 goes to the charitable remainder beneficiary. The total payments made to the lead beneficiary over the 40-year NIMCRUT equal $5,464,289. Therefore, taking the $1,000,000 investment in the NIMCRUT, over a 40 year period, with a future value of $5,464,289, that gives Taxpayer a 4.34% return. If you include the charitable gift, the total future value is $9,739,143, giving Taxpayer a total return of 5.84%.

Not only does the retirement CRT serve as a substitute for or a supplement to a retirement plan, it can also be used to smooth out income to enable the taxpayer to avoid the 3.8% net investment income tax (NIIT) and the higher marginal tax brackets. In the years before retirement, when the taxpayer is in higher tax brackets, the NIMCRUT lead interest beneficiary (i.e., the taxpayer) will receive very small, if any, payments, deferring income and taxes. Then in the years after retirement, when the taxpayer is in lower tax brackets, the NIMCRUT lead interest beneficiary (i.e., the taxpayer) will receive the larger payments taxed at a lower rate; thus, deferring and lowering taxes. Also recall from the CRT sections of this book how the payments from the CRT are characterized when planning a retirement CRT, i.e., the four-tier income ordering rules.

However, careful planning must be done in order to avoid increasing the taxpayer's taxes under the new NIIT during the years of distribution from the NIMCRUT. In the years before retirement, there should be little impact on the taxpayer's net investment income because the payments will be small, if not zero. After retirement though, the payments will be much larger. Careful planning must be done to ensure that a taxpayer who but for the NIMCRUT payment would not have been subjected to the NIIT, still is not; i.e., the taxpayer continues to be under the applicable threshold amount in § 1411.[21]

In the end, the purpose of this strategy is to harbor net investment income in a tax-exempt environment while at the same time leveling and deferring income over a longer period of time to

[21] Also recall and consider the two accounting methods for distributions of NII from a CRT to a non-charitable beneficiary as discussed under the "Substantial Sale CRT" topic in this book.

keep MAGI below the applicable threshold amount under § 1411 and to keep the taxpayer out of the higher tax brackets.

One final note: There are more aggressive variations on the strategy that might produce even more favorable results. For example, a taxpayer could have a NIMCRUT invest in a tax-deferred annuity. No trust income would be produced until the annuity starting date. Thus, by fixing the annuity starting date at the taxpayer's retirement date, the taxpayer could ensure that there was no income before retirement, but a relatively favorable income stream after retirement. But before having a retirement CRT invest in deferred annuities, or even zero-coupon bonds, partnership assets, or life insurance, etc., do more research; there are arguments being made that the IRS could, in certain situations, find that such CRTs violate the CRT or grantor trust rules and, therefore, result in a failure to qualify as a CRT.

#7: Roth IRA Conversions

Roth IRAs have a number of advantages over traditional IRAs:

- Lower overall taxable income long-term;
- Tax-free, rather than tax-deferred growth;
- No required minimum distributions (RMDs) at age 72;
- Tax-free withdrawals for beneficiaries after the death of the owner;
- More effective funding of the bypass trust; and
- Facilitates 3.8% net investment income tax (NIIT) planning and income smoothing.

Whether a Roth conversion will be favorable for a particular taxpayer, however, depends on the facts of the case. Although a Roth conversion might make sense more often than not, a detailed quantitative analysis is required to determine whether it provides an overall economic benefit in a particular case. This analysis begins with a comparison of the taxpayer's marginal income tax rate at the time of the conversion and the taxpayer's expected marginal income tax rate when distributions are received. If the tax rate at the time of the conversion is lower, the taxpayer will achieve a better economic result by converting. If the tax rate is expected to be far higher than when distributions are received, the taxpayer will generally be better off not converting. If the tax rate at the time of conversion is expected to be slightly to moderately higher than at the time of distribution, a Roth IRA conversion might still be advisable because of special factors that favor a Roth IRA.

Perhaps the most important of these factors is that if a taxpayer can pay the Roth conversion tax with outside funds he or she can, in effect, pack more value into the IRA.

> ***Example 1.*** Wilma is a single taxpayer in a 40% combined federal and state income tax bracket in 2020. She has $1,000,000 in a traditional IRA and $400,000 of liquid assets in a side fund, which may be used to pay the taxes from a Roth IRA conversion if Wilma chooses to do one. Assume that the assets in the IRA will increase in value by 300% by the time Wilma retires in 30 years, but the side fund will grow by only 200% because it is subject to tax. At the end of the 30-year period, Wilma will receive a distribution of the full amount in the IRA and will be in the same 40% marginal income tax bracket. The charts below compare the terminal wealth from a traditional IRA and a Roth IRA.

A. No Conversion—Leave assets in Traditional IRA

Beginning Balance	$ 1,000,000
Conversion Tax	$ 0
Value after Conversion Tax	$ 1,000,000
Value after 30 Years (4 x $1,000,000)	$ 4,000,000
Tax on Distribution (0.4 x. $ 4,000,000)	$ (1,600,000)
Amount after Distribution Tax	$ 2,400,000
+ Value of Side Fund (3 x $ 400,000)	$ 1,200,000
Total Terminal Wealth	$ 3,600,000

B. Roth IRA Conversion – Don't use side fund to pay conversion tax

Beginning Balance	$ 1,000,000
Conversion Tax	$ 400,000
Value after Conversion Tax	$ 600,000
Value after 30 Years (4 x $600,000)	$ 2,400,000
Tax on Distribution	$ 0
Amount after Distribution Tax	$ 2,400,000
+ Value of Side Fund (3 x $400,000)	$ 1,200,000
Total Terminal Wealth	$ 3,600,000

C. Roth IRA Conversion – Use side fund to pay conversion tax

Beginning Balance	$ 1,000,000
Conversion Tax (use side fund)	$ 400,000
Value after Conversion Tax	$ 1,000,000
Value after 30 Years (4 x $1,000,000)	$ 4,000,000
Tax on Distribution	$ 0
Amount after Distribution Tax	$ 4,000,000
+ Value of Side Fund (eliminated to pay tax)	$ 0
Total Terminal Wealth	$ 4,000,000

The $400,000 difference is due to the fact that the $400,000 side fund was, in effect, added to the value of the IRA rather than continuing to grow at its taxable rate. Thus, the difference is ($400,000 x 4) - ($400,000 x 3) = $400,000.

There are many other factors that might favor a Roth IRA conversion:

- A taxpayer has special favorable tax attributes, including charitable deduction carry-forwards, investment tax credits, net operating losses, high basis nondeductible traditional IRA, etc., that may help offset the taxable conversion amount.
- Suspension of the minimum distribution rules at age 72 provides a considerable advantage to the Roth IRA holder if the holder doesn't need the payments for support and can accumulate them for transfer to their heirs.
- Taxpayers benefit from paying income tax before estate tax (when a Roth IRA election is made) compared to the income tax deduction obtained when a traditional IRA is subject to estate tax.
- Taxpayers making the Roth IRA election during their lifetime reduce their overall estate, thereby lowering the effect of higher estate tax rates.
- Federal tax brackets are more favorable for married couples filing joint returns than for single individuals; therefore, possibly lowering the conversion tax if the taxpayer is married. Also, Roth IRA distributions won't cause an increase in tax rates for the surviving spouse when one spouse is deceased because the distributions are tax-free.
- Post-death distributions to beneficiaries are tax-free which is especially important after the Secure Act Ten-Year.
- Tax rates are expected to increase in the near future.

- ➢ The 3.8% NIIT – Roth IRA distributions are not included in net investment income or MAGI.
- ➢ The 199A Deduction – Roth IRA distributions will not increase taxable income for 199A and a conversion could actually increase the deduction in certain circumstances.

Roth conversions to take advantage of these factors fall into four categories:

- ➢ ***Strategic conversions*****:** Taking advantage of a client's long-term wealth transfer objectives.
- ➢ ***Tactical conversions*****:** Taking advantage of short-term client-specific income tax attributes that are set to expire (i.e., low tax rates, tax credits, charitable contribution carryovers, current year ordinary losses, net operating loss carryovers, AMT, etc.).
- ➢ ***Opportunistic conversions*****:** Taking advantage of short-term stock market volatility, sector rotation and rotation in asset classes.
- ➢ ***Hedging conversions*****:** Taking advantage of projected future events that will result in the client being subject to higher tax rates within the near future.

Avoiding the 3.8% NIIT

The 3.8% NIIT created an additional reason for doing a Roth IRA conversion—income smoothing. Recall that the amount of net investment income subject to the 3.8% NIIT is the lesser of:

1. Net Investment Income (NII), or
2. The excess of MAGI over the applicable threshold amount (ATA).

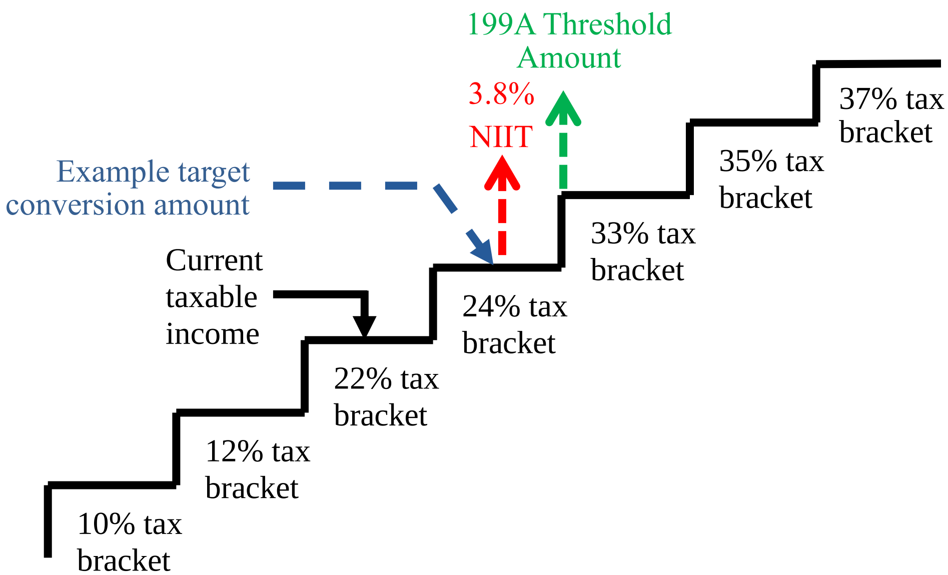
Distributions from a traditional IRA are not considered NII, but they do increase MAGI. Thus, they could create or increase a taxpayer's NIIT. By contrast, a Roth IRA distribution is neither NII nor MAGI, so it does not create or increase a taxpayer's NIIT. Therefore, a taxpayer can use a Roth IRA conversion to keep future income out of higher brackets and eliminate all future NIIT on IRA distributions.

	Traditional IRA	**Roth IRA**
Impacts MAGI	YES	NO
NII	NO	NO

Example 2. Taxpayer (T), filing single, has salary income of $100,000 and dividend income of $100,000. T is not subject to the NIIT despite having $100,000 of NII because his MAGI does not exceed his ATA ($200,000 - $200,000). If later, T also receives a $75,000 RMD from his traditional IRA, the NIIT will apply to the lesser of NII ($100,000) or the excess of MAGI over ATA ($275,000 - $200,000). Thus, the traditional IRA distribution will subject T to NIIT on $75,000 of income. If instead, the traditional IRA had previously been converted to a Roth IRA and T received a distribution of $75,000, T would not be subject to any NIIT; his MAGI would not exceed his ATA because a distribution from a Roth IRA does not count towards MAGI ($200,000 - $200,000).

Analysis of Roth IRA Conversions

If a taxpayer's income is currently lower than it is expected to be in later years, the taxpayer might want to do a Roth conversion to "smooth out" income. The conversion can be done in stages so that the tax payable on the conversion does not push the taxpayer into a higher tax bracket or increase MAGI and NIIT in the year of conversion. Taxpayers can limit annual conversions to the amount that fills up their current marginal tax bracket. It should be noted, however, that there may be times when it does make sense to convert more and go into the higher tax brackets.



Re-characterizing a Roth IRA Conversion

Prior to the 2017 Tax Cuts and Jobs Act of 2017 (TCJA), the ability to re-characterize a Roth IRA back to a traditional IRA if the assets dropped in value, eliminated much of the risk of Roth conversions. Following the Act, however, re-characterizations are no longer allowed.

Faster appreciating assets should generally be held in a Roth IRA rather than a traditional IRA. This is because Roth IRAs have no RMDs; thus, enabling the assets to grow at their higher rate of return for a longer period of time.

Finally, listed below are four steps to planning for a Roth IRA conversion:

1. Develop a ten to fifteen-year projection of income and deductions and compare these projections to the various taxes.
2. Develop an analysis to determine the client's "permanent tax bracket." Analysis will test whether any "intra-bracket" conversions increase the 3.8% NIIT, the AMT, or impact the Section 199A limitations.

3. Develop a series of “bracket-crossing conversions” analyses. Each analysis must be measured autonomously standing on its own and take into account the various taxes.

4. Repeat the above taking into account changes in value and the opportunity to re-characterize.

Much of the Roth IRA conversion planning discussed above can be done with Keebler & Associates, LLP’s Tax Rate Evaluator and Roth Conversion Software.

For the use of Roth conversions to address the SECURE Act’s maximum 10-year distribution period for non-spousal inherited IRAs see Planning Opportunity #41.

#8: Oil and Gas Investments

When the NIIT is taken into account, income tax rates could be as high as 40.8% on ordinary income and short term capital gains and as high as 23.8% on long term capital gains. This makes smoothing income to avoid the high tax brackets extremely important. In general, there are two ways to avoid having taxable income in a higher tax bracket. One is by taking income from an unusually high-income tax year and spreading it over several tax years. Two of the key strategies for doing this are charitable remainder trusts and installment sales. The other is by creating large deductions or credits in the high-income year. Perhaps the best way to create a large deduction in a tax year is with oil and gas investments.

Intangible Drilling Costs

Congress created important tax incentives to encourage domestic oil and gas production. Investors can deduct 100 percent of their share of intangible drilling costs (IDCs) in the year they are incurred. IDCs are those expenses that have no salvage value even if the well later turns out to be dry. They include expenses for labor, drilling rig time, drilling fluids, removing the oil rig, plugging the well if it is dry, and surface and crop damage to landowners. IDCs typically produce deductions equal to 65 to 85 percent of the total investment. Thus, a $100,000 investment could produce an immediate deduction of $65,000 to $85,000. Investors ordinarily pay these amounts before drilling begins, but the costs are deductible in the current year provided that drilling begins by March of the following year. Moreover, the deduction is available regardless of whether the well strikes oil.

Under the special rule of IRC § 469(c)(3), a working interest in an oil or gas well is not a passive activity, regardless of the taxpayer's participation in the activity, unless the taxpayer holds the interest through an entity that limits the taxpayer's liability. For this purpose, liability is limited if the taxpayer holds a limited partnership interest, stock in a corporation, or an interest in an entity that, under applicable state law, limits the potential liability of a holder of such interest to a determinable fixed amount.[22] If a taxpayer has both limited and general partner interests in an oil and gas partnership, the total interest is treated as non-passive.[23]

The deduction can be used to offset active income from wages, interest, business profits, or capital gains. This can produce large tax savings as the following example illustrates.

> ***Example 1.*** Carl is a single taxpayer who expects taxable income of $100,000 – all ordinary income – in 2020 absent selling any assets. However, consider that he sells X Corporation stock, with a basis of $100,000, for $500,000, recognizing a long-term capital gain of $400,000. The first $100,000 of gain is taxed at 15%, the next $241,450 of gain is taxed at 18.8%, and the remaining $58,550 of gain is taxed at 23.8%, as shown in the following chart:

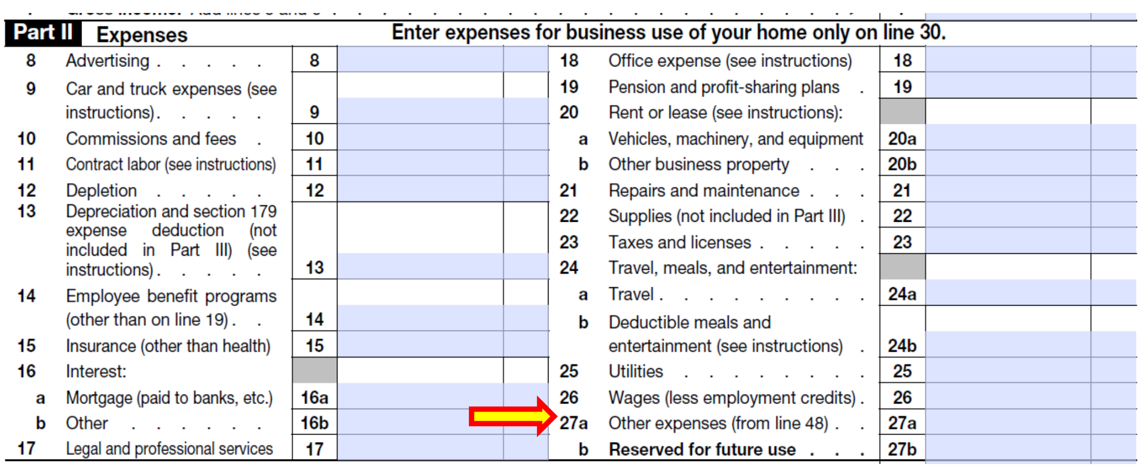
[22] Reg. § 1.469-1T(e)(4).
[23] *Id.*

	Capital Gain Tax Rate	Tax Payable
First $100,000 of gain	15%	$15,000
Next $241,450 of gain	18.8%	$45,393
Last $58,550 of gain	23.8%	$13,935

Now suppose Carl re-invests the proceeds from the sale, about $375,000 say, in an oil and gas partnership that produces $50,000 of income each year from 2021-2025. However, this investment also produces a tax deduction of $300,000 in 2020, assuming 80% of the investment is deductible intangible drilling costs (.8 x $375,000).

This deduction would first eliminate all of Carl's $100,000 of ordinary taxable income taxed at 22%, 12%, and 10%. Then it would begin to reduce capital gains. On net, Carl would go from having $100,000 of ordinary income and $400,000 of capital gain to merely $200,000 of capital gain subject to taxation. $40,000 of this capital gain would be subject to a 0% rate and $160,000 would be subject to a 15% rate for a total tax bill of just $24,000.

According to IRS Publication 535, a taxpayer elects to deduct IDCs as a current business expense by taking the deduction on Form 1040 for the first tax year the taxpayer has eligible costs. Furthermore, no formal statement is required. If a taxpayer files a Schedule C (Form 1040), enter these costs under "Other expenses."



Part II Expenses — Enter expenses for business use of your home only on line 30.

8	Advertising	8	18	Office expense (see instructions)	18
9	Car and truck expenses (see instructions)	9	19	Pension and profit-sharing plans	19
10	Commissions and fees	10	20	Rent or lease (see instructions):	
11	Contract labor (see instructions)	11	a	Vehicles, machinery, and equipment	20a
12	Depletion	12	b	Other business property	20b
13	Depreciation and section 179 expense deduction (not included in Part III) (see instructions)	13	21	Repairs and maintenance	21
14	Employee benefit programs (other than on line 19)	14	22	Supplies (not included in Part III)	22
15	Insurance (other than health)	15	23	Taxes and licenses	23
16	Interest:		24	Travel, meals, and entertainment:	
a	Mortgage (paid to banks, etc.)	16a	a	Travel	24a
b	Other	16b	b	Deductible meals and entertainment (see instructions)	24b
17	Legal and professional services	17	25	Utilities	25
			26	Wages (less employment credits)	26
			27a	Other expenses (from line 48)	27a
			b	**Reserved for future use**	27b

Part V	Other Expenses. List below business expenses not included on lines 8–26 or line 30.		
48	**Total other expenses.** Enter here and on line 27a	48	

Additional Tax Benefits

Oil and gas investments produce the following additional benefits.

Tangible Drilling Costs. These represent the direct cost of drilling the well and 100 percent can be written off over a seven-year period (IRC § 263).

Alternative Minimum Tax (AMT). Prior to 1992, IDCs from working interests in oil and gas were subject to the AMT. However, the 1992 Act specifically excluded IDCs as a tax preference item.

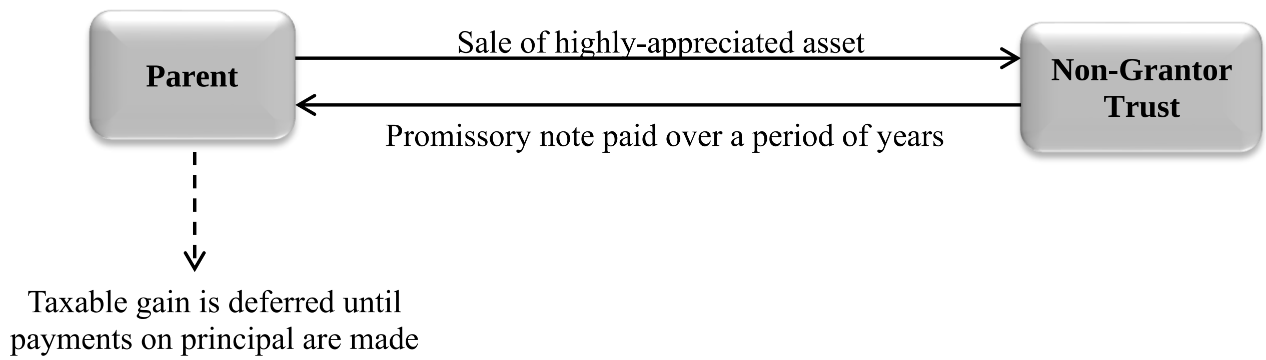
Depletion Deduction. After a well starts producing, the investors can shelter some of the gross income from the sale of oil or gas with a depletion deduction. There are two kinds of depletion allowances—cost depletion and percentage depletion. Cost depletion is based on current production as a percentage of total recoverable reserves. Percentage depletion generally shelters 15% of a well's annual production from income tax. Assuming a 15% depletion deduction, the following chart shows the effective tax rate after the depletion deduction for each of the income tax brackets:

Marginal Tax Rate	Effective Tax Rate
10.0%	8.50%
12.0%	10.20%
22.0%	18.70%
24.0%	20.40%
32.0%	27.20%
35.0%	29.75%
37.0%	31.45%

#9: Two-Year Installment Sale Strategy

Prior to 1980, taxpayers used a double sale strategy to create a timing mismatch between realization of appreciation and realization of taxable gain. By using this strategy to transfer property to their children, the children could receive the full value of appreciated property in cash before any taxable gain was recognized.

- Parent (P) owns Blackacre, undeveloped land with a basis of $100,000 and an FMV of $1,000,000
- P sells Blackacre to a non-grantor trust (T) for the benefit of P's children and takes back a ten-year installment note
- T receives a stepped-up basis for Blackacre
- T immediately sells Blackacre to an unrelated buyer for cash
- Little, if any gain, is recognized on the second sale
- T currently receives the full $1,000,000 value of Blackacre in cash
- T makes installment payments to P, deferring gain recognition over a ten-year period



Congress partially blocked this strategy in 1980 by enacting IRC § 453(e). This section provides as follows:

> *If—*
>
> > *(A) any person disposes of property to a related person (hereinafter in this subsection referred to as the "first disposition"), and*
> >
> > *(B) before the person making the first disposition receives all payments with respect to such disposition, the related person disposes of the property (hereinafter in this subsection referred to as the "second disposition"),*
>
> *then, for purposes of this section, the amount realized with respect to such second disposition shall be treated as received at the time of the second disposition by the person making the first disposition.*

If the original buyer receives the full value of the property on a second sale or other disposition in the first year, the amount treated as received by the original seller is the full amount received on the second sale. Because the purpose of IRC § 453(e) is to prevent the original buyer from receiving the transferred property before capital gains tax is recognized on it, however, the statute includes a limitation accelerating income recognition by the original seller in a taxable year only to the extent that the original buyer receives cash or other property during that year.

The term "*related person*" includes the same persons and entities described in the attribution rules of IRC § 318 and the related party rules of IRC § 267(b). Thus, it includes the original seller's spouse, siblings, lineal descendants and ancestors. It also includes certain partnerships, trusts, estates and corporations.[24]

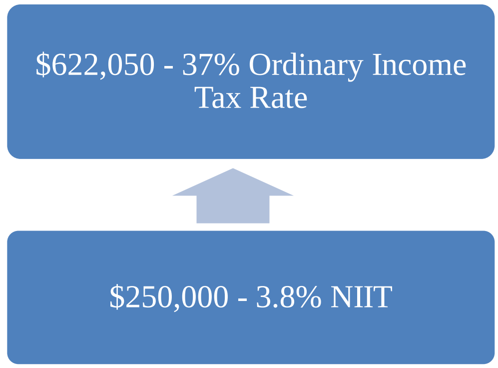
Continuing Tax Planning Opportunity

Except in the case of marketable securities, IRC § 453(e) only applies if the date of the second disposition is not more than two years from the date of the first disposition.[25] Thus, much of the economic benefit of mismatching receipt of income and gain recognition is still available if the original buyer is willing to hold the purchased property for more than two years before selling it.

> ***Example 1.*** Parent (P) sells Greenacre, with a basis of $500,000 and FMV of $1,000,000 to a trust for P's children (CT). P takes back a 10-year note calling for 10 annual principal payments of $100,000 and adequate stated interest. CT's basis in Greenacre is $1,000,000, the amount of the note. In the first two years, CT makes payments of $100,000 to P and P recognizes $50,000 of gain on each payment. After making the second payment, T sells Greenacre to an unrelated party for $1,000,000 and recognizes no gain because CT's basis is equal to the selling price. CT has cashed out the full $1,000,000 value of Greenacre even though P has paid tax on only $100,000 of the gain. T will continue to pay off the note over the next eight years, gaining a substantial timing advantage.

Perhaps more importantly, a two-year installment sale can be used to smooth out income in order to reduce or eliminate exposure to the NIIT and higher tax brackets. The numbers shown apply to married taxpayers filing jointly.

[24] IRC § 453(f).
[25] IRC § 453(e)(2).



Example 2. In order to also illustrate the tax and income smoothing benefits of a two-year installment sale, assume the same facts as in Example 1, and also that P, married filing jointly, has taxable income of $200,000. Consider the following two scenarios:

> Scenario 1: P sells Greenacre to a third-party for $1,000,000 in year one. Therefore, P will be taxed on the entire $500,000 of gain in year one.

Total Gain in Year 1	$500,000
$50,000 Taxed @ 15%	$7,500
$246,600 Taxed @ 18.8%	$46,361
$203,400 Taxed @ 23.8%	$48,409
Total After-Tax Gain ($500,000-$102,270)	$397,730

> Scenario 2: P sells Greenacre to CT (the trust for P's children) and takes back a 10-year installment note calling for 10 annual payments of $100,000 with adequate interest. For the next 10 years, P receives $100,000 (plus interest) and therefore, must recognize $50,000 in gain each year.

Total Gain Each Year	$50,000
Taxed @ 15%	$7,500
10-Year Total Gain	$500,000
10-Year Total Tax	$75,000
Total After-Tax Gain	$425,000

Two traps for the unwary should be noted. First, IRC § 453(e)(2) suspends the running of the two-year period for any time during which the related person's risk of loss is substantially diminished by (1) the holding of a put with respect to such property (or similar property), (2) the holding by another person of a right to acquire the property, or (3) a short sale or any other transaction.

Example 3. P makes an installment sale of Brownacre to T on September 1, 2020. On June, 1, 2022 T enters into a contract to sell Brownacre to an unrelated buyer on December 1, 2022. The six months from June 1, 2020 to December 1, 2020 do not count towards the two-year requirement. Thus, on December 1, 2022, T is treated as selling Brownacre only 21 months after the original sale by P, triggering application of IRC § 453(e).

Second, there is no two-year limitation period for a sale of marketable securities. Assuming that the original seller has not yet received all payments from the related party, IRC § 453(e) applies regardless of the time period between the two sales.

#10: Nonqualified Tax Deferred Annuities

Deferred annuities are another income smoothing strategy. Basically, a taxpayer, during higher tax bracket years, will invest in deferred annuities, thereby reducing taxable income, and thus, income taxes and the net investment income tax (NIIT). Then later, when the taxpayer is in lower tax bracket years, payments from the deferred annuities will begin, thus, smoothing out income and subjecting the taxpayer to lower taxes.

Deferred annuities are often purchased to provide for or to supplement retirement savings. While annuities are not qualified retirement plans, they do still receive preferential tax treatment – the earnings accumulate tax-free and are not taxable until withdrawn. Deferred annuities may be either fixed or variable; fixed annuities pay a fixed interest rate while variable annuities allow the annuity owner to select from various investment options that produce variable rates of return, e.g., stock and bond mutual funds.

<u>Taxation of Fixed Annuities</u>

Different tax rules apply depending on whether a distribution from an annuity is an annuity payment or a non-annuity payment. Annuity payments are payments that are:

1. Received on or after an annuity starting date;
2. Payable in regular periodic intervals (e.g., monthly, quarterly, semi-annually); and
3. Either the total is determinable at the starting date (i.e., fixed annuity) or the payments are made over a definite or determinable time, such as a term of years or life expectancy (i.e., variable annuity).[26]

Payments that meet these requirements are taxed by applying an exclusion ratio, which divides the amount received as an annuity into a taxable portion and a tax-free recovery of basis. In the case of a fixed annuity, the exclusion ratio is the investment in the contract divided by the expected return on the contract.[27] The investment in the contract is generally the total amount of premiums paid.[28] The expected return on the contract is the total amount to be received under the contract as of the annuity starting date.[29] In the case of a term annuity, it is the amount of each payment times the number of payments to be received.[30] In the case of a life annuity, it is the amount of the payments times the number of payments expected to be received based on the annuitant's life expectancy from Table V of Reg. § 1.72-9.[31]

> ***Example 1.*** Tim bought a fixed life annuity for $1,000,000 with payments to begin at age 65. Under Table V, Tim's life expectancy is 20.0 years. The annuity payments are $75,000/year. The expected return on the contract is $1,500,000 (20.0 x $75,000). The exclusion ratio is .667 (2/3). Thus, 1/3 of each payment is taxable

[26] Reg. § 1.72-2(b)(2).
[27] IRC § 72(b).
[28] IRC § 72(c)(1).
[29] IRC § 72(c)(3).
[30] IRC § 72(c)(3)(B).
[31] IRC § 72(c)(3)(A).

($25,000) and 2/3 is excluded ($50,000). Note that if Tim lives longer than expected and the investment in the contract is used up, all further payments are subject to tax.

All income from annuity payments is taxed as ordinary income. This is true even if the income was generated from stocks that would normally be characterized as capital gains. On the surface this may not look like a great deal, but remember that the purpose of deferred annuities is to take income from higher tax bracket years and defer it to lower tax bracket years. Therefore, even though the annuity payments are taxed as ordinary income, the income will be taxed at a lower rate than it would have been had a deferred annuity not been purchased.

The tax treatment of non-annuity payments (cash withdrawals, loans and dividends) depends on when the payments are received. If such payments are received on or after the annuity starting date they are fully taxable.[32] If they are received before the annuity starting date they are taxable only to the extent they exceed the cost of the contract (i.e., accumulated premiums paid).[33] For purposes of computing the taxable portion of future non-annuity payments, non-taxable amounts reduce the cost of the contract.[34]

Taxation of Variable Annuities

Since annuity payments from variable annuities will fluctuate based on the performance of the underlying investments, the payments are taxed differently than those from fixed annuities. The nontaxable portion of each payment is constant over the term of the annuity. It is calculated by dividing the investment in the annuity contract (adjusted for any refund feature) by the number of expected periodic payments. Any portion of each payment that exceeds this amount is taxable as ordinary income. If the annuity payment is less than the recovery portion of the basis, in later years the taxpayer may elect to re-compute the nontaxable amount. If such an election is made, then the portion of the basis that was not recovered in the earlier year is spread out over the remainder of the annuity contract term. Once the nontaxable portion (or basis) has been completely recovered, any additional annuity payments are fully taxable.[35]

Example 2. Taxpayer (T) purchased a variable annuity for $150,000. T retires at age 70 and begins taking annuity payments based on his life expectancy. At this time, the value of the annuity contract is $200,000. T receives an annuity payment of $12,500 in the first year of the annuity. The taxable amount is calculated as follows:

Cost of the Annuity Contract	$ 150,000
Life Expectancy Multiple for Age 70 from Table V	16.0 years
Tax-Free Amount for Each Payment ($150,000 / 16.0)	$ 9,375
Amount Included in Ordinary Income ($12,500 - $9,375)	$ 3,125

[32] IRC § 72(e)(3)(A).
[33] IRC § 72(e)(3)(B).
[34] IRC § 72(e)(6)(B).
[35] Reg. §§ 1.72-2(b)(3) and 1.72-2(d)(3).

Example 3. Assume that the next year, the value of T's annuity investments decline. Since T owns a variable annuity, the amount he receives is based on the value of the contract. In Year 2, T receives an annuity payment of only $5,000. Since this is below T's nontaxable amount, none of it is taxable. Next, assume that in Year 3, the annuity investments have recovered in value and T receives $12,000. Therefore, his nontaxable amount that year is again $9,375. In addition, T may make an election to re-compute his excludable amount for the remainder of the annuity term because Year 2's payment was less than his excludable amount. The amount of nontaxable recovery of basis that was not used in the previous year is allocated over the remainder of the recovery period based on T's life expectancy at the time of the recalculation. T is now 72 years old, and therefore, has a life expectancy of 14.6 years under Table V.

= ($9,375 - $5,000) / 14.6 = $ 300

Thus, $300 of the nontaxable recovery of basis is added to the nontaxable recovery of basis for each remaining year; giving T a nontaxable amount of $9,675 per year. Therefore, in the current year T has nontaxable recovery of $9,675 and ordinary income of $2,325.

<u>Tax Savings from Deferred Annuities</u>

An annuity contract is a perfect investment for taxpayers currently in high tax brackets who expect to be in lower tax brackets in the future. Such taxpayers could avoid having income subject to both the 37% tax rate and the 3.8% NIIT by purchasing an annuity contract in the current year, and then later receive the annuity payments when they are in a lower tax bracket and below the applicable threshold amount for the NIIT.

Example 4.[36] Taxpayer (T), a 50 year-old filing single, has $400,000 of salary income and a $1,000,000 high-yield bond portfolio that produces $50,000 of annual interest income. T expects to have the same income for the next 15 years until he retires at age 65. T does not need the $50,000 of bond income while he is still working. After T retires, he expects to have $100,000 of annual income from his Roth IRA plus the income from the bond portfolio. Compare the following two scenarios.

<u>Scenario 1</u>: T does no planning. Therefore, the $50,000 of interest income is taxed at the 37% rate (his taxable income is over $400,000) and at the 3.8% NIIT rate (he has NII of $50,000 and his AGI is over the $200,000 applicable threshold amount). Thus, his total tax on the $50,000 is 40.8% or $20,400 per year for the next 15 years.

After retirement, he will only have taxable income of $50,000 from the bond portfolio because the Roth IRA distribution is not taxable. Furthermore, he is not subject to the NIIT because his total MAGI is below the applicable

[36] All figures computed with 2020 rates.

threshold amount of $200,000 (recall that Roth IRA distributions are not included in MAGI). The tax on this amount, without regard to any deductions T may have, will be:

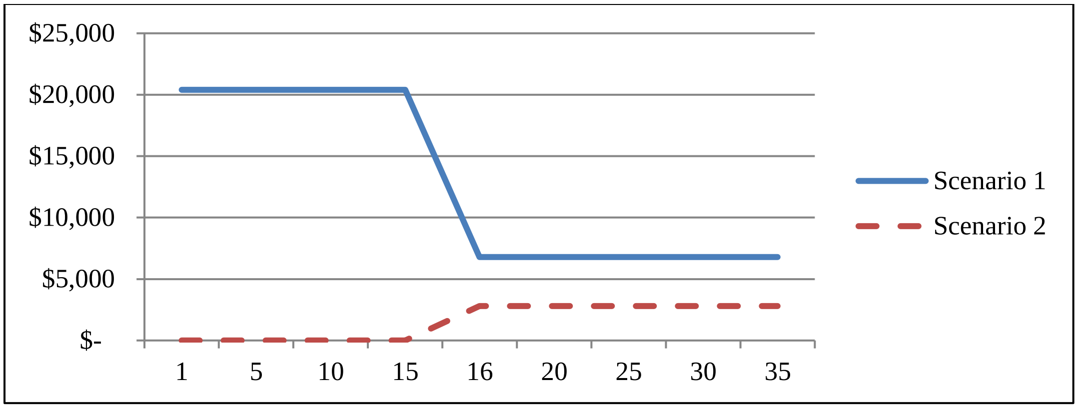
Taxable Income	**Rate**	**Tax**
Less than $9,875	10%	$ 987.50
Over $9,875, under $40,125	12%	$ 3,630.00
Over $40,125, under $85,525	22%	$ 2,172.50
Total:	13.58%	$ 6,790.00[37]

Scenario 2: Instead, T plans and invests the $1,000,000 bond portfolio in a fixed deferred annuity. Assume that given T's age at retirement, the $1,000,000 will buy an annual annuity of $75,000 per year. In the current year, T will have eliminated any income above $400,000; thus, staying out of the highest income tax bracket. Furthermore, T will not have any NII, thereby eliminating any NIIT he might have to pay. The same result will occur for the next 15 years.

After retirement, T will have total income of $175,000 per year ($75,000 annuity payment and $100,000 Roth IRA distributions). Therefore, T's MAGI will be below the $200,000 applicable threshold amount (recall that Roth IRA distributions are not included in MAGI); and thus, not subject to the 3.8% NIIT. Given T's life expectancy of 20 years, T's expected return is $1,500,000, giving him an exclusion ratio of 2/3. This makes T's total taxable income after retirement $25,000 ($75,000 x 1/3 included). The tax on this amount, without regard to any deductions T may have, will be:

Taxable Income	**Rate**	**Tax**
Less than $9,875	10%	$ 987.50
Over $9,875, under $40,125	12%	$ 1,815.00
Total:	11.21%	$ 2,802.50[38]

Below is a line graph demonstrating the taxes paid on that bond portfolio income under the two scenarios:



Note that the tax savings are even more impressive if we take the time value of money into account. Assuming a 5% opportunity cost of capital, the present value of the $20,400 tax payments on the $50,000 of annual bond income for years 1-15 is $211,745. In addition, for years 16-35, the present value of the $6,790 tax payments is $44,875. Therefore, under Scenario 1, the present value of the total tax payments is $256,620. By contrast, the present value of the $2,802.50 tax payments on the $75,000 of annuity income for years 16-35 is $16,800 under Scenario 2 (the present value of tax payments for years 1-15 is zero). Thus, the taxpayer saves $239,820 in present value terms by going with Scenario 2 instead of Scenario 1.

#11: Borrowing from Permanent Life Insurance Policies

Borrowing from permanent (cash value) life insurance policies can assist in bracket management. Selected loans can be used to shift income from years when a taxpayer is in a higher tax bracket to years when the taxpayer is in a lower tax bracket. A permanent life insurance policy is required because it accrues cash value; the cash surrender value is what is being borrowed against. Thus, the borrowing cannot exceed the amount of the cash surrender value. Furthermore, under the policy, interest is earned on the cash surrender value.

This strategy involves paying into the life insurance policy in high income years, perhaps using other assets that would have produced taxable income, and avoiding the higher tax brackets and net investment income tax (NIIT). Then in later years, if taxpayers need additional income, they can increase their available funds, without selling taxable assets and pushing themselves into a higher tax bracket, by borrowing funds from the life insurance policy instead.

However, borrowing against the cash surrender value can affect the life insurance policy in several different ways. First, the death benefit on a variable life policy is reduced by the amount of the loan; it does, however, increase as the loan is repaid. Second, future premiums on a level death benefit policy may be increased to offset and compensate the insurance company for the loss of expected cash accumulation. Finally, the insurer can charge the taxpayer interest on the loan, which is not actually paid but added to the amount of the outstanding loan. Note that the cost of borrowing may be higher than the stated interest rate on the loan. When a policy holder borrows, the insurance company often reduces the interest rate earned on the policy's cash value. If so, this interest rate reduction should be added to the stated interest rate on the loan to arrive at the true cost. The interest accrued on the policy loan is not deductible by the taxpayer, further increasing the cost of borrowing.[39]

While it is not required that a policyholder repay the loan, in the event the policy is terminated or the policyholder dies, the amount of the life insurance policy proceeds can be reduced by any outstanding principal of the loan as well as any interest that has accrued on the loan.

Generally, when a taxpayer borrows against a life insurance policy, the loan proceeds are not taxable. An exception to this general rule is if the policy is a modified endowment contract (MEC). A MEC is a life insurance policy, purchased after June 20, 1988, where the accumulated premiums paid at any time during the first seven years exceed the sum of the net level premiums for a policy that would be paid up after seven years. A loan from a MEC is treated as a distribution from the policy, and thus is subject to the income-out-first rule. In other words, as amounts are distributed, they are treated as consisting of taxable income to the extent that they do not exceed the excess of cash surrender value of the policy over the investment in the MEC, i.e., premiums paid less tax-free distributions. Additionally, the taxable income will be subject to a 10% penalty tax unless the distribution is made after age 59½, on account of disability, or as part of a series of substantially equal periodic payments.[40]

[39] See Pond, Personal Financial Planning Handbook at ¶ 5.03.
[40] IRC §§ 72(e)(1)(A) and 7702A.

> ***Example 1.*** Taxpayer has a MEC with a cash surrender value of $100,000. Taxpayer has paid premiums totaling $25,000. Taxpayer decides to take a policy loan of $80,000. The first $75,000 of the loan is taxable income to the taxpayer immediately ($100,000 cash surrender value - $25,000 total premiums paid, i.e., investment in the contract).

However, an outstanding loan will generally be treated as an amount received if the policy later lapses or is surrendered; thus, possibly resulting in taxable income. A policy can lapse if the taxpayer fails to make premium payments and, as a result, the policy benefits are exhausted and the policy terminates. An example of this happening is noted above – the amount borrowed plus interest equals or exceeds the cash surrender value and the taxpayer fails to pay-in additional amounts of life insurance premiums.

Additionally, a taxpayer can surrender a policy to the insurer in return for the cash surrender value (minus any amount of outstanding loan plus interest). If the taxpayer surrenders his or her policy or the policy lapses, any gain realized is taxable at the taxpayer's ordinary income tax rate. The gain is equal to the excess of the amount the taxpayer received over the net premium cost. The amount received is the amount the taxpayer got when the policy was surrendered or terminated plus any outstanding loan. The net premium cost, or basis, is the total premiums paid by the taxpayer minus tax-free distributions received. Therefore, if a policy is surrendered or lapses, ensure that the taxpayer is in a lower tax bracket year so the amount received is recognized at a lower tax rate – i.e., the taxpayer took out the loan tax-free during a higher tax bracket year, five years later the policy is surrendered when the taxpayer is in a lower tax bracket year, in which year the taxpayer must now recognize the amount received above basis but at a lower tax rate.

> ***Example 2.*** Taxpayer has a life insurance policy with a cash surrender value of $100,000. He has paid total premiums of $50,000. He also has an outstanding policy loan of $50,000. There have been no distributions from the policy. Taxpayer decides to surrender the policy to the insurer for $50,000 cash. Therefore, the taxpayer will have taxable ordinary income of $50,000 ($50,000 cash + $50,000 loan - $50,000 premiums paid).

> ***Example 3.*** Taxpayer has a life insurance policy with a cash surrender value of $100,000. He has paid premiums of $50,000. He also has an outstanding policy loan of $100,000. There have been no distributions from the policy. The policy lapses because the amount borrowed equals the amount of the cash surrender value. Therefore, the taxpayer will have taxable ordinary income of $50,000 ($100,000 loan - $50,000 premiums paid).

If the life insurance policy is used effectively, taxpayers will purchase the policy when they are in a high tax bracket year and then borrow from it when they are in a low tax bracket year and need the extra income.

> ***Example 4.*** Taxpayer (T), filing single, expects to have $200,000 of salary income each year for the next ten years, after which T plans to retire. After retirement T will need $100,000 per year to cover his expenses. Currently, T has a $400,000

high-yield bond portfolio that pays 5% interest, giving him $20,000 of net investment income each year. If T doesn't sell the bond portfolio, he will pay $760 per year for the next ten years in NIIT (.038 x $20,000). Instead, T decides to sell the bond portfolio and use the proceeds to buy a life insurance policy, thus eliminating any NIIT over the next ten years. Suppose that after retirement T's income fluctuates as follows:

1st year of retirement	$110,000
2nd year of retirement	$90,000
3rd year of retirement	$115,000

Since taxpayer needs $100,000 a year after retirement to live on, he can borrow tax-free from his life insurance policy in his 2nd year of retirement to bring his income up to $100,000.

Chapter 3: Income Shifting Strategies

#12: Income Shifting Charitable Remainder Trust

An income shifting charitable remainder trust (CRT) or standard CRT for the donor's children is the same as the CRT discussed in an earlier CRT topic in this book, except that the donor's children or grandchildren are the income beneficiaries of the lead interest, not the donor. An income shifting CRT uses a CRT to eliminate or reduce the donor's taxes by shifting ordinary income and capital gains to the donor's children or grandchildren while also benefiting charity. As shown by the examples below, by shifting income, the donor can avoid the net investment income tax (NIIT), the higher ordinary income tax brackets, and the higher capital gains brackets.

Capital Gains Rates

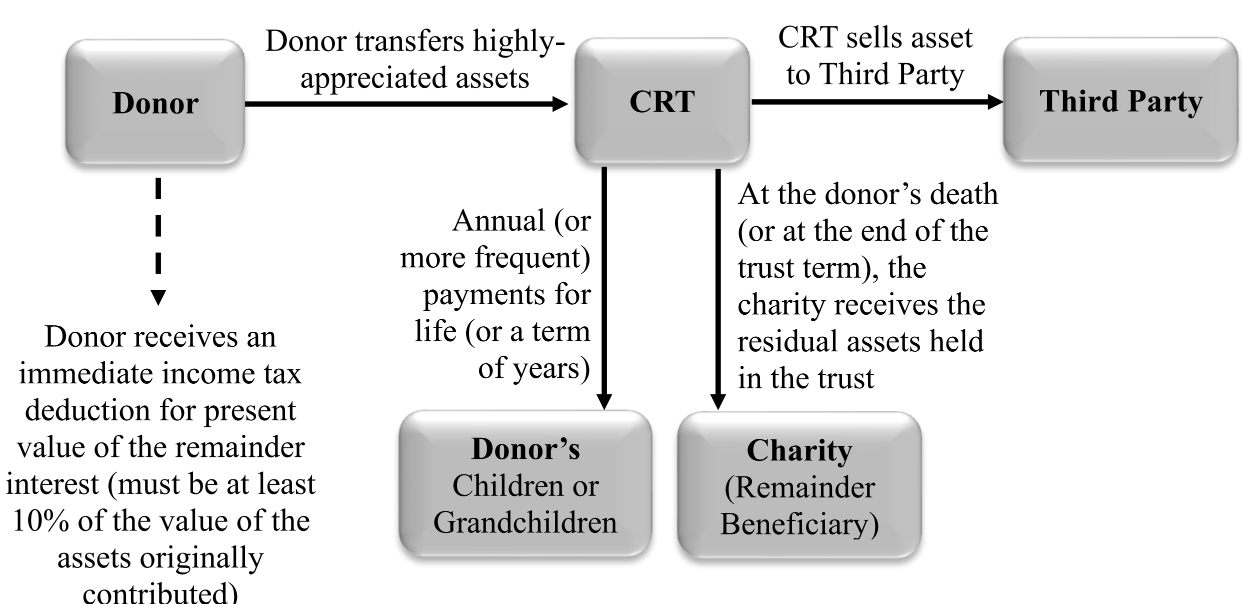
The capital gains rates in 2020 are as follows:

	Single	MFJ
0%	up to $40,000	up to $80,000
15%	$40,001 - $441,450	$80,001- $496,600
20%	>$441,450	>$496,600

If the capital asset sold is not an asset from a business in which the taxpayer actively participates, it will be treated as net investment income (NII) for purposes of the 3.8% NIIT. This could raise the federal tax rate on the gain to as high as 23.8%, and perhaps even higher with state taxes. Thus, shifting capital gains to the children or grandchildren by using a CRT could reduce the capital gains rate from 23.8% to 15% or even to the 0% capital gains rate.

How the Strategy Works

The diagram below shows the basic mechanics of an income shifting CRT for the benefit of the donor's children or grandchildren.



Tax Savings

The tax benefits are illustrated in the following examples:

> ***Example 1.*** Assume that Donor and Spouse are married taxpayers filing jointly with $500,000 of taxable income from salaries. They have two children in their 20's. Child A is a married taxpayer filing jointly with taxable income of $20,000 and Child B is a married taxpayer filing jointly with $85,000 of taxable income. Donor owns Blackacre, non-business property with a basis of $100,000 and fair market value of $400,000.
>
> If Donor and Spouse sell the land they will recognize a gain of $300,000, which will be taxed at 23.8%. The total tax payable will be $71,400 (.238 x $300,000).
>
> Suppose instead, that the parents transfer the land to an eight-year CRAT for the benefit of Child A. The CRAT sells Blackacre and recognizes no gain because it is a tax-exempt entity. When distributions are made, Child A will pay no tax because the income (approximately $37,500 per year) will keep him in the 0% capital gain tax bracket, which ends at $80,000.

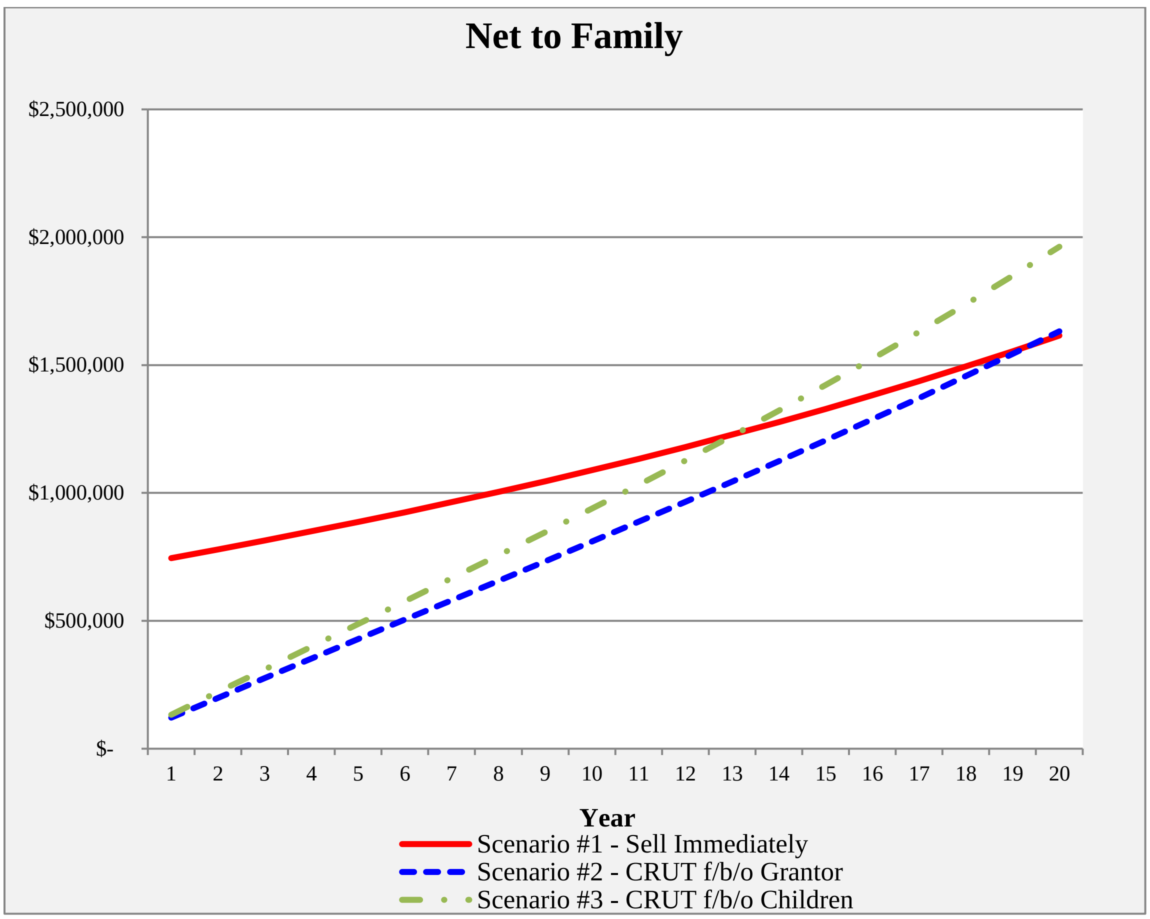
	Donor	**Child A**
Taxable Amt. @ 15% Cap. Gains Tax	$ 0	$ 0
Taxable Amt. @ 20% Cap. Gains Tax	$ 300,000	$ 0
Taxable Amt. @ 3.8% NIIT	$ 300,000	$ 0
Total Tax	$ 71,400	$ 0
Total Tax Savings	**$ 71,400**	

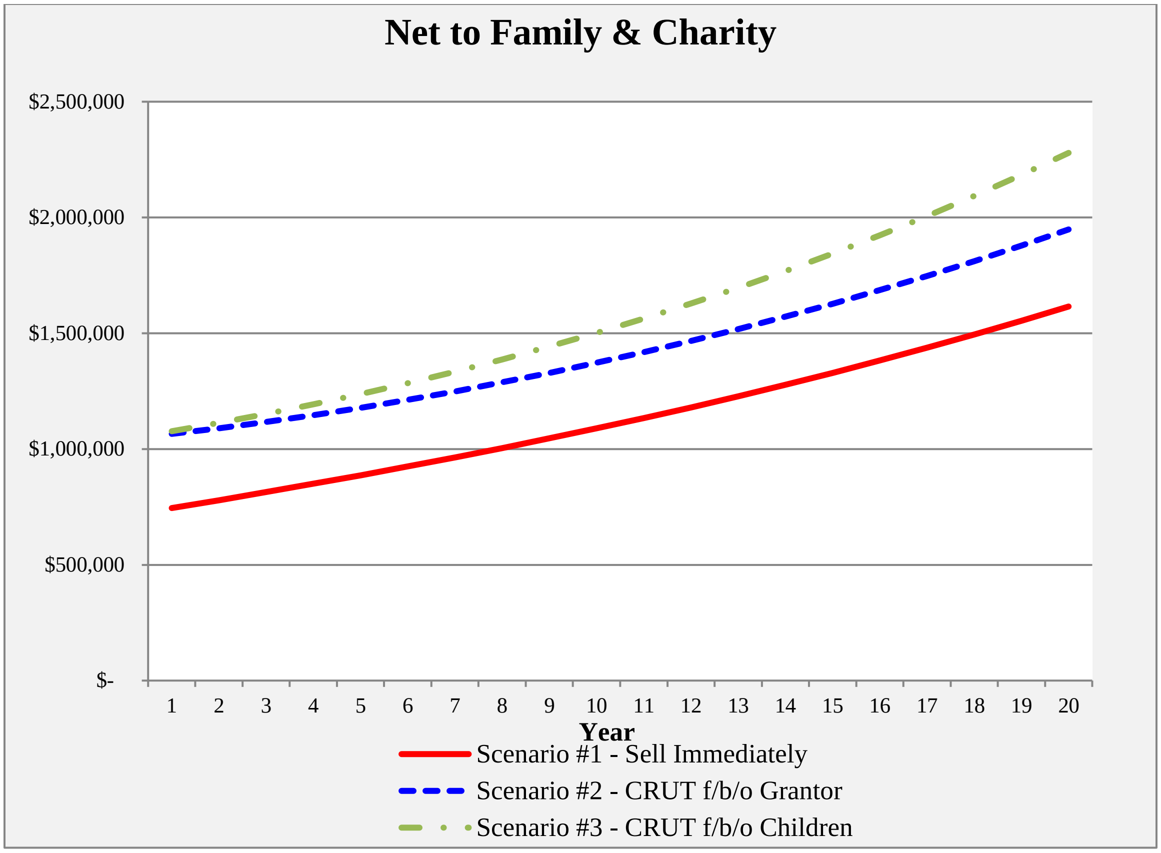
> If instead, the parents transfer the land to an eight-year CRAT for the benefit of Child B, when the distributions are made, Child B will pay tax because the income (approximately $37,500 per year) will be in the 22% income tax bracket, and thus, the 15% capital gains rate will apply. However, the NIIT will not apply because Child B's MAGI ($122,500) is below the applicable threshold amount of $250,000. The chart below compares the tax that will be paid over the entire term of the CRT for the $300,000 in capital gains with the tax that would have been paid if the parents had sold the property.

	Donor	**Child B**
Taxable Amt. @ 15% Cap. Gains Tax	$ 0	$ 300,000
Taxable Amt. @ 20% Cap. Gains Tax	$ 300,000	$ 0
Taxable Amt. @ 3.8% NIIT	$ 300,000	$ 0
Total Tax	$ 71,400	$ 45,000
Total Tax Savings	**$ 26,400**	

Example 2. Taxpayer has a $1 million stock position with a $0 basis. The charts below compare the economic consequences of three different planning scenarios:

> <u>Scenario 1</u>: Taxpayer sells the entire position, incurring a 20% capital gains tax, a 3.8% NIIT, and a 5% state tax.
>
> <u>Scenario 2</u>: Taxpayer moves the entire position to a 20-year CRUT for his own benefit. The CRUT is assumed to distribute at an 11.093% rate per year after the first year. The tax savings from the charitable donation are reinvested. A 4% growth rate and 1.5% yield is assumed for the assets.
>
> <u>Scenario 3</u>: Taxpayer moves the entire position to a 20-year CRUT for the benefit of his children. The CRUT is assumed to distribute at an 11.093% rate per year after the first year. The tax savings from the charitable donation are reinvested. The children will have a 15% capital gains tax rate on the Federal capital gains. A 4% growth rate and 1.5% yield is assumed for the assets.





As shown in the examples above, this is yet another great way to save money on taxes, provide for one's children, and contribute to charity. It must be noted, however, that the tax consequences are different when the donor's children are the lead beneficiaries instead of the donor. If the donor is the lead beneficiary, there is no taxable gift. The remainder interest isn't taxable because of the charitable deduction, while the lead interest is not taxable because the donor still owns it. When the donor's children are the lead beneficiaries, however, the amount of the taxable gift is equal to the present value of the annuity or unitrust interest (i.e., the amount transferred minus the present value of the remainder interest). Given the high applicable exclusion amount currently in effect, however ($11,580,000 in 2020) and adjusted for inflation thereafter), most taxpayers can make contributions to CRTs without incurring any gift tax.

Whether the transfer qualifies for the $15,000 annual exclusion in 2020 depends on the facts of the case. If there is only one lead beneficiary, the gift qualifies for the annual exclusion.[41] If there are multiple lead beneficiaries and their percentage interests are not fixed (e.g., the trustee has discretion as to how much each receives), no part of the gift qualifies for the annual exclusion.[42] If there are multiple lead beneficiaries and their percentage interests are fixed, annual exclusions would evidently be available based on these percentages. If there are successive lead beneficiaries, only the gift to the first beneficiary qualifies for the annual exclusion.

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[41] Reg. § 25.2503-3(b); *Commissioner v. Sharp*, 153 F2d 163 (9th Cir. 1946); *Commissioner v. Lowden*, 131 F2d 127 (7th Cir. 1942).

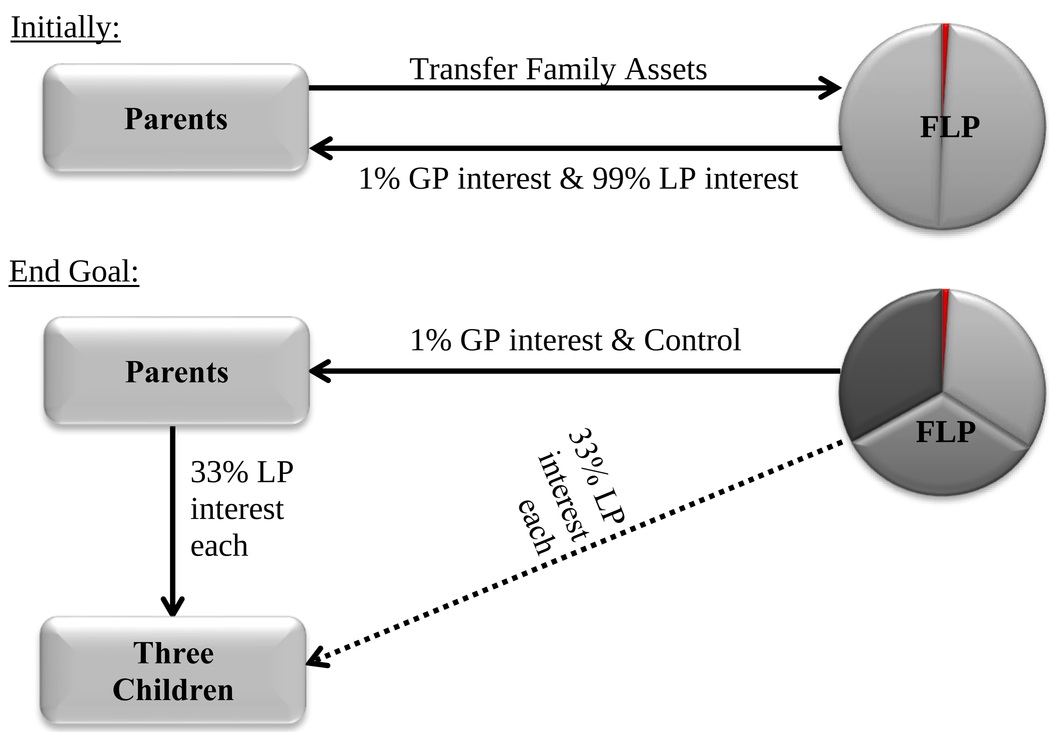
[42] Reg. § 25.2503-2.

An important caveat should be noted for this strategy. It only works if the children aren't subject to the Kiddie Tax. If they are, the distributions they receive from the CRT will be taxable at the rates applicable to trusts and estates. A child is subject to the Kiddie Tax if (1) the child is 18 or under, or (2) is 19-23 and a full-time student.

#13: Family Limited Partnership (FLP)

Another tax efficient way to shift wealth to future generations is by using a family limited partnership (FLP). By transferring family assets to a FLP, the senior members of a family are able to share the value of the assets with the younger members of the family while simultaneously maintaining control over the assets. In addition, by transferring the assets to a FLP, it takes them out of the senior family member's estate, generally at a substantially reduced transfer tax value.

One or both parents create the FLP and serve as the general partner(s), while the children and/or grandchildren serve as the limited partners. Initially, the parents hold both the general partner interests and the limited partner interests. Typically, the general partner interest will be as little as 1% of the total equity in the FLP and the limited partner interest will be the remainder of the equity in the FLP so it can be divided up among the children and/or grandchildren by the parents.



The parents, as general partners, maintain full and complete control over the FLP while gifting as many of the limited partner units to their children as they desire; thus, reducing their taxable estates. Furthermore, gift tax and use of the applicable exclusion amount (formerly known as the unified credit) can be avoided if the value of the units transferred to each child does not exceed the annual exclusion amount ($15,000 per donee in 2020).

> ***Example 1.*** Parents transfer an asset with a fair market value of $1,000,000 to an FLP. In return, Parents receive a 1% general partner interest and a 99% limited partner interest. Parents wish to split the 99% interest evenly among their three children. To avoid paying gift tax or using any applicable exclusion amount (AEA), Parents gift $30,000 per year to each child (2020 annual gift exclusion of $15,000

> x 2 parents). Therefore, in the first year, Parents will transfer 3% of the FLP in limited partner interests to each child (3% x $1,000,000 = $30,000). That accounts for 9% of the FLP in limited partner interests per year. At this rate, assuming no increase in the annual gift tax exclusion amount and no increase in the value of the asset, it will take Parents 11 years to transfer the entire limited partner interest to their children tax-free (99% / 9%). Remember, even when the children own the entire 99% limited partner interest, Parents will still have exclusive control over the asset and the FLP because they are the only general partners.

If Parents wish to transfer assets faster, they can still avoid gift tax by using their AEA. For 2020, this amount is set at $11.58 million per donor.

Valuation Discounts

The limited partner interests have no control over the FLP or its underlying assets, cannot be transferred without the general partner's permission, may represent only a minority position in the FLP, and have low marketability. As a result, their fair market value is lower than their proportionate share of the underlying partnership assets, making it appropriate to apply valuation discounts. This allows the parents to increase the amount of property that can be transferred with each annual exclusion amount. Combining all of these discounts could reduce the value of a limited partner interest by as much as 30-50% depending on the circumstances.

> ***Example 2***. Assume the same facts as in Example 1, except that a 30% valuation discount applies to the limited partner interest. Instead of Parents only being able to gift $30,000 per year to each child, they will be able to gift $42,857 per year to each child ($30,000 / (1 - .3)). That accounts for 12% of the FLP in limited partner interest per year. Assuming everything else stays equal, it will take Parents 9 years to transfer the entire limited partner interest to the children tax-free (99% / 12%).

Most assets change in value each year. This requires the limited partner interests to be revalued on an annual basis before making any gifts. If the value goes up, it will take the parents longer to gift the entire interest to their children; if the value goes down, it will not take the parents as long to gift the entire interest to their children. Furthermore, one must be careful with the type of discount rate they use – this is one way the IRS may try to disregard the FLP. The discount should be determined by experts and well documented.

These valuation discounts also enable Parents to leverage the amount of their AEA. Again, assuming a 30% valuation discount, the value of each AEA increases to $16.54 million ($11.58 million /.7) and the total AEA for both parents becomes $33.08 million. If Parents transfer limited partner units with a discounted value in excess of $33.08 million, gift tax will be payable.

Other Benefits

In addition to the valuation discounts and the non-tax benefits of a FLP already discussed above – parents retain full control over the assets, the assets are excluded from the parent's estate, and the children receive the assets tax-free – a FLP also has the ability to protect the assets from the children's creditors. A creditor can attach to the child's limited partner interest and usually obtain a "charging order" but that would only give a creditor the right to receive distributions if and when the child received them from the FLP. Since the child's parents are the general partners of the FLP, they control distributions. If a child owes money to a creditor, the parents can decide not to make distributions to the child. Therefore, if the creditor acquires the child's limited partner interest, it will not receive any money but will still be taxed on its share of partnership income. As a result, it is unlikely a creditor would even try to go after the child's limited partner interest.

FLPs can also provide the following additional non-tax benefits:

(1) Ensuring the continuation of a business after the senior members die;
(2) Limiting the liability of individual owners;
(3) Consolidating management of family businesses across a single entity;
(4) Enabling family members to pool their assets;
(5) Simplifying estate administration;
(6) Creating joint family management of assets;
(7) Helping children learn how to manage assets;
(8) Facilitating gifting;
(9) Protecting assets from irresponsible family members; and
(10) Reducing the expenses of managing assets.

Potential IRS Challenges

As noted above, the IRS is hostile toward valuation discounts on transfers of FLP units to family members and has used numerous strategies in an attempt to disallow or reduce discounts. These include:

- Taking the position that the FLP lacks economic substance and should be disregarded;
- Arguing that a gift occurred on formation of the FLP, resulting in a transfer of the FLP's underlying assets rather than a transfer of discounted partnership units;
- Using IRC § 2036(a) to bring the entity's assets back into the parents' gross estates if they retained too much control over the property transferred to the FLP;
- Using IRC § 2703 to disregard value reducing restrictions in the FLP agreement;
- Using IRC § 2704(a) to argue that the conversion of an ownership interest into an assignee's interest is a taxable transfer;
- Using IRC § 2704(b) to disregard any restrictions on liquidation that would otherwise reduce the value of the partnership interests; and
- Using their own valuation experts to challenge the amount of discounts claimed by the taxpayer's appraiser.

Furthermore, the FLP must be specifically designed to accomplish a valid business or investment purpose in order to pass muster. Some acceptable purposes are to:

- Conduct a family business;
- Pool family wealth and manage it in a coherent, structured way;

- Combine family wealth in order to have more opportunities for growth and investment; and
- Implement a succession plan for transferring management of the business from one generation to another.

The transfer tax benefits from using a FLP can be significant, but if it is not set up properly, the tax consequences can be very unfavorable. An experienced expert should always be consulted when setting up a FLP.

Income Shifting Benefits

In addition to the wealth shifting benefits of a FLP, it also provides various income shifting benefits. As the parents shift more and more of the limited partner interest in the FLP to their children, they are also shifting FLP income to their children. This can help lower the parent's taxable income, potentially allowing them to avoid the higher tax brackets and the net investment income tax (NIIT). However, remember to consider the Kiddie Tax.

> ***Example 3.*** In 2020, parents have $372,050 of salary income and $300,000 of net investment income (NII) from family assets (assume for ease of explanation that there are no deductions or other adjustments). After they retire, the parents will have adequate income from their 401(k) plans and IRAs. Parents also have three adult children filing joint returns and who each have income of $80,000. Consider the following scenarios:
>
> > <u>Scenario 1</u>: Parents do nothing. Therefore, they are subject to the highest income tax bracket (37%) on the last $50,000 of income and the NIIT (3.8%) on $300,000 of NII. This makes the NIIT payable $11,400 (.038 x $300,000).
> >
> > <u>Scenario 2</u>: Parents set up a FLP and transfer their yield producing assets to it. Assume for purposes of this example that 33% is transferred outright to each child with no other tax consequences. This shifts $99,000 of income to each child and leaves Parents with $372,050 of salary income and only $3,000 of NII ($300,000 NII from the FLP x 1%). Thus, they are no longer in the highest tax bracket because they are below the $622,050 threshold amount. Their highest tax bracket is now 32%. Moreover, their NIIT liability is reduced from $11,400 to $114. The additional income will be taxable to the children in the 22% and 24% marginal brackets and they will not be subject to the NIIT.

Family LLCs

Family LLCs can be used in the same way as family limited partnerships. LLCs are hybrid business entities that combine the limited liability of a corporation with the pass-through tax advantages of a partnership. The LLC owners are referred to as members. The parents can retain control over the entity by designating themselves as managing members or by creating a separate management entity.

LLCs are often preferred over a limited partnership because they provide the same favorable tax treatment as limited partnerships with the following advantages:

> *Limited Liability for All Members*. All members of an LLC have limited liability, including the managing members. With a limited partnership, only the limited partners have limited liability.
>
> *Governance Flexibility*. In a limited partnership, limited partners lose their liability shield if they participate in management decisions. In an LLC, participation by non-managing members is permissible if the parents want the children to have a voice in management. LLCs also eliminate the problems sometimes caused by the use of a corporate general partner.
>
> *Estate Tax Advantage*. Using an LLC will generally make it possible to do a post-death, non-taxable liquidation of the entity.

One possible disadvantage of using an LLC instead of a limited partnership is that valuation discounts may be somewhat lower. However, if the entity is formed in a state with a favorable LLC statute, valuation discounts should be similar.

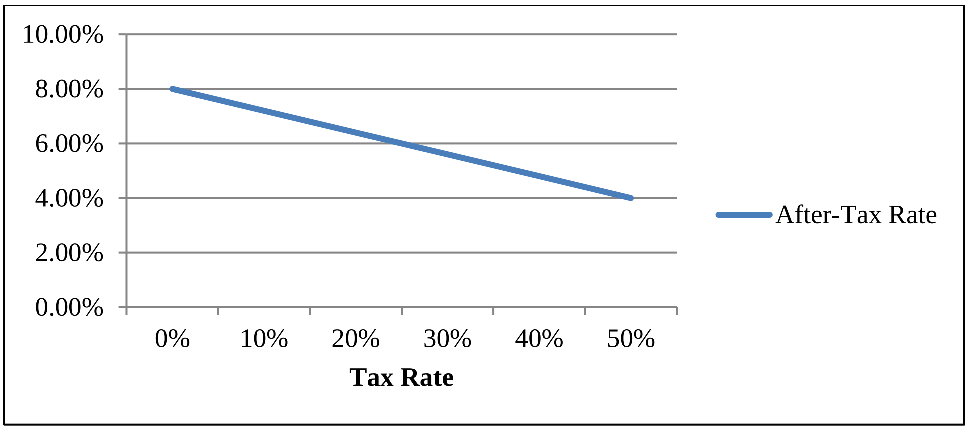
Chapter 4: Reducing Taxable Income Strategies

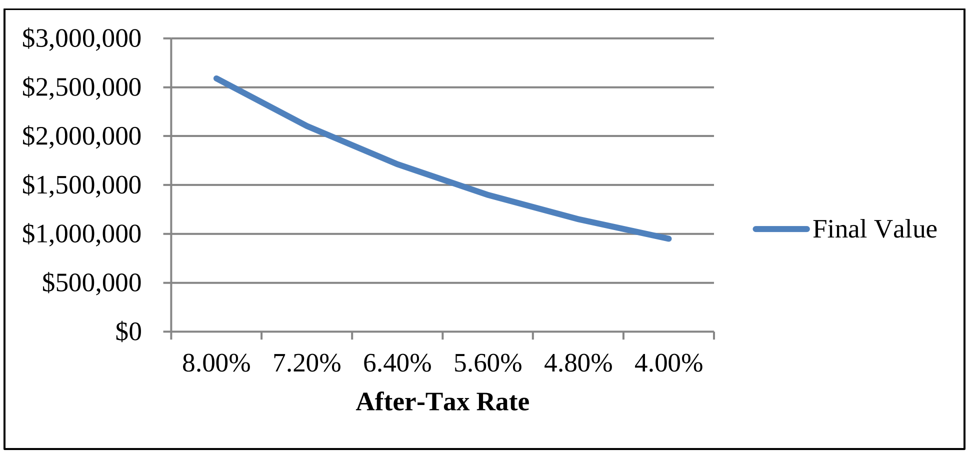
#14: Tax-Aware Investing

Taxes are the biggest drag on investment performance, having a greater effect than either commissions and management fees. Over a long period of time, "tax drag" can have a dramatic effect on wealth accumulation.

> ***Example 1.*** Joe and Heather are a young married couple who plan to invest $10,000 each year for 40 years, at which time they will retire. Assume that their investments will grow at a pre-tax rate of 8%. The following chart compares how much they will accumulate at the end of the 40-year period assuming different effective income tax rates.

Tax Rate	After-Tax Growth Rate[43]	Final Value
0%	8.0%	$ 2,590,565
10%	7.2%	$ 2,102,199
20%	6.4%	$ 1,712,216
30%	5.6%	$ 1,400,380
40%	4.8%	$ 1,150,637
50%	4.0%	$ 950,255





[43] After-tax growth rate = 8% x (1 - Tax Rate).

Until recently, tax planning was usually not a large part of the investment process. Most investors focused on achieving the highest possible pre-tax return and left the tax planning until after investment gains or losses had already been realized. They may have engaged in year-end tax planning to harvest losses, but ignored the effect of taxes on the choice of investment assets, investment style, portfolio design, asset allocation and asset location.

There has been a growing realization among taxable investors that it's not what you earn that counts, but what you keep after taxes. The top tax rates are currently 37% for ordinary income and 20% for capital gains, 40.8% and 23.8% respectively when the 3.8% NIIT is taken into account.

Tax-Aware Investing

Tax-aware investing includes the following components:

(1) Increasing investment in tax-favored assets;
(2) Deferring gain recognition;
(3) Changing portfolio construction;
(4) After-tax asset allocation;
(5) Tax-sensitive asset location;
(6) Managing income, gains, losses and tax brackets from year-to-year; and
(7) Managing capital asset holding periods.

Managing income, gains, losses, tax brackets and holding periods are covered under other topics in this book (e.g., bracket management, loss harvesting, Roth IRA conversions, CRTs, etc.), so they will not be covered here. The other components are addressed below.

<u>Increasing Investment in Tax-Favored Assets</u>

Some investment assets are taxed at much higher rates than others. For high income taxpayers, interest is taxed at 40.8%, gain on stock sales is taxed at 23.8% and income from tax-exempt bonds is not taxed at all. Tax-aware investing suggests that investors might wish to invest more in "low tax asset classes" and less in "high tax asset classes." It is important to remember, however, that the goal of tax-aware investing is not to minimize taxes, but to maximize after-tax return.

Investors obviously save on taxes by switching from taxable corporate bonds to tax-exempt municipal bonds, but is this always a good idea? Consider the following example.

> ***Example 2.*** May, a single taxpayer in the 37% marginal income tax bracket, owns $1,000,000 worth of corporate bonds that pay 4% interest ($40,000/year). May could switch to tax-exempt bonds paying 2.75% interest and avoid both income tax and the NIIT. But, would this be a good idea?
>
> May's after-tax return on the taxable corporate bonds is $40,000 - (.408 x $40,000) = $23,680. This makes the after-tax return 2.368%. Her after-tax return on the tax-exempt bonds would be $27,500, or 2.75%. Thus, switching to tax-exempt bonds

would produce a better economic result. However, if the tax-exempt bonds instead produced only 2.0% interest, May would be better off keeping the taxable bonds.

Deferring Gain Recognition

Everything else being equal, the lower the turnover ratio of a portfolio, the higher the effective growth rate will be and the greater the terminal wealth from an investment. This is illustrated in the next example.

Example 3. Walt has $1,000,000 worth of stock that he will invest for 10 years using one of two investment strategies. In Strategy 1, Walt will sell the stock, recognize the gain and reinvest the sale proceeds for 10 years. In Strategy 2, he will hold the stock until the end of the 10-year period, then sell it. Assume that with both strategies the pre-tax return is 10%. The following chart compares the terminal wealth for the two strategies after 10 years:

STRATEGY 1

$1,000,000 appreciated @ 7.62%[44] for 10 years	$ 2,084,154
Effective after-tax rate of return	7.62%

STRATEGY 2

Value of stock after 10 years ($1,000,000 appreciated @ 10% for 10 yrs)	$ 2,593,742
Gain recognized ($2,593,742 - $1,000,000)	$ 1,593,742
Tax payable (.238 x $1,593,742)	$ 379,311
Terminal value after tax	$ 2,214,431
Effective after-tax rate of return	8.275%

This suggests that taxpayers should employ passive buy-and-hold strategies and invest in assets with low turnover ratios like tax-efficient mutual funds, index funds, exchange traded funds (ETFs) or Standard & Poor's Depository Receipts (SPDRs).

Two caveats are in order, however. First, although research indicates that alpha[45] from active management is generally insufficient to offset the additional tax paid, this is not always the case. Second, total turnover isn't the best measure of tax efficiency. Rather, what counts is net turnover (capital gains that can't be offset with capital losses). Thus, a portfolio with moderate gains that aggressively harvests capital losses might also produce excellent after-tax returns, regardless of the tax rate.

[44] This is the after-tax rate of return given a 23.8% annual tax rate-- 10.0% x (1 - .238).

[45] Alpha is a measure of how well an asset has performed compared to other assets of comparable risk. A positive alpha means that the portfolio has produced a return higher than what would be expected given its level of risk. A negative alpha indicates that the portfolio has produced a lower return than what would be expected given its level of risk.

Portfolio Construction

Constructing a portfolio to maximize after-tax return may be very different from constructing a portfolio to maximize pre-tax return. Research suggests that, assuming the portfolio will eventually be liquidated, high volatility, low correlation portfolios produce the best after-tax returns. The reason was thought to be that this combination created the greatest opportunity for netting gains and losses.[46]

Many portfolio managers are now suggesting a tax aware investment approach that seeks to attain both pre-tax alpha and after-tax alpha. This approach, generally referred to as the multi-manager, core-and-satellite strategy, begins with a core portfolio of low turnover assets like tax-efficient mutual funds, SPDRs and ETFs, and passively managed stocks to minimize taxes. It then creates satellite portfolios, managed by other advisors that actively manage individual stocks to try to beat the market. Although the stocks in these satellite portfolios are volatile and are likely to produce large capital gains, they are also likely to produce large capital losses. By aggressively harvesting capital losses, the managers of these portfolios hope to beat the market after-tax as well as before tax.

Tax-Aware Asset Allocation

In tax-aware investing, asset allocation is done in the usual manner, except that after-tax values are used for the assets instead of pre-tax values. The following example illustrates this.

> ***Example 4.*** Bill is a taxpayer nearing retirement age. He expects a 30% combined federal and state income tax bracket after retirement and wants a 50/50 allocation between stocks and bonds. Bill has a $1,000,000 worth of tax-exempt bonds and a Traditional IRA with $1,000,000 worth of stocks. If asset allocation is done on a pre-tax basis, Bill has reached his objective – a 50/50 allocation. On an after-tax basis, however, the stock Traditional IRA is worth only 70 cents on the dollar because all distributions will be taxed at a 30% tax rate.[47] This reduces Bill's effective after-tax allocation of stocks to $700,000 (.7 x $1,000,000) and makes his percentage allocations look like this:

	Pre-Tax Allocation	**After-Tax Allocations**
Stocks	50% ($1,000,000/$2,000,000)	41.2% ($700,000/$1,700,000)
Bonds	50% ($1,000,000/$2,000,000)	58.8% ($1,000,000/$1,700,000)

> If Bill wants to create an after-tax 50/50 allocation between stocks and bonds, he must increase the amount in his stock Traditional IRA to $1,428,572 ($1,000,000 / .7). This will make the after-tax value of the stock Traditional IRA $1,000,000 (.7 x $1,428,572 = $1,000,000).[48]

[46] Brunel, *The Upside Down World of Tax-Aware Investing*, Trusts & Estates (1997).
[47] Assume that all contributions were pre-tax.
[48] *See* Reichenstein, *Tax Efficient Saving and Investing*, TIAA CREF Institute (February 2006).

Tax Sensitive Asset Location

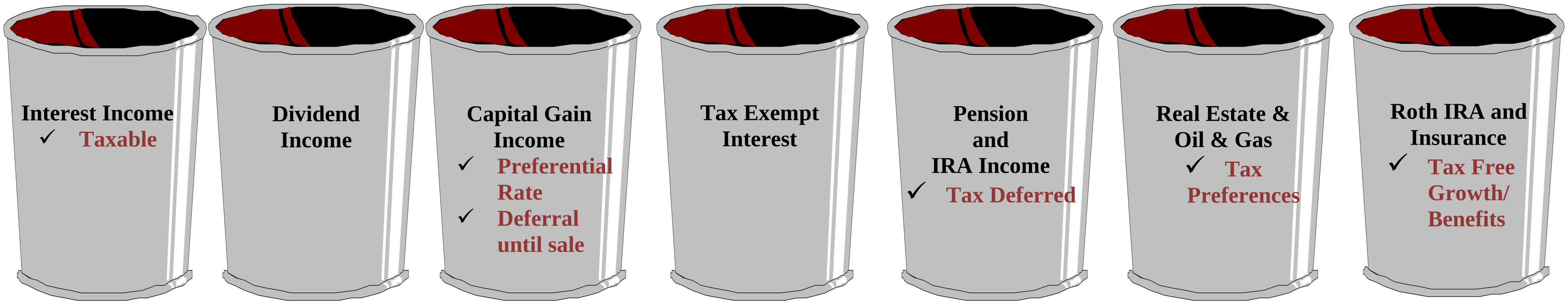
After asset allocation has been completed, the investor needs to spread the assets across the taxable accounts, tax-deferred accounts (e.g., traditional IRAs and 401(k) plans) and tax-exempt accounts (e.g., Roth IRAs and Roth 401(k) accounts) to minimize total taxes. The first step in the asset location process is to create a rough chart ranking the various investment assets by their tax efficiency. Such a chart would look something like this:

- Corporate Bonds
- Real estate investment trusts (REITs)
- CDs
- Actively-managed single stocks
- Actively managed stock funds
- Tax-efficient mutual funds
- Passively invested individual assets
- Tax-exempt bonds

The taxpayer starts at the top of the chart and works her way down, filling the tax-exempt and tax-deferred accounts with the least tax-efficient assets in the portfolio until their contribution limits are reached. For example, an investor might first transfer all corporate bonds, particularly junk bonds paying high interest rates, to an IRA. Although the income would ordinarily be taxed at rates up to 40.8%, the IRA would pay no tax (once distributed the taxpayer will though). By contrast, transferring long-term capital gain assets to an IRA would save taxes at a maximum rate of 23.8% and transferring tax-exempt bonds would save nothing. If the investor has a choice between making a transfer to a tax-exempt account (Roth IRA or Roth 401(k)) and a tax-deferred account (traditional IRA or 401(k)), it is generally better to transfer the fastest appreciating assets to the tax-exempt accounts first because they are not subject to the required minimum distribution rules and can appreciate longer in a tax-favored account.

Any remaining assets are then assigned to taxable accounts. These assets would typically be those subject to tax at a lower rate or no tax at all. They would also tend to be passively managed assets with infrequent gain recognition. Attached as an exhibit are some of the more common tax asset classes.

EXHIBIT: TAX ASSET CLASSES



Interest Income

- Money market
- Corporate bonds
- US Treasury bonds

Attributes

- Annual income tax on interest
- Taxed at highest marginal rates

Dividend Income

- Equity securities

Attributes

- Qualified dividends at LTCG rate
- Return of capital dividend
- Capital gain dividends

Capital Gain Income

- Equity Securities

Attributes

- Deferral until sale
- Reduced capital gains rate
- Step-up basis at death

Tax Exempt Interest

- Bonds issued by State and local Governmental entities

Attributes

- Federal tax exempt
- State tax exempt

Pension and IRA Income

- Pension plans
- Profit sharing plans
- Annuities

Attributes

- Growth during lifetime
- RMD for IRA and qualified plans
- No step-up

Real Estate & Oil & Gas

Real Estate

- Depreciation tax shield
- 1031 exchanges
- 199A deduction
- Deferral on growth until sale

Oil & Gas

- Large up front IDC deductions
- Depletion allowances

Roth IRA and Insurance

Roth IRA

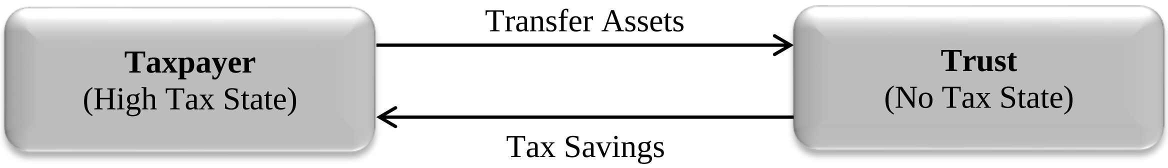
- Tax-free growth during lifetime
- No 72 RMD
- Tax-free distributions out to beneficiaries life expectancy*

Life Insurance

- Tax-deferred growth
- Tax-exempt payout at death

#15 Incomplete Gift, Non-Grantor (ING) Trusts

Taxpayers in high income tax states should consider transferring assets to a trust in a state that does not tax trust income.



Over time such a trust could produce impressive tax savings.

> ***Example 1.*** Bill Johnson owns a $3,000,000 investment portfolio that produces $200,000 of interest, dividends and capital gains per year. Assume that Bill's home state has a 10 percent income tax rate, but would not tax income from a trust created by Bill in another state. By transferring the portfolio to a trust in a state that doesn't tax trust income, and by satisfying certain other requirements, Bill could save $20,000 per year in state income tax (0.1 x $200,000). If Bill could reinvest the savings at seven percent, Bill's wealth would increase by $819,910 over a 20-year period.

Large tax savings might also be achieved by taxpayers holding assets with large capital gains.

> ***Example 2.*** Ellen Smith, a resident of a state taxing long-term capital gains at 10 percent, owns Blackacre with a basis of $100,000 and FMV of $1,100,000. If Ellen transferred Blackacre to a trust like the one in Example 1, she could save $100,000 of state capital gains tax (0.1 x $1,000,000 gain). Some commentators have cautioned that in a case like this it might be safer not to make the sale soon after transferring the appreciated asset to the trust.

Mechanics of the Strategy

To accomplish the desired results, the transaction must be carefully structured to meet all of the following requirements:

(1) The trust must be created in a state that does not tax trust income;
(2) The income from the trust must not be taxable by the grantor's home state;
(3) The trust must allow discretionary distributions to the settlor without making the trust a grantor trust; and
(4) Transfers to the trust must be incomplete gifts for federal gift tax purposes without making the trust a grantor trust.

Trust Located in a State that Doesn't Tax Trust Income

The ING trust must be set up in a state that (1) doesn't tax trust income, (2) has a domestic asset protection trust (DAPT) statute, and (3) allows the settlor to retain a lifetime and testamentary non-general power of appointment. Nevada has perhaps become the most popular state for ING trusts. Other states that work include Alaska, Delaware, Ohio, South Dakota and Wyoming.[49]

Trust Not Subject to Tax in the Settlor's Home State

Locating the trust in one of the states listed above does not necessarily mean that the trust income will not be taxed by the grantor's home state. Most states tax the income of what they refer to as resident trusts. The definition of a resident trust varies from state to state and could include trusts created in other states. For example, Connecticut, the District of Columbia, Illinois, Louisiana, Maine, Maryland, Michigan, Minnesota, Nebraska, Ohio, Oklahoma, Pennsylvania, Utah, Vermont, Virginia, West Virginia and Wisconsin treat trusts as resident trusts if the grantor was a state resident when the trust became irrevocable, regardless of where the trust is located. Other states treat out-of-state trusts as resident trusts based on some combination of the following factors: (1) whether the trust is administered in the state; (2) whether the trustees live in the state; and (3) whether the trust beneficiaries live in the state. Creating a trust in a state that does not tax trust income does not help if the trust income is taxable in the settlor's home state anyway.

Discretionary Distributions to the Settlor

The trustee must be given the power to make discretionary distributions to the settlor so that the settlor can receive the trust income. However, this must be accomplished without making the trust a grantor trust. If the out-of-state trust is treated as a grantor trust, the settlor will be deemed to be the owner of the trust assets under IRC § 671 and all trust income will be reported on the settlor's Form 1040. This makes the trust income the personal income of the settlor, taxable by the home state just like any other individual income.

Reg. § 1.677(a)-1(d) provides that a trust is treated as a grantor trust if the grantor's creditors can reach the trust assets under applicable state law. In most states, creditors can reach trust assets to the extent a trust allows discretionary payments of income to the settlor. If the trust is structured as a domestic asset protection trust (DAPT), however, allowing discretionary distributions does not make the trust a grantor trust. The states that allow DAPTs and meet the other requirements for an ING trust are listed above.

Incomplete Gift

Historically, most taxpayers who transferred assets to a state income tax saving trust did not want the transfer to be subject to the gift tax. Thus, they needed to retain enough control over the transferred assets to avoid making a completed gift subject to the federal gift tax and without creating grantor trust status. This was accomplished by (1) giving the settlor a testamentary special power of appointment over the trust assets, and (2) requiring the consent of a distribution committee for any distributions to the settlor. The testamentary special power of appointment made

[49] Tennessee and a few other states may also qualify.

the transfer to the trust an incomplete gift and the consent requirement allowed the trust to avoid grantor trust status.

However, in CCA 201208026, the IRS took the position that retention of a testamentary special power of appointment makes a transfer in trust incomplete only with respect to the value of the remainder interest, making the value of the lead interest subject to gift tax. Thus, to make the gift incomplete, it is necessary to give the settlor a lifetime special power of appointment as well as a testamentary special power of appointment.

Estate Planning

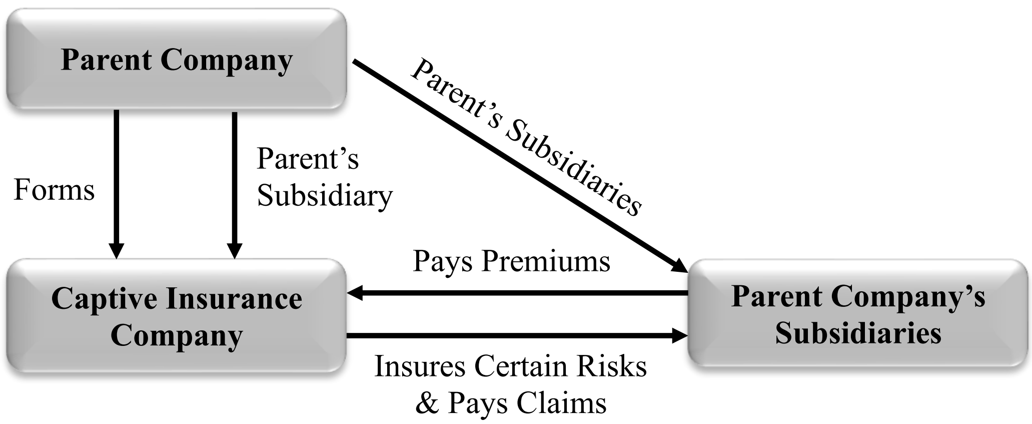
The sooner wealthy taxpayers can start making lifetime gifts, the more future appreciation they can transfer out of their estates. Until recently, however, there were two factors that discouraged them from doing so. One was a reluctance to pay gift tax or use up the applicable exclusion amount of $11,580,000 (2020 amount with inflation adjustments). The other was a concern that they might need the assets in the future. The permanent increase in the applicable exclusion amount and the emergence of DAPTs address both concerns. As a result, taxpayers may now wish to make completed transfers to a NING or other DAPT. By doing so, they can remove large amounts from their estates and still have a substantial amount of their applicable exclusion left for future planning. Moreover, if the transfer is made to a DAPT, the trustee can be given discretion to make distributions to the settlor if needed. Such trusts are sometimes referred to as "*rainy day trusts*."

The 2017 Tax Cuts and Jobs Act enhanced the tax benefit of ING trusts by limiting the federal tax deduction for state and local taxes to $10,000. The reduced deduction makes avoiding state income tax even more important. Note that ING trusts have been approved in numerous private letter rulings including PLRs 201310002, 201410001, 201440012, 201550005, 201613007, 202006002 and 202007010.

#16: Captive Insurance Companies

Captive insurance companies ("captives") may greatly benefit small to medium sized businesses by formalizing their business' uninsured, self-insured and underinsured risk management programs. While larger captives still benefit from general insurance accounting and tax advantages enabling deduction of reserves against uncertain future losses, a "mini-captive," or a § 831(b) captive, has greater tax advantages. This topic will focus on § 831(b) captives.

Basically, a captive is a privately held insurance company that is a subsidiary or affiliate of a parent company that is formed to insure certain risks of subsidiaries or affiliates.



The business reasons for creating a captive insurance company are that commercial insurance for the business is either over-priced or difficult to find for certain types of risks. Like commercial insurance companies, a captive insurance company issues policies, collects premiums, and pays claims; only it is not offered to the public. Businesses form captives to insure different enterprise and catastrophic risks that were uninsured, self-insured or underinsured; such risks include, insurance policy exclusions, operating risks, credit default, disability, business interruption, extended warranty, technology risks, regulatory risks, key employee risks, key customer risks, key supplier risks, construction defects, natural disasters and others. Most businesses already self-insure against these risks; but, without a captive, this self-insurance is not tax-deductible. Furthermore, the captive policies must be written for "real" insurance risks; but they can still have a low probability of occurrence. For example, the policy cannot be written for hurricane insurance for a Wisconsin business – not a "real" insurance risk. In addition, the policy cannot be for a "risk" that is sure to happen; in other words, it has to be a risk not a certainty.

In order to determine if a captive is the right strategy, the operating parent company should generally have the following characteristics:

- Be a profitable business entity with $500,000 or more in sustainable operating profits, and seeking substantial annual adjustable tax deductions;
- Have multiple subsidiaries or be able to create multiple operating subsidiaries or affiliates;
- Have the requisite risks currently uninsured, self-insured, or underinsured;

- Have a business owner(s) interested in personal wealth accumulation and/or family wealth transfer strategies; and
- Have a business owner(s) looking for asset protection.

Tax Benefits

Taxpayers ordinarily cannot deduct claims until the claims are paid. If the taxpayer is an insurance company, however, it can claim a current deduction for "incurred, but not reported claims" before payments are made. A company can claim the same timing benefit if its captive qualifies as an insurance company.

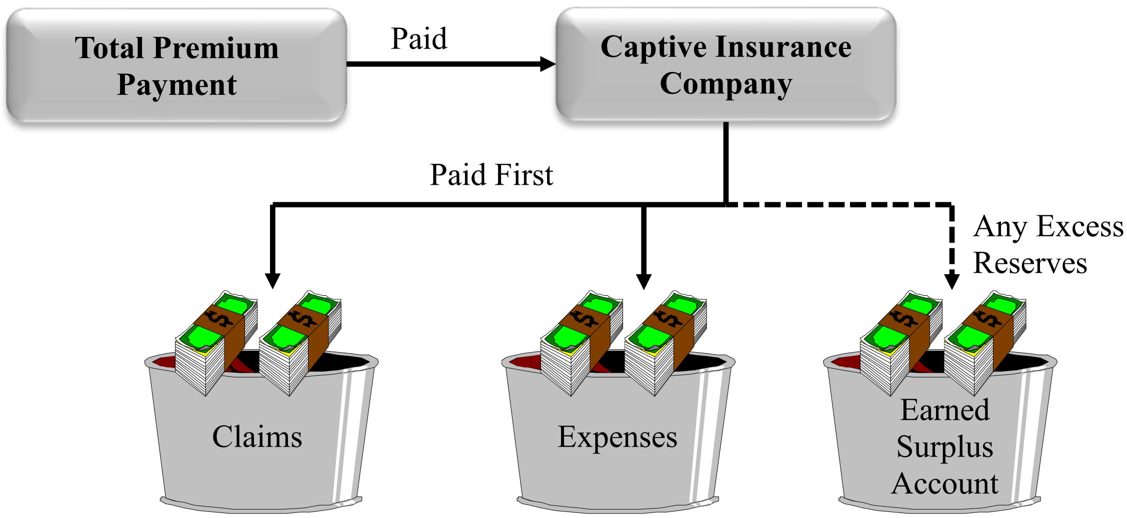
By forming a § 831(b) captive, a business could accelerate deductions on up to $420,000 annually in federal income taxes, allowing that savings to be retained within the business and the family. This is because the IRC § 831(b) election allows the operating company to deduct premiums paid (up to $1,200,000/year), while also allowing the related party captive to exclude premium income from federal income tax (up to $1,200,000/year); provided the 831(b) captive is designed properly to meet the business purpose and economic substance tests. Furthermore, if the captive is properly designed and managed, the captive's asset reserves accumulate outside the business owner's estate, protecting assets and enabling the business to survive unexpected disruptions and more easily accumulate business succession reserves.

> ***Example.*** Assume that ABC Family Business has $1,200,000 of consolidated pre-tax operating income subject to an effective tax rate of 21%. Consider the following two scenarios.
>
> > Scenario 1: ABC does nothing. Its $1,200,000 of taxable operating income will result in $252,000 of income tax liability ($1,200,000 x 21%). This leaves ABC with $948,000 after taxes to invest and protect its business.
> >
> > Scenario 2: ABC forms an 831(b) captive that writes $1,200,000 of insurance to its subsidiaries to protect them from otherwise uninsured / self-insured risks. ABC takes an insurance expense deduction for $1,200,000, saving it $252,000 ($1,200,000 x 21%) in federal income taxes. In other words, ABC is not taxed on any of that income. ABC's captive keeps the $1,200,000 to invest. Furthermore, if the captive does not have any significant losses to pay, any distributions to its shareholders of its excess reserves will be taxed at a lower dividend or capital gains rate.

Any premiums paid to the captive in excess of its claims and expenses each year will be transferred to an earned surplus account and such excess reserves will be available for more aggressive investment activities. Most of the restrictions that apply to retirement plans do not apply to the excess reserves in an 831(b) captive. The excess reserves accumulating in the 831(b) captive may be used for a variety of purposes:

- Loaned to the insured operating company who paid the premiums (or other family businesses);

- Invested in related family businesses;
- Invested in real estate;
- Distributed as dividends (historically taxed at more favorable rates);
- Distributed on a liquidation wind-up (historically taxed at more favorable rates); and
- For the most sophisticated families, an 831(b) captive can allow the family business to exit the insurance business, retain its accumulated reserves, and evolve into a family fortress entity of one type or another.



The greatest benefit that an 831(b) captive offers a company is that it is able to accumulate surplus from the premium payments tax-free. This allows the operating business to build up risk reserve assets while retaining investment control over the premiums. Furthermore, a captive can insure risks (with pre-tax dollars) that were previously self-insured with after-tax dollars. However, the investment income in a captive is still taxable.

Other benefits of a captive include:

- Asset protection from the claims of business and personal creditors;
- The ability to distribute profits to shareholders of the captive as dividends or upon liquidation;
- Ownership of the captive by a family trust, LLP, FLP, or other entity for the benefit of future generations; and
- The ability to give key employees restricted ownership in the captive, in order to provide increased incentives.

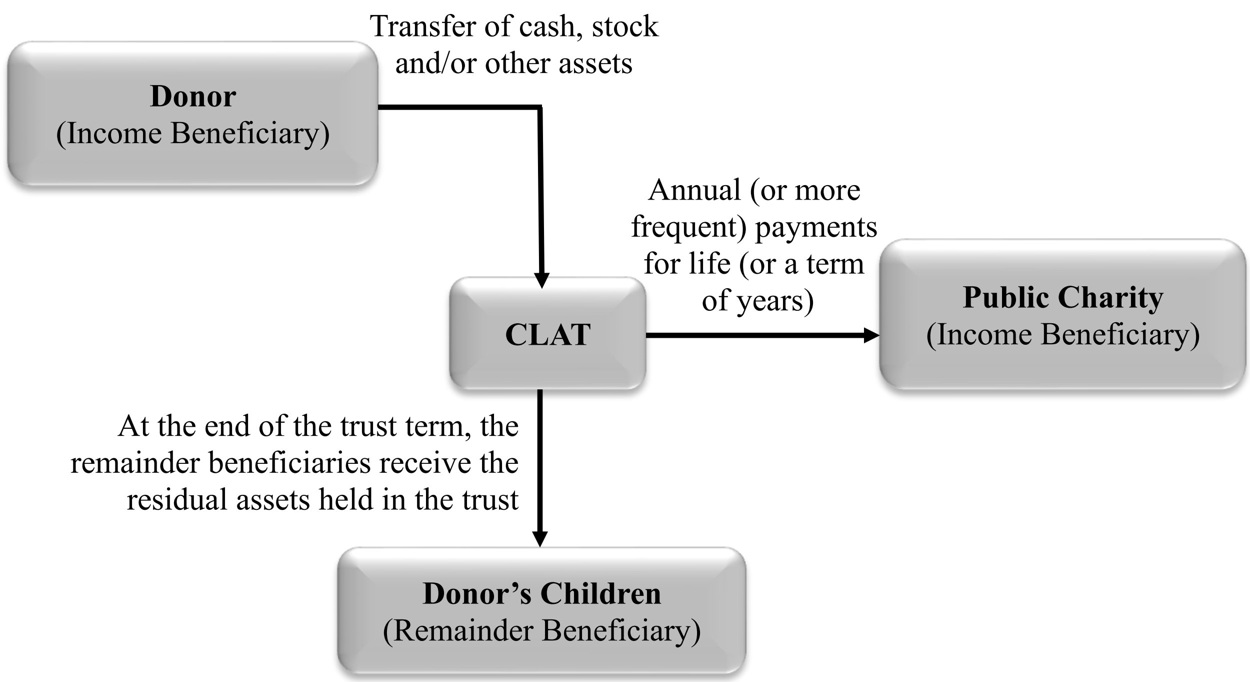
When a captive is integrated with an estate plan, the wealth protection and accumulation benefits can be substantial. This is because the tax-free asset build-up may avoid gift, estate and generation-skipping tax consequences and later transfer directly to the business owner's children and grandchildren. Furthermore, if the shareholders of the captive are family members or trusts with family members as beneficiaries, any distributions will not be taxed at the gift and estate tax rate, only the applicable dividend or capital gains tax rate. That is because the transaction would be in the ordinary course of business, and therefore, no gift or estate tax will attach to the intra-family transfer of wealth.

Note that sufficient research must be done before forming a captive; not only must an insurance license be obtained but the captive must provide insurance to the operating company or its affiliates. Insurance has been defined for tax purposes as including elements of risk shifting and risk distribution. Those elements are even further defined. Plus, formation of a captive will include feasibility studies, financial projections, determining domicile, actuarial reports, and more. The use of an experienced and capable captive management company should be used. But beware, if the captive is set-up improperly, substantial tax and penalties are possible.

Chapter 5: Specific Net Investment Income Tax Strategies

#17: Inter Vivos Charitable Lead Annuity Trust (CLAT)

An inter vivos charitable lead annuity trust (CLAT) is a split-interest trust created by a donor during the donor's life that pays an annuity to charity for a term of years or for the life of the donor or another individual. At the end of the term, any assets remaining in the trust pass to non-charitable remaindermen, generally the donor's children.



Gift Tax Benefits

CLATs for a term of years produce gift tax benefits in the same way as grantor retained annuity trusts (GRATs). The gift taxes can be zeroed out and if the assets produce a return in excess of the IRC § 7520 rate, value will remain in the trust to pass tax-free to the remaindermen at the end of the trust term.

Lifetime CLATs cannot be zeroed out, however, because of the exhausting corpus rule of Reg. § 20.7520(b)(2). The IRS valuation tables assume that the trust assets grow at the § 7520 rate. Thus, if the annuity payout exceeds the § 7520 rate, as it would if the payment was set to zero out the CLAT, the assets would be exhausted before they returned the full value of the annuity. To address this overvaluation issue, the regulations require that the annuity payments can be valued only up to the time the trust assets would run out, given the payout rate and the assumed growth at the § 7520 rate. The result of applying the exhausting corpus rule is that a lifetime CLAT will always produce a taxable gift. The older the donor, the larger the taxable gift will be. Nevertheless, lifetime CLATs can still produce very favorable gift tax results if the return on the trust assets substantially exceeds the IRC § 7520 rate.

> ***Example 1.*** Taxpayer (T), age 60, transfers $1,000,000 to a lifetime CLAT when the most favorable § 7520 rate available is 2.0%.[50] The CLAT pays an annual annuity of $59,762 to charity. If not for the exhausting corpus rule, this payment would zero out the CLAT. Because of the rule, however, there is a taxable gift of $160,597. Suppose that the CLAT produces a return of 10% and T dies 21 years later after reaching T's Table 2000 CM life expectancy. The amount left in the CLAT when T dies is $3,575,333 and it passes to T's heirs with no further tax consequences. To provide T's heirs with the same value after 21 years from an outright gift of the same $160,597, the transferred assets would have to grow at 15.92%. Thus, the inter vivos CLAT provides substantial leverage if the § 7520 rate is favorable.

<u>Advanced Gift Tax Applications</u>

Lifetime CLATs as a Bet-to-Die Strategy. Reg. § 1.7520-3(b)(3) provides that taxpayers transferring interests in property can use the tables prescribed under IRC § 7520 unless the person who is the measuring life has an "incurable illness or other deteriorating physical condition, resulting in a 50-percent or greater chance of dying within one year." The regulations go on to state that if the person lives for at least eighteen months after the transfer, it creates a rebuttable presumption that the 50-percent test was satisfied.

This makes it possible for taxpayers with life expectancies of more than one year, but far less than the average life expectancy reflected in the IRS tables, to make large tax-free transfers.

> ***Example 2.*** Assume the same facts as in Example 1 except that T is expected to live for only three years; therefore, the charity only receives three $59,762 annuity payments before T dies. Again assuming a 10% growth rate, the value of the CLAT is $1,133,188 at that time. Thus, T's heirs receive $1,133,188 on a taxable gift of $160,597. Assuming that T has no remaining applicable exclusion amount, the gift tax payable on that gift is $64,239 (40% x $160,597). Applying a 6% discount rate, the present value of the amount received by the heirs is $951,446 as of the time of the gift. Thus, the effective gift tax rate on the transfer is only 6.75% ($64,239 / $951,446).

Shark Fin CLATs. The more that annuity payments in a lead annuity trust can be back loaded, the greater the tax-free transfer the trust will produce if the assets grow faster than the IRC § 7520 rate. Reg. § 25.2702-3(b)(1)(ii)(A) provides that GRAT payments cannot increase by more than 20% from one year to the next. There is no comparable limitation on CLATs. Therefore, several commentators recommend extremely back-loaded CLATs, commonly referred to as shark fin CLATs. It is not clear how these CLATs will be received by the IRS and the courts though.

[50] A CLAT can use the § 7520 rate for the month of the transfer or the rate for either of the two previous months. The lower the § 7520 rate, the smaller the value of the remainder interest and the more favorable the transfer, the 2.0% rate is selected.

Income Tax Benefits

There are two kinds of CLATs for income tax purposes, **grantor CLATs** and **non-grantor CLATs**. With a grantor CLAT, the donor receives an income tax charitable deduction for the full present value of the lead interest at the time the trust is created. The donor then pays the trust's tax liability each year under the grantor trust rules.

A grantor CLAT increases the basic gift tax benefit of an inter vivos CLAT in two ways. First, payment of the CLAT's income tax produces an additional tax-free transfer to heirs. Second, the upfront deduction may be worth more than the later tax cost. The donor receives the deduction when the trust is created, but the tax on the trust's income is deferred. Moreover, the upfront deduction may offset ordinary income now, while the income the donor is taxed on later may be capital gains taxed at a lower rate. However, grantor CLATs are not helpful for reducing the 3.8% net investment income tax (NIIT) because all trust income is added to the donor's other income on his or her Form 1040.

With a non-grantor CLAT, the donor receives no income tax deduction when the trust is created. However, since the CLAT is a taxable entity, it receives an income tax charitable deduction under IRC § 642(c) as annuity payments are made to the charitable lead beneficiary. Thus, in effect, the CLAT is subject to income tax only on income in excess of the annuity payment amount.

Non-grantor CLATs can be used to reduce the 3.8% NIIT. Outright gifts to charity and transfers to charitable remainder trusts do not reduce the NIIT because they produce below-the-line deductions under IRC § 170 that do not reduce the donor's modified adjusted gross income (MAGI) or net investment income (NII). By contrast, non-grantor CLATs produce charitable deductions that can indirectly benefit the donor. When a CLAT makes its annual annuity or unitrust payments to the charitable lead beneficiary, the NII of the CLAT is reduced by the share of the § 642(c) deduction allocable to the NII distributed to the charity; thus, reducing the amount of NIIT on the CLAT. Consider the following comparison.

Individual IRC § 170 Deduction

Wage Income	$260,000
Interest Income	$100,000
Dividend Income	$50,000
MAGI	$410,000
Less: Threshold Exemption	($250,000)
Subtotal	$160,000
Lesser of Excess over Threshold or NII	$150,000
NII Tax at 3.8%	$5,700

Trust – IRC § 642 Deduction

Interest Income	$100,000
Dividend Income	$50,000
MAGI	$150,000
Less: Charitable Deduction	($150,000)
AGI	$0
NII Tax at 3.8%	$0

*Does not reflect the charitable limitations

Because the deduction leaves more in the trust to pass to the non-charitable remaindermen, it indirectly provides the donor with a charitable deduction against the NIIT.

#18: Grouping Business Activities to Create Material Participation and Avoid the NIIT

IRC § 469 provides that losses from passive activities can only be deducted against passive income and not against non-passive income like wages, capital gains, dividends and interest. Prior to 2013, planning under the passive loss rules involved (1) creating passive income to offset passive losses, and (2) creating non-passive losses that could be used to offset either passive or non-passive income. After enactment of the NIIT, however, passive loss planning might be quite different. While non-passive losses are still desirable, taxpayers will often be better off avoiding passive income because it will generally be subject to the NIIT.

For individuals, the amount subject to the NIIT is the lesser of (1) net investment income (NII), or (2) the excess of a taxpayer's modified adjusted gross income (MAGI) over an applicable threshold amount based on filing status.[51]

3.8% X
the lesser of

1. Net Investment Income
   OR
2. The excess (if any) of—
   - "Modified Adjusted Gross Income (MAGI)
   - "Threshold Amount"

Net investment income (NII) includes not only interest, dividends, annuities, royalties and rents, but also income and net gain from a trade or business that is a passive activity with respect to the taxpayer.

Activity Grouping Rules--Background

To avoid the passive loss rules with respect to a business activity, a taxpayer must materially participate in the activity. To establish material participation, the taxpayer must satisfy one or more of the seven tests listed at Reg. § 1.469-5T. These are generally quantitative tests that require a taxpayer to participate for a specified number of hours in the activity. Under the most frequently used test, the taxpayer must have more than 500 hours of participation. Because these material participation tests are applied at the activity level, taxpayers may be able to combine more than one operation into a single activity to achieve the requisite hours of participation needed to make the activity non-passive.[52] As a general rule, the more operations the taxpayer can combine, the more likely it is that the taxpayer will have met one of the material participation tests.

Activities can be grouped into a single activity if they constitute an appropriate economic unit for measuring gains and losses under IRC § 469, taking into account all the facts and circumstances. The most important factors to consider are:

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[51] The ATAs are $200,000 for single taxpayers, $250,000 for married taxpayers filing jointly and $125,000 for married taxpayers filing separately.
[52] Reg. § 1.469-4(c)(1).

(1) Similarities and differences in types of trades or businesses;
(2) The extent of common control;
(3) The extent of common ownership;
(4) Geographical location; and
(5) Interdependencies between or among the activities.[53]

While taxpayers have considerable flexibility in deciding how to group activities, there are some important limitations:

(1) A rental activity can only be grouped with a trade or business activity if the activities being grouped together constitute an appropriate economic unit and--

1. The rental activity is insubstantial in relation to the trade or business activity;
2. The trade or business activity is insubstantial in relation to the rental activity; or
3. Each owner of the trade or business activity has the same proportionate ownership interest in the rental activity.[54]

(2) Real property rental activities cannot be grouped with personal property rental activities.[55]

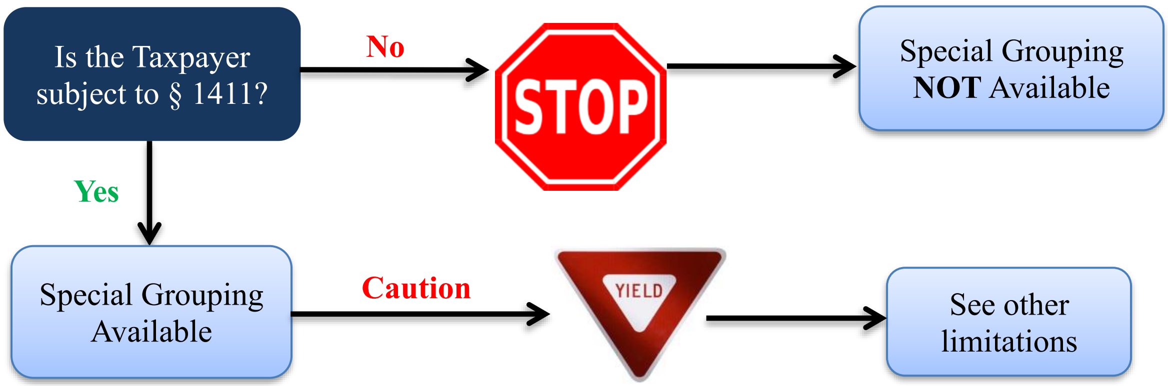
(3) The following activities cannot be grouped with any other activity:

1. Holding, producing, or distributing motion pictures;
2. Farming;
3. Leasing an IRC § 1245 property;
4. Exploring for, or exploiting oil and gas resources; and
5. Exploring for, or exploiting geothermal deposits.[56]

Special Planning Opportunity

Taxpayers generally have only one chance to group activities. Once made, the grouping election ordinarily cannot be changed.[57] The final regulations for implementing the NIIT include a special fresh start provision, however, that allows taxpayers to regroup activities in the first year the taxpayer is subject to the NIIT. Only one regrouping is allowed, and once made, the regrouping applies to all subsequent years.[58]

[53] Reg. § 1.469-4(c)(2)(i)-(v).
[54] Reg. § 1.469-4(d)(1)(i).
[55] Reg. § 1.469-4(d)(2).
[56] Reg. § 1.469-4(c).
[57] Reg. § 1.469-4(e)(1).
[58] Reg. § 1.469-11(b)(3)(iv).



Given the changed planning objectives following the effective date of the NIIT, this provision may be helpful for many taxpayers. Consider the following example.

> ***Example 1.*** Sally owns a restaurant and a bakery. She participates approximately 1200 hours in the restaurant, but only about 200 hours in the bakery. Both businesses have several other employees who work full time. Before 2013, Sally did not group the two businesses, treating them as separate activities. Thus, she was treated as materially participating in the restaurant, but not in the bakery. If Sally does not exercise the special regrouping election, the income from the bakery will be treated as net investment income and may be subject to the 3.8% NIIT. If Sally is first subject to the NIIT in the current year, she may be able to combine the restaurant and the bakery into one activity so that she can be treated as materially participating in both, and avoid the NIIT on the bakery income.

Furthermore, rental activities can be grouped with other activities under limited circumstances; and, therefore, the rental income in those limited circumstances will not be treated as NII. The limited circumstances provided by the Final Regulations under the NIIT are for certain self-rental activities and real estate professional activities. Self-rental income will not be treated as NII if the rental income is treated as non-passive by reason of Reg. § 1.469-2(f)(6) (which recharacterizes what otherwise would be passive rental income from a taxpayer's property as nonpassive when the taxpayer rents the property for use in an activity in which the taxpayer materially participates) or because the rental activity is properly grouped with a trade or business activity under Reg. § 1.469-4(d)(1) and the grouped activity is a non-passive activity.[59]

If the taxpayer qualifies as a real estate professional (as defined in § 469(c)(7)) and the real estate activities constitute a "trade or business," then the activities will be treated as nonpassive, and thus, not subject to the NIIT. There are two ways for the real estate activities of a real estate professional to constitute a "trade or business:" 1) fall under the safe harbor as provided for in the Final Regulations; or 2) meet the definition of a "trade or business" under § 162. A real estate professional qualifies for the safe harbor if: 1) they participate more than 500 hours per year in the real estate activities, or 2) participated more than 500 hours annually in the real estate activities in the past five out of ten years. An election to treat all rental real estate as a single rental activity under Reg. § 1.469-9(g) is allowed under this test. [60]

[59] See Reg. § 1.1411-4(g)(6).
[60] See Reg. § 1.1411-4(g)(7).

#19: Choice of Filing Status to Avoid the 3.8% NIIT

Married individuals have a choice between filing jointly or filing separately. The choice they make could make a significant difference in the amount of net investment income tax (NIIT) they pay.

Background

Before explaining the potential planning opportunity, it is important to review how the 3.8% NIIT on unearned income and the 0.9% Additional Medicare Tax on earned income are calculated. The amount subject to the 3.8% NIIT on unearned income is the lesser of (1) net investment income (NII), or (2) the excess of a taxpayer's modified adjusted gross income (MAGI) over an applicable threshold amount (ATA). NII generally includes gross income from interest, dividends, annuities, royalties, a trade or business that is a passive activity with respect to the taxpayer and gain from the sale of property held in a passive business. Some of the items of income that are specifically excluded are distributions from qualified retirement plans, wages and salaries and self-employment income. The ATA for married taxpayers filing jointly is $250,000 and the ATA for married taxpayers filing separately is $125,000.

An individual is liable for the 0.9% Additional Medicare Tax to the extent that the individual's wages, compensation, and self-employment income (plus such income of the individual's spouse if a joint return is filed) exceeds the threshold amount for the individual's filing status. These threshold amounts are the same as those for the 3.8% NIIT.

Example 1. Warren is a single taxpayer with the following income in 2020:

Salary Income	$180,000
Self-Employment Income	$30,000
Dividends	$10,000
Interest	$15,000

The amount subject to the NIIT is the lesser of NII ($25,000) or MAGI - ATA ($235,000 - $200,000). Thus, $25,000 is subject to the NII and the tax payable is $950 (.038 x $25,000). The amount subject to the 0.9% Additional Medicare Tax is $10,000 ($210,000 - $200,000) and the tax payable is $90 (.009 x $10,000).

Choice of Filing Status

On the surface it might appear that it should not make any difference whether married taxpayers file jointly or separately because the ATA is exactly double for joint filers. A closer analysis reveals, however, that filing jointly is sometimes better and filing separately is sometimes better, depending on the facts of the case.

If one spouse has most of the NII and the other spouse has most of the non-NII, filing separate returns may save significant amounts on the 3.8% NIIT.

> ***Example 2.*** Ted and Kelly are married taxpayers. Ted has $450,000 of salary income and no NII. Kelly has $100,000 of NII from interest and dividends and no other income. First assume that they file a joint return. The amount subject to the NIIT will be the lesser of NII ($100,000) or MAGI - ATA ($550,000 - $250,000 = $300,000). Thus, if they file jointly $100,000 will be subject to the NIIT and the tax payable will be $3,800 (.038 x $100,000).
>
> Now assume the same facts, except that Ted and Kelly file separate returns. Although Ted has MAGI well above the ATA of $125,000 for a married taxpayer filing separately, he has no income subject to the 3.8% NIIT because he has no NII. Although Kelly has substantial NII, she is not subject to the NIIT either because her MAGI is below her ATA. Thus, the couple saves $3,800 of NIIT by filing separately.

It is also possible for NIIT to be payable if spouses file separate returns but not payable if they file jointly. The added $125,000 of ATA for a joint return could cover NII that would have been subject to the NIIT on a separate return.

> ***Example 3.*** John and Amanda are married taxpayers. John has $50,000 of salary income and no NII. Amanda has $100,000 of salary income and $100,000 of NII. If they file separate returns, John will not be subject to the 3.8% NIIT. Amanda, however, will be subject to the NIIT on the lesser of NII ($100,000) or MAGI - ATA ($200,000 - $125,000). Thus, $75,000 of her income will be subject to the NIIT and she will pay $2,850. If John and Amanda file a joint return, no NIIT will be payable. Their NII will be $100,000, but their MAGI will be only $250,000—not above the ATA of $250,000 for married taxpayers filing jointly. This means that by filing jointly they can save $2,850 in NIIT.

Caveat

In determining which filing status is better for NIIT purposes, the 0.9% Additional Medicare Tax must also be taken into account.

> ***Example 4.*** George and Martha are married taxpayers. George has $250,000 of salary income and no NII. Martha has $25,000 of NII and no other income. If George and Martha file separate returns, neither of them will be subject to the 3.8% NIIT because George has no NII and Martha's MAGI is below her ATA of $125,000. If they file jointly, they will be subject to the 3.8% NIIT on the lesser of NII ($25,000) or MAGI - ATA ($275,000 - $250,000). Thus, $25,000 will be subject to the 3.8% NIIT and they will pay $950 in tax (.038 x $25,000). Thus, they will save $950 on the 3.8% NIIT by filing separately.
>
> However, this is not the end of the analysis. What about the 0.9% Additional Medicare Tax on earned income? If George and Martha file jointly, they will have total earned income of $250,000. Because this is not above their ATA of $250,000 they will not be subject to the 0.9% tax. If they file separately, Martha will not be subject to the 0.9% tax, but it will apply to $125,000 of George's income ($250,000

earned income - $125,000 ATA). The tax payable on this earned income would be $1,125 (.009 x $125,000). If we combine the added 0.9% tax (+ $1,125) with the savings on the 3.8% NIIT (- $950), by filing separately it actually increases the tax paid by $175 ($1,125 - $950).[61]

Note that the reduction in the 0.9% Additional Medicare Tax is due to the fact that the ATA for married taxpayers filing jointly is higher than the ATA for a married taxpayer filing separately. Because the maximum additional ATA for a joint return is $125,000, the maximum reduction in the 0.9% Additional Medicare Tax is $125,000 x .009 = $1,125 by filing jointly as opposed to separately. If the NIIT savings from filing separately exceeds this amount, separate filing will always produce a net tax reduction when both taxes are taken into account.

Furthermore, when considering which filing status is best for NIIT purposes, the effects of choosing one filing status over another for other tax purposes must also be considered. For example, the regular income tax brackets for taxpayers filing separately are much more condensed than for taxpayers filing jointly. Thus, although a taxpayer may save on the NIIT by filing separately, they may end up paying much more in regular income taxes because of that filing status.

[61] See Kaplan, Richard L., *Rethinking Medicare's Payroll Tax After Health Care Reform*, TAXES, August 2011.

Chapter 6: Wealth Transfer Strategies

#20: Intra-Family Loans

When interest rates are very low, intra-family loans can produce substantial tax-free transfers for families with estates subject to wealth transfer tax. The mechanism for producing this tax benefit is simple rate arbitrage. If parents loan money to their children at a low interest rate and the children can invest the borrowed money at a higher rate, the difference represents a tax-free increase in wealth for the children.

The minimum interest rate that must be charged on a note is the appropriate applicable federal rate (AFR) for the month of the transfer. For notes with terms of three years or less, the short term AFR is used, for notes with terms of more than three years, but not more than nine years, the midterm AFR is used and for notes with terms of more than nine years, the long-term AFR is used. For March, 2020, the semi-annual AFRs were as follows:[62]

Short-term AFR	1.49%
Mid-term AFR	1.52%
Long-term AFR	1.92%

> ***Example 1.*** In March 2020, Father loans $1,000,000 to his son Bill and takes back a 12-year, interest-only balloon note. The interest rate on the note is 1.92% (equal to the long-term AFR for the month of the transfer). Bill is able to invest the $1,000,000 to produce a 10% after-tax return. At the end of the 12-year period, Bill's investment has grown to $3,138,428. The amount due on the loan is $1,212,631. The difference ($1,925,797) is a tax-free transfer of wealth.

Parents might also loan money to children not to invest, but to reduce interest payments on a mortgage. Avoiding interest payable at a high rate on a mortgage would have the same effect as investing the borrowed funds at the interest rate on the mortgage.

> ***Example 2.*** Mark and his wife, Alice, have a $400,000, 30-year mortgage with interest at 7% that allows prepayment. They have no equity in the house so they can't refinance and their current monthly mortgage payment is $2,661.21. Mark's parents loan them $400,000 that they use to pay off the mortgage. The loan has a 20-year term with interest at 1.92%. The new loan reduces Mark and Alice's monthly payment to $2,009 and shortens the term by ten years.

For the loan to be respected by the IRS, it must be a bona fide loan. The family members must observe all loan formalities just as they would if the loan was between unrelated parties.

Less Affluent Transferors

With the gift and estate tax applicable exclusion amount set at $11,580,000 for 2020, most parents need not be concerned with the gift tax consequences when they shift wealth to their children. Thus, the transfer tax benefits illustrated in the previous examples would not apply to them. On

[62] Rev. Rul. 2014-1. The AFRs vary depending on whether the interest rate is annual, semi-annual, quarterly, or monthly.

the surface then, it might appear that such parents should just make outright gifts if they want to shift wealth to their children.

However, intra-family loans may still have value for such families. Loans are still useful for parents who are not willing to give up money permanently or who need some cash flow from the property even if it is less than the cash flow they could otherwise earn. In addition, some parents don't want children to obtain money too easily. If the children have to repay a loan they will learn that they have to work for money even if interest is payable at a rate below the market rate.

Parents would also have some flexibility in determining the interest rate on the loan. They could set the rate higher than the minimum AFR, but still significantly lower than the market rate of interest.

Income Tax Considerations

If the children invest the borrowed funds in property that will produce investment income (e.g., interest or dividends) or property purchased in the expectation that it will increase in value and be sold at a gain, the children would have an interest deduction and the parents would have interest income. This interest deduction would be limited to the total amount of the children's net investment income for the year (IRC § 163(d)(1)). Subject to certain limitations, mortgage interest would also be deductible by the children and taxable to the parents (IRC § 163(h)(3)).[63]

Mortgage Loans

Mortgage loans might be particularly favorable for a family, providing benefits for both the borrower and the lender. Advantages for children borrowing from parents rather than a bank might include:

(1) A lower interest rate;
(2) More flexible terms;
(3) Avoidance of origination and other transaction fees;
(4) Ability to borrow even with a poor credit rating;
(5) No increase in interest rate for a poor credit rating; and
(6) A parent may not insist on a down payment.

Advantages for the parents include:

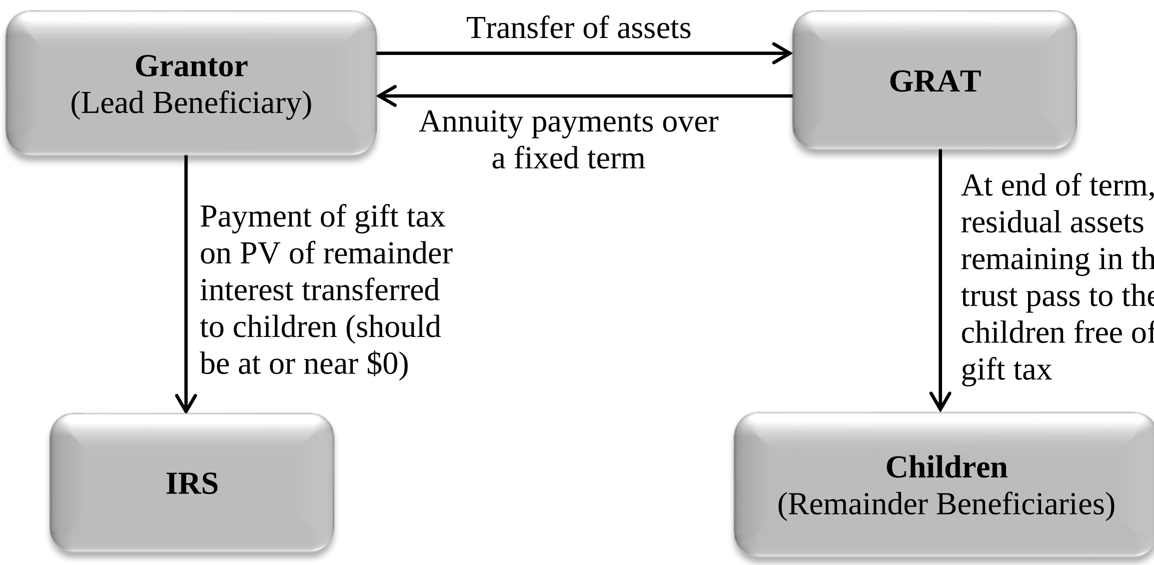
(1) Keeping interest payments in the family; and
(2) An income stream that may exceed the return on CDs or a bond portfolio.

The downside for parents is that they may be taking significant risk by offering more favorable terms than a bank would.

[63] The maximum amount that can be treated as indebtedness is $1,000,000 (IRC § 163(h)(3)(B)(ii)) and the deduction is phased out as AGI increases above $100,000 (IRC § 163(h)(3)(E)(ii)).

#21: Grantor Retained Annuity Trust (GRAT)

A GRAT is a split-interest trust in which the grantor retains an annuity interest for a term of years. At the end of the annuity term, any assets remaining in the trust pass to the remainder beneficiaries, typically the grantor's children. The amount of the taxable gift is the value of the property transferred to the trust minus the present value of the lead annuity interest retained by the grantor. The value of the lead interest can be set equal to the full value of the property transferred, creating a "zeroed-out GRAT" with no taxable gift. However, grantors generally leave a minimal taxable gift to start the statute of limitations and to avoid a possible argument that the GRAT has no substance because the grantor didn't transfer any value under the relevant IRS tables.



Transfer Tax Benefits

The transfer tax benefits of a GRAT are produced by interest rate arbitrage. If a zeroed-out GRAT produces a total return equal to (or less than) the assumed interest rate (IRC § 7520 rate), there will be nothing left in the GRAT at the end of its stated term. The remainder interest will be valued at, and actually worth, zero. However, if the GRAT assets produce a return in excess of the IRC § 7520 rate, property will remain in the GRAT at the end of its term to pass tax-free to the remainder beneficiary. This is shown in the following examples.

> ***Example 1.*** Assume that Taxpayer (T) transfers $1,000,000 to a zeroed-out, 4-year GRAT when the IRC § 7520 rate is 2.2%. The annual payout needed to zero out the GRAT is $263,901. Assume that the actual return produced by the trust is 2.2%. Operation of the GRAT is shown below.

Year	Beg. Balance	Return (2.2%)	Payout	Ending Balance
1	$1,000,000	$22,000	$263,901	$758,099
2	$758,099	$16,678	$263,901	$510,876
3	$510,876	$11,239	$263,901	$258,214
4	$258,214	$5,681	$263,901	$0[64]

Example 2. Assume the same facts as in Example 1 except that the GRAT assets produce an actual return of 10%. The operation of the GRAT is as follows:

Year	Beg. Balance	Return (10.0%)	Payout	Ending Balance
1	$1,000,000	$100,000	$263,901	$836,099
2	$836,099	$83,610	$263,901	$655,808
3	$655,808	$65,581	$263,901	$457,488
4	$457,488	$45,749	$263,901	$239,336

The higher the total return produced by the GRAT, the larger the tax-free transfer. The following chart shows the tax-free transfers for a $1,000,000 zeroed-out GRAT for various after-tax rates of return for the GRAT assets, assuming the same general fact pattern as in Examples 1 and 2.

2.2%	$0
4.0%	$49,213
6.0%	$108,012
8.0%	$171,322
10.0%	$239,336
15.0%	$431,250

Income Tax Benefits

Although some planners add special grantor trust provisions, a GRAT's basic structure should make it a grantor trust. It should be a grantor trust with respect to income because the settlor retains an income interest in the trust. It should be a grantor trust with respect to corpus because if income is insufficient to make the annual annuity payments, corpus must be used.

Since GRATs are grantor trusts, all GRAT income is reported on the grantor's Form 1040; thus, the grantor pays the GRAT's income tax liability. Payment of the GRAT's income tax liability by the grantor produces an additional tax-free transfer to the remaindermen, enabling the GRAT assets to grow at their pre-tax rate of return. To illustrate, suppose that one of the GRATs we have been considering produces a pre-tax return of 10% and an after-tax return of 8%. As the chart above indicates, having the grantor pay the trust's income tax increases the tax-free transfer from $171,322 to $239,336 (because the after-tax return becomes 10% as opposed to 8% since the grantor is paying the tax).

[64] Note small rounding error.

Planning with GRATs

GRATs are generally most favorable when the IRC § 7520 rate is low. The lower this rate is, the easier it is for trust returns to exceed it and produce tax-free transfers.

Another important consideration in structuring GRATs is to ensure that the grantor survives the term of the trust. If the grantor dies prematurely, the full value of the trust assets is generally included in the grantor's estate, thereby eliminating any transfer tax benefit. Therefore, GRATs are generally given a short term.

GRAT benefits can be enhanced in a number of ways. One strategy is to create multiple GRATs to separate favorable returns from unfavorable returns to prevent losses and gains from netting each other out.

> ***Example 3.*** T transfers \$1,000,000 worth of Asset A and \$1,000,000 worth of Asset B to a four-year GRAT described above. Asset A produces a -10% return and Asset B produces a +10% return. The net return for the GRAT is zero and, therefore, there is no tax-free transfer. If, however, T had created separate GRATs for the two assets, i.e., GRAT 1 for Asset A and GRAT 2 for Asset B, T would have produced a tax-free transfer of \$239,336 (\$0 for GRAT 1 and \$239,336 for GRAT 2). Note that although GRAT 1 would be underwater at the end of its term, there is no obligation for a GRAT to make up any shortfalls; the GRAT simply dries up when it runs out of assets.

Another strategy is to create a series of short-term rolling GRATs to minimize mortality risk and put more assets to work; i.e., when the grantor receives a payment from a GRAT it is immediately contributed to a new GRAT. Suppose, for example, that a grantor can choose between a single 10-year GRAT and a series of nine two-year GRATs. If the grantor dies after the end of year 9 under the first alternative, the full value of the GRAT would ordinarily be included in the grantor's estate and there would be no tax-free transfer. By contrast, if the grantor uses rolling GRATs, any excess growth from the first eight GRATs has already passed to the remaindermen, tax-free.

A third strategy is to back load payments by up to 20% as permitted in the IRC § 7520 regulations. Assuming that the trust return exceeds the IRC § 7520 rate, back loading increases the amount of the tax-free transfer by allowing more value to grow in the GRAT during its early years.

> ***Example 4.*** Assume the same facts as in Example 2, except that the GRAT has a 20% increasing payout feature. The tax-free transfer increases from \$239,336 to \$259,625, an improvement of \$20,289.

Year	Beg. Balance	Return (10.0%)	Payout	Ending Balance
1	$1,000,000	$100,000	$197,617	$902,383
2	$902,383	$90,238	$237,140	$755,481
3	$755,481	$75,548	$284,568	$546,461
4	$546,461	$54,646	$341,482	$259,625

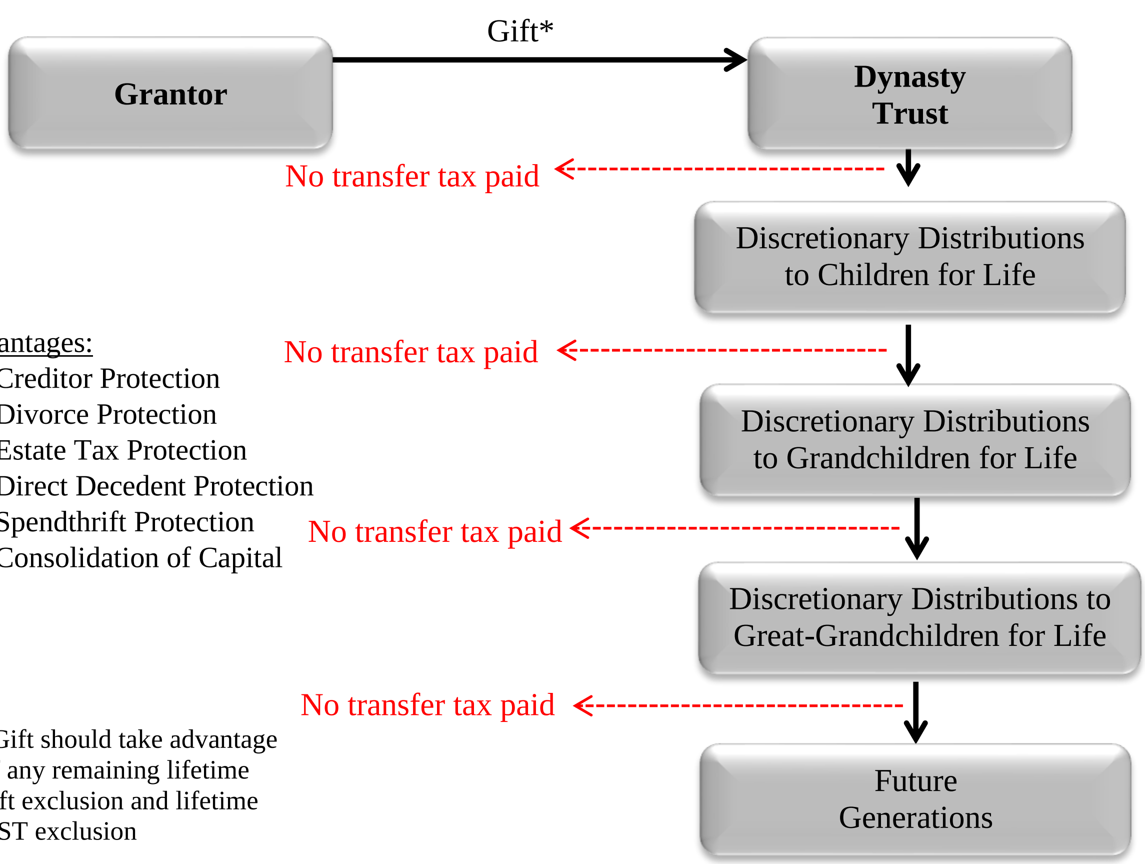
Although discounted assets can be contributed to a GRAT, their usefulness is limited. With the typical short-term GRAT, the bulk of each annuity payment must be made in kind with the assets used to fund the trust. The same discount applies to the assets when they are distributed, netting out any benefit of discounting.

#22: Dynasty Trust

Historically, taxpayers paid gift or estate tax only once on a wealth transfer regardless of how many generations the transferee was below the generation of the transferor. For example, the tax on a transfer to a great grandchild was the same as the tax on a transfer to a child. Moreover, taxpayers could drop assets down multiple generations by creating a trust with successive life estates.

In an attempt to block this strategy, Congress enacted the generation-skipping transfer tax (GSTT). The GSTT does not apply a tax each time property drops down a generation, but simply adds a second layer of tax to transfers that skip one or more generations, regardless of how many generations they skip. Thus, the tax on a transfer to a grandchild is taxed the same as a transfer to a great grandchild or a transfer to a trust that skips multiple generations. In all cases, there is one level of gift or estate tax and one level of GSTT.

A dynasty trust takes advantage of how the GSTT is applied by passing assets down through successive generations of a family for as long as the trust is permitted to last under applicable state law. A taxpayer uses the gift and GSTT exclusion amount to avoid tax on the initial transfer to the trust. No transfer tax is payable at any generation of beneficiaries thereafter because the beneficiaries have only discretionary interests that are not includable in their estates when they die. Thus, in some states, a one-time use of the gift and GSTT exemption eliminates transfer tax for a family forever.



Advantages:

- Creditor Protection
- Divorce Protection
- Estate Tax Protection
- Direct Decedent Protection
- Spendthrift Protection
- Consolidation of Capital

*Gift should take advantage of any remaining lifetime gift exclusion and lifetime GST exclusion

Future trustees can be given absolute discretion to make distributions they deem appropriate or the grantor can provide guidelines for distributions, providing a measure of control long into the future. For example, the grantor might establish distribution standards designed to positively affect future behavior. The following example illustrates how a dynasty trust works.

> ***Example 1.*** In 2020, F transfers $10,000,000 to a dynasty trust for the benefit of her son S for life, upon S's death to S's daughter GS, then to GS's children and so on down through the generations of F's family in perpetuity. F pays no tax when the trust is created because the gift tax is eliminated by the $11,580,000 gift tax exemption in effect for 2020 and the GSTT is eliminated by the $11,580,000 GSTT exemption. Moreover, no tax is paid when F dies, when S dies, when GS dies or when any other beneficiary dies. No federal transfer tax will be paid even when the trust terminates and the trust property is distributed to the last beneficiaries.

The following examples illustrate the power of dynasty trusts over a long period of time.

> ***Example 2.*** F transfers $10 million to a testamentary dynasty trust for the benefit of his heirs. Assume that all trust income is transferred to trust beneficiaries and none is accumulated. The chart below compares the family's wealth at the end of each generation if a dynasty trust is used with the family's wealth if the family does no planning and each generation transfers the assets at death. The chart assumes that a 40% estate tax rate applies throughout the time period.[65]

Generation	Dynasty Trust	No Dynasty Trust	% of Initial Balance
One	$10,000,000	$10,000,000	100%
Two	$10,000,000	$6,000,000	60.0%
Three	$10,000,000	$3,600,000	36.0%
Four	$10,000,000	$2,160,000	21.6%
Five	$10,000,000	$1,296,000	12.96%

Note that the amount of wealth left at the end of a given generation is simply A * 0.6^{n-1}, where "A" is the initial amount used to fund the trust, 0.6 is 1 minus the estate tax rate of 40%, and "n" is the number of generations. Thus, for example, the amount left at the end of Generation 6 is $10,000,000 * 0.6^{5-1} = $10,000,000 x 0.6 x 0.6 x 0.6 x 0.6 = $1,296,000.

> ***Example 3.*** Assume the same facts as in Example 2 except that the dynasty trust makes no distributions, instead accumulating value for future generations. Assume further that the trust assets grow at seven percent after tax and that the generations of the family are 30 years apart. The following chart shows the wealth accumulation of the dynasty trust.

[65] The chart also assumes that at each generation, the decedents have sufficient other assets (to use up their lifetime gift exclusion amount) so that assets passed down from the original $10,000,000 are fully subject to a 40% estate tax rate.

Generation	Dynasty Trust Value
One	$10,000,000
Two	$76,122,550
Three	$579,464,268
Four	$4,411,029,799
Five	$33,577,877,560

Of course, inflation and the time value of money would have to be taken into account to make a fair comparison. For example, if we apply a 4% inflation adjustment to the $4,411,029,799 amount in the trust at the end of the 4th generation (90 years after F dies), the amount is reduced to $129,282,415. This is still an excellent result considering that we are using constant value dollars.

Perhaps a more likely fact pattern is one in which some of the trust income is distributed and the balance is left to accumulate in the trust. Consider this final example.

> ***Example 4.*** Assume the same facts as in Example 2 except that the trustees do not distribute all of the trust income, leaving enough in the trust to provide a 2% growth rate. The growth of the trust assets is shown below.

Generation	Dynasty Trust Value
One	$10,000,000
Two	$18,113,616
Three	$32,810,308
Four	$59,431,331
Five	$107,651,630

In addition to the impressive transfer tax benefits, dynasty trusts can also provide creditor protection, divorce protection, and spendthrift protection for beneficiaries. If the grantor is not a beneficiary of the trust, the grantor's creditors cannot reach the trust assets because the grantor no longer owns them. The trust can provide creditor protection even if the trustee is given discretion to make distributions to the grantor if it is structured as a domestic asset protection trust (DAPT). Such trusts can be created in Alaska, Delaware, Hawaii, Michigan, Mississippi, Missouri, Nevada, Ohio, Oklahoma, New Hampshire, Rhode Island, South Dakota, Tennessee, Utah, Virginia and Wyoming.

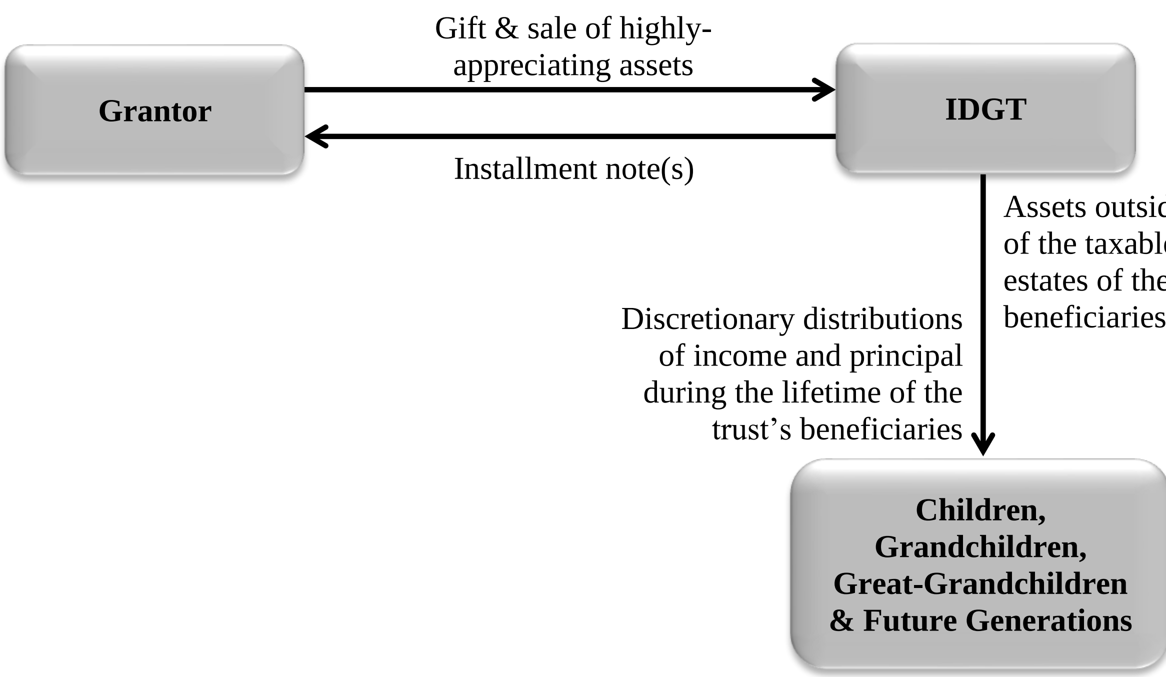
The rules for DAPTs vary considerably from state to state. For example, some states allow more exception creditors (e.g., divorcing spouses, child support creditors, tort creditors). The states also have different statutes of limitations for when transferred assets are protected. Although numerous states now allow DAPTs, almost all of them have been created under the laws of four states—Alaska, Delaware, Nevada and South Dakota. Of these leading DAPT states, Nevada appears to have the most favorable laws, particularly for taxpayers who wish to use the DAPT to save on state income taxes. For a detailed discussion of the use of Nevada Incomplete Gift, Non-Grantor Trusts (NINGs) to save on state income taxes, see the NING topic in this book.

#23: IDGT Sale

Sales to an intentionally defective grantor trust (IDGT) are completed transfers for gift and estate tax purposes, but are ignored for income tax purposes. As a result, the grantor is taxed on all trust income but the transferred assets are removed from the grantor's estate. This produces important gift and income tax benefits for very large estates as explained below.

Basic Mechanics

1. Grantor creates an irrevocable trust for the benefit of his or her descendants.
2. Grantor "seeds" the trust by gifting assets having at least one-ninth the value of the assets to be sold to the trust to avoid the argument that the grantor has retained an income interest in the trust assets under IRC § 2036.
3. Grantor allocates generation-skipping transfer tax (GSTT) exemption to the trust to cover the amount of the seed money gift.
4. Grantor sells assets to the trust that are expected to increase rapidly in value and takes back an installment note.
5. The sale price is equal to the full fair market value of the property sold so that there is no taxable gift on the sale.
6. Valuation discounts may be available to reduce the selling price.
7. The interest rate on the note is set at the lowest rate allowed under the tax law (AFR).



Transfer Tax Benefits

IDGT sales produce the following transfer tax benefits. First, if the total return on the assets sold exceeds the interest rate on the note, value is transferred tax-free to the trust beneficiaries.

> ***Example 1.*** Taxpayer (T) sells $1,000,000 worth of FLP units to a nine-year IDGT at a time when the mid-term AFR applicable to the note is 1.75%. The assets grow at 10% after-tax and 12% before-tax. Assume that the trust includes a provision permitting, but not requiring, the trustee to reimburse the grantor for income tax paid on the trust income and the trustee exercises this discretion.[66] At the end of nine years, the value of the transferred assets has grown to $2,357,948 in the IDGT ($1,000,000 appreciated @ 10% for nine years). Meanwhile, the IDGT pays the grantor $17,500 of interest each year and pays back the $1,000,000 principal amount at the end of year nine. Assuming that the grantor reinvests the interest payments at the same 10% rate, the future value of the seller's income stream paid at the end of the nine years is $237,641. Thus, the future value of the property transferred is $2,357,948 and the value of the property that has come back into the grantor's estate is $1,237,641 ($1,000,000 principal payment + $237,641 future value of interest stream). This makes the tax-free transfer $1,120,307 ($2,357,948 - $1,237,641).

Trust Assets

N	I	PV	FV
9 years	10%	$1,000,000	$2,357,948

Interest Payments

N	I	PMT	FV
9 years	10%	$17,500	$237,641

The tax-free transfer to the IDGT can be enhanced by transferring discounted assets.

> ***Example 2.*** Assume the same facts as in Example 1 except that the transferred assets qualify for a 30% valuation discount. The interest payments are now $12,250 per year instead of $17,500 (FV = $166,349) and the principal repayment amount is reduced from $1,000,000 to $700,000. This increases the tax-free transfer to $1,491,599 ($2,357,948 - ($700,000 + $166,349)).

N	I	PMT	FV
9 years	10%	$12,250	$166,349

Payment of the trust's income tax liability provides a further enhancement.

[66] Reimbursement clauses are often included in IDGTs to prevent cash flow problems for grantors, who are otherwise taxed on income they do not receive. Such a clause does not cause estate inclusion for the IDGT assets absent additional facts, such as (1) an understanding between the trustee and the grantor that the trustee will exercise the discretion, or (2) the grantor's power to remove the trustee (Rev. Rul. 2004-64).

Example 3. Assume the same facts as in Example 2 and also assume that the grantor pays the IDGT's income tax and there is no reimbursement provision. As a result, the IDGT assets grow at 12% instead of 10%. After nine years the value of the transferred assets is $2,773,079 and the amount of the tax-free transfer is $1,906,730 ($2,773,079 - $866,349). Note that the benefit of the grantor paying the IDGT's income tax continues after the end of the note term.

Trust Assets

N	I	PV	FV
9 years	12%	$1,000,000	$2,773,079

Interest Payments

N	I	PMT	FV
9 years	10%	$12,250	$166,349

Income Tax Benefits

As a result of grantor trust status:

1. The grantor recognizes no gain or loss on the sale;
2. The grantor is not taxed on the interest payments received from the trust;
3. The grantor recognizes no gain if installment payments are made in kind;
4. The grantor pays the trust's income tax liability; and
5. The trust is an eligible S corporation shareholder.

Disadvantages

IDGTs also have several disadvantages. First, although the IDGT receives a basis step up for any appreciation in the purchased property as of the time of the sale, there is no basis step up for any appreciation between the sale date and the grantor's date of death. However, the combined benefits of removing appreciation from the estate, taking advantage of valuation discounts and having the grantor pay the trust's income tax will ordinarily outweigh this basis disadvantage.

Second, if the sale is not properly structured, it could be treated as a gift with a retained income interest under IRC § 2036. This could happen, for example, if note payments are based on available trust income rather than on the stated terms of the note. Sections 2701 and 2702 could also apply if the note is not structured to make it bona fide debt.

Finally, payment of the trust's income tax by the grantor could cause a cash flow problem because the grantor is paying the trust's income tax without receiving the trust's income. It may be possible to avoid this problem by giving the trustee the power to turn off grantor trust status if desirable.

#24: Domestic Asset Protection Trust (DAPT)

According to the American Society for Asset Protection, millions of lawsuits are filed in the United States each year. These claims can arise in a number of different contexts—medical malpractice, premises liability, divorce, support claims, contract claims and violation of statutes (e.g., sexual harassment). Not only are there more claims, the amount of the claims has risen sharply in recent years. For example, the average medical malpractice settlement in the United States in 2019 was approximately $425,000.

This has led family planners to develop a number of strategies to protect assets from creditors. These include outright gifts of property, various forms of co-ownership, family limited partnerships and LLCs. The most popular strategy, however, is an asset protection trust.

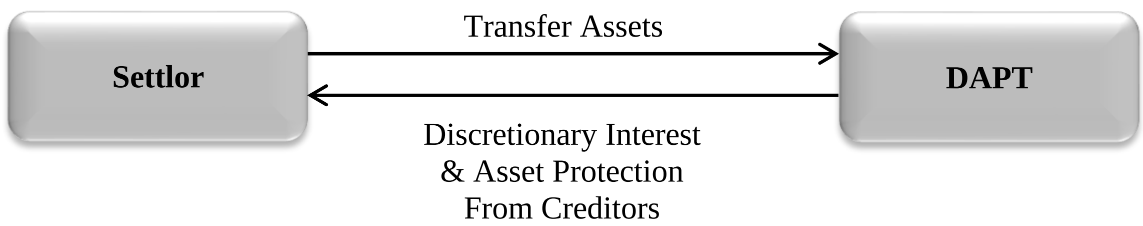
Trusts could always be used to provide creditor protection for beneficiaries. A spendthrift provision could be included in the trust to prevent attachment of trust assets by creditors or assignment of trust assets by beneficiaries. Discretionary distribution provisions provided the same creditor protection. Because the beneficiary of a discretionary trust cannot force the trustee to make distributions, a creditor of the beneficiary cannot do so either.

However, a spendthrift or discretionary distribution provision did not prevent creditors from reaching an interest retained in a trust by a settlor. The traditional rule was found in § 156 of The Restatement (Second) of Trusts, which provides that (1) a spendthrift provision does not prevent creditors from reaching a settlor's interest in a trust, and (2) if a trust provides for discretionary distributions to a settlor, creditors can reach the maximum amount that the trustee could pay the settlor or apply for the settlor's benefit. Prior to 1997, this rule applied in every state.

As the demand for asset protection increased, individuals started looking at asset protection trusts (APTs) as a possible solution. Because no state allowed an asset protection trust, however, they turned to foreign jurisdictions. This led to the creation of offshore APTs in the 1980's in places like Belize, the Cayman Islands, the Cook Islands, the Channel Islands, Bermuda and Nevis. Although these trusts became quite popular, many Americans were reluctant to use them because of their cost, complexity and the risk of fines or imprisonment.

As an alternative to an offshore APT, states began enacting new trust laws providing creditor protection for trusts in which the settlor retained a discretionary interest (self-settled APTs). Alaska enacted the first domestic APT (DAPT) statute in 1997 and as of the end of 2019 there were seventeen states that allow DAPTs—Alaska, Delaware, Hawaii, Michigan, Mississippi, Missouri, Nevada, New Hampshire, Ohio, Oklahoma, Rhode Island, South Dakota, Tennessee, Utah, Virginia, West Virginia and Wyoming. The statutes in these states vary substantially.[67]

[67] *See* Steve Oshins' "10th Annual Domestic Asset Protection Trust State Rankings Chart," *available at* http://www.oshins.com/images/DAPT_Rankings.pdf.



Structure of a DAPT

DAPT statutes vary by state, but all DAPTs have the following features:

(1) The trust is irrevocable;
(2) The trustee has absolute discretion to make distributions to the settlor;
(3) The trust includes a spendthrift clause prohibiting payments to most of the settlor's creditors;
(4) The trustee is independent of the settlor and a resident of the selected DAPT state;
(5) Some or all of the trust assets must be located in the DAPT state; and
(6) Certain special creditors can reach the trust assets (e.g., for child support payments).

Estate Planning Benefit

While the primary goal of a DAPT is to provide asset protection, it may also afford estate planning benefits, serving as an alternative to a spousal limited access trust (SLAT), discussed in another topic in this book. DAPTs enable a taxpayer to give away assets and remove future appreciation from his or her gross estate while retaining the benefit of the assets if needed. They provide more asset protection than a SLAT, but are more complex and require payment of trustee fees outside the family.

<u>NING Trusts</u>

DAPTs can also be used as state income tax saving trusts. Because the settlor can be given a discretionary interest in these trusts only if creditors cannot reach the trust assets, a DAPT must be used. Of the DAPT jurisdictions, Nevada is currently the best for state income saving trusts. These trusts, commonly referred to as Nevada Incomplete Gift, Non-Grantor (NINGs) Trusts are discussed in another topic in this book.

Do DAPTs Work?

DAPTs remain a controversial strategy. No court has ruled directly on whether they protect assets from creditors. Creditors could make the following arguments that they should not work.

<u>Fraudulent Transfer</u>

Transfers to a DAPT can be set aside if they violate the fraudulent conveyance statute of the DAPT state or the Federal Bankruptcy Code.[68] The argument can be avoided, however, by creating the DAPT and making transfers before the transferor has any current or foreseeable creditor problems.

[68] *See* 11 U.S.C. § 548(e) (allowing courts to look back 10 years for fraudulent transfers).

Full Faith and Credit Clause of the U.S. Constitution[69]

The full faith and credit clause of the U.S. Constitution requires that the courts of one state must recognize the judgments of courts in other states. Thus, if a creditor obtained a judgment in its home state or in the state of the DAPT settlor, the judgment would generally have to be respected in the DAPT state. There is an important exception, however. The DAPT state could refuse to enforce the decision if it had strong public policy reasons for doing so; but it is unclear whether a state's interest in enforcing its DAPT statute would be considered a strong public policy reason.

Choice of Law Provision May Not Be Respected

DAPTs typically include a choice of law provision requiring that all issues relating to the trust be decided by a court in the DAPT state. If a creditor brought a lawsuit in the debtor's home state (a non-DAPT state), however, the home state might not respect the choice of law provision.

Bankruptcy Courts

A bankruptcy court must generally apply the law of the state in which it sits. Because the bankruptcy court generally sits in the settlor's home state, it provides no asset protection in bankruptcy for a DAPT settlor from a non-DAPT state.

Bottom Line

DAPTs should work if the settlor is a resident of the DAPT jurisdiction where the trust is created, provided there is no fraudulent transfer. However, if the settlor is from a non-DAPT state, it is not clear whether a DAPT will protect assets from creditors. Although DAPTs have been used for 16 years, there are still no cases addressing this question. This lack of case law suggests, however, that creditors have been deterred from trying to reach DAPT assets, perhaps believing either that such an attempt would be fruitless or that it would not be worth the trouble and expense. Nevertheless, DAPTs should be considered a fairly aggressive strategy and clients should consult an attorney who practices in this area of the law before considering them.

Income Tax Issues

DAPTs are generally structured as grantor trusts, making them tax neutral for the settlor. The settlor continues to pay income tax on the trust income just as he or she did before the trust was created. Grantor trust status does have important implications for gift and estate tax purposes, though. Payment by the settlor of the trust's income tax liability results in a gift tax-free transfer to the trust beneficiaries. Over time, this transfer of value could be quite substantial. DAPTs can also be structured as non-grantor trusts if the trustees are adverse parties.

Gift and Estate Tax Issues

An important advantage of lifetime gifts is that they remove future appreciation from the transferor's estate. Nevertheless, many taxpayers are unwilling to make lifetime gifts because they are concerned

[69] Article IV, Section 1.

that they might need the assets in the future. DAPTs can arguably give a taxpayer the best of both worlds--the tax benefits of a lifetime transfer and the continuing enjoyment of the transferred property as a discretionary beneficiary. To accomplish this result, the transfer to the DAPT must be complete for gift and estate tax purposes so the date of death value is not included in the transferor's gross estate. A transfer to a DAPT is only a completed gift if creditors cannot reach the assets. Because there is still no clear law on whether DAPTs are effective to protect assets from creditors, whether a transfer to a DAPT is a completed gift is still uncertain.

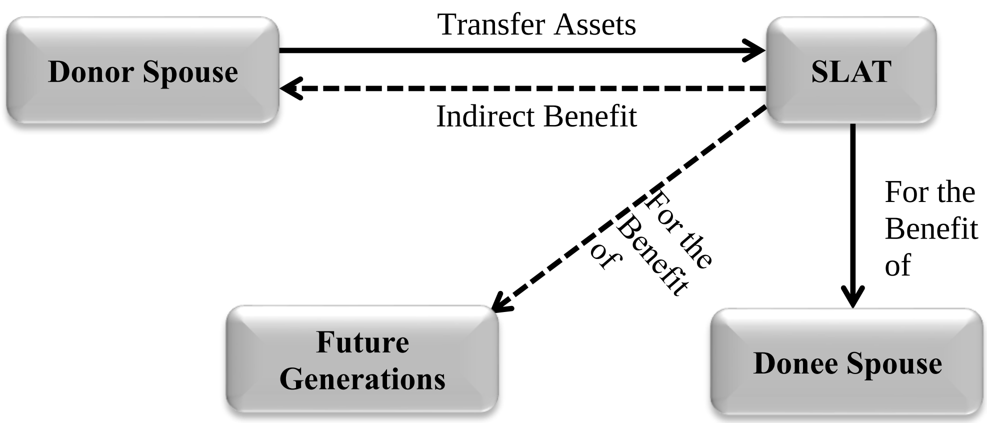
Even if the transfer is complete for gift tax purposes, the transferred property could still be included in the transferor's estate at its date of death value under IRC § 2036 if the transferor retained the possession or enjoyment of the property for life. Thus, there is a question of whether the trustee's discretion to distribute income or principal triggers IRC § 2036. This section will apply if (1) there is an express or implied understanding between the settlor and the trustee that distributions will be made, or (2) that the settlor's creditors can reach the trust assets. Whether there is an implied agreement must be determined by looking at all the facts of the case.[70] Whether creditors can reach trust assets again depends on whether DAPTs are effective against creditors. There is authority holding that if creditors cannot reach trust assets under applicable state law and there is no express or implied agreement, the transfer to the trust is complete for estate tax purposes.[71]

If the DAPT is used as a state income tax saving trust (e.g., a NING), the transferor typically has the opposite objective—making the transfer to the trust incomplete to avoid gift tax or use of unified credit. See the NING topic in this book for a discussion of this issue.

[70] See, for example, *Estate of Wells*, TC Memo 1981-574.
[71] *Estate of Uhl*, 241 F2d 867 (7th Cir. 1957); *Estate of German*, 7 Cl. Ct. 641 (1985).

#25: Spousal Limited Access Trusts

A spousal limited access trust (SLAT) is an irrevocable trust established by one spouse (the "Donor Spouse") for the benefit of the other spouse (the "Donee Spouse"), with the remainder interest passing to the couple's children and grandchildren when the donee spouse dies. Creating a SLAT may be a good way to take advantage of the relatively high current applicable exclusion amount ($11,580,000 in 2020) and remove substantial amounts of appreciation from the gross estate while indirectly retaining the ability to access the funds if necessary through distributions to the spouse.



The transfer of assets by the donor spouse to establish the trust is considered a gift and will use some or all of the donor spouse's gift tax applicable exclusion amount. Any amount up to the exemption amount and any future appreciation of that amount in the SLAT will eventually pass estate tax-free to the donor spouse's children, grandchildren, or future generations.

At the same time, however, the SLAT is set up to allow for distributions to the donee spouse to meet his or her needs and, indirectly, those of the donor spouse.

> ***Example 1***. Donor spouse wishes to make a gift of $11,580,000 to use his entire gift tax exemption in 2020. However, donor spouse also worries about making such a large gift all at once. What if the market crashes and donor spouse needs those funds in the future? Donor spouse could create a SLAT for his wife's benefit and transfer the $11,580,000 to the trust. The SLAT could provide distributions to donee spouse for her needs and their children's needs.

The tax savings produced by making a lifetime transfer could be quite dramatic as shown in the following example.

> ***Example 2.*** Ron and Betty are married taxpayers with a large estate they plan to leave to their children. They each own an $11,580,000 investment account they plan to leave to their children. Ron and Betty do not feel comfortable giving away any of the assets outright. Because a SLAT enables them to access trust income and

principal, however, they are willing to create SLATs for each other immediately.[72] The following illustration compares the tax results of creating the two SLATs now with the tax results of dying with the investment accounts. To keep the analysis as straightforward as possible, assume that the applicable exclusion amount stays at $11,580,000 for the next 10 years. Further assume a growth rate of 5% and an estate and gift tax rate of 40%.

> Scenario 1—Create Two SLATs Now: In Year 1, Ron sets up a SLAT for Betty and Betty sets up a SLAT for Ron. In both cases the remainder interest passes to the children. They take advantage of their entire lifetime exemption amounts and transfer the full $23,160,000 value of the investment accounts to the SLATs. In Year 10, both Ron and Betty die. There is no tax in Year 1 because the spouses' applicable exclusion amounts completely cover the gifts. In Year 10, the Year 1 transfers are included in their respective estates as adjusted taxable gifts, but the full value is covered by the applicable exclusion amount. Thus, by creating two SLATs, Ron and Betty can transfer their full estate with no transfer tax.

Year 1 SLATs	$23,160,000
FMV of SLATs @ Year 10	$37,725,200
Taxable Amt.	$0
Estate Tax Payable	$0
Total Value Transferred	$37,725,200

> Scenario 2—Dying with the Investment Accounts: Ron and Betty never set up a SLAT and die with the investment accounts. The tax consequences are shown in the following chart.

Year 1 Inv. Accts.	$23,160,000
FMV of Inv. Acct. @ Year 10	$37,725,200
Estate AEA	$23,160,000
Taxable Amt.	$14,565,200
Estate Tax Payable	$5,826,080
Total Value Transferred	$31,899,120

Thus, by creating SLATs, Ron and Betty save $5,826,080 in estate tax. Instead of locking in the tax value of the assets in Year 1 at $23,160,000, $14,565,200 of growth was included in their gross estates in Scenario 1, increasing the tax payable by $5,826,080 (.4 x $14,565,200).

For income tax purposes, a SLAT is usually considered a grantor trust. This means that the donor spouse will report the trust's taxable income and deductions on his or her personal income tax return. This allows the SLAT assets to grow at their pre-tax rate of return, increasing the amount that will transfer tax-free to the children at the end of the trust term. However, grantor trust status could create a cash flow problem for the donor spouse because he is paying tax on income he is not receiving. If

[72] Note the cautions about avoiding the reciprocal trust doctrine at the end of this topic.

the trust is created in a state that permits domestic asset protection trusts (DAPTs), this problem can be addressed by giving the trustee discretion to reimburse the donor for the tax paid.

However, if funds are available outside of the trust, it is generally advisable to use those funds first rather than making distributions out of the SLAT to the donee spouse. Any amount taken out of the SLAT brings assets back into the parents' estate, reducing its value and thus, its effectiveness for transferring wealth tax-free to future generations. The next example illustrates the negative effect of tax reimbursements and distributions to the spouse on the amount of the tax-free transfer.

> ***Example 3.*** Let's suppose that donor sets up a SLAT for the benefit of his spouse, with the remainder to his children. Donor has $5,340,000 of applicable exclusion amount remaining and transfers this amount to the SLAT, incurring no gift tax. The entire amount left in the trust after the donee's death (i.e., the donor's spouse's death) will pass estate tax-free to the donor's children. Assume that the donor dies 20 years later and that the trust assets grow at 6% per year.
>
> The table below shows the amount passing tax-free to the children at the end of 20 years in each of the four scenarios. In Scenario 1, the donor pays the taxes himself, with no reimbursement, and no distributions are made to the spouse. In Scenario 2, the donor is reimbursed by the trustee for the taxes he paid (assume a 23.8% tax rate) but there are no distributions made to the spouse. In Scenario 3, the donor pays the taxes himself, with no reimbursement, but there are distributions made to the spouse (assume 50% of trust income is paid to the spouse). In Scenario 4, the donor is reimbursed by the trustee for the taxes he paid (23.8% tax rate) and distributions are made to the spouse (50% of trust income). Note that the lower the distributions, the larger the transfer to the children.

	Scenario 1	**Scenario 2**	**Scenario 3**	**Scenario 4**
Total Value after 20 Years	$17,126,103	$13,057,185	$9,644,634	$8,391,994
Total Increase in Value after 20 Years	$11,786,103	$7,717,185	$4,304,634	$3,051,994
Total Return over 20 Years	220.71%	144.52%	80.61%	57.15%
Compounded Rate of Return Per Year	6.0%	4.6%	3.0%	2.29%

<u>Possible Limitations</u>

There are some issues that one must consider before jumping into a SLAT though. Since the SLAT will be set up for the benefit of the donor's spouse, and thus, only indirectly benefiting the donor if the spouse takes a distribution, the donor loses access to the trust when the spouse dies and perhaps also if there is a divorce. Therefore, it is best to only put those funds in the SLAT that the donor can reasonably expect to do without. Another way to avoid this issue is to have both couples set up a SLAT for each other's benefit; i.e., husband sets up a SLAT for wife and wife sets up a SLAT for husband. This would also enable the spouses to take advantage of both $11,580,000 exclusion amounts.

If the spouses create two trusts, however, they must plan carefully to avoid the reciprocal trust doctrine. In *United States v. Estate of Grace*,[73] a husband created a trust for his wife and the wife created an identical trust for the benefit of her husband. Because neither spouse retained an interest in the trust that spouse created, IRC § 2036 didn't apply. However, because the trusts were interrelated and left the settlors in approximately the same position they would have been in if they had created trusts for themselves, the court uncrossed the trusts, treating the husband as the settlor of the trust for his benefit and the wife as the settlor of the trust for her benefit. Thus, IRC § 2036 applied to both trusts, making the transferred assets includible in the transferors' gross estates.

It appears it is possible to avoid the reciprocal trust doctrine if the trusts created by the spouses are sufficiently different from each other. For example, in *Estate of Herbert Levy,*[74] the Tax Court refused to uncross trusts created for each other by spouses because the husband's trust gave the wife a special power of appointment over the trust assets, while the wife's trust did not confer such a power on the husband. Commentators have suggested that the reciprocal trust doctrine might also be avoided by having the trusts be created at different times, including different remainder beneficiaries or giving the donee spouses different powers over the trust assets.[75]

Since the assets transferred to the SLAT are a gift, a gift tax return must be filed. Furthermore, since the spouse is a beneficiary of the trust, gifts to the SLAT are usually not eligible for gift-splitting, so one-half of the gift cannot be reported by each spouse. Therefore, plan on only funding the trust with an amount up to or less than the donor's available gift and estate exemption. Lastly, before setting up a SLAT, there are some important drafting techniques that must be researched and considered.

[73] 395 US 316 (1969).
[74] TC Memo 1983-453.
[75] Peterson, Lori. "Make Use of the Gift Tax Exemption With Spousal Access Trusts." May 2013.

Chapter 7: IRC Section 199A Planning

#26: IRC § 199A Overview

On December 22, 2017 President Trump signed into law the Tax Cuts and Jobs Act (TCJA). One of the key provisions in the Act is a 20% deduction for qualified business income (QBI) under new Code Section 199A. The deduction has broad application, benefiting the owners of sole proprietorships, partnerships, LLCs, S corporations and rental real estate and is available to trusts and estates as well as to individuals. When the 20% deduction applies in full, it reduces the top tax rate on pass-through income from a maximum of 37% to a maximum of 29.6%. Code § 199A is effective for tax years after 2017 and, unless lawmakers act sooner, it sunsets on December 31, 2025.

The 20% deduction applies only for income tax purposes and doesn't reduce the net investment income tax, Medicare tax or the self-employment tax.[76] The deduction isn't allowed in computing adjusted gross income (AGI), but rather is applied against *taxable* income.[77]

Calculation of the Deduction

The statute begins with a relatively straightforward computation of the deduction.[78]
For most taxpayers the deduction is the lesser of—

(1) The "combined qualified business income" (QBI) of the taxpayer, or
(2) 20% of the excess of the taxpayer's taxable income over net capital gain.

> ***Example 1.*** Cindy, a single taxpayer, is the sole proprietor of a small appliance store with $155,000 of income in 2020 from the business and no other income. Cindy claims the $12,400 standard deduction for single taxpayers giving her $142,600 of taxable income. Cindy's tentative § 199A deduction is $31,000 ($155,000 x 20%). However, her deduction can't exceed 20% of taxable income over net capital gains. 20% of Betty's taxable income is $142,600 x 20% = $28,520, so her § 199A deduction is reduced from $31,000 to $28,520.

<u>Additional Limitations on the Amount of the Deduction</u>

In addition to the 20% of taxable income limitation, there are two additional limitations, a W-2 wage/unadjusted basis limitation and a limitation on specified service trades or businesses (SSTBs).

<u>W-2 Wage/Unadjusted Basis Limitation</u>

Under this limitation, QBI from the trade or business can't exceed the greater of

(1) 50% of the taxpayer's allocable share of the wages paid by the business with respect to QBI, or

[76] IRC § 199A(f)(3).
[77] New IRC § 62(a), as added, by Act Sec. 11011(b).
[78] IRC § 199A.

(2) 25% of the taxpayer's allocable share of wages plus 2.5% of the unadjusted basis of qualified property owned by the business.[79]

The W-2 wage/unadjusted basis limitation begins to be phased in when taxable income reaches $326,60000 in 2020 for married taxpayers filing jointly and $163,300 in 2020 for all other eligible taxpayers. The phase-in is complete for married taxpayers filing jointly at $426,600 in 2020 and for all other taxpayers at $213,30000 in 2020.

> ***Example 2.*** Joe and Brenda own a restaurant that produces $500,000 of taxable income each year. In 2020, they have another $44,000 of ordinary income and claim the standard deduction of $24,800. Ward and Joyce purchased the restaurant building for $600,000 and they paid $120,000 of W-2 wages in 2020. Because their taxable income exceeds $426,600, the W-2/unadjusted basis limitation applies in full. The QBI deduction for Joe and Brenda is—
>
> The lesser of
>
> - 20% of pass-through income ($500,000 x 20% = $100,000)
>
> Or the greater of
>
> - 50% of W-2 wages ($120,000 x 50% = $60,000), or
> - 25% of W-2 wages ($30,000) + 2.5% of the unadjusted basis in the restaurant building ($15,000) = $45,000
>
> Thus, the deduction is the lesser of $100,000 or $60,000 = $60,000.
> This $60,000 deduction is substantially less than 20% of the couple's taxable income so the taxable income limitation doesn't apply.

In the case of a partnership or S corporation, IRC § 199A is applied at the partner or shareholder level. Each partner or shareholder takes into account that person's allocable share of each qualified item of gain, W-2 wages and unadjusted basis.

Specified Service Trade or Business (SSTB) Limitation

Under the general rule, the § 199A deduction doesn't apply to SSTBs.[80] These businesses include businesses performing services in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any trade or business where the principal asset of the trade or business is the reputation or skill of one or more owners or employees. Also included are businesses performing services in the fields of investment management, trading, or dealing in securities.[81]

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[79] IRC § 199A(b).
[80] IRC § 199A(d)(2).
[81] IRC § 199A(d)(2)(A).

However, taxpayers in these businesses can still claim a full 20% deduction if their income is below certain threshold levels. For married taxpayers filing jointly, the threshold level is $326,600 and for all other taxpayers, $163,300. As income rises above these levels, the deduction is gradually phased out. For married taxpayers filing jointly, the phase-out is complete at income of $426,600 and for all other taxpayers at income of $213,300.

Definitions

To calculate the amount of the deduction, it is necessary to understand the key terms.

<u>QBI</u>

The term QBI is generally the pass-through income of a qualified trade or business of the taxpayer after payment of wages and business expenses. Among the items of income it doesn't include are—

(1) Capital gains and losses, including amounts treated as capital gains or losses under IRC § 1231;
(2) Guaranteed payments;
(3) Salary paid to the business owner;
(4) Dividends or dividend equivalents;
(5) Any qualified REIT dividends, qualified cooperative dividends, or qualified publicly traded partnership income;
(6) Any interest income other than interest income properly allocable to a trade or business.[82]

<u>W-2 Wages</u>

The term W-2 wages includes—

(1) Wages paid to an employee;
(2) Elective deferrals;
(3) Deferred compensation; and
(4) Designated Roth IRA contributions.

These amounts only count, however, if they are properly allocable to QBI. They are also excluded if they aren't properly included in a return filed with the Social Security Administration on or before the 60th day after the due date (including extensions) for such return. Elective deferrals include elective contributions made to SIMPLE IRAs, 401(k) plans, SARSEPs, and 403(b) plans.[83]

A partner's share of W-2 wages is determined in the same manner as the partner's share of wage expense. W-2 wages don't include payments to independent contractors or management fees. Note that S corporations can pay W-2 wages to the business owners, but partnerships, LLCs and sole proprietorships can't. Note also that the statute favors business owners and self-employed individuals over wage earners. To obtain a deduction, employees must either become independent contractors or own or invest in a business.

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[82] IRC §§ 199A(c)(3) and 199A(c)(4).
[83] IRC § 199A(b)(4).

Qualified Property

The 2.5% of unadjusted basis component of the W-2 wages/unadjusted basis limitation applies to depreciable property used at any time during the tax year for the production of QBI.

The basis of qualifying property is the basis of the property immediately after it was acquired. The depreciable period starts on the date the property is first placed in service and ends on the *later* of—

(1) 10 years after the beginning date, or
(2) The last day of the last full year of the applicable recovery period.

This means that property can qualify even if it has reached the end of its applicable recovery period if it was placed in service within the past 10 years. If a taxpayer makes additions to or improvements in qualified property that is already in service, the addition or improvement is treated as separate qualified property first placed in service on the date such addition or improvement is placed in service.[84]

Planning Considerations

IRC § 199A presents numerous planning issues. The first consideration is managing the limitation amounts. This may involve (1) increasing or decreasing W-2 wages, (2) increasing adjusted basis, and (3) increasing ordinary income to avoid the 20% of gross income limitation.

Other potential planning issues include the following—

(1) Choosing between a pass-through entity and a C corporation following enactment of the TCJA;
(2) Creating multiple trusts to increase limitation exclusion amounts;
(3) Using incomplete gift, non-grantor trusts;
(4) Employee vs. independent contractor status;
(5) Increasing or decreasing QBI;
(6) Tax planning for sales of crops—deciding whether to sell to a cooperative or to a non-cooperative buyer; and
(7) Aggregation of trades or businesses.

Clients should consult with their tax advisor for advice on their specific situation.

[84] Prop. Reg. § 1.199A-2(c)(1)(ii).

#27: Managing IRC § 199A Limitation Amounts

IRC § 199A provides owners of pass-through businesses with an income tax deduction of up to 20% of their share of qualified business income (QBI). However, the deduction is subject to three important limitations when taxable income exceeds certain threshold amounts. There is a specified service trade or business (SSTB) limitation, a W-2 wage/unadjusted basis limitation and a limitation based on taxable income.

The SSTB and W-2 wage/unadjusted basis limitations both begin when taxable income exceeds $163,300 for single taxpayers and $326,600 for married taxpayers and are fully phased at $213,300 for single taxpayers and $426,600, respectively (2020 figures). When fully phased in, the SSTB limitation completely eliminates the § 199A deduction and the W-2 wage/limitation restricts the deduction to the greater of (1) 50% of the taxpayer's share of W-2 wages, or (2) 25% of the taxpayer's share of W-2 wages plus 2.5% of the taxpayer's share of the unadjusted basis of qualified property owned by the business (UBIA). In addition, the § 199A deduction can't exceed 20% of taxable income in excess of capital gains.

Planning for the Limitation Amounts

There are five strategies for avoiding or minimizing the effect of the limitations.

(1) Increasing W-2 wages
(2) Decreasing W-2 wages
(3) Increasing UBIA
(4) Reducing taxable income below the threshold amounts
(5) Increasing taxable income to avoid the taxable income limitation

Increasing W-2 Wages

Disregarding UBIA for the time being, if 20% of QBI exceeds 50% of W-2 wages it may be possible to increase the limitation amount by increasing wages.

> ***Example 1.*** Bart and his wife, Helen, had taxable income of $425,000 in 2018. They own a tire business. The business—
>
> - Is structured as a sole proprietorship
> - Had $280,000 of QBI
> - Has no employees
> - Has no qualified property because it leases its space and equipment
>
> Because Bart and Helen had taxable income over $421,400 and the business is a non-service business (non-SSTB), the W-2/UBIA limitation applies in full. A sole proprietorship can't pay W-2 wages to its owners. Thus, Bart and Helen's 199A deduction is the lesser of
>
> - 20% of QBI ($56,000), or

- The greater of (1) 50% of W-2 wages ($0), or (2) 25% of W-2 wages ($0) + UBIA ($0).

Thus, Bart and Helen have a § 199A deduction of $0.

Example 2. Assume the same facts as in Example 1 except that Bart and Helen convert the business to an S corporation. An S corporation can pay W-2 wages to its owners as well as to employees. If the business pays Helen $100,000 in W-2 wages, the IRC § 199A deduction is the lesser of

- 20% of QBI (.2 x $180,000 = $36,000), or
- 50% of W-2 wages (.5 x $100,000) = $50,000

Thus, the § 199A deduction is increased to $36,000.

Note that the optimal amount of income to be paid as wages to a business owner is achieved when 50% of wages equals 20% of QBI. This would be accomplished by paying Helen 2/7 of the sum of flow-through income and wages, or $80,000, then—

20% of QBI (.2 x $200,000 = $40,000)
50% of wages (.5 x $80,000 = $40,000)

If Helen is paid either more or less than this amount, the deduction will go down. Unfortunately, if the business doesn't pay Helen reasonable compensation for the work she does, the IRS will re-characterize a portion of the profits interest passing through to her as wages to prevent avoidance of self-employment tax.

It may also be possible to increase W-2 wages by converting independent contractors to employees. This may not be as easy as it sounds, however. Workers may prefer to be independent contractors because independent contractors can qualify for their own IRC § 199A deduction while employees can't. Also, the workers would have to meet IRS requirements for employee status.

<u>Decreasing W-2 Wages</u>

In the previous examples, 20% of QBI exceeded 50% of W-2 wages so it was advantageous to increase W-2 wages. If, 20% of QBI is less than the 50% W-2 wage/UBIA limitation, it may be advisable to reduce wages and increase QBI.

Example 3. Herb and his wife, Jane, are the sole owners of an S corporation that makes widgets. In 2020, business produced $200,000 of profit and paid Jane a salary of $160,000 for operating the business. The couple's taxable income is $500,000. The business owns no depreciable property. If Herb and Jane do no planning, their § 199A deduction is the lesser of

20% of QBI (.2 x 200,000).. $40,000

Or the greater of

50% of W-2 wages (.5 x $160,000). .... $80,000, or
25% of W-2 wages + 2.5% of unadjusted basis............................ $40,000

This makes the § 199A deduction $40,000. To increase the deduction, they decide to reduce Jane's W-2 wages by $50,000. This increases QBI by $50,000 to $250,000 and increases their § 199A deduction to the lesser of

QBI (.2 x 250,000. .... $50,000

Or the greater of

50% of W-2 wages (.5 x $110,000) .... $55,000, or
25% of W-2 wages + 2.5% of unadjusted basis............................ $27,500

By reducing Jane's wages by $50,000, the § 199A deduction is increased from $40,000 to $50,000. This is a good result, but the deduction could be made slightly higher by paying Jane 2/7 of the sum of Jane's wages plus company profit. This amount would be 2/7 x $360,000 = $102,857, leaving $257,143 of pass-through income ($360,000 - $102,857). Then, the § 199A deduction would be the lesser of

20% of QBI (.2 x $257,143)... $51,429

Or the greater of

50% of W-2 wages (.5 x $102,857) .... $51,429, or
25% of W-2 wages + 2.5% of unadjusted basis............................ $25,714

Again, the IRS might question whether the business was paying reasonable compensation.

Increasing Unadjusted Basis

The W-2 wage/UBIA limitation amount can also be increased by either acquiring depreciable property or by owning property instead of leasing it.

Example 4. Ward and Kay own a small unincorporated business that manufactures garden tools. The business produced $600,000 of pass-through income in 2020. Ward and Kay do all the work themselves and lease the machinery used to make the tools so they have no W-2 wages. Their taxable income is $650,000 so the taxable income limitation doesn't come into play. If Ward and Kay do no planning, their § 199A deduction will be $0, the lesser of

20% of QBI (.2 x $600,000)... $120,000

Or the greater of

50% of wages (.5 x $0) ....$0, or
25% of wages ($0) + 2.5% of basis ($0)... $0

Now suppose that instead of leasing, Bill and Kay decide to buy the building and machinery for $800,000. Their § 199A deduction amount is now the lesser of

QBI (.2 x $600,000)... $120,000

Or the greater of

50% of wages (.5 x $0) ....$0, or
25% of wages ($0) + 2.5% of basis ($20,000)............................. $20,000

Reducing Taxable Income Below the Threshold Amounts

It may be possible to avoid, or at least diminish the effect of the SSTB and W-2 wage/UBIA limitations by decreasing taxable income. Two easy ways to reduce taxable income are making charitable contributions and making contributions to qualified plans.

Example 5. Emily, a single taxpayer, is a lawyer with a solo practice that generates $200,000 of QBI. She pays $150,000 in wages to her employees and has taxable income of $215,000. The building that houses the practice is leased. Without planning, Emily's IRC § 199A deduction would be totally phased out because the business is a service business and her taxable income exceeds $213,300. If Emily makes a $52,000 charitable contribution to her church, however, she can reduce her taxable income to $163,000 and claim a § 199A deduction of $40,000 (.2 x $200,000).

Oil and Gas Investments. A more sophisticated strategy for reducing taxable income is making oil and gas investments. Investors can deduct 100% of their share of intangible drilling costs (IDCs) in the year they are incurred. IDCs typically produce deductions equal to 65 to 85 percent of the total investment. Thus, a $100,000 investment could create an immediate deduction of $65,000 to $85,000.

Gifts of Business Interests. Taxpayers might also consider gifting shares of a business to family members. This would spread income from the business among several taxpayers, creating additional threshold amounts and making it easier to stay below the phase-in or phase-out thresholds.

Example 6. Greg and April are married taxpayers filing jointly with $600,000 of QBI from GA Partnership and taxable income of $490,000. The GA Partnership pays no wages. Because Greg and April have taxable income over $421,400, the W-2 wage limitation applies in full and they receive no IRC § 199A deduction. Greg and April have two children, Ray and Lauren, both married taxpayers filing jointly, each with taxable income of $100,000.

Greg and April gift a 15% interest in GA to Greg and a 15% interest in GA to April, shifting $90,000 of qualified business income to each of them. Following the transfer, Greg and April have taxable income of $310,000 ($490,000 - $180,000) and Ray and Lauren have taxable income of $190,000 each. Thus, all of them qualify for the full 20% deduction on GA pass-through income.

Increasing Taxable Income

Even if QBI isn't limited by the W-2 wage/UBIA limitation, it may be limited by the 20% of taxable income over capital gains limitation. If so, an owner of a non-SSTB may be able to avoid the limitation by earning additional income outside the pass-through business.

> ***Example 7.*** Bill is the sole proprietor of a non-SSTB business that produces $110,400 of pass-through income. Bill has no other income and claims the $12,400 standard deduction, reducing his taxable income to $98,000. Although his tentative QBI deduction is $22,080 (.2 x $110,400), the deduction is limited to $19,600 (.2 x $98,000) because of the taxable income limitation (20% of taxable income over capital gains). Bill earns an additional $12,000 coaching at the local high school and tutoring students in math. This increases his taxable income to $110,000 and his taxable income limitation to $22,000 (.2 x $110,000).

#28: Choice of Entity Decision After the TCJA--Converting a Pass-Through Entity to a C Corporation

Following enactment of the Tax Cuts and Jobs Act (TCJA) taxpayers may wish to consider the possibility of converting a pass-through entity to a C corporation.

Historically, pass-through entities generally had more favorable tax consequences for businesses than C corporations. The top initial tax rates on operating income were similar: 35% for C corporations versus 39.6% for pass-through entities. However, when the income was distributed to owners or the business was sold, there was a second level of tax for C corporations but not for pass-through entities. Dividends were subject to a second level of tax at rates as high as 23.8%. If a shareholder sold the C corporation stock, income retained in the company increased the value of the stock and the gain recognized on the sale. This second level of tax brought the effective tax rate on C corporation income up to a maximum rate of 50.47% ((.35) + (.65 x .238) = .35 + .1547 = 50.47%).

By contrast, distributions from S corporations are tax-free to shareholders unless the distribution exceeds the shareholder's basis in the stock[85] or the S corporation is a former C corporation and the distribution exceeds the S corporation's accumulated adjustment account (AAA).[86] Moreover, S corporation shareholders increase the basis of their stock by their share of corporate income, in effect eliminating the second level of tax when the stock is sold.[87] Thus, the difference in rates between C corporations and pass-through entities was generally 10.87 percentage points for taxpayers in the highest tax bracket (50.47% minus 39.6%).

<u>Changed Tax Rates</u>

The most important goal of the TCJA was to lower C corporation tax rates to make American corporations more competitive. This was accomplished by reducing the corporate tax rate from 35% to 21%. If this had been the only rate change, however, it would have made C corporations far more favorable relative to S corporations, partnerships, LLCs and sole proprietorships. This presumably would have led to mass conversion of these latter businesses into C corporations. To prevent this, the TCJA made a comparable reduction in the tax rate for pass-through entities by enacting the 20% IRC § 199A deduction. The following chart shows how the two changes left the spread between the top tax rates for C corporations and S corporations nearly the same when the second level of tax on C corporation income is taken into account.

[85] IRC § 1368(b). The excess amount is treated as a dividend to the extent of earnings and profits.
[86] IRC §§ 1368(c) and 1368(e).
[87] IRC § 1367(a)(1).

	Before TCJA	After TCJA
C corporation total tax rate	50.47%[88]	39.80%[89]
S corporation tax rate	39.60%	29.60%[90]
Spread	10.87%	10.20%

Thus, on the surface it might appear that the TCJA shouldn't change business owners' decisions about whether to operate their business as a C corporation or as a pass-through entity. The chart only shows the maximum rate for each type of entity, however, and assumes that the § 199A deduction can be claimed in full. Because the actual C corporation tax rate could be much lower and actual pass-through tax rate could be much higher for a given business owner, the TCJA might make conversion from a pass-through entity to a C corporation very favorable.

Lower C Corporation Rate

There are five reasons why the top C corporation rate may be substantially lower than 39.8%.

Distributions May Be Deferred. An owner's share of the income earned by a pass-through entity is taxed to the owner in the year it is earned, whether it is distributed or not. By contrast, income earned by a C corporation is taxed to owners only when it is distributed. The second level of C corporation tax may not be paid for a long time after the income is earned because it is deferred until the income is distributed as a dividend or until the stock is sold.[91]

Distributions May Be Totally Eliminated. There may never be a second level of tax at all. If dividends aren't paid and the shareholder dies with the stock, the heirs will receive a step-up in basis, eliminating the increase in the stock's value due to the retained earnings. While retaining earnings will reduce the effective C corporation tax rate, C corporations must be careful to avoid the accumulated earnings tax.[92] IRC § 531 imposes a 20% tax on the "accumulated taxable income" of C corporations that accumulate income beyond the reasonable needs of the business.

IRC § 1202 Gain Exclusion for Qualified Small Business Stock. If the C corporation stock is qualified small business stock (QSBS), qualifying for a 100% IRC § 1202 deduction when it is sold, the second level of tax will also be eliminated. While a detailed discussion of IRC § 1202 is beyond the scope of this book, a basic overview is provided below.

[88] 35% corporate level tax + 28% tax at individual level on qualified dividends, corporate liquidation or sale of the stock by the shareholder. Then, .35 + (.238 x .65) = .5047 = 50.47%.
[89] .21 + (.238 x .79) = .398 = 39.8%.
[90] 37% top rate x .8 = 29.6%.
[91] Note that many closely-held C corporations never pay dividends.
[92] IRC §§ 531-537.

Under IRC § 1202, non-corporate taxpayers can exclude 100% of the gain realized on the sale of qualified small business stock.[93] Qualified small business stock is stock in a C corporation that meets the following requirements.[94]

(1) The stock was issued after August 10, 1993[95]
(2) The issuer of the stock was a "qualified small business" when the stock was issued[96]
(3) The taxpayer acquired the stock at original issue in exchange for money or property other than stock or as compensation for services to the corporation (other than as underwriter of the stock)[97]
(4) The corporation met an active business requirement and was a C corporation during substantially all of the taxpayer's holding period for the stock[98]
(5) The value of the corporation's aggregate gross assets doesn't exceed $50 million[99]

Finally, to qualify for the exclusion, the qualified small business stock must be held for at least five years.[100]

Larger State and Local Tax Deductions. C corporations may be able to claim larger deductions for state and local taxes. The TCJA limits the deduction for state and local taxes to $10,000 for individuals ($5,000 for married individuals filing separately).[101] Thus, state or local taxes paid by an individual on income received from a pass-through entity are generally subject to the $10,000 limitation. The $10,000 limitation doesn't apply to C corporations so the state and local income taxes paid by a C corporation are fully deductible, reducing the effective tax rate on C corporation income.

Sale of Ownership Interest. Reduction of the C corporation tax rate to 21% largely eliminated the capital gains disadvantage of C corporations relative to pass-through entities. For C corporations, capital gains are taxed at the same rate as ordinary income. Thus, prior to the TCJA, C corporations paid a 35% tax on capital gains compared with the 15% and 20% long-term capital gain rate paid by the owners of pass-through entities. Following enactment of the 21% C corporation tax rate, the tax rate differential is greatly reduced.

Higher S Corporation Rate

In many cases, owners of pass-through entities won't receive the full benefit of the 20% § 199A deduction because of the phase-in and phase-out rules. Some entities will lack the W-2 wages or basis in property necessary to provide a significant benefit from the new deduction for their owners.

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[93] IRC § 1202(a). Note that this 100% exclusion applies only to qualified small business stock acquired after September 27, 2010. For stock acquired between February 17, 2009 and before September 28, 2010, the exclusion rate is 75%. For stock acquired before February 17, 2009, the exclusion rate is 50%.
[94] IRC § 1202(c)(1).
[95] IRC § 1202(c)(1).
[96] IRC § 1202(c)(1)(A).
[97] IRC § 1202(c)(1)(B).
[98] IRC § 1202(c)(2)(A).
[99] IRC § 1202(d)(1)(A).
[100] IRC § 1202(a)(1).
[101] New IRC § 164(b)(6)(B).

Others will be specified service businesses. These limitations might substantially increase the rate of tax paid on pass-through income from 29.6% to as high as 37% or 40.8% if the NIIT applies. For many taxpayers, converting from a pass-through entity to a C corporation will make sense. If the C corporation owner can avoid the second level of tax by dying with the stock or claiming the IRC § 1202 deduction, C corporation income will be taxed at 21% compared with a top rate of 29.6% for income from pass-through entities, 33.4% if the income is subject to the net investment income tax. This produces a very significant spread of 8.6 to 12.4 percentage points in the tax rate. If the pass-through owner can't qualify for the full 20% deduction, the spread could be even greater, perhaps as high as 19.8% (40.8% - 21%). This large tax rate advantage would make converting from a pass-through entity to a C corporation highly favorable in many cases.

To summarize, the most favorable situation for converting from a pass-through entity to a C corporation is the following.

(1) The entity plans to retain a substantial portion of its earnings, plans to defer distributions of earnings for a significant period of time or can qualify for the IRC § 1202 exclusion on a sale of stock;
(2) The individuals who own the business don't qualify for the IRC §199A deduction or qualify for only a very limited deduction; and
(3) The pass-through income is subject to the NIIT.

Conversely, the least favorable scenario for converting is one in which—

(1) Retained earnings must be distributed;
(2) The entity can't qualify for the IRC § 1202 tax exclusion;
(3) The business can qualify for the full IRC § 199A deduction; and
(4) The NIIT doesn't apply to pass-through income.

Decision Factors Other Than the Effective Tax Rate

Of course, the choice of entity decision involves factors other than the effective tax rate. While a detailed discussion of these factors is beyond the scope of this topic, note that each type of entity has advantages and disadvantages compared with the other entities. For example, a C corporation can deduct income distributed in the form of wages, fringe benefits and deferred compensation.[102] It also has more flexibility in choosing a tax year, is the only corporate entity that can claim charitable deductions[103] and has fewer ownership restrictions than S corporations. On the other hand, losses of a pass-through entity can be passed out to owners, but losses of a C corporation can't.

[102] The IRS may try to re-characterize these payments as dividends under IRC § 316.
[103] Up to 10% of taxable income.

#29: Using Multiple Trusts to Enhance the Benefits of IRC § 199A

Creating multiple trusts to hold business interests might produce large tax savings for many individuals following enactment of the TCJA.

> The threshold amount for a trust or estate is $163,300 in 2020, with cost of living adjustments thereafter. For purposes of determining whether a trust or estate has taxable income in excess of the threshold amount, taxable income is determined before taking into account any distribution deduction under IRC § 651 or 661 (i.e., the DNI deduction) (Prop. Reg. § 1.199A-6(d)(3)(iii)). Thus, it appears that income from qualified businesses could be split among multiple non-grantor trusts. By splitting the income among multiple trusts, each trust could stay below the SSTB and W-2 wage/UBIA limitations and take full advantage of the deduction. For a taxpayer in the 37% marginal income tax bracket, this would be worth $32,660 per trust (.2 x $163,300). For example, with four trusts the tax savings would be $130,640.

IRC § 643(f) Anti-Abuse Rule

To make this multiple trust strategy work, however, taxpayers must plan around the anti-abuse rule of IRC § 643(f). This section authorizes the Treasury Department to issue regulations to prevent taxpayers from—

- Creating multiple trusts,
- Or contributing additional capital to existing trusts,
- To avoid federal income tax.[104]

Proposed Regulations Under IRC § 199A

In 2018 proposed regulations were issued under IRC § 643(f) to accompany the proposed regulations under IRC § 199A. New Prop. Reg. § 1.643(f)-1 exercises this § 643(f) authority to prevent abuse of IRC § 199A. Under the proposed regulations two or more trusts will be aggregated and treated as a single trust if—

- The trusts have substantially the same grantors and primary beneficiaries, and
- A principal purpose of creating the trusts or contributing additional cash or other property to them is the avoidance of federal income tax.[105]

For purposes of applying this rule, spouses are treated as one person.[106]

A principal purpose will be presumed if creating or funding the trusts,

- Results in a significant income tax benefit, unless

[104] IRC § 643(f). The IRS might also be able to aggregate trusts using substance over form arguments.
[105] Prop. Reg. § 1.643(f)-1(a).
[106] Prop. Reg. § 1.643(f)-1(a).

– There is a significant non-tax benefit that couldn't have been achieved without the creation of the separate trusts.[107]

The regulations provide two examples. The first illustrates a fact situation in which trusts will be aggregated. The second illustrates a fact situation in which trusts won't be aggregated.

Example 1.
Facts

- T operates a pizzeria and several gas stations
- T's income from the businesses exceeds the applicable threshold amount and T lacks adequate W-2 wages to maximize the § 199A deduction
- T reads an article recommending that T can avoid the W-2 wage limitation by creating multiple trusts
- T creates three trusts
    - Trust 1—For T's sister S1 and T's brothers B1 and B2
    - Trust 2—For T's other sister S2 and for B1 and B2
    - Trust 3—For S2
- Other than the beneficiaries named, the trusts have identical terms
- Under each trust, the trustee is given discretion to pay any current or accumulated income to any one or more of the beneficiaries
- If not for the enactment of § 199A and the desire to avoid the W-2 wage limitation, T wouldn't have created the trusts
- Later, T creates a family limited partnership
- T contributes ownership interests in the pizzeria and gas stations to the FLP
- T names his oldest son F trustee
- T takes back a 50% GP and a 50% LP interest in the FLP
- Later, T contributes a 15% LP interest in the FLP to each trust
- The trustee (F) has no power or discretion to manage the partnership or any of its businesses on behalf of the trusts or to dispose of LP interests without the consent of the general partner
- Each trust has taxable income below the threshold amount and claims the full 199A deduction for its QBI, without regard to any W-2 wage limitation

Conclusion

- Trusts 1, 2, and 3 will be aggregated and treated as one trust
- All three requirements are satisfied:
    – The trusts are created by the same grantor
    – Although the trusts have somewhat different beneficiaries, because of the overlap of beneficiaries in the trusts and the trustee's discretion, all or most of the income of the trusts could be paid to the same beneficiaries
    – The purpose of creating multiple trusts was to avoid the W-2 limitation amount and avoid tax[108]

[107] Prop. Reg. § 1.643(f)-1(b).
[108] Prop. Reg. § 1.643(f)-1(c), Example 1.

Example 2.

Facts

- X establishes two irrevocable trusts
  - Trust 1
    - For X's daughter (D)
    - Trustee is required to apply all current income to D for D's life
    - X's son (S) is the remainder beneficiary
  - Trust 2—for S
    - S is income beneficiary
    - Trustee authorized to accumulate or pay income, in its discretion, to S for S's education, support and maintenance
    - The trustee can also pay income to D for her medical expenses
    - D is the remainder beneficiary of Trust 2

Conclusion

- The example states that there are two significant non-tax differences between the two trusts, so tax avoidance isn't presumed.
- These non-tax differences are evidently different income beneficiaries and different remainder beneficiaries.
- Unless there are other facts or circumstances indicating that a principal purpose of creating two trusts was tax avoidance, the two trusts won't be aggregated.[109]

Multiple Trusts—Additional Guidance

The Notice of Proposed Rulemaking states that the determination of whether an arrangement involving multiple trusts is subject to IRC § 643(f) will be made on the basis of the statute and the legislative history of § 643(f). The Committee Report provides some additional guidance—

(1) Trusts will not be treated as having different primary beneficiaries merely because the trust has different contingent beneficiaries.
(2) Trusts will not be treated as having different grantors by having different persons making nominal transfers to the trusts.
(3) Trusts won't be aggregated and treated as one trust where there are substantial independent purposes aside from tax avoidance.

There are also two PLRs that address the question of when multiple trusts will be aggregated. In PLR 199923004, the IRS concluded that IRC § 643(f) applies to subtrusts that result from division of a trust, but there is no aggregation if the trusts have different primary beneficiaries and are separately managed and administered. In PLR 200209008 the taxpayer created two trusts instead of one because of the need to resolve a dispute among beneficiaries over investment strategies. Thus, there was a significant non-tax reason for creating more than one trust and no aggregation.

[109] Prop. Reg. § 1.643(f)-1(c), Example 2.

Planning

The proposed regulations under IRC § 163 indicate that multiple trusts will be respected if there is sufficient differentiation with respect to beneficiaries and trust terms. Unfortunately, however, the proposed regulations don't clearly delineate between trusts that will be aggregated and trusts that won't be aggregated. For example, it isn't clear from the proposed regulations whether creating trusts with the same grantor and the same lead beneficiaries would be aggregated if the trusts have very different dispositive provisions. It also isn't clear how much overlap in beneficiaries is allowable before trusts will be aggregated. Thus, in structuring trusts, taxpayers should be cautious.

Some commentators have suggested that instead of creating multiple non-grantor trusts, taxpayers might consider using IRC § 678 trusts. This section provides that a person other than the grantor will be treated as the owner of any the trust so there would be only one trust, but multiple threshold amounts, one for each deemed portion of a trust with respect to which such person has a power exercisable solely by himself to vest the corpus or the income therefrom in himself. Thus, the IRC § 199A threshold amounts would seem to pass through to the deemed owners.

<u>Caution</u>

Prop. Reg. § 1.199A-6 suggests that the IRS might try to completely disregard trusts even if they have different lead beneficiaries, different grantors or very different terms. This section reads as follows.

> (v) Anti-abuse rule for creation of multiple trusts to avoid exceeding the threshold amount. Trusts formed or funded with a significant purpose of receiving a deduction under section 199A will not be respected for purposes of section 199A. See also §1.643(f)-1 of the regulations.[110]

This provision is inconsistent with Prop. Reg. § 1.643(f)-1 in two ways. First, it makes a significant purpose of avoiding applicable threshold amounts the sole criteria for denying a tax benefit rather than requiring both a tax avoidance purpose and trust similarities. Second, it completely disregards trusts instead of aggregating them. This would be more unfavorable for taxpayers than aggregating trusts because with aggregation you could still create one more threshold amount rather than none.

Treasury notes that the application of proposed § 1.643(f)-1 is not limited to avoidance of the limitations under § 199A.

<u>Caveat</u>

Prop. Reg. § 1.199A-6 suggests that the IRS might try to completely disregard trusts even if they have different lead beneficiaries, different grantors or very different terms. This section reads as follows.

> (v) Anti-abuse rule for creation of multiple trusts to avoid exceeding the threshold amount. Trusts formed or funded with a significant purpose of receiving a deduction

[110] Prop. Reg. § 1.199A-6(d)(3)(v).

> under section 199A will not be respected for purposes of section 199A. See also §1.643(f)-1 of the regulations.[111]

This provision is inconsistent with Prop. Reg. § 1.643(f)-1 in two ways, however. First, it makes a significant purpose of avoiding applicable threshold amounts the sole criteria for denying a tax benefit rather than requiring both a tax avoidance purpose and trust similarities. Second, it completely disregards trusts instead of aggregating them. This would be more unfavorable for taxpayers than aggregating trusts because with aggregation you could still create one more threshold amount rather than none.

In Rev. Proc. 2019-3 the IRS included questions on whether two or more trusts should be treated as one trust for income tax purposes as a no-ruling area.

[111] Prop. Reg. § 1.199A-6(d)(3)(v).

#30: Aggregating Trades or Businesses to Increase the § 199A Deduction

Before reading this topic it might be helpful to review the basics of the IRC § 199A deduction at Topic # 26.

Under the right circumstances, aggregating trades or businesses may greatly increase the amount of the IRC § 199A deduction. The potential tax benefit is illustrated in the following example.

Example 1. T owns two businesses with the following characteristics—

Business 1

W-2 wages	$0
QBI	$1,500,000
UBIA	$0

Business 2

W-2 wages	$700,000
QBI	$0
UBIA	$0

Assume further that T has $1,600,000 of taxable income.

Businesses Treated as Separate

If the businesses are treated as separate for purposes of IRC § 199A, T's deductions would look like this—

Business 1

T's deduction is the lesser of:

(1) 20% of T's pass-through income (.2 x $1,500,000 = $300,000), or
(2) 0% of X's allocable share of W-2 wages (.5 x $0 = 0)

Thus, the deduction is the lesser of $300,000 or $0 = $0.

Business 2

T's deduction is the lesser of:

(1) 20% of T's pass-through income (.2 x $0 = $0), or
(2) 50% of X's allocable share of W-2 wages (.5 x $1,000,000 = $500,000).

Again, the deduction is $0.

Businesses Aggregated

By contrast, if T could aggregate the two businesses, the deduction would be calculated as follows.

T's deduction is the lesser of:

(3) 20% of T's pass-through income (.2 x $1,500,000 = $300,000), or
(4) 50% of X's allocable share of W-2 wages (.5 x $700,000 = $300,000).

Now, the deduction is $300,000. Note that the 20% of taxable income limitation doesn't apply (.2 x $1,600,000 = $320,000).

Aggregation Requirements

However, aggregation is only allowed if it meets the requirements of Prop. Reg. § 1.199A-4. If the requirements are met, aggregation is permitted, but not required.

Trades or businesses can be aggregated if an individual can demonstrate all of the following—

(1) Each component trade or business is itself a trade or business
(2) The same person or group of persons owns, directly or indirectly, 50% or more of each trade or business
   - For a trade or business owned by an S corporation, 50% or more of the issued and outstanding shares
   - For a trade or business owned by a partnership—50% or more of the capital or profits in the partnership[112]
(3) Such ownership must be held for the majority of the taxable year in which the items attributable to each trade or business are included in income[113]
(4) All of the items attributable to each trade or business are reported on returns with the same taxable year, not taking into account short taxable years[114]
(5) None of the trades or businesses is a specified service trade or business (SSTB)[115]
(6) The trades or businesses satisfy at least two of the following factors (based on all of the facts and circumstances)
   A. The trades or businesses provide products and services that are the same or customarily offered together, e.g.,[116]
      - A restaurant and a food truck
      - A gas station and a car wash
   B. The trades or businesses share facilities or share significant centralized business elements, such as personnel, accounting, legal, manufacturing, purchasing, human resources, or information technology resources[117]
   C. The businesses are operated in coordination with, or reliance on, other businesses in the aggregated group (for example, supply chain interdependencies)[118]

<u>Special Rule for Self-Rentals</u>

As noted above, businesses can generally be aggregated only if each of them qualifies as a trade or business. Under a special rule, however, the rental or licensing of property that doesn't rise to the level of a trade or businesses is nevertheless treated as a trade or business for purposes of the aggregation rules if the property is rented or licensed to a business with 50% or more common

[112] Prop. Reg. § 1.199A-4(b)(1)(i).
[113] Prop. Reg. § 1.199A-4(b)(1)(ii).
[114] Prop. Reg. § 1.199A-4(b)(1)(ii).
[115] Prop. Reg. § 1.199A-4(b)(iv).
[116] Prop. Reg. § 1.199A-4(b)(v)(A).
[117] Prop. Reg. § 1.199A-4(b)(v)(B).
[118] Prop. Reg. § 1.199A-4(b)(v)(C).

ownership.[119] The rule applies if the same person or persons own 50% or more of both the rental activity and the IRC § 162 trade or business.[120] Ownership of a spouse, child, grandchild or parent can be included in applying the 50% rules.[121]

Examples

The following examples illustrate the aggregation rules.

> ***Example 2***. X wholly owns and operates a catering business and a restaurant through separate disregarded entities. Both businesses are owned for the entire tax year and all items of income are properly reported. The catering business and the restaurant share centralized purchasing to obtain volume discounts and a centralized accounting office that performs all of the bookkeeping, tracks and issues statements on all of the receivables, and prepares the payroll for each business. X maintains a website and print advertising materials that reference both the catering business and the restaurant. X uses the restaurant kitchen to prepare food for the catering business. The catering business employs its own staff and owns equipment and trucks that are not used or associated with the restaurant.
>
> <u>Analysis</u>
>
> Aggregation would be permitted under these facts.
>
> (1) Each component trade or business is itself a trade or business.
> (2) Because the restaurant and catering businesses are held in disregarded entities, X will be treated as operating each of these businesses directly and thereby satisfies the 50% ownership requirement
> (3) Ownership is held for the requisite period of time
> (4) Items of income are reported for the same taxable year
> (5) Neither of the trades or businesses is a specified service trade or business (SSTB)[122]
> (6) The trades or businesses satisfy two of the three factors:
>   A. The trades or businesses provide products and services that are the same or customarily offered together--both businesses offer prepared food to customers,
>   B. The trades or businesses share facilities or share significant centralized business elements, such as personnel, accounting, legal, manufacturing, purchasing, human resources, or information technology resources--the two businesses share the same kitchen facilities in addition to centralized purchasing, marketing, and accounting.

[119] Prop. Reg. §1.199A-4(b)(13)).
[120] Prop. Reg. § 1.199A-4(b)(1).
[121] Prop. Reg. § 1.199A-4(b)(3).
[122] Prop. Reg. § 1.199A-4(b)(iv).

C. The businesses are operated in coordination with, or reliance on, other businesses in the aggregated group (for example, supply chain interdependencies)[123]

Example 3. W owns a 75% interest in S1, an S corporation, and a 75% interest in the capital and profits of PRS, a partnership. S1 manufactures clothing and PRS is a retail pet food store. Assume that W meets requirements 1, 3, 4 and 5 above.

Analysis

W owns more than 50% of the stock of S1 and more than 50% of the capital and profits of PRS thereby satisfying requirement 2. Although W manages both S1 and PRS, W is not able to satisfy the requirements of the two of three tests because the two businesses do not provide goods or services that are the same or customarily offered together; there are no significant centralized business elements; and no facts indicate that the businesses are operated in coordination with, or reliance upon, one another. Thus, W must treat S1 and PRS as separate trades or businesses for purposes of applying § 1.199A-1(d).[124]

Operating Rules—Individuals

The proposed regulations provide the following operational rules for individuals.[125]

- An individual can aggregate trades or businesses operated directly and also the individual's share of QBI, W-2 wages, and UBIA from trades or businesses operated through Relevant Pass-through Entities (RPEs)
- Multiple owners of an RPE need not aggregate in the same manner
- For those trades or businesses directly operated by the individual, the individual computes QBI, W-2 wages, and UBIA of qualified property for each trade or business before applying the aggregation rules
- If an individual aggregates multiple trades or businesses, the individual must combine the QBI, W-2 wages, and UBIA of qualified property for all aggregated trades or businesses for purposes of applying the W-2 wage and UBIA limitations

For purposes of applying the 50% ownership requirements, family attribution is taken into account.[126]

- An individual is treated as owning the interest in each trade or business owned, directly or indirectly, by or for—
    - The individual's spouse (other than a spouse who is legally separated from the individual under a decree of divorce or separate maintenance), and
    - The individual's children, grandchildren and parents

[123] Prop. Reg. § 1.199A-4(b)(v)(C).
[124] Prop. Reg. § 1.199A-4(d), Example 3.
[125] Prop. Reg. § 1.199A-4(b)(2).
[126] Prop. Reg. § 1.199A-4(b)(3).

To aggregate businesses, taxpayers must also comply with reporting and consistency rules and individual disclosure requirements.

Reporting and Consistency Rules

The proposed regulations create the following reporting and consistency requirements.[127]

- Individuals who choose to aggregate trades or businesses must consistently report the aggregated trades or businesses in all subsequent tax years
- However, an individual may add a newly created or newly acquired trade or business to an existing aggregated trade or business if the aggregation requirements are met
- If facts change so that an aggregation no longer meets the aggregation requirements, the trades or businesses can no longer be aggregated

Individual Disclosure Requirements[128]

- For each taxable year, individuals must attach a statement to their returns identifying each trade or business they are aggregating.
- The statement must contain the following information.
  - A description of each trade or business
  - The name and EIN of each entity in which a trade or business is operated
  - Information identifying any trade or business that was formed, ceased operations, was acquired, or was disposed of during the taxable year; and
  - Such other information as the Commissioner may require in forms, instructions, or other published guidance.
- If an individual fails to attach the required statement the IRS may disaggregate the individual's trades or businesses.

[127] Prop. Reg. § 1.199A-4(b)(3).
[128] Prop. Reg. § 1.199A-4(c).

Chapter 8: Ten More Must Know Strategies for 2020

#31: Trust Decanting

Many irrevocable trusts could be amended to better accomplish the objectives of the grantor and increase the benefit to beneficiaries. The simplest and least expensive way to do so is by decanting the old trust into a new one. Instead of exercising its power to make distributions to, or for the benefit of beneficiaries, the trustee distributes assets to a new trust with different terms.

Legal Authority for Decanting

It is unclear under the common law of most states whether a trustee's power to distribute property to a beneficiary includes the power to transfer property to a trust for the beneficiary's benefit. Recently, however, many states have enacted statutes expressly authorizing trust decanting. As of October 15, 2018, these states included Alabama, Alaska, Arizona, California, Colorado, Delaware Florida, Illinois, Indiana, Kentucky, Michigan, Minnesota, Missouri, Nevada, New Hampshire, New Mexico, New York, North Carolina, Ohio, Rhode Island, South Carolina, South Dakota, Tennessee, Texas, Virginia, Washington, Wisconsin and Wyoming. The statutes vary considerably with respect to whether:

(1) A trust with an ascertainable standard can be decanted;
(2) Notice must be given to beneficiaries;
(3) A trust with an ascertainable standard can be decanted into a discretionary trust;
(4) A mandatory income interest can be removed; and
(5) A power of appointment can be granted to a beneficiary of the second trust in favor of a person or entity that is not a beneficiary.

Some statutes, like those in South Dakota and Nevada confer very broad decanting powers while others, like those in Florida and Indiana, allow decanting only if the trustee has unrestricted discretion to make distributions of principal to beneficiaries. Almost all of the statutes include specific limitations on the use of decanting. For example, many of the statutes prohibit decanting if it would cause a trust to lose its status as an eligible S corporation shareholder or eliminating a vested beneficiary's right to income.[129]

Reasons to Decant

Trust decanting can be used to address a variety of trust issues. Some of the most popular reasons for decanting a trust are discussed below. Before utilizing any of the strategies, advisors should make sure the decanting is allowed under the applicable state decanting statute and consider any tax issues that might be raised. Potential tax issues are noted later in this topic. Although the subject is beyond the scope of this topic, the fiduciary responsibilities of the trustees must also be considered.

Extending the Term of the Trust

Many trusts are structured to terminate and pay all trust assets to a beneficiary when the beneficiary reaches a certain age or to pay assets to beneficiaries at staggered ages (e.g., 1/3 at age 25, 1/3 at

[129] For a ranking of state decanting statutes in order of favorability for trustees and beneficiaries see Oshins, Steve, 1st Annual Trust Decanting State Rankings Chart. This chart can be obtained from Mr. Steve Oshins at soshins@oshins.com. It is also included at the end of this topic as an exhibit.

age 35 and 1/3 at age 45). This can open up the trust to unnecessary estate tax, creditors and divorcing spouses. It might also have negative effects on the beneficiary's career motivation and lifestyle, particularly if trust investments have been highly successful. If the beneficiaries have not yet reached the requisite age or ages, the trustee should consider decanting the trust into a trust that delays distributions of principal. If estate tax is a concern, the trustee might consider a transfer to a dynasty trust.[130]

Changing Trust Situs

Some states have much more favorable laws for trusts than others. For example, seven states don't tax trust income at all, while others have top trust income tax rates as high as 13.3%.[131] State laws also vary widely with respect to creditor protection and the maximum length for a trust. If the trust is located in a state with a decanting statute it may be possible to transfer assets into a new trust in a better trust jurisdiction.[132] It may be possible not only to save substantial amounts of state income tax, but also to lengthen the term of a dynasty trust, to move a trust to a state allowing domestic asset protection trusts (DAPTs), or to move an existing DAPT to another DAPT state offering greater creditor protection. Note that state income tax-saving trusts and DAPTs involve complex tax issues. See the Nevada Incomplete Gift Non-Grantor (NING) Trust topic and the DAPT topic in this book.

Correcting Drafting Errors or Clarifying Ambiguities

Many trusts have drafting errors or ambiguous terms that need to be fixed. While many newer trusts give a trust protector or independent trustee the power to make necessary changes, older trusts generally do not. Instead of an expensive court reformation, the trustee should consider decanting the trust into a new trust.

Combining Trusts

Clients often set up multiple trusts for their heirs that have very similar provisions. To increase administrative efficiency and save costs, trustees should consider decanting all but one trust into a single trust or decanting all the original trusts into a new one.

Splitting Trusts

Many trusts are drafted so that the entire family benefits from a single pot trust that sprinkles income. This might be a good arrangement for some families, but more often than not it creates problems because different beneficiaries have different financial needs, investment philosophies or opinions of the trustee. Subject to limitations in the applicable state statute, it may be possible to decant a large pot trust into separate trusts for each beneficiary or for different branches of a family. A trust may also have an inclusion ratio between zero and one and the trustee may want to divide it into an exempt and a non-exempt trust for generation-skipping transfer tax purposes.

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[130] Dynasty Trusts are covered in another topic in this book.

[131] The 13.3% rate is in California. Other high top rates include Oregon 9.9%, New York 8.82%, Iowa 8.98%, Maine 7.95%, Minnesota 7.85% and Wisconsin 7.85%.

[132] Transferring the trust to a more favorable jurisdiction may also be possible if the trust is located in a state that does not have a decanting statute if the trust includes a change of situs provision.

Stretching Out IRA Distributions

IRAs are often payable to a trust and may have contingent beneficiaries who are far older than the primary beneficiaries. Assuming that all beneficiaries of the trust are individuals, the designated beneficiary of the trust is the oldest individual. Thus, it might be possible to substantially increase the time period over which required minimum distributions (RMDs) must be paid by decanting to a new trust that eliminates the older contingent beneficiaries.

Adding Trustee Powers

A trustee generally has only the powers listed in the governing instrument plus any default powers included in the applicable state statute. In older trusts, these powers are often quite limited. For example, they may not provide for a succession of trustees or include a provision allowing the trustee to waive the duty to diversify or to apply the state's prudent investor statute. Older trusts might also set trustee compensation too high or too low, based on a percentage of trust accounting income or the value of the trust principal. Finally, older trusts may provide no mechanism for removing a trustee or allowing a trustee to resign without going to court. In a jurisdiction with a decanting statute, these and other trustee powers can be added or changed.

Qualifying a Trust to Own S Corporation Stock

Only certain trusts are qualified S corporation shareholders. These include grantor trusts, IRC § 678 trusts, qualified subchapter S trusts (QSSTs), electing small business trusts (ESBTs), certain testamentary trusts and voting trusts.[133] Many trusts have been drafted without considering the possibility that the trust might hold S corporation stock at some time in the future. If the trust agreement doesn't give a trust protector or an independent trustee the power to add provisions qualifying the trust as an S corporation shareholder, the trust could be decanted to add the required provisions.

Changing a Support Trust into a Discretionary Trust

Many trusts are drafted to give the trustee the power to make distributions to beneficiaries under a health, education, maintenance and support (HEMS) standard. Under the laws of some states the assets of these support trusts can be reached by certain classes of creditors, such as divorcing spouses. A discretionary trust, on the other hand, gives the trustee absolute discretion over distributions and thus generally protects the assets from all classes of creditors. Thus, decanting a support trust into a discretionary trust can be a valuable strategy.

Modifying Powers of Appointment

When the estate tax unified credit amount was much lower and the estate tax rate was higher, trusts were generally drafted to avoid having trust assets included in the grantor's estate for estate tax purposes. Although assets not included in the estate did not receive a basis step-up at death, this disadvantage was outweighed by avoiding the estate tax, which had much higher rates. With recent increases in the unified credit (now referred to as the applicable exclusion amount), decreases in the

[133] IRC § 1361(c)(2).

estate tax rate and increases in the income tax rate, it may be more advantageous to have trust assets included in the grantor's gross estate. Decanting can be used to give a beneficiary a general power of appointment over assets, causing the assets to be included in the power-holder's estate and creating a basis step-up in the assets for heirs.

Adding Flexibility

Decanting can be used to increase the ability of a trust to meet changing circumstances by adding trust protectors, investment direction advisors, distribution advisors, or special asset advisors.

Spendthrift Clause

A spendthrift clause is a trust provision that prevents creditors from reaching a beneficiary's interest in a trust until the beneficiary receives distributions. Decanting can be used to add a spendthrift provision to a new trust to protect a beneficiary's assets from creditors or divorcing spouses. It can also be used to remove a spendthrift clause.

Creating a Grantor or Non-Grantor Trust

It may be possible to use decanting to convert a grantor trust to a non-grantor trust or a non-grantor trust to a grantor trust. The new trust might also be given a mechanism for toggling grantor status on and off.[134]

Other Reasons

Other possible reasons for decanting a trust include:

(1) Creating a special needs trust;
(2) Separating high risk assets;
(3) Qualifying a trust as a QDOT or IRA conduit trust;
(4) Reducing distribution rights to qualify for Medicaid; and
(5) Eliminating an insured as a trustee to avoid estate inclusion of a life insurance policy under IRC § 2042.

Tax Issues

Trust decanting is a developing wealth management strategy with uncertain tax consequences under current law. It raises numerous income, gift, estate and generation-skipping transfer tax issues. The IRS is studying the tax implications of decanting and considering approaches to addressing the relevant tax issues in published guidance. While these issues are under study, the IRS will not issue PLRs with respect to a decanting that results in a change in the beneficial interests of a trust (Rev. Proc. 2011-3).[135]

[134] See, for example, the Illinois decanting statute at 760 Ill. Comp. Stat 5/16.4.
[135] Note that the IRS Priority Guidance Plan for 2012-2013 did not include decanting, raising questions about when decanting guidance might be available.

In Notice 2011-101, the IRS asked for comments on the following income tax, gift and estate tax and generation skipping transfer (GST) tax issues.

Income Tax Questions

1. Whether a decanting power makes a trust a grantor trust under IRC §§ 671-679.
2. Whether the distribution from one trust to another requires gain recognition by the transferring trust under IRC § 1001.
3. Whether the distribution from one trust to another requires gain recognition for any trust beneficiary under IRC § 1001.
4. Whether the transferee trust takes all the tax attributes of the first trust.
5. Whether transferring property from one trust to another by decanting is a distribution requiring computation of DNI.

Gift and Estate Tax Questions

1. Whether a beneficiary whose interests in a trust that are reduced by the decanting has made a taxable gift.
2. Whether a beneficiary whose interests in a trust that are reduced by decanting has made an IRC § 2036 or 2038 transfer.
3. Whether a beneficiary who consents to a decanting or acquiesces in a decanting has made a taxable gift.
4. Whether a decanting power in a QTIP trust will cause the trust to lose its charitable deduction.

GST Questions

1. Whether a GST grandfathered trust that receives decanted property loses its grandfathered trust status.
2. Whether decanted property has the same GST inclusion ratio in the trust receiving the property that it had in the original trust.
3. Whether a non-exempt trust can be decanted to allow allocation of GST exemption to only a portion of the original trust.

Whether decanting assets held in the original trust that is exempt from GST tax will cause the new trust to lose exempt status is squarely addressed by Reg. § 26.2601-1(b)(4)(i)(E), Example 2. This example provides that the decanting will not taint the GST-exempt status of a grandfathered trust provided that both:

1) The decanting could not (under any circumstance) shift a beneficial interest in the trust to a beneficiary who occupies a lower generation than the persons who held the beneficial interest prior to the decanting; and
2) The decanting does not extend the time for vesting of any beneficial interest in the trust beyond the period provided in the original trust.

Thus, with careful planning, it is possible to extend the duration of the trust without subjecting the new trust to GST tax. These principles governing grandfathered trusts should apply equally to trusts exempt from the GST tax by reason of the allocation of GST exemption.[136]

Is Decanting Advisable Given the Current Tax Uncertainty?

Whether planners should go ahead with decanting may depend on the type of decanting they wish to do. Commentators have suggested that if the decanting changes only administrative provisions, there is little risk even though it is not possible to get a PLR on the tax consequences. If the decanting changes distributions or lengthens the term of the trust, however, a number of unfavorable tax consequences are possible and practitioners should proceed with caution.

[136] See Ltr. Ruls. 200822008, 200743028, and 200714016.

7th Annual Trust Decanting State Rankings Chart – Page 1 of 2

Rank	State	Has Decanting Statute? (50% weight)	Can Decant Trust with Ascert. Standard? (7.5% weight)	Notice to Beneficiaries Required? (7.5% weight)	Can Decant Trust with Ascertainable Standard into Discretionary Trust? (7.5% weight)	Can Remove Mandatory Income Interest? (5% weight)	Allow Power of Appointment in Second Trust to Non-Bene? (2.5% weight)	Can Accelerate Remainder Bene's Interest? (5% weight)	Dynasty Trust State Ranking (7.5% weight)	Domestic Asset Protection Trust State Ranking (2.5% weight)	Total Score
1	SD	§55-2-15	Yes	No	Yes	Yes	Yes	Yes	Ranked #1	Ranked #2	99.5
2	NV	§163.556	Yes	No	Yes	Yes	Yes	Yes	Ranked #2	Ranked #1	99
3	DE	12, §3528	Yes	No	No	Yes	Yes	Yes	Ranked #8 (tie)	Ranked #7	88.5
4	TN	§35-15-816(b)(27)	Yes	No	Yes	No	Yes	Silent	Ranked #3	Ranked #5 (tie)	87.5
5	NH	§564-B:4-418	Yes	No, except charitable trusts	Yes	No	Yes	Silent	Ranked #8 (tie)	Ranked #5 (tie)	84.5
6	OH	§5808.18	Yes	Yes	No	Yes	Yes	No	Ranked #7	Ranked #3	77.5
7	MO	§456.4-419	Yes	Yes, only to beneficiaries of second trust	No	Yes	Silent	Yes	Ranked #10 (tie)	Ranked #4	77
8 (tie)	AK	§13.36.157-159; §13.36.215	Yes	Yes	No	No	Yes	No	Ranked #4	Ranked #8	72.5
8 (tie)	IL	760 ILCS 5/16.4	Yes	Yes	No	No	Yes	Silent	Ranked #10 (tie)	Not allowed	72.5
10 (tie)	IN	§30-4-3-36	Yes	Yes	Yes	No	Silent	Silent	Unranked	Not yet ranked	70
10 (tie)	SC	§62-7-816A	Yes	Yes	No	Yes	Yes	No	Unranked	Not allowed	70
10 (tie)	TX	§§112.071 to 112.087	Yes	Yes	No	No	Yes	Yes	Unranked	Not allowed	70
13	WY	§4-10-816(a)(xxviii)	Yes	No	Yes	Silent	Silent	Silent	Ranked #5	Ranked #10	69
14	RI	§18-4-31	Yes	Yes	Silent	No	Silent	No	Ranked #6	Ranked #9	66.5
15	FL	§736.04117	Yes	Yes	No	No	Silent	Silent	Ranked #12	Not allowed	66

WARNING: THIS 7TH ANNUAL TRUST DECANTING STATE RANKINGS CHART IS MERELY A GUIDE. THE USER MUST BE SURE TO ACCESS THE ACTUAL DECANTING STATUTE AND READ THE TRUST PROVISIONS RATHER THAN SIMPLY RELYING ON THIS CHART. FOR EXAMPLE, IN THE MAJORITY OF DECANTING STATES, A TRUST WITH AN ASCERTAINABLE STANDARD MAY ONLY BE DECANTED INTO A TRUST THAT HAS A SIMILAR ASCERTAINABLE STANDARD FOR THE SAME BENEFICIARIES AS THE BENEFICIARIES OF THE CURRENT TRUST. THAT IS ONE EXAMPLE OF A LIMITATION THAT WOULD NOT BE REFLECTED IN THIS STATE RANKINGS CHART.

*The Dynasty Trust State Ranking column is based on the 8th Annual Dynasty Trust State Rankings Chart and the Domestic Asset Protection State Rankings Chart is based on the 10th Annual Domestic Asset Protection State Rankings Chart, both at http://www.oshins.com/state-rankings-charts.
*This Trust Decanting State Rankings Chart created in January 2020. Original Trust Decanting State Rankings Chart created in January 2014.

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#32: S-Election to Save Employment Taxes

The S-election is generally thought of as a tool merely to achieve pass-through taxation of C corporation income to avoid the double tax. However, other domestic entities are eligible for Subchapter S treatment too. Electing Subchapter S treatment may also be a beneficial strategy for many pass-through entities because a portion of income will not incur employment taxes.

Business organizations, other than corporations, that are eligible to make the election include: sole proprietorships, partnerships, limited partnerships (LPs), limited liability companies (LLCs), limited liability partnerships (LLPs), and limited liability limited partnerships (LLLPs). It is very important to note, however, that such entities do not have to reorganize under state law to a corporation in order to be eligible for the election. In-fact reorganizing many businesses may have negative consequences, such as increased state taxes and changes in liability protection.

While the details are quite complicated, the general prerequisites to make the S-election are simple and easily met for many businesses:

(1) Be a domestic entity;
(2) Have only allowable shareholders which include individuals, who are not nonresident aliens, and certain trusts and estates;
(3) Have no more than 100 shareholders;
(4) Have only one class of stock; and
(5) Not be ineligible; e.g., certain financial institutions and insurance companies.

In order to receive Subchapter S treatment, Form 2553 must be filed. The Form outlines a number of requirements and limitations, none of which are prohibitory for many businesses. Nevertheless, it should be noted that the election must be filed within two months and 15 days of the start of the tax year the entity wishes Subchapter S treatment to begin and all the shareholders must consent to the election.

However, before consulting a qualified professional to assist you or your client to make the S-election, the benefit of doing so must be analyzed. For pass-through entities, the S-election may be beneficial because a portion of income will not be subject to employment taxes. These taxes include Social Security Tax, Medicare Hospital Insurance Tax, and the Additional Medicare Tax.

Social Security Tax

Social Security Tax is assessed against all wages, salary, tips and Schedule C income at a rate of 12.4%. It is only assessed on income up to the contribution base ($137,700 in 2020). Employees and employers each pay half of the tax. Self-employed taxpayers pay 12.4% of 92.35% of their wages, salary, tips and Schedule C income.

Example 1: Mary is self-employed and expects to make $140,000 in 2020.

Income	$ 140,000
2020 contribution base	$ 137,700
Lesser of income or contribution base	$ 137,700
92.35% of taxed income	$ 127,166
Social Security Tax owed	$ 15,769

The Medicare Hospital Insurance Tax

The Medicare Hospital Insurance Tax is assessed against all wages, salary, tips and Schedule C income at a rate of 2.9%. Employees and employers each pay half of the 2.9% tax while the self-employed pay 2.9% of 92.35% of their income.

Example 2: Mary is employed and her salary $140,000 in 2020.

Income	$ 140,000
Employer’s share	$ (2,030)
Employee’s share	$ (2,030)
Total 2.9% Medicare Tax owed	$ (4,060)

The Additional Medicare Tax

The Additional Medicare Tax is assessed at a rate of 0.9% against all wages, salary, tips and Schedule C income that exceeds a threshold amount. Unlike the Social Security tax and 2.9% Medicare tax, employees are responsible for the entire 0.9% tax. Income of the self-employed which exceeds a threshold amount is also subject to the 0.9% tax. The following table shows the threshold amounts, which are not indexed for inflation, by filing status:

Filing Status	**Threshold**
Married Filing Jointly	$ 250,000
Married Filing Separately	$ 125,000
All Others	$ 200,000

Example 3: Mary is single and employed. Her salary is $240,000 in 2020.

Income	$ 240,000
Applicable Threshold	$ (200,000)
Income Subject to the 0.9% Tax	$ 40,000
Employer’s Share	$ 0
Employee’s Share	$ 360
Total 0.9% Medicare Tax Owed	$ 360

The S-Election

The S-election allows a business owner to save on these employment taxes because earnings can be segregated between wages and distributions. Wages are subject to employment taxes, whereas distributions are not. Thus, it is advantageous to treat amounts received from an S corporation as distributions rather than as wages to the maximum extent possible.

How earnings are allocated to each category is contentious and unclear. "There are no specific guidelines for reasonable compensation in the Code or the Regulations. The various courts that have ruled on this issue have based their determinations on the facts and circumstances of each case."[137] However, it is clear the wages paid to the business owner-employee must be reasonable; i.e., not too low. If the wage compensation is determined to be unreasonably low the Service has the authority to subject a portion of the distributions to employment taxes;[138] i.e., the Service will treat part or all of the distributions as wages. Reasonable compensation varies by what the business owner-employee does for the business.[139] The source of revenue is a key consideration and the Service has created three categories:

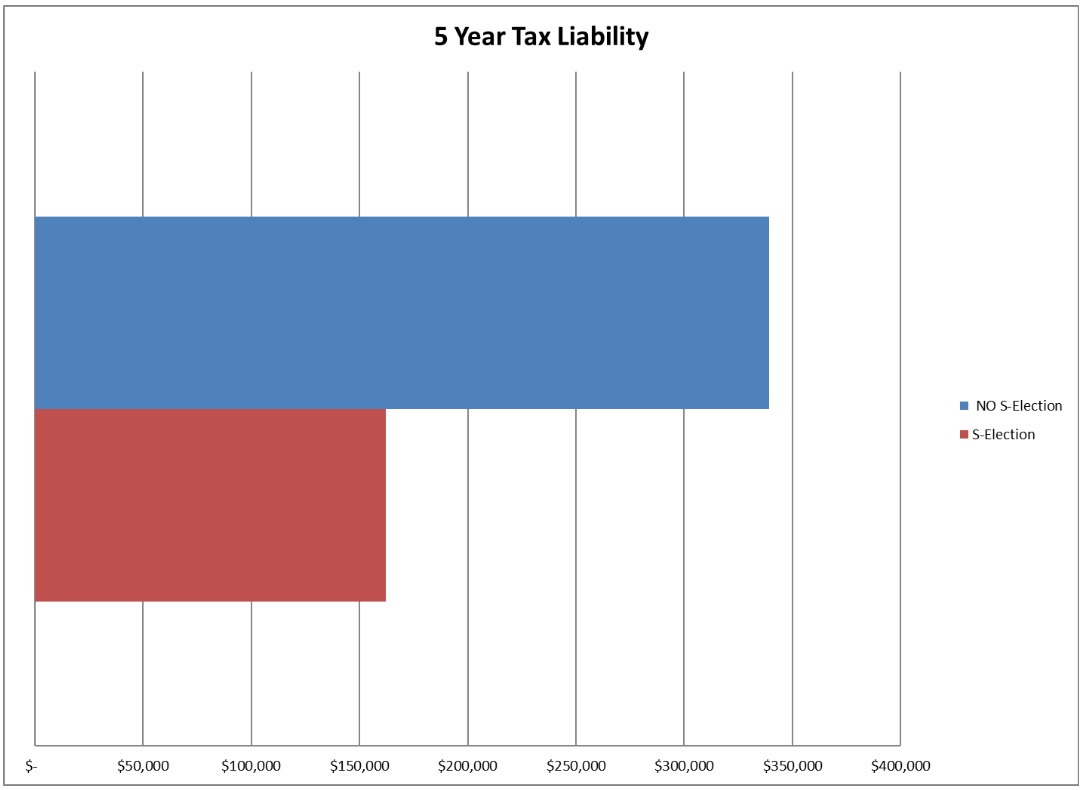
(1) Services of the shareholder;
(2) Services of non-shareholder employees; and
(3) Capital & equipment.[140]

Revenue derived from (2) and (3) should not be allocated as compensation whereas revenue derived from (1) should be.[141] A qualified professional should help you determine how to allocate earnings between each category.

> ***Example 4***: Mike, married filing jointly, is the 100% owner and active manager of a factory. He has $5,000,000 of equipment and 35 manufacturing employees. The business is organized as an LLC and he reports $1,500,000 in net profit annually on which he pays Social Security and Medicare taxes. His profits increase by 3% each year and his discount rate is 5%.
>
> Assume a qualified professional determined a fair wage for Mike, if he was merely an employee rather than the business owner, is $500,000.

[137] Wage Compensation for S Corporation Officers, FS-2008-25, August 2008, available at http://www.irs.gov/uac/Wage-Compensation-for-S-Corporation-Officers.
[138] Rev. Rul. 74-44; Rev. Rul. 73-361; *RADTKE*, 895 F2d 1196; *C.D. ULRICH, LTD. v. U.S.*, 692 F. Supp. 1053; *YEAGLE DRYWALL*, 54 Fed. Appx. 100.
[139] http://www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/S-Corporation-Compensation-and-Medical-Insurance-Issues
[140] *Id.*
[141] *Id.*

5-Year Summary	NO S-Election	S-Election	Difference
2019 Tax Liability	$ 70,419	$ 33,680	$ 36,739
2020 Tax Liability	72,553	34,708	37,844
2021 Tax Liability	74,749	35,767	38,982
2022 Tax Liability	77,010	36,855	40,155
2023 Tax Liability	79,336	37,974	41,363
Total Taxes Over 5-Year Period	$ 374,067	$ 178,984	$ 195,083
Present Value Adjustment	$ 339,110	$ 162,255	$ 176,856



Adjusted for present value, Mike will save $176,856 over the next five years if he chooses to make the election.[142]

As shown above, the savings of making the S-election can be significant. However, this strategy can only be applied to a limited number of taxpayers and it is especially prudent to involve an experienced professional when making the S-election. A cursory examination of eligibility and computing the potential savings are the essential first steps in employing the strategy. If made deliberately and with care, the S-election is powerful.

[142] The tax liability calculations in this example were calculated using the "Employment Tax Analyzer" created by Keebler & Associates, LLP. The COLA is assumed to be 2.8%.

#33: Portability

An interesting provision within the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 ("2010 Tax Relief Act") allows an executor of an estate of a married decedent the option to transfer any unused estate tax exemption amount to the surviving spouse.[143] Thus, for example, if a decedent used only a portion of his or her estate tax exemption, the estate could elect to have the remaining portion pass to the surviving spouse, giving the surviving spouse a larger estate tax exemption.[144] Although this portability provision seems simple on the surface, it introduces important planning considerations and traps for the unwary.

When Congress created portability it gave us several new terms. The *Basic Exclusion Amount* (BEA) is the maximum estate tax exclusion amount allowed for a single decedent. The BEA is set by statute and indexed for inflation. For 2019 and 2020, the amount is $11,400,000 and $11,580,000 respectively. However, the BEA is reduced by prior taxable gifts.

The *Deceased Spousal Unused Exclusion Amount* (DSUE) is the estate tax exclusion amount a deceased spouse may transfer to the surviving spouse. It equals the deceased's unused BEA. DSUE cannot exceed the lesser of: (1) the statutory BEA, or (2) the BEA of the last deceased spouse minus the amount on which the tentative tax on the estate of the last deceased spouse is determined. DSUE is calculated when the first spouse dies and is not indexed for inflation.[145]

Most importantly, note that the <u>election to transfer the unused exemption amount must be made on a timely filed estate tax return (Form 706)</u>.[146] This means that many individuals will need to file an otherwise unnecessary return merely to make the election. Many practitioners are missing this key step, thereby creating significant issues for their clients. However, fortunately, several taxpayers have obtained relief from the IRS under § 301.9100-3 of the regulations by obtaining a Private Letter Ruling.

Furthermore, by making the election, the statute of limitations remains open for the decedent spouse's estate tax return until the statute of limitations has run on the surviving spouse's estate tax return.[147] Thus, the IRS can audit the deceased spouse's estate tax return (even after the normal statute of limitations has run) and add any increase in tax to the surviving spouse's estate tax return.

The transfer of DSUE is limited by a number of rules. First, only the DSUE from the last deceased spouse may transfer to the surviving spouse; a surviving spouse cannot aggregate DSUEs or choose the largest DSUE from previously deceased spouses. Secondly, transfer of DSUE requires marriage or privity.

> ***Example 1.*** *Last deceased spouse.* H1 and W1 are married at the time H1's death in 2011. Although H1's taxable estate is $5,000,000, the executor of H1's estate

[143] The American Taxpayer Relief Act of 2012 made the portability of estate tax exemption permanent.
[144] It should be noted that portability does NOT allow the decedent's unused portion of the GST tax exemption to transfer to the surviving spouse.
[145] Section 303 of the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010; IRS Form 706; Reg. § 20.2010-2T(b)(1).
[146] No election can be made on a late-filed return.
[147] However, the "adequate disclosure" rules (applying to post-1997 gifts) do NOT apply.

transfers the entire estate to W1 (via the unlimited marital deduction) and elects to transfer H1's entire estate tax exclusion amount ($5,000,000) to W1 (i.e., DSUE). W1 then marries H2. In 2020, H2 dies with a taxable estate of $10,000,000, whereby the executor of H2's estate chooses to utilize $9,000,000 of H2's $11,580,000 estate tax exclusion amount. Based on these facts, the DSUE available to W1 is $2,580,000 (i.e., H2's remaining estate tax exclusion amount).

Example 2. *Privity*. H1 and W1 are married at the time of H1's death in 2011. The executor of H1's estate transfers the entire estate to W1 (via the unlimited marital deduction) and elects to transfer H1's entire estate tax exclusion amount ($5,000,000) to W1 (i.e., DSUE). W1 then marries H2. In 2020, W1 dies with a taxable estate of $10,000,000, whereby the executor of W1's estate chooses to utilize $10,000,000 of W1's $11,580,000 estate tax exclusion amount. Based on these facts, the DSUE available to H2 is $1,580,000 (i.e., W1's remaining estate tax exclusion amount).

- While W1 had a $16,580,000 total estate tax exclusion amount ($5,000,000 DSUE from H1 + $11,580,000 BEA), only $10,000,000 was used.
- Of the $10,000,000 estate tax exclusion that was used, the entire amount was attributable to W1's BEA.
- Therefore, only $1,580,000 of W1's total estate tax exclusion amount (i.e., $11,580,000 BEA - $10,000,000 BEA used) may be utilized by H2.
- It is important to note that W1's $5,000,000 DSUE estate tax exclusion amount from H1 is completely lost and cannot be used by H2.

The mechanics of how the exclusion transfers between individuals is not terribly complicated. However, analyzing whether to make the portability election can be. There are a number of factors which affect this decision:

- Size of combined estate;
- Anticipated growth of the surviving spouse's estate;
- Changes in the future estate tax law;
- Asset protection issues; and
- Additional basis step-up of property in surviving spouse's taxable estate.

Example 3. John and Jane have a combined estate of $12,000,000. Assume that John dies in 2020 and Jane dies later that year.

The couple had two options at John's death. The first was to transfer property to Jane using the Marital Deduction and file portability. The second option would be to use a portion of John's exemption at his death.

	OPTION 1 - 100% Marital Deduction			OPTION 2 - Utilize Full Exemption at First Death		
	John	Jane	TOTAL	John	Jane	TOTAL
FMV of Gross Estate	$ 7,000,000	$ 5,000,000	$12,000,000	$ 7,000,000	$ 5,000,000	$12,000,000
Marital Deduction	(7,000,000)	7,000,000	-	-	-	-
Subtotal	$ -	$12,000,000	$12,000,000	$ 7,000,000	$ 5,000,000	$12,000,000
Appreciation in Gross Estate at Second Death	-	2,400,000	2,400,000	-	1,000,000	1,000,000
Subtotal	$ -	$14,400,000	$14,400,000	$ 7,000,000	$ 6,000,000	$13,000,000
Less: Estate Tax Exemption	-	(22,360,000)	(22,360,000)	(11,180,000)	(11,180,000)	(22,360,000)
Net Taxable Estate	$ -	$ -	$ -	$ -	$ -	$ -
FMV of Property at Second Death	$ -	$14,400,000	$14,400,000	$ 8,400,000	$ 6,000,000	$14,400,000
Less: Cost Basis	-	(14,400,000)	(14,400,000)	(7,000,000)	(6,000,000)	(13,000,000)
Net Capital Gain	$ -	$ -	$ -	$ 1,400,000	$ -	$ 1,400,000
Estate Tax @ 40%	$ -	$ -	$ -	$ -	$ -	$ -
Capital Gains Tax @ 15%	-	-	-	210,000	-	210,000
Total Taxes	**$ -**	**$ -**	**$ -**	**$ 210,000**	**$ -**	**$ 210,000**

The couple incurs some capital gains tax by utilizing the exemption at John’s death and since their combined estate is below the combined exclusion amount, taking John’s exemption at his death increases their tax liability. However, if Jane significantly outlives John, choosing to utilize the full exemption at John’s death may be prudent.

***Example* 4.** Mike and Mary have a combined estate of $24,000,000. Assume that Mike dies in 2019 and that at Mary’s death at the end of 2019 the value of the total estate is $28,800,000 (20% growth rate).

	OPTION 1 - 100% Marital Deduction			OPTION 2 - Utilize Full Exemption at First Death		
	Mike	Mary	TOTAL	Mike	Mary	TOTAL
FMV of Gross Estate	$12,000,000	$12,000,000	$24,000,000	$12,000,000	$12,000,000	$24,000,000
Marital Deduction	(12,000,000)	12,000,000	-	-	-	-
Subtotal	$ -	$24,000,000	$24,000,000	$12,000,000	$12,000,000	$24,000,000
Appreciation in Gross Estate at Second Death	-	4,800,000	4,800,000	-	2,400,000	2,400,000
Subtotal	$ -	$28,800,000	$28,800,000	$12,000,000	$14,400,000	$26,400,000
Less: Estate Tax Exemption	-	(22,360,000)	(22,360,000)	(11,180,000)	(11,180,000)	(22,360,000)
Net Taxable Estate	$ -	$ 6,440,000	$ 6,440,000	$ 820,000	$ 3,220,000	$ 4,040,000
FMV of Property at Second Death	$ -	$28,800,000	$28,800,000	$14,400,000	$14,400,000	$28,800,000
Less: Cost Basis	-	(28,800,000)	(28,800,000)	(12,000,000)	(14,400,000)	(26,400,000)
Net Capital Gain	$ -	$ -	$ -	$ 2,400,000	$ -	$ 2,400,000
Estate Tax @ 40%	$ -	$ 2,576,000	$ 2,576,000	$ 328,000	$ 1,288,000	$ 1,616,000
Capital Gains Tax @ 15%	-	-	-	360,000	-	360,000
Total Taxes	**$ -**	**$ 2,576,000**	**$ 2,576,000**	**$ 688,000**	**$ 1,288,000**	**$ 1,976,000**

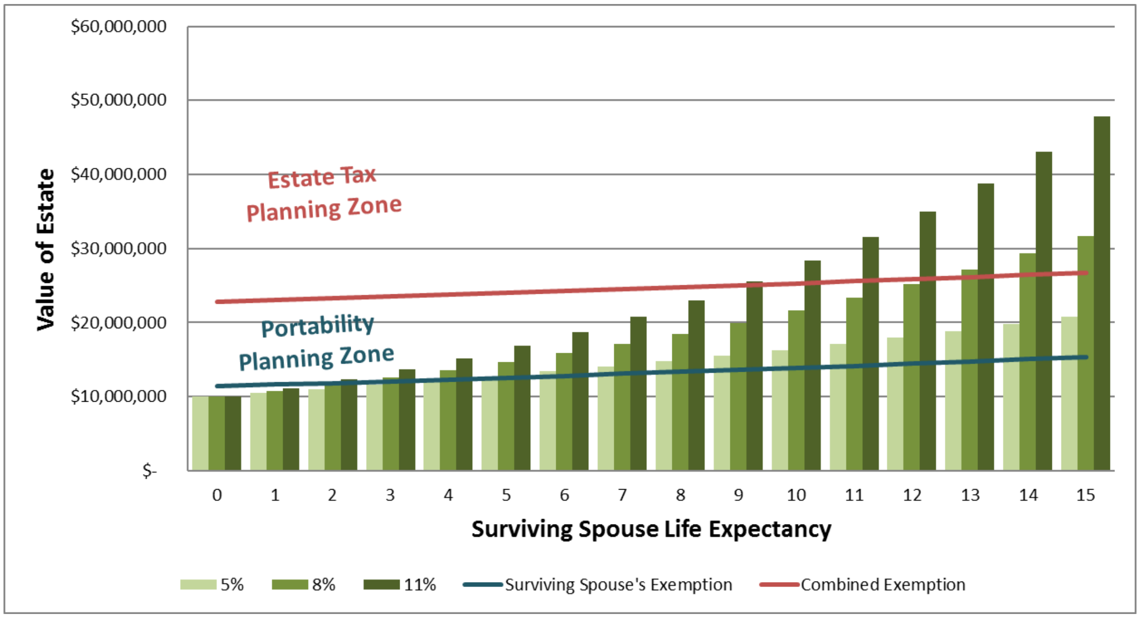
The couple incurs some capital gains tax by utilizing the exemption at Mike’s death, however since their combined estate is above the combined exclusion amount because of its growth after Mike’s death, taking Mike’s exemption at his death decreases their tax liability.

Note that the couple does save some tax by utilizing the full exemption amount at the first death; however, the potential savings increase the longer the surviving spouse lives. In this case, given the huge assumed growth rate, the resulting tax savings could become dramatic over-time.

In addition to the effect explained in Examples 3 and 4, moderate wealth taxpayers should have other considerations which might include:

- ❖ State estate tax in decoupled states will remain a substantial cost;
- ❖ Inflation may push their estates above the thresholds; and
- ❖ The future may bring a lower exclusion amount; "Wait and see" may turn into "Wait and pay"
- ❖ Asset protection and related concerns.

Example 5. Assume that an estate planning practitioner encounters a couple with a gross estate of $10M. The couple is resistant to filing Form 706 because of the associated costs. Depending on their circumstances that resistance to incur the associated costs might be prudent or very short sighted as the following chart demonstrates:



The above chart projects the resulting size of the estate in relation to the two possible exemption amounts and considering three possible growth rates. Clearly, the higher the growth rate and the longer the surviving spouse lives, the more planning that is necessary. Once an estate's value exceeds the surviving spouse's BEA (the blue line), it is prudent to file a Form 706 for portability. Once an estate value exceeds the combined value of the DSUE and BEA (the red line), it is prudent to consider a bypass trust.

Understanding portability and using it strategically can have a significant impact on taxpayers. The initial steps to understanding the new scheme and remembering to file for the election are overwhelmingly simple and important. The advanced strategy, that is analyzing whether to utilize the exemption at the first death or to wait until the second death, is considerably more complicated, has a narrow application, and involves more unknowns; however, it is very powerful.

#34: Trusts Named as IRA Beneficiaries

Wealth grows in a tax-deferred environment inside an IRA. When it is distributed from the IRA, the taxpayer generally either spends the funds or reinvests it in a taxable account. This means that for taxpayers who don't need their IRA funds for support, the more slowly the funds can be withdrawn from the IRA, the faster they can accumulate wealth. The reason is simply that wealth grows faster in a tax-deferred account than in a taxable account. In the tax deferred account it grows at its pre-tax rate of return and in a taxable account it grows at its after-tax rate of return.

However, not much planning is available for distributions to <u>owners</u> of traditional IRAs. Once they reach age 72 they must begin receiving payments and the payment percentages are locked in. The IRA owner does have control over who the beneficiaries are, however, and this creates an important planning opportunity. The younger the designated beneficiary of the IRA is, the smaller the annual payments can be and the more wealth that is left to grow in the tax-deferred environment (again assuming that the beneficiary does not need the funds); thus, the longer the life expectancy of the designated beneficiary, the better. Careful planning to minimize required minimum distributions (RMDs) is particularly important when a trust is named as the IRA beneficiary.

Almost any person or entity can be the beneficiary of an IRA, but if the beneficiary is a non-person with a life expectancy of zero, like an estate or trust, the IRA will be treated as having no "designated" beneficiary. If so, the full value of the IRA must be paid out (1) over the IRA owner's hypothetical life expectancy if he or she had reached her required beginning date before he or she died, or (2) by the end of the fifth year after the IRA owner's death if the IRA owner had not reached his or her required beginning date (age 72 or the date of retirement of later).

Trusts as IRA Beneficiary

IRA owners generally name individuals as beneficiaries of their IRAs because trusts increase complexity and raise potential problems; these include:

(1) The difficulty of qualifying a trust as a designated beneficiary;
(2) Legal and trustee fees;
(3) The necessity of filing trust income tax returns;
(4) The possibility that income tax will be higher on distributions to a trust than distributions to an individual because of the compressed tax brackets for trusts;
(5) The administrative difficulty of determining how to allocate distributions between income and principal; and
(6) Determining whether the trust or its beneficiaries are subject to tax.

Naming an individual as beneficiary may lead to more serious problems, however. Such problems may include:

(1) The IRA owner has no control over how the assets will be managed or distributed after his or her death;
(2) The IRA owner cannot protect the assets from creditors after his or her death;
(3) The IRA owner has no control over who receives the IRA payments after the death of the primary beneficiary; and

(4) The IRA owner has no control over how fast payments are made.

Naming a trust as beneficiary can solve all of these problems. Thus, IRA owners concerned about any of the issues listed above should give serious consideration to this option. Careful planning is necessary, however, to create the best possible result for the family and to avoid traps for the unwary.

There is a special rule under Reg. § 1.401(a)(9)-4, Q&A 5 that permits an IRA owner to name a trust as beneficiary of his or her IRA (and not the trust itself) treated as the designated beneficiary for RMD purposes if four requirements are satisfied:

(1) The trust is valid under state law, or would be but for the fact that there is no corpus;
(2) The trust is irrevocable or will by its terms become irrevocable upon the death of the IRA owner;
(3) The beneficiaries of the trust can be identified from the trust instrument; and
(4) Proper documentation has been provided to the plan administrator.

If the trust does not meet all four requirements, the IRA will be treated as having no designated beneficiary.

Naming a Qualified Terminable Interest Property (QTIP) Trust as IRA Beneficiary

An IRA owner who wants his or her spouse to benefit from his or her IRA but is concerned that he or she will not be able to manage the assets or will pass remaining assets to children of his or her first marriage when he or she dies should think about naming a QTIP trust as his or her IRA beneficiary. By transferring the IRA to a QTIP trust, the owner can provide the spouse with an income interest for life but no power to designate remainder beneficiaries upon his or her death. If properly structured, a QTIP trust enables the IRA owner to defer estate taxes until the death of the surviving spouse without giving up control over where any remaining assets go at his or her death.

A QTIP trust must meet the same four requirements as any other trust to qualify the spouse as a designated beneficiary. In addition, the planner must make sure that the trust qualifies for the marital deduction.

A QTIP trust qualifies for a marital deduction under IRC § 2056(b)(7) if all of the following requirements are satisfied:

(1) The surviving spouse is entitled to all income from the property, payable at least annually (IRC § 2056(b)(7)(B)(ii)(I);
(2) No person has a power to appoint any part of the property to any person other than the surviving spouse (IRC § 2056(b)(7)(B)(ii)(II));
(3) An election is made on the decedent's estate tax return to treat the trust property as QTIP (IRC § 2056(b)(7)(B)(v));
(4) The value of the trust is included in the surviving spouse's estate when he or she dies (IRC § 2044); and

(5) The trust must either hold productive assets or give the surviving spouse the power to require the trustee to make the assets productive (Reg. § 20.2056(b)(f)(4) and PLR 9717005).

Requirements 2-5 are relatively straightforward. Having an IRA as a trust asset adds considerable complexity to requirement (1), however. The IRS has provided the following guidance to help planners understand the requirement:

- Reg. § 20.2056(b)-5(f)(1) provides that requirement (1) is satisfied if the surviving spouse is entitled for life to income as determined by applicable local law that provides for a reasonable apportionment between the income and remainder beneficiaries of the total return of the trust and that meets the requirements of IRC § 1.643(b)-1.

- Reg. § 20.2056(b)-5(f)(8) provides that the surviving spouse is entitled to all income for life, payable at least annually, if the spouse has the right to require that the trust distribute all income to him or her at least annually, even if no distributions are actually made.

- Reg. § 1.643(b)-1 provides that the term "income" means the amount of income of the estate or trust for the taxable year determined under the terms of the governing instrument and applicable local law. Allocations made between income and principal under applicable state law will be respected if the state law provides a reasonable apportionment between the income and remainder beneficiaries of the total return of the trust for the year.

Revenue Ruling 2000-2 provides that if an IRA is payable to a trust, both the IRA and the trust must meet the marital deduction requirements. This will be the case if the surviving spouse has the power, exercisable annually, to compel the trustee of the QTIP trust to withdraw the income earned on the IRA assets and to distribute that income (along with the income earned on the trust assets other than the IRA) to the surviving spouse. In other words, the surviving spouse must be entitled to both the income of the trust and the income of the IRA.

If the surviving spouse exercises this power, the trustee must withdraw from the IRA the greater of: (a) the amount of income earned on the IRA assets during the year, or (b) the RMD and distribute at least the income to the surviving spouse (Rev. Rul. 2000-2). If the surviving spouse does not exercise the power, the trustee is required to withdraw from the IRA only the RMD (Rev. Rul. 2000-2). Any IRA income in excess of the RMD can stay in the IRA to grow in a tax-deferred environment. Note that the RMD only needs to be distributed from the IRA to the QTIP and not from the QTIP to the surviving spouse (Reg. 1.401(a)(9)-8, Q&A 11). In light of this requirement, advisors should review the governing instrument of a QTIP to make sure the surviving spouse is entitled not only to all income of the QTIP trust, but also to all the income of the IRA.

Naming a Credit Shelter Trust as IRA Beneficiary

A common estate planning strategy is to combine a marital trust with a credit shelter trust to make full use of both spouses' applicable exclusion amounts. The credit shelter trust ordinarily gives the trustee discretion to pay income to the surviving spouse pursuant to an ascertainable standard and possibly also principal, with the remainder interest passing tax-free to the children.

IRAs often comprise the great bulk of an estate so the only way to fund the credit shelter trust is to use IRA assets. This may create a difficult planning problem, however. If the credit shelter trust is not fully funded, the estate tax could be increased in the estate of the second spouse to die (although this concern has lightened somewhat given the newly available portability election). Also, by making the credit shelter trust the beneficiary of the IRA, it generally shortens the stretch-out period for distributions and decreases the amount of wealth that can be accumulated for the family. The reason is that it prevents the family from using the spousal rollover option.

In certain circumstances it may be advantageous for an IRA owner to convert to a Roth IRA immediately prior to death in an attempt to reduce the value of his or her taxable estate. In turn, the Roth IRA could be used to fund the deceased IRA owner's credit shelter trust. If both of these strategies are employed, this will result in lower overall taxes (estate and income) not only for the decedent IRA owner, but also for his or her beneficiaries. One of the downsides of naming a credit shelter trust as an IRA beneficiary is that IRA distributions may be taxed at a higher marginal income tax rate than they would be if they were paid to the surviving spouse because of the compressed income tax rates of the trust. Trust income could be shifted to the surviving spouse by distributing to him all the income and giving the trust a DNI deduction. The effect would be to have the income taxed at the spouse's marginal tax rate which might be lower than the trust's tax rate. However, large distributions to the surviving spouse would bring amounts back into his or her estate and defeat the purpose of the credit shelter trust. Moreover, regardless of who paid the income tax, the full amount of the applicable exclusion amount would not be used because some would be lost to income tax when distributions were made. This problem could be solved by converting the traditional IRA to a Roth IRA. No tax would be paid on the distributions to the surviving spouse so the exemption amount could be used to its full advantage.

Spousal Rollover Option

The Internal Revenue Code provides a very favorable option when the surviving spouse is the sole beneficiary of an IRA. The spouse can roll the IRA over into his or her own IRA and name new beneficiaries (e.g., his or her children), greatly increasing the deferral period (IRC § 402(c)(9)). As an added benefit, if the IRA owner dies before the surviving spouse reaches his or her required beginning date, he or she can delay the start of distributions until he or she reaches age 72 (Reg. § 1.401(a)(9)-3(a)(3)(B)).

The IRS has taken the position, however, that the option is only available if the surviving spouse has total control over the disposition of the plan assets (PLR 200944059). Thus, the spouse must ordinarily be the outright beneficiary of the IRA pursuant to a specific beneficiary designation (Reg. § 1.408-8, Q&A 5(a)). If anyone other than the surviving spouse controls the IRA proceeds (e.g., a trustee other than the surviving spouse), a rollover is generally not available (PLR 9851050). Giving the surviving spouse a power to withdraw the trust assets would make it possible to do a spousal rollover (PLRs 200950053 and 200928045), as would making the spouse the trustee of the credit shelter trust with the power to control distributions (*See, for example*, PLRs 200943046 and 200831025).[148] If the spousal rollover is not available, the life expectancy of the surviving spouse

[148] Giving the spouse control over the trust assets would cause the assets to be included in his or her estate under IRC § 2042, eliminating the benefit of the credit shelter trust.

would have to be used instead of the life expectancy of the oldest child and distributions to the surviving spouse would begin when the IRA owner died.

Disclaimer Planning by the Surviving Spouse

The decision as to whether the surviving spouse should be the IRA beneficiary or whether he or she should disclaim can be delayed until nine months after the IRA owner dies. If the surviving spouse is named the primary beneficiary and the credit shelter trust the contingent beneficiary, the spouse could either continue to be the primary beneficiary or disclaim, letting the IRA pass to the trust.

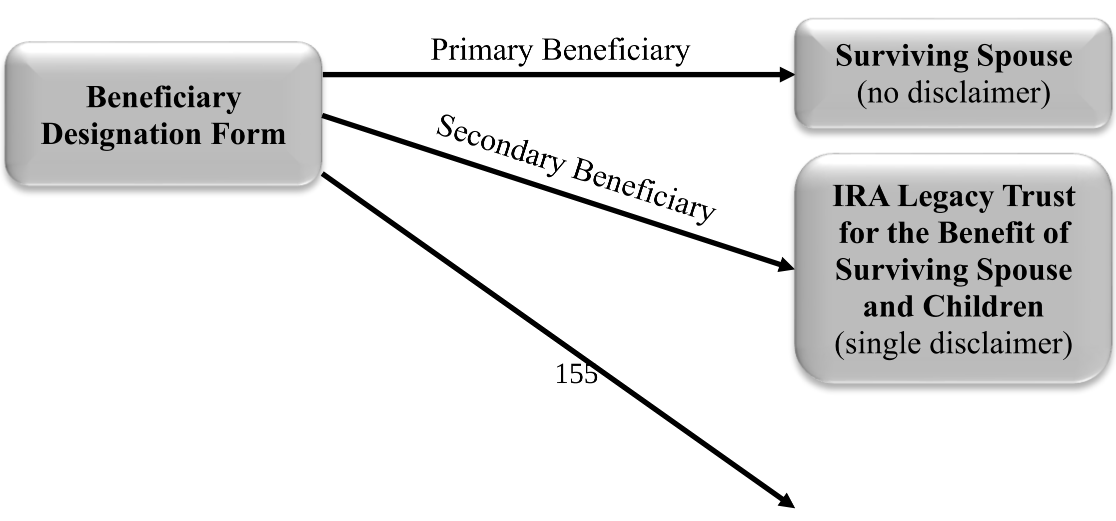
Further, the "Double Disclaimer Strategy," is designed to allow the surviving spouse to choose among the following possibilities:

- Retirement plan assets will pass to the surviving spouse as a direct beneficiary, and he or she will be allowed to roll those assets into a new IRA and name the beneficiaries of his or her choice for that new IRA.

- In the event of a disclaimer, retirement account assets will pass to a stand-alone credit shelter trust that includes the surviving spouse as a beneficiary who will receive the financial protection provided by those assets while allowing the assets to be protected from future tax by full use of the deceased spouse's unified credit.

- In the event of a second disclaimer, retirement account assets will pass to a stand-alone credit shelter trust for the benefit of children, allowing the children to take required distributions based upon the oldest child's life expectancy.

This can also be illustrated as follows:



IRA Legacy Trust for the Benefit of Children
(double disclaimer)

To make this strategy work, both the beneficiary designation and the trust that may become the beneficiary must be carefully drafted to comply with the complex tax rules that qualify the trust as a potential beneficiary and allow the disclaimer to have its intended effect. First, the Beneficiary Designation Form must provide that although the surviving spouse is the primary beneficiary, in the event that he or she disclaims his or her interest, it will be paid to the credit shelter trust for the benefit of spouse and children.

The credit shelter trust for the benefit of spouse and children must be set up to qualify as a designated beneficiary and provide that beneficial distributions of income or principal or both may be made to the surviving spouse. In addition, the beneficiary designation form must provide that in the event that the surviving spouse disclaims his or her beneficiary interest in the credit shelter trust, the retirement asset proceeds will be paid in separate shares to the children, or in the alternative to qualifying trusts for their benefit.

Each scenario has its own potential benefits, which can be chosen, depending upon the laws and priorities in existence at the first spouse's death. These include the following:

<u>Scenario One: The surviving spouse does not disclaim</u>

If the surviving spouse does not disclaim the retirement account, he or she will be the beneficiary. He or she will then have complete discretion to make withdrawals based upon his or her needs and income tax circumstances. The surviving spouse would also be able to roll over the account into an account set up and maintained in his or her name as opposed to keeping it titled as an inherited IRA. The retirement account will have minimum distributions calculated each year based upon the surviving spouse's life expectancy in that year. This strategy will therefore produce lower required minimum distributions and, thus, a larger benefit from tax deferred growth within the retirement account than in the second scenario.

In addition, the surviving spouse will be able to name new beneficiaries for the retirement account who will inherit their shares upon the surviving spouse's death. If the surviving spouse performs a spousal rollover and carefully sets up his or her beneficiary designations, the new beneficiaries, who will most likely be children, will be allowed to take distributions from their shares of the retirement account over their own individual life expectancies.

<u>Scenario Two: The surviving spouse disclaims all or a portion of the account</u>

If the surviving spouse enters a single disclaimer, he or she will no longer be the sole beneficiary of the retirement account and will not be able to roll the account over to treat it as his or her own.

However, the retirement account will now be paid to the credit shelter trust that will be able to use the deceased spouse's available unified credit. If the retirement account is paid to this trust, it will not be subject to death or transfer tax upon the surviving spouse's death, no matter what changes Congress makes to the tax rates or the exemptions and credits.

The payments from the retirement account can be used for the benefit of the surviving spouse and the children, or if the grantor chooses, the assets of the trust can also be used for the benefit of other family members.

Minimum distributions will be calculated based upon the surviving spouse's life expectancy in the year following the year of the deceased spouse's death. Because other persons are also beneficiaries (the children), calculations will use the first year factor reduced by one for each subsequent year. After the surviving spouse's death, required distributions will continue to be calculated based upon his or her life expectancy.

This scenario allows the retirement account to be used for the benefit of the surviving spouse, while still protected from further estate or transfer tax. It should be given strong consideration if the deceased spouse dies without other assets that can be used to take full advantage of his or her unified credit exemption equivalent.

The surviving spouse would not have to disclaim the entire retirement account, but instead could disclaim only a portion of the account. The portion not disclaimed could be rolled over into a retirement account, set up, and maintained in the surviving spouse's name.

<u>Scenario Three: The surviving spouse disclaims twice</u>

If the surviving spouse disclaims his or her interest as direct beneficiary of the IRA, as well as his or her interest in the credit shelter trust, the beneficiary designation may provide that the retirement account will then be paid either directly to the children (or grandchildren) or to the credit shelter trust solely for the children's benefit.

In this scenario, not only may the full unified credit equivalent be used, but also the retirement account will have required distributions based upon the age of the oldest child. This will usually produce the lowest required distributions and therefore the largest benefit from the continued tax deferral of the investments in these accounts.

Since the surviving spouse will receive no benefits under this scenario, the "double disclaimer" strategy will only be used where he or she has other assets to provide for his or her financial needs. When this strategy is employed, the value of the wealth transferred is greatly enhanced by the lengthy deferral of withdrawal that is possible when younger individuals are named as beneficiaries. This arrangement also has some possible downsides:

(1) The surviving spouse makes the decision rather than the IRA owner;
(2) A timely disclaimer may not be made by the surviving spouse even though it might be advisable; and
(3) The surviving spouse may decide to keep the benefits even if a disclaimer would be best for the family.

Correcting Unfavorable Beneficiary Designations

Ideally, the IRA owner will plan ahead and have a favorable designated beneficiary when he or she dies. Mistakes are often made in naming beneficiaries, however, shortening the deferral period.

Fortunately, beneficiary designations can be improved with post-mortem planning. Because only individuals or entities who are beneficiaries both when the IRA owner dies and on the following September 30 of the year following the IRA owner's death are countable for purposes of determining a designated beneficiary, there is a window period for correcting unfavorable beneficiary designations. This window period, which could last from just over nine months to just under 21 months, can be used to eliminate unwanted beneficiaries that shorten the payout period.

Beneficiaries can disclaim an interest in an IRA if (1) they meet all the general requirements for a qualified disclaimer under IRC § 2518, and (2) the disclaimer is made by September 30 of the year following the IRA owner's death. The general requirements for a qualified disclaimer are as follows:

(1) There must be an irrevocable and unqualified refusal by a person to accept an interest in property;
(2) The refusal must be in writing;
(3) The written refusal must be given to the transferor of the interest within nine months after the date on which the transfer creating the interest is made;
(4) The disclaiming person hasn't accepted the interest or any of its benefits; and
(5) As a result of such refusal, the interest passes without any direction on the part of the person making the disclaimer and passes either (a) to the spouse of the decedent, or (b) to a person other than the person making the disclaimer (IRC § 2518(b)).

Note that as a practical matter, the September 30 deadline does not really change the general requirements. The nine-month period can never end after September 30 of the year following the IRA owner's death and, in most cases, will expire long before that date. A second option is to cash out a beneficiary's interest before September 30 of the year following death. This is done by simply paying the beneficiary to be eliminated such beneficiary's interest in the IRA. This method might be used to eliminate non-individuals like charities that might be unwilling to disclaim.

Historically, disclaimers were generally used to eliminate an older individual as a countable beneficiary. This made a younger person with a longer life expectancy the designated beneficiary; thus, decreasing the required minimum distributions. Following the SECURE Act, distributions to non-spousal beneficiaries must generally be made within 10-years after the IRA owner dies, eliminating much of this planning.

#35: Sale to an Intentionally Defective Grantor Trust (IDGT) with a Self-Cancelling Installment Note (SCIN) Hedge

As a result of large increases in the applicable exclusion amount and a reduction of the estate tax rate to 40%, income tax planning and particularly basis building has become more important for most wealthy taxpayers than estate planning. However, for ultra-high net worth individuals, estate planning is still very much alive. Individuals who expect to have a taxable estate might benefit from combining bet-to-live and bet-to die strategies. Bet-to-live strategies are those that are more favorable if a taxpayer lives a long time and bet-to-die strategies are those that are more favorable if a taxpayer dies prematurely.

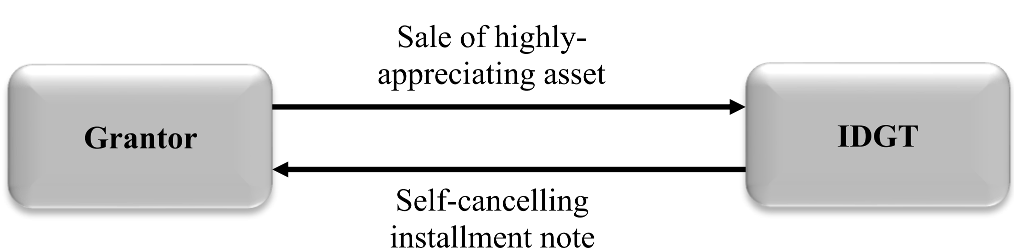
Some of the “bet-to-live” strategies include:

- Lifetime Gifts
    - Annual exclusion gifts
    - Applicable exclusion amount (unified credit) gifts
    - Taxable gifts
- Grantor Retained Annuity Trusts (GRATs)
- Dynasty Trusts
- Sales to an Intentionally Defective Grantor Trust (IDGT)
- Charitable Remainder Trusts

Some of the “bet-to-die” strategies include:

- Self-Canceling Installment Notes (SCINs)
- Private Annuities
- Charitable Lead Trusts
- Life Insurance

Some of the above strategies are covered in more detail in other parts of this book. The focus here is on a great way to achieve a balance of the “bet-to-live” and “bet-to-die” strategies – a sale to an intentionally defective grantor trust (IDGT) with a self-cancelling installment note (SCIN) hedge. The objective with this strategy is to substantially reduce the estate tax of the taxpayer regardless of how long the taxpayer lives.



The Strategy

Self-cancelling installment notes (SCINs) are a special type of installment sale in which the obligation to make further payments is canceled when the seller dies. There are two types of SCINs: 1) a hedge SCIN; and 2) a mortality SCIN. A hedge SCIN is a SCIN designed to hedge against the possibility of death during a "bet-to-live" strategy. A mortality SCIN is a SCIN designed for those who have a high likelihood of dying within a short period of time.

A sale to an IDGT with a SCIN hedge is a similar transaction to and generally structured in the same way as an ordinary installment sale to an IDGT which is covered in more detail in another part of this book. All this strategy adds is a cancellation-at-death feature to the note. This means that if the grantor dies during the term of the SCIN, the obligation to make any additional payments is canceled and the note and assets sold to the IDGT are not included in the grantor's estate. Because a cancellation-at-death feature is added to the note, a mortality risk premium must be paid on the note to compensate the seller for the possibility of not receiving all of the payments under the note. This premium can either be in the form of additional principal or an increased interest rate. The following table provides a sample of SCIN interest rate risk premiums:

SINGLE LIFE				JOINT LIFE				
Age	**SCIN Risk Premium**	**AFR**	**Total Interest Rate**	**Age 1**	**Age 2**	**SCIN Risk Premium**	**AFR**	**Total Interest Rate**
53	0.870%	1.75%	2.620%	53	53	0.067%	1.75%	1.817%
58	1.346%	1.75%	3.096%	58	58	0.153%	1.75%	1.903%
63	2.042%	1.75%	3.792%	63	63	0.332%	1.75%	2.082%
68	3.183%	1.75%	4.933%	68	68	0.742%	1.75%	2.492%
73	5.115%	1.75%	6.865%	73	73	1.675%	1.75%	3.425%
78	8.211%	1.75%	9.961%	78	78	3.554%	1.75%	5.304%

The above table assumes a 9-year term installment note, with annual interest payments and a balloon payment at the end of the 9-year term. The AFR is the January 2014 mid-term AFR.[149] Note that the risk premium increases with the seller's age and is higher for a single life SCIN than for a joint life SCIN. The reason, of course, is that the risk premium reflects the probability that the seller or sellers will die during the note term. It is more likely that one person will die during a given time interval than two and more likely that an older person will die during a time interval than a younger person. Also, the total interest rates will change depending on the current AFR and the length of the note (i.e., whether the short-term, mid-term or long-term AFR is used); the longer the term of the note, the higher the AFR and the higher the risk-premium. Finally, if the sale does not adequately compensate the seller for the mortality risk, the IRS may take the position that the transaction is part sale and part gift; therefore, resulting in gift tax liability.

<u>Mortality SCIN</u>

Reg. § 25.7520-3(b)(3) provides that the IRS actuarial tables can be used instead of a taxpayer's actual life expectancy to value interests for a term of years, life estates, remainder interests and

[149] Rev. Rul. 2014-1.

reversions unless the taxpayer is terminally ill at the time the interest is created. A seller who is known to have an incurable illness or other deteriorating physical condition is considered to be terminally ill if there is at least a 50-percent probability that the taxpayer will die within one year. If the seller actually survives for at least 18 months following the sale, the seller is presumed not to have been terminally ill at the time of the transfer unless the contrary is shown by clear and convincing evidence.

This suggests a great planning opportunity for a seller with an actual life expectancy that is more than one year, but substantially less than the seller's actuarial life expectancy under the IRS tables. For example, if the seller has an actual life expectancy of five years, but an actuarial life expectancy of fifteen years, the seller could sell his or her assets to an IDGT with a SCIN hedge and take back a SCIN with an interest rate based on the tables prescribed under § 7520 for a person with a life expectancy of fifteen years plus a morality risk premium. Since the seller would expect to only receive five interest payments under the SCIN, this could, in effect, be an expected tax-free transfer to the beneficiaries of the last ten interest payments and principal balloon payment.

However, the IRS takes the position that a SCIN does not create an interest for a term of years, a life estate, a remainder interest or a reversion so Reg. § 25.7520-3(b)(3) does not apply. Instead, the risk premium in a SCIN must be valued by reference to the seller's actual life expectancy using a willing buyer, willing seller approach. This would mean that a practitioner would take into account any factors that might be expected to give the seller a shorter life expectancy than the average person of the same age. Thus, it may be advisable to obtain a medical opinion that the seller was in normal health for a person of his or her age when the sale was made. Although it is not clear that the IRS argument would prevail, this IRS hostility makes mortality SCINs an aggressive strategy.

Hedge SCIN

A hedge SCIN is not used by a taxpayer with a shorter than average actual life expectancy, but by a taxpayer who is making an IDGT sale and wants to hedge against the possibility of dying prematurely before the IDGT sale has had time to generate substantial tax benefits. The following example illustrates how it works.

> ***Example 1.*** Suppose a Taxpayer, 58 years old, contacted you to discuss a sale to an IDGT with a SCIN hedge. Taxpayer owns a $10,000,000 asset that will be used in this sale. The Taxpayer will sell the asset to the IDGT and take back a SCIN with a 9-year term and a balloon payment of the principal at the end of the SCIN term. Assume the current mid-term AFR rate is 1.75% and the risk premium is 1.346%, a total interest rate of 3.096%. Furthermore, assume the IDGT earns a 10% rate of return. Because the present value of the note equals the value of the property transferred, there is no taxable gift. Below is a table representing the payment schedule and balances:

Year	Beginning Balance	IDGT Income	Annual Payment	Ending Balance
1	$10,000,000	$1,000,000	($309,600)	$10,690,400
2	$10,690,400	$1,069,040	($309,600)	$11,449,840
3	$11,449,840	$1,144,984	($309,600)	$12,285,224
4	$12,285,224	$1,228,522	($309,600)	$13,204,146
5	$13,204,146	$1,320,415	($309,600)	$14,214,961
6	$14,214,961	$1,421,496	($309,600)	$15,326,857
7	$15,326,857	$1,532,686	($309,600)	$16,549,943
8	$16,549,943	$1,654,994	($309,600)	$17,895,337
9	$17,895,337	$1,789,534	($10,309,600)	$9,375,271

This represents a $9,375,271 estate and gift tax-free transfer to the beneficiaries.

Also note, that if the Taxpayer had passed away before the end of the term, let's assume in year 6, this would have represented a $15,326,857 estate and gift tax-free transfer to the beneficiaries. Additionally, both amounts, if Taxpayer survived until the end of the term or if Taxpayer died in year 6, would be excluded from the Taxpayer's estate.

If the seller survives the term, there is a cost to using a SCIN, however. Without the death terminating feature, the annual installment payments would have been $175,000 per year instead of $309,600 and the amount in the SCIN at the end of nine years would have been $11,202,468 instead of $9,375,271, a difference of $1,827,197. Thus, the seller is giving up $1,827,197 of tax-free transfer for the possibility of eliminating the $10,000,000 balloon payment.

Now, if the SCIN would have been a joint life SCIN, the interest rate on the SCIN would have been lower because the risk premium would have been lower. Assume Taxpayer and Spouse, both age 58, were the joint lives. The interest rate on the SCIN would instead be 1.903%. At the end of the SCIN term, $10,995,302 would have transferred estate and gift tax-free to the beneficiaries; that is $1,620,031 more than under the single life SCIN. Further, if both Taxpayer and Spouse died by the end of year 6, $16,247,329 would have been transferred estate and gift tax-free to the beneficiaries; that is $920,472 more than under the single life SCIN.

In the two-life alternative, the cost of hedging is much less than for a single life SCIN. The death terminating feature increases the annual payment from $175,000 to $190,300 instead of $309,600. If the seller survives the SCIN term there will be $10,995,302 in the IDGT. Thus, the seller is giving up only $207,166 by using a SCIN instead of a straight installment note. On the other hand, the probability that both sellers will die during the term and cancel any further payments is far less.

Advantages and Disadvantages

As with any tax planning strategy there are some advantages and some disadvantages. Some of the advantages of a sale to an IDGT with a SCIN hedge include:

- The future appreciation above the installment note's interest rate (including both the AFR and the risk premium) is removed from the grantor's estate;
- The asset sold and principal owed on the note is not included in the grantor's estate if the grantor prematurely dies during the SCIN term;
- In most cases, the value of the assets transferred out greatly exceeds the value of the payments coming back into the estate of the grantor if he or she passes away prematurely;
- No gain or loss is recognized on the sale;
- Payment of the trust's income tax liability by the grantor creates an additional tax-free gift and allows for greater appreciation to inure to future generations;
- Valuation adjustments increase effectiveness of the sale for estate tax purposes; and
- Because the IDGT is a grantor trust, it is an eligible S corporation shareholder.

Some of the disadvantages of a sale to an IDGT with a SCIN hedge include:

- Complex calculation of the risk premium;
- Possible gift tax exposure if the SCIN risk premium is inadequate;
- Possible gift tax exposure if the trust is insufficiently funded;
- Possible gift tax under IRC § 2701 or § 2702 if note is not treated as bona fide debt (*Karmazin*);[150]
- Possible estate inclusion under IRC § 2036 if seller is treated as retaining an income interest rather than a debt instrument (*Karmazin*);[151]
- No step-up in basis at grantor's death;
- Possible acceleration of capital gain at grantor's death;[152]
- Death terminating feature increases payments back to seller and brings more value back into the seller's estate;
- Trust income taxable to grantor during his or her life could cause a cash flow problem if there is not sufficient income earned by the grantor; and
- Possible upstream transfer if the grantor survives the term of the note (or lives a significant portion of the term and/or is relatively old).

Why it Works

There are many reasons why a sale to an IDGT with a SCIN hedge works; some of these include:

- Backend-loading of installment payments;
- Payment of trust income taxes by the grantor;
- Valuation adjustments;
- The cancellation-at-death feature; and
- The difference between the actual rate of return and the risk-adjusted AFR.

The difference between the actual rate of return and the risk-adjusted AFR is already demonstrated above and in the Sale to an IDGT topic – the greater the difference between the actual rate of return and the risk-adjusted AFR, the greater the estate and gift tax-free transfer to the beneficiaries will

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[150] *See Karmazin v. Commissioner*, Tax Court Docket No. 2127-03 Unagreed Report. Case settled without going to trial.
[151] *Id.*
[152] *See Madorin v. Commissioner*, 84 TC 667 (1980); Reg. § 1.1001-2(c), Example 5.

be. Furthermore, by having the SCIN include a balloon payment at the end of the term for the principal amount, the strategy backend loads the payments. This allows funds and assets within the IDGT to grow and accumulate. Moreover, if the grantor dies prematurely, the cancellation-at-death feature of the note will take effect and more will transfer to the beneficiaries tax-free and not be included in the grantor's estate.

Valuation Adjustments

The effect of valuation adjustments is covered in the Sale to an IDGT topic, but it is an important concept to understand and, therefore, deserves another illustration of its effects. To recap, if a valuation discount can be applied to the asset when it is sold to the IDGT, it will allow more to transfer estate and gift tax-free to the beneficiaries. Additionally, it reduces both the amount of principal (should the grantor survive the term of the note) and the amount of interest payments that come back into the grantor's estate. Valuation discounts may apply to assets like interests in closely-held family businesses.

> ***Example 2.*** Assume the same facts as in Example 1, except that a valuation discount of 30% applies to the asset. Therefore, the balloon payment at the end of the term of the SCIN will only be $7,000,000 and the interest payment will be based off that same principal of $7,000,000 as opposed to the full $10,000,000. The effects of the valuation discount are illustrated in the table below:

Year	Beginning Balance	IDGT Income	Annual Payment	Ending Balance
1	$10,000,000	$1,000,000	($216,720)	$10,783,280
2	$10,783,280	$1,078,328	($216,720)	$11,644,888
3	$11,644,888	$1,164,489	($216,720)	$12,592,657
4	$12,592,657	$1,259,266	($216,720)	$13,635,202
5	$13,635,202	$1,363,520	($216,720)	$14,782,003
6	$14,782,003	$1,478,200	($216,720)	$16,043,483
7	$16,043,483	$1,604,348	($216,720)	$17,431,111
8	$17,431,111	$1,743,111	($216,720)	$18,957,502
9	$18,957,502	$1,895,750	($7,216,720)	$13,636,533

> This represents a $13,636,533 estate and gift tax-free transfer to the beneficiaries. Because of the effect of the 30% valuation discount, $4,261,262 more is transferred tax-free to the beneficiaries than in Example 1. Also note, that if Taxpayer had passed before the end of the term, let's assume in year 6, this would have represented a $16,043,483 estate and gift tax-free transfer to the beneficiaries. Again, the effect of the valuation discount transfers $716,626 more tax-free to the beneficiaries than in Example 1 (assuming Taxpayer died in year 6 in Example 1 too).

Payment of the IDGT's Income Taxes by the Grantor: "Tax Burn" SCIN Strategy

Payment of the IDGT's income taxes by the grantor is best demonstrated by the "tax burn" SCIN strategy. If at all possible, the "tax burn" SCIN strategy should be implemented with the sale to an IDGT with SCIN hedge. The "tax burn" SCIN strategy involves the grantor paying the annual income tax liability on behalf of the trust. The grantor's payment of income tax on the trust's behalf is a tax-free gift to the trust;[153] thus, increasing the net downstream transfer of value to the beneficiaries. This additional tax-free transfer by the grantor can be used to offset the increased cost of the SCIN (i.e., the mortality risk premium). To the extent that the income tax liability on the IDGT's income is greater than the installment payments received from the trust, the excess income tax liability will reduce the grantor's taxable estate (i.e., "tax burn").

> ***Example 3.*** Assuming a $10,000,000 FMV of the assets held in the IDGT, at a 10% pre-tax rate of return and a 40% income tax rate, the income tax payable by the grantor in year one will be $400,000. If the installment note has a $6,300,000 principal value (applying a valuation discount) and a 2% AFR with a 4% risk premium (6% total interest rate), the installment payment received by the grantor from the IDGT in year one will be $378,000. Below is a chart illustrating the "tax burn" over the first 5 years:

Year	Income Tax on IDGT Income	Payment Received from IDGT	"Tax Burn"	Cumulative "Tax Burn"
1	$ 400,000	$ 378,000	$ 22,000	$ 22,000
2	$ 440,000	$ 378,000	$ 62,000	$ 84,000
3	$ 484,000	$ 378,000	$ 106,000	$ 190,000
4	$ 532,400	$ 378,000	$ 154,400	$ 344,400
5	$ 585,640	$ 378,000	$ 207,640	$ 552,040

Recall that if the grantor dies during the term of the SCIN, the note and assets sold to the IDGT are not included in the grantor's estate. If the grantor survives the term of the SCIN, then the repayment of the note will be included in the grantor's estate. However, the beauty of "tax burn" means that if the grantor survives the term of the SCIN, then the "tax burn" will have eroded the grantor's estate to the point where the repayment of the note will not increase the grantor's taxable estate.

> ***Example 4.*** Assume that Taxpayer sells an asset with an FMV of $10,000,000 to an IDGT with a SCIN hedge for $6,300,000 after applying a valuation discount. The Taxpayer takes back a SCIN with a 6% interest rate (including AFR and the risk premium) with a balloon payment at the end of 15 years. The IDGT earns a 10% rate of return. Taxpayer (grantor) pays the income tax (40%) on the IDGT income.

[153] *See* Rev. Rul. 2004-64 (July 6, 2004).

Year	Income Tax on IDGT Income[154]	Payment Received from IDGT[155]	"Tax Burn"	Cumulative "Tax Burn"	SCIN Principal Balance
1	$ (400,000)	$ 378,000	$ (22,000)	$ (22,000)	$ 6,300,000
5	$ (585,640)	$ 378,000	$ (207,640)	$ (552,040)	$ 6,300,000
10	$ (943,179)	$ 378,000	$ (565,179)	$ (2,594,970)	$ 6,300,000
15	$ (1,518,999)	$ 378,000	$ (1,140,999)	$ (7,038,993)	$ 6,300,000

The initial burn point in the above example is in year one – the point at which the income tax liability paid by the grantor becomes greater than the installment payments received from the trust. As you can see, the full burn point is in year 15 – the point at which any cumulative reinvested "positive transfers" (i.e., installment payment received > tax liability) by the grantor and the SCIN are eliminated by the cumulative effect of the "tax burn." In other words, at the end of the 15 year SCIN term, should the Taxpayer have survived, the cumulative effect of the "tax burn" of $7,038,993 eliminates the value of the $6,300,000 SCIN principal balance being paid back into the Taxpayer's estate.

Caveat

If the seller does die during the term of the SCIN, the IRS will take the position that all gain on the SCIN is accelerated and will assert that the gain is reportable on the estate's Form 1041. Such a position by the IRS was supported by the Eighth Circuit's decision in *Estate of Frane.*[156] Furthermore, in that same case, the Tax Court (prior to the appeal to the Eighth Circuit) held that the gain is reportable on the decedent-seller's final Form 1040.[157] It should be noted, however, that some commentators do argue that no gain should be recognized at all. Therefore, careful analysis and much consideration should be undertaken before engaging in a sale to an IDGT with a SCIN hedge; but, if done correctly, the dividends can be rewarding as demonstrated above.

[154] For year 1, the calculation is $10,000,000 FMV of asset held in IDGT x 10% rate of return x 40% tax (compounded by 10% per year).
[155] The calculation is $6,300,000 SCIN principal (discounted) x 6% interest rate.
[156] *See Estate of Frane*, 998 F.2d 567 (8th Cir. 1993).
[157] *See Estate of Frane*, 98 TC 341 (1992).

#36: Qualified Small Business Stock

IRC section 1202 allows non-corporate taxpayers to exclude 50%, 75%, or 100% of any gain from the sale or exchange of qualified small business stock (QSBS) held for more than five years. The exclusion percentage is—

- 50% if the QSBS was acquired before February 18, 2009,
- 75% if the QSBS was acquired after February 17, 2009, and before September 28, 2010, and
- 100% if the QSBS was/is acquired after September 27, 2010.

QSBS Requirements

QSBS stock is stock that meets the following requirements—

- The stock was issued after August 10, 1993[158]
- The issuer of the stock was a "qualified small business" when the stock was issued.[159] A qualified small business is—
    - a domestic C corporation;
    - with assets totaling $50 million or less at all times after August 10, 1993 and before the date of issuance;
    - that agrees to submit reports to the IRS verifying compliance with the $50 million requirement.[160]
- The taxpayer acquired the stock at original issuance in exchange for money or property other than stock or as compensation for services to the corporation (other than as underwriter of the stock).[161] Certain conversions of stock[162] or tax-free transfers may also qualify.[163]
- The corporation meets an active business requirement on the stock issuance date and during substantially all of the taxpayer's holding period for the stock.[164]
    - Active business requirement—at least 80% of the value of the corporation's assets are used in the active conduct of one or more qualified trades or businesses and such corporation is an eligible corporation.[165]
    - Qualified trade or business requirement—a qualified trade or business is any business other than—
        - Any trade or business involving the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any trade or business where the principal asset

[158] IRC § 1202(c)(1).
[159] IRC § 1202(c)(1)(A).
[160] IRC § 1202(d)(1).
[161] IRC § 1202(c)(1)(B).
[162] IRC § 1202(f).
[163] IRC § 1202(h).
[164] IRC § 1202(c)(2)(A).
[165] IRC § 1202(e)(1).

        of such trade or business is the reputation or skill of one or more of its employees,
        - Any banking, insurance, financing, leasing, investing or similar business,
        - Any farming business,
        - Any business involving the production or extraction of products subject to percentage depletion, and
        - Any business of operating a hotel, motel, restaurant or similar business.[166]
    - Eligible corporation—an eligible corporation is any domestic corporation other than—
        - A DISC or former DISC, a REIT, a REMIC, a regulated investment company, a cooperative or a corporation with respect to which an IRC § 936 election is in effect (relating to the Puerto Rico and Possession Tax Credit).

<u>Pass-Through Entities</u>

If a pass-through entity owns QSBS, gain on the disposition of the stock passes through to the entity's owners. The $10 million gain limitation is applied separately for each partner, shareholder or beneficiary. To qualify for QSBS treatment, the stock must be QSBS in the hands of the entity and the taxpayer must have held an interest in the entity on the date the stock was acquired and at all times thereafter before the disposition of the stock.[167]

<u>Anti-Avoidance Rules</u>

The purpose of IRC § 1202 was to encourage investment in small business corporations. Thus, anti-avoidance rules were necessary to prevent corporations from redeeming existing stock and reissuing it under § 1202.

IRC § 1202(c)(3)(A) provides that stock acquired by a taxpayer is not QSBS if, at any time during the four-year period beginning two years before the issuance of such stock, the corporation issuing the stock purchased (directly or indirectly) any of its stock from the taxpayer or from a related person (within the meaning of § 267(b) or § 707(b)).

IRC § 1202(c)(3)(B) provides that stock issued by a corporation is not QSBS if, during the two-year period beginning one year before the issuance of such stock, the corporation made any purchases of its stock with an aggregate value (as of the time of the respective purchases) exceeding 5% of the aggregate value of all of its stock as of the beginning of the two-year period.

There are two exceptions to these rules. First, a corporation can redeem de minimis amounts of stock. Under this exception, stock acquired from the taxpayer or a related person exceeds a de minimis amount only if the aggregate amount paid for the stock exceeds $10,000 and more than two

[166] IRC § 1202(e)(3).
[167] IRC § 1202(g).

percent of the stock owned by the taxpayer and related persons is acquired.[168] Second, there is an exception for redemptions due to termination of services, death, disability or mental incompetency and divorce.[169]

Amount of Excludable Gain

The total gain that can be excluded is generally limited to $10 million per taxpayer, or $5 million for married taxpayers filing separately. If the spouses file jointly, they share a single $10 million exclusion amount. In the case of pass-through entities, the $10 million gain limitation is applied separately for each partner, shareholder or beneficiary.

Tax Planning

Planning to maximize the benefits of the QSBS exclusion involves the following questions—

(1) Does stock lose its QSBS status if it is gifted or bequeathed?
(2) Can a trust claim an exclusion amount on the sale of QSBS?
(3) Does stock lose its QSBS status if it is transferred to an incomplete gift non-grantor (ING) trust?
(4) Can an individual claim a $10 million exemption amount for himself or herself and create an irrevocable trust to claim a second $10 million exclusion amount?
(5) If an individual transfers QSBS stock to two or more trusts, will IRC § 643(f) apply, treating the trusts as a single trust and barring more than one $10 million exclusion amount?
(6) Can a pass-through entity be incorporated to enable its owners to take advantage of IRC § 1202?
(7) Can the required business activities be conducted through a subsidiary?
(8) Can gain be rolled over into a replacement QSBS?

Gift or Bequest of QSBS

IRC § 1202(h)(2)(A) provides that if stock is received by gift or bequest, the transferee is treated as having acquired the stock in the same manner as the transferor and having held such stock during the period held by the transferor. This means that, assuming that the stock would meet all the requirements for QSBS treatment if it was sold by the donor, it will also qualify for QSBS treatment if sold by the donee.

Trusts and QSBS

Unfortunately, Congress didn't address trusts in the statute or in its legislative history, nor did the IRS mention them in its regulations. IRC § 1202(g) provides that if a pass-through entity holds QSBS, the exclusion on a sale of the stock passes through to the entity's owners in proportion to their ownership percentages. This section lists only partnerships, S corporations, regulated investment companies and common trust funds as pass-through entities, however. Thus, because a

[168] Reg. § 1.1202-2(a)(2).
[169] Reg. § 1.1202-2(d).

trust is a non-corporate taxpayer and isn't included as a pass-through entity, there is a strong argument that a trust could claim a QSBS exclusion at the entity level. Note that if a trust is a simple trust its income would pass through in much the same way as it would in a partnership or S corporation, but this wouldn't be the case for a complex trust.

ING Trust

ING trusts have become the favorite strategy for avoiding state income tax. As the name indicates, transfers to an ING trust are incomplete gifts. This raises the question of whether an incomplete gift qualifies for the special gift rule under IRC § 1202(h)(2)(A) explained above. There is no guidance on whether IRC § 1202(h)(2)(A) applies only to completed gifts or also includes incomplete gifts. A plausible argument could be made that the gift exception should also apply to ING trusts—

- The statute doesn't say that the gift must be complete for gift tax purposes.
- It would be treated as a gift for state property law purposes.
- It would shift income tax exposure from the grantor to the trust.
- It would be treated as a gift for income tax purposes.
- Because IRC § 1202 is an income tax provision and not a gift tax provision, whether there was a completed gift for gift tax purposes would seem to be irrelevant.
- The rationale for the special gift/bequest rule under IRC § 1202(h) is that the listed transfers are income tax-free. A gratuitous transfer to a trust would ordinarily be tax-free regardless of whether it was a completed gift for federal gift tax purposes.

Exclusion Amount for Both a Trust and an Individual

For taxpayers with large holdings of stock, the exclusion amount could be doubled if an individual and a trust could transfer stock to a trust and both the individual and the trust could claim a $10 million exclusion. There appear to be no treasury regulations, private letter rulings or cases on the question of whether an individual can claim an exclusion amount for himself or herself and a second exclusion amount for a trust. A phone conference with Chief Counsel confirmed that there is no law on this issue. The IRS considered drafting regulations on the subject but decided not to. This was apparently because such regulations would be complex and time consuming and there was far less interest in § 1202 when the exclusion was only 50%.

IRC § 1202(g) states that in the case of pass-through entities (partnerships, S corporations, regulated investment companies or common trust funds) the $10 million gain limitation is applied separately for each partner, shareholder or beneficiary. In other words, the relevant taxpayers for applying the $10 million limitation are individuals rather than the pass-through entities. This would prevent a taxpayer from creating multiple partnerships or S corporations, RICs or common trust funds to obtain more than one $10 million exclusion amount. No matter how many of such entities the taxpayer created, she would be entitled to only one exemption amount. As explained above, however, § 1202(g) doesn't include trusts as a pass-through entity.

An argument could be made that there is substantial authority for claiming a second exclusion. Reg. § 1.6662-4(d)(3)(ii) lists the types of authority that can be used to establish a reasonable basis for a position or substantial authority. These include, for example, the Tax Code, regulations, cases, revenue rulings, etc. Under our facts, there is no applicable law other than the Tax Code. Reg. §

1.6662-4(d)(3)(ii) indicates, however, that the Tax Code may be sufficient by itself to establish substantial authority. It provides in relevant part as follows—

> There may be substantial authority for the tax treatment of an item despite the absence of certain types of authority. Thus, a taxpayer may have substantial authority for a position that is supported only by a well-reasoned construction of the applicable statutory provision.

The conclusion that a $10 million exclusion amount should be available for both an individual and a trust created by the individual would seem to be a well-reasoned construction of IRC § 1202. First, the exclusion is said to apply to any non-corporate taxpayer and the individual and an irrevocable, non-grantor trust are separate taxpayers. Further, if Congress had intended for the exclusion amount to flow through to the trust beneficiaries it could have included trusts as pass-through entities under IRC § 1202(g). Nevertheless, caution is advised in using this strategy.

Multiple Trusts and IRC § 643(f)

IRC § 643(f) provides that two or more trusts shall be treated as one trust if—

- such trusts have substantially the same grantor or grantors and substantially the same primary beneficiary or beneficiaries, and
- a principal purpose of such trusts is the avoidance of income tax.

Thus, it appears that this section wouldn't cause trusts to be aggregated if they have different primary beneficiaries and different dispositive provisions. Trusts should also be treated as separate if there are important non-tax reasons for creating more than one trust.[170]

Incorporating a Pass-Through Business

An LLC, partnership or S corporation can be converted to a C corporation and qualify for the § 1202 exclusion, but § 1202 only applies to post incorporation gain. Moreover, the stock must be held for five years after the incorporation. The IRS treats an LLC that elects to be taxed as a C corporation like any other C corporation for purposes of § 1202(a). In Revenue Procedure, 84-111, the IRS provided guidance on how to convert a partnership to a C corporation to take advantage of IRC

[170] Prop. Reg. § 1.199A-6 suggests that for purposes of the 20% deduction on passthrough income under IRC § 199A, IRS might try to completely disregard trusts even if they have different lead beneficiaries, different grantors or very different terms. This section reads as follows.

> (v) Anti-abuse rule for creation of multiple trusts to avoid exceeding the threshold amount. Trusts formed or funded with a significant purpose of receiving a deduction under section 199A will not be respected for purposes of section 199A. See also §1.643(f)-1 of the regulations.

Note that this provision is inconsistent with Prop. Reg. § 1.643(f)-1 in two ways. First, it makes a significant purpose of avoiding applicable threshold amounts the sole criteria for denying a tax benefit rather than requiring both a tax avoidance purpose and trust similarities. Second, it completely disregards trusts instead of aggregating them.

§ 1202.[171] Note that a C corporation conversion is more favorable now that the C corporation tax rate has been lowered to 21%.

Conducting Business Activities Through a Subsidiary

IRC § 1202(e)(5) provides that the required business activities can be conducted through subsidiaries. If there is a disregarded entity between the holding company and the subsidiaries, the disregarded entity is ignored and the holding company is treated as conducting the business activities of the subsidiaries directly to the extent of its ownership interest in the subsidiaries (provided it owns more than 50%).

Rolling Over Gain into a Replacement QSBS

IRC § 1045 allows taxpayers who have held QSBS for at least six months to roll over gain into replacement QSBS if the replacement QSBS is purchased within 60 days of the sale of the QSBS. Gain is recognized only to the extent that the amount of the sale proceeds exceeds the cost of any QSBS purchased during the replacement period and any portion of such cost already used to shelter gain under § 1045 with other reinvestments.

[171] 1984-2 C.B. 88.

#37: Opportunity Zones

The Tax Cuts and Jobs Act of 2017 (TCJA) created important tax benefits for investments in opportunity zones (IRC § 1400Z-2). The Act provides three incentives for rolling capital gains on the sale or exchange of property into new investments in low-income communities: (1) deferral of gain recognition on the original investment, (2) basis step up on the original investment and (3) permanent exclusion of gain on the opportunity zone investment.

Deferral of Gain Recognition

If a taxpayer elects to reinvest capital gain from another investment in an opportunity zone, the gain isn't included in income until the earlier of the date on which the opportunity zone investment is disposed of or December 31, 2026 (IRC § 1400Z-2(b)(1)). There is no dollar limit on the amount of gain that can be deferred.

> ***Example 1.*** Art sells stock with a basis of $200,000 for $300,000 on December 15, 2019. Instead of recognizing the $100,000 gain and paying tax on it, Art reinvests the $100,000 in an opportunity zone in January 2020 and is able to defer recognizing the gain.

Basis Step-Up

The taxpayer's basis in the original investment is zero for purposes of the opportunity zone rules. If the investment is held for at least five years, this basis is increased by 10% of the deferred gain. If the investment is held for at least seven years, this basis is increased by 15% of the deferred gain (IRC § 1400Z-2(b)(2)(B)).

> ***Example 2.*** Assume the same facts as in Example 1 except that Art sells the opportunity zone investment on December 20, 2025. Because he held the opportunity zone investment for over five years, Art is given a basis equal to 10% of the deferred gain. This reduces the gain on the stock to $90,000 and the tax payable to $21,400 (.238 x $90,000). If Art had held the stock for seven years or more, the gain would have been reduced to $85,000 and the tax payable to $20,230 (.238 x $85,000).

Permanent Exclusion of Gain on Opportunity Zone Investment

If the opportunity zone investment is held for at least 10 years, no gain is recognized when the opportunity zone investment is sold (IRC § 1400Z-2(c)).

Return on Opportunity Zone Investment vs. Return on Investment in Stock Portfolio

The following examples illustrate how the three tax benefits described above combine to increase the return on investment.

> ***Example 3.*** Jane has $100,000 of unrealized gains in her stock portfolio. On December 31, 2019, she reinvests this $100,000 into an opportunity zone fund. Jane

holds the investment for 10 years. Assume that the investment grows in value by eight percent each year. The following chart shows how much Jane ends up with from the investment after 10 years.

Initial value	$100,000
Value on December 31, 2027	$185,093
Tax payable (.238 x $85,000)	$20,230
After-tax amount	$164,863
Value on December 31, 2029	$192,296
Return on investment	6.76%

Example 4. Assume the same facts as in Example 3 except that instead of investing in the opportunity zone fund, Jane keeps the $100,000 of capital gain in the stock portfolio investment and sells it after 10 years.

Initial Value	$100,000
Value on December 31, 2029	$215,892
Tax payable	$51,382
After-tax amount	$164,510
Return on investment	5.10%

Examples 3 and 4 assume that the opportunity zone and the stock portfolio produce the same return, isolating the tax benefit. If the opportunity zone investment produced a higher return than the stock portfolio, the advantage of the opportunity zone would be greater. On the other hand, if the stock portfolio produced a higher return, the return advantage of the opportunity zone investment would either be less or the stock portfolio would produce a higher return.

Example 5. Assume the same facts as in Example 4 except that the stock portfolio produces an 11% return.

Initial Value	$100,000
Value on December 31, 2029	$283,942
Tax payable	$67,578
After-tax amount	216,364
Return on investment	8.02%

Qualification Requirements

To qualify for the tax benefits illustrated above, a taxpayer must reinvest the capital gain portion of a sale or exchange within 180 days in a "qualified opportunity fund" (IRC § 1400Z-2(a)). The gain can't arise from a sale or exchange with a related person. For purposes of § 1400Z-2, persons are related to each other if such persons are described in § 267(b) or 707(b)(1), determined by substituting 20% for 50% each place it occurs in such sections (IRC § 1400Z-2(e)(2)). Nor is there deferral for gain from a position that is or has been part of an offsetting-positions transaction (Prop. Reg. § 1.1400Z-2(b)(2)(iv)).

Qualified Opportunity Fund (QOF)

A qualified opportunity fund is any investment vehicle organized as a corporation or partnership for the purpose of investing in qualified opportunity zone property that holds at least 90% of its assets in qualified opportunity zone property (IRC § 1400Z-2(d)(1)).

Qualified Opportunity Zone Property

Qualified opportunity zone property is property that is qualified opportunity zone stock, a qualified opportunity zone partnership interest, or qualified opportunity zone business property (IRC § 1400Z-2(d)(2)). A list of qualified opportunity zones can be found in IRS Notice 2018-48.

Eligible Taxpayer

An eligible taxpayer is any person that may recognize gains for purposes of Federal income tax accounting. Thus, eligible taxpayers include individuals; C corporations, including regulated investment companies (RICs) and real estate investment trusts (REITs); partnerships; S corporations; trusts and estates (Prop. Reg. § 1.1400Z-2(a)-1(b)).

Eligible Interest in a Qualified Opportunity Fund

An eligible interest in a QOF is an equity interest issued by the QOF, including preferred stock or a partnership interest with special allocations. Thus, the term eligible interest excludes any debt instrument within the meaning of § 1275(a)(1) and §1.1275-1(d) (Prop. Reg. § 1.1400Z-2(a)-1(b)(3)(i)).

Election Procedure

The election to defer gain is made on the return on which the tax on that gain would be due if it wasn't deferred (IRS Website--Opportunity Zones Frequently Asked Questions). The Commissioner may prescribe in guidance published in the Internal Revenue Bulletin on the manner in which the election is to be made.

#38: Puerto Rico Tax Incentives

Puerto Ricans are U.S. citizens but don't have the right to vote in federal elections and have no representation in Congress. Because they lack representation, Puerto Ricans pay no U.S. tax. Instead Puerto Rico has its own tax code for residents and companies operating there. This has enabled it to offer unique tax incentives, particularly Act 20 (Promotion of Export Services Act) and Act 22 (Act to Promote the Relocation of Individual Investors to Puerto Rico).

Act 20

Act 20 provides tax incentives for companies that establish export services that are rendered from Puerto Rico for the benefit of non-resident individuals or foreign entities. This export services income (EIS) is taxed at a 4% corporate rate. Moreover, dividends distributed out of EIS are 100% exempt from Puerto Rican tax. The Act also provides for a 60% exemption on municipal taxes and certain businesses receive a 100% exemption on property tax for the first five years and a 90% exemption thereafter. The business owner and employees must receive a reasonable salary based on the services provided, however, which is taxed at ordinary Puerto Rican income tax rates (as high as 33%).

> ***Example 1***. T owns a Puerto Rican export company that makes $300,000/year. T receives a reasonable salary of $100,000 and pays the full Puerto Rican personal income tax on this amount. The remaining $200,000 of income is taxed at a 4% rate and the rest can be taken out of the company as a dividend that is 100% exempt from tax.

Eligible business types include:

1. Research and development
2. Advertising and public relations
3. Consulting services, including, but not limited to, economic, scientific, environmental, technological, managerial, marketing, human resources, computer, and auditing consulting services
4. Advice services on matters related to any trade or business
5. Creative industries
6. Production of blueprints, engineering, and architectural services, and project management
7. Professional services such as legal, tax, and accounting services
8. Centralized managerial services, including, but not limited to, strategic direction, planning, and budgeting, provided by regional headquarters or a company engaged in the business of providing such services
9. Electronic data processing centers
10. Development of licensable computer software
11. Telecommunications voice and data between persons located outside of Puerto Rico
12. Call centers
13. Shared service centers
14. Storage and distribution centers

15. Educational and training services
16. Hospital and laboratory services, including telemedicine facilities and medical tourism services
17. Investment banking and other financial services, including, but not limited to, asset management, management of investment alternatives, management of activities related to private capital investment, management of coverage funds or high-risk funds, management of pools of capital, trust management that serves to convert different groups of assets into securities, and escrow account management services
18. Commercial and mercantile distribution of products manufactured in Puerto Rico for jurisdictions outside Puerto Rico
19. Assembly, bottling, and packaging operations of products for export
20. Trading companies

<u>Requirements</u>

To qualify for the tax benefits, taxpayers must meet the following requirements:

1. The operation of the business must be in Puerto Rico. This means that the work output or value created must be accomplished in Puerto Rico.
2. The work must be performed for clients outside Puerto Rico. The following services will be considered to have Puerto Rican clients and won't be eligible services:
    - (a) Business or income-producing activities that are or have been performed in Puerto Rico by the applying business
    - (b) The sale of any property for the use, consumption, or disposition in Puerto Rico
    - (c) Counseling on the laws, regulations, and administrative determinations of the government of Puerto Rico and its instrumentalities
    - (d) Lobbying on the laws, regulations, and administrative determinations of the government of Puerto Rico and its instrumentalities
    - (e) Any other activity designated by the Secretary of the Department of Economic Development and Commerce of Puerto Rico
3. The business must submit an application with the Office of Industrial Tax Exemption (OITE) of Puerto Rico to obtain a tax exemption decree.
4. Prior to July 11, 2017, businesses were required to hire at least five Puerto Ricans to work in the business. Changes to the law on that date generally removed this requirement. However, there may be minimum employment requirements for a very limited number of businesses under regulations that have yet to be drafted (probably for call centers and telemedicine). It is anticipated that there will be no employment requirements for service and tech businesses.
5. To take advantage of the tax benefits, the taxpayer must become a resident of Puerto Rico. U.S. citizens are generally taxed on all income from whatever source derived. However, IRC § 933 provides an exception. Bona fide residents of Puerto Rico can exclude all Puerto Rico source income from U.S. income taxation, assuming that they aren't federal employees. Note that a resident of Puerto Rico is still subject to U.S. tax on income from sources outside of Puerto Rico.

Act 22

This Act gives new Puerto Rico residents the following benefits for income accrued after moving to Puerto Rico:

1. 100% tax exemption from Puerto Rico income taxes on all dividends
2. 100% tax exemption from Puerto Rico income taxes on all interest
3. 100% tax exemption from Puerto Rico income taxes on all short-term and long-term capital gains

To be a resident of Puerto Rico and qualify for the tax benefits, a taxpayer must satisfy three tests:

1. **Presence test**: The individual must generally be present in Puerto Rico for at least 183 days during the taxable year.
2. **Tax home test**: The individual doesn't have a tax home outside of Puerto Rico during the taxable year.
3. **Closer connection test**: The individual doesn't have a closer connection to the United States or a foreign country than to Puerto Rico.

<u>Pre-Move Gains</u>

Capital gains accrued before the individual established residency in Puerto Rico are subject to preferential Puerto Rican income tax rates. If gain is recognized within 10 years after moving to Puerto Rico, it is taxed only at the U.S. federal income tax rate for capital gains. If gain is recognized more than 10 years after establishing residency in Puerto Rico, it will be taxed at a flat Puerto Rico tax of 5%, and there will be no U.S. capital gains tax.

> ***Example 2*** *(sale within 10 years)*. T, a U.S. resident acquires stock in 2011 for $100. The stock is worth $200 when T moves to Puerto Rico in 2015. The stock is sold by the now Puerto Rican resident in 2020 for $300. T has $100 of U.S. income and pays tax of $23.80 on $100 of long-term capital gain (.238 x $100). The second $100 of gain is Puerto Rico gain subject to a 0% tax rate. Thus, the total tax paid on the $200 of gain is $23.80.

> ***Example 3*** *(sale after 10 years).* Assume the same facts as in Example 2 except that the stock is sold in 2026 (more than ten years after T moved to Puerto Rico). T pays tax on the $100 of pre-Puerto Rico gain at the special 5% Puerto Rico rate ($5). T pays no tax on the gain that accrued after T moved to Puerto Rico. Thus, the total tax paid on the $200 of gain is $5.

<u>Bottom Line</u>

A U.S. citizen might wish to consider the benefits of Acts 20 and 22 if (1) the taxpayer is willing to become a bona fide resident of Puerto Rico, and (2) the amount of income the individual can generate from sources within Puerto Rico is enough to justify the move.

#39: Timing the NQSO Exercise Decision

Non-qualified stock options (NQSOs) are any options granted to an employee for services rendered that don't qualify as incentive stock options (ISOs). The tax consequences of NQSO are as follows:

- Grant—No tax consequences unless option has ascertainable value (rarely the case)
- Exercise—ordinary income equal to FMV minus exercise price (spread)
- Sale of underlying stock—capital gain equal to sale price minus exercise price

> ***Example 1***. T receives an NQSO with a strike price of $100 on January 2, 2019. Assume that T's combined state and local ordinary income tax rate is 40% and T's combined state and local long-term capital gains rate is 20%. T exercises the option on January 2, 2021. The FMV of the stock on this date is $120. T recognizes $20 of ordinary income as of the date of exercise. There are no further tax consequences until the underlying stock is sold. T sells the stock on January 2, 2026 when the FMV of the stock has increased to $200. At this time, T recognizes capital gain equal to the difference between the amount of the sale proceeds ($200) and his basis in the stock ($120), or $80. Thus, T has $20 of ordinary income and $80 of capital gain. The total tax payable is $24 [(.4 x $20) + (.2 x $80)].

On the surface, it might appear that the earlier the taxpayer can exercise the options the better the economic result will be. The longer the taxpayer waits to exercise, the more capital gain is converted to ordinary income.

> ***Example 2.*** Assume the same facts as in Example 1 except that T waits until the end of the option term to exercise and sells the stock received on the same day. T now has $100 of ordinary income ($200 - $100) and no capital gain, making the total tax payable $40 instead of $24.

<u>Advantage of Late Exercise</u>

It turns out, however, that notwithstanding the unfavorable tax consequences, taxpayers are generally better off waiting as long as possible to exercise their NQSOs. The economic benefit of an NQSO is that its owner gets the benefit of any increase in value of the underlying stock without paying anything to get it. In effect, the owner gets a double return on her money—the growth on the stock underlying the option plus whatever return the money saved by not paying the exercised price earned during the period between the early exercise date and the later exercise date. The longer the owner has the use of this "side fund" to invest, the better. This benefit will generally outweigh the unfavorable income tax consequences of late exercise. By contrast, if the owner exercises early he gets only the growth on the underlying stock. The double return benefit of late exercise will generally outweigh its unfavorable income tax consequences.

> ***Example 3.*** Assume the following facts.
>
> - T is granted an NQSO
> - Strike price = $100
> - Present FMV of underlying stock = $100

- NQSO expires in seven years
- T has one option + $92.94 in a side fund
- The stock price will increase at 10% per year
- The value of the side fund will increase at 8% per year
- T's ordinary income rate = 40%
- T's capital gain rate = 20%

Scenario 1—*Exercise in Two Years*

- FMV of stock after 2 years = $121
- Tax payable on exercise = $8.40 (.4 x $21)
- Value of side fund after 2 years = $108.40
- T uses full $108.40 from side fund to pay tax on exercise
- Remaining value in side fund = $0
- Value of stock at end of 7-year option term = $194.87
- T sells stock for $194.87
- Tax on gain = $194.87 - $121.00 = $73.87
- All gain is long-term capital gain
- Tax payable = $14.77 (.2 x $73.87)
- T ends up with $180.10 from stock ($194.87 - $14.77)
- Side fund is gone
- Total to T after tax = $180.10

Scenario 2—*Exercise at End of Term*

- Side fund grows to $159.28 after 7 years
- T exercises option
- This reduces side fund by $100
- $59.28 left in side fund
- FMV of stock at end of term = $194.87
- Ordinary income on exercise = $94.87
- Tax on exercise = $37.95 (.4 x $94.87)
- Leaves $21.33 in side fund ($59.28 - $37.95)
- T sells stock for $194.87
- No capital gain on sale (T's basis = $194.87)
- Total to T after tax = $216.20 ($194.87 + $21.33)
- This is $36.10 more than in Scenario 1 ($216.10 - $180.10)

Explaining the Results

- Growth in side fund from year 2 to year 7 = $50.88 ($159.28 - $108.40)
- This is a benefit for Scenario 2
- Tax payable in Scenario 2 = $37.95 OI
- Tax payable in Scenario 1 = $23.17 ($8.40 OI + $14.77 CG)
- Extra tax paid in Scenario 2 = $14.78 ($37.95 - $23.17)

- Net benefit in Scenario 2 = $36.10 ($50.88 - $14.78)

Non-Tax Considerations

The foregoing analysis focused on the tax aspects of the NQSO exercise timing decision, but there are also important non-tax considerations. Most of these factors favor early exercise. First, option holders don't receive dividends on the underlying stock until the options are exercised. This factor could make an important difference if dividends are expected to be substantial. Second, the taxpayer might not consider the underlying stock a good investment. If so, it might be better to exercise the NQSOs early, sell the stock and make more favorable investments. Third, the taxpayer might have a concentrated position in the employer stock. Assuming that the company doesn't discourage early exercise, it might be best to exercise early, sell the stock and diversify the portfolio. Fourth, the taxpayer might need the money and can't afford to wait for it. Finally, early exercise might become more favorable if tax rates are expected to increase substantially in the future. Taxpayers may also wish to spread out exercise to avoid bunching income in one tax year and pushing themselves into higher tax brackets.

#40: Cost Segregation

Cost segregation studies can produce tax savings in two ways. First, they can substantially increase the present value of depreciation deductions and increase cash flow. Without cost segregation, taxpayers must depreciate residential property using straight-line depreciation over a 27.5-year period[172] and non-residential property using a straight-line method over 39 years. Cost segregation may enable the taxpayer to depreciate part of the cost of a building over a shorter period of time using a faster depreciation method.

A second benefit of a cost segregation analysis is that it can increase the amount of property subject to depreciation by reallocating the purchase price of a building between building components and tangible personal property or between land and land improvements.

Cost Segregation Procedure

Cost segregation is accomplished by segregating building costs into five components—

- Five-year personal property
- Seven-year personal property
- Land improvements
- Buildings
- Land

Five-Year Personal Property

This is the most favorable property for depreciation purposes. Taxpayers cannot only depreciate it over a short five-year period, they can use the very favorable double-declining balance method. Property in this category includes office machinery (such as typewriters, calculators and copiers), computers and peripheral equipment, and any property used in research and experimentation. It also includes appliances, carpets, furniture, etc., used in a residential rental real estate activity. Taxpayers should attribute as much of the cost of a building as possible to this category.

Seven-Year Personal Property

This category of property can also be depreciated using the double declining balance method. Although the depreciation period is somewhat longer, it still receives highly favorable treatment. Seven-year personal property includes office furniture and fixtures (such as desks, files and safes), agricultural machinery and equipment and railroad tracks.

Land Improvements

Certain improvements made directly to land can be depreciated over a 15-year period using a 150% declining balance method. Property included in this category includes shrubbery, landscaping, fences, roads, sidewalks, bridges and docks.

[172] Assuming that the alternative depreciation system isn't being used.

Buildings

Although buildings are depreciated over a much longer period of time than personal property or land improvements and use the less favorable straight-line method, allocating purchase price to buildings is still much more favorable than allocating it to land. After allocating as much value as possible to personal property, buyers want to maximize the portion of the remaining value allocated to buildings because any residual value will be attributed to non-depreciable land.

Increasing the Present Value of Depreciation Deductions

The following example illustrates the economic benefit of shorter depreciation periods and more favorable depreciation methods.

> ***Example 1.*** In January 2019, T buys a non-residential building for $10,000,000 from an unrelated party. If T doesn't utilize cost segregation, it must use straight-line depreciation over 39 years. Instead, T has a cost segregation study done. The study concludes that $9,000,000 of the purchase price should be allocated to the building and $1,000,000 to 5-year property. Assume the following additional facts:
>
> - The building is depreciated using the full month convention
> - The salvage value of the building is $0
> - T is in the 37% marginal income tax bracket
> - T's opportunity cost of capital is 7%
>
> A. No Cost Segregation
>
> The annual depreciation deduction will be $256,410.26 ($10,000,000/39). The present value of this payment stream discounted back to present value at 7% is $3,401,263 and the present value of T's tax deduction is $1,258,468 (.37 x ($3,401,263).
>
> B. Cost Segregation
>
> If cost segregation is used, 39-year straight-line depreciation will still apply to 90% of the $10,000,000 total value. Thus, the present value of the straight-line depreciation on the building will be $1,132,621 (.9 x $1,258,568).
>
> However, the $1,000,000 worth of five-year property will be depreciated using the double declining balance method. The annual depreciation deductions will look like this:

Year	Depreciation	P.V.	P.V. x 37%
2018	$400,000	$373,832	$138,318
2019	240,000	209,625	77,561
2020	144,000	117,547	43,492
2021	86,400	65,914	24,388
2022	51,840	36,961	13,676
Total			$297,435

C. Tax Savings

The following chart shows the depreciation deductions in the two scenarios.

Scenario A	*Scenario B*
$1,258,468	$1,132,621
	+ 297,435
	$1,430,056

Thus, under the assumed facts the present value of the tax savings from using cost segregation is $171,588 ($1,430,056 - $1,258,468).

Increasing the Amount of Property that Can Be Depreciated

A cost segregation study may also increase the amount of property that can be depreciated by identifying aspects of a building that could be treated as tangible personal property and depreciated rather than components of a building. For example, the following are among the many items held to be personal property:

- Wall-to-wall carpeting in a motel (Rev. Rul. 67-349);
- Vinyl floor and wall coverings (*Hospital Corporation of America*, 109 TC 21);
- Chandeliers and hanging lanterns in a restaurant (*Shoney's Inc.,* TC Memo 1984-413);
- Ornamental lighting fixtures (*Laurence A, Duaine*, TC Memo 1985-39); and
- Clothes dryer vents, gas lines in common laundry rooms and electrical outlets for refrigerators, stoves, washers and dryers in an apartment complex (*Amerisouth XXXII Ltd*., TC Memo 2012-67).

If land improvements can be identified and segregated from the land, additional property can be depreciated.

Additional Benefits

A cost segregation study may produce two additional benefits. First, the study may identify assets eligible for bonus depreciation or IRC §179 expensing. Following the 2017 Tax Cuts and Jobs Act (TCJA), bonus depreciation allows taxpayers to immediately deduct 100% of the cost of qualifying property. Under the TCJA, qualified property is defined as tangible personal property with a recovery period of 20 years or less. Use of the property by the taxpayer need not be the original use provided that the taxpayer hasn't previously used the acquired property and the property wasn't acquired from a related party. In other words, it may be possible to get the bonus depreciation from used property. To obtain 100% expensing, the taxpayer must acquire the property after September 27, 2017.

Second, although taxpayers aren't allowed to depreciate components of a building separately, a cost segregation study can value a component to give it a basis if it later needs replacement.

Example 2. T buys an apartment building in 2019. A cost segregation study values the roof at $300,000. In 2021 when the value of the roof is $275,000, it is seriously damaged in a hurricane. T can claim a $275,000 deduction for the loss of the roof. Without the cost segregation study, the cost of the roof couldn't be separated from the cost of the building as a whole.

Disadvantages of Cost Segregation

A cost segregation study may have the following disadvantages:

- It won't be worth the time and expense if the taxpayer has little or no income or plans to sell a building within a few years after it is purchased;
- The tax savings may not be sufficient to justify the cost;
- There may be depreciation recapture subject to ordinary income rates;
- Possible § 1250 gain taxed at 25%;
- If a study is too aggressive or includes erroneous information, the IRS could assess penalties on the additional tax due to a substantial valuation misstatement.the additional tax due to a substantial valuation misstatement.

#41 BONUS IDEA: Distribution Planning for Non-Spousal Inherited IRAs Following the SECURE Act

The stretch IRA was the ideal method for maximizing the time during which IRA assets could grow on a tax-deferred basis for non-spouse beneficiaries. Although the SECURE Act eliminated the stretch IRA for most non-spousal inherited IRAs, generally requiring that the full value of the IRA be distributed within 10 years after an IRA owner's death, several strategies are still available to increase the amount that can be accumulated for a family. These strategies include (1) naming a charitable remainder trust as the IRA beneficiary, (2) Roth IRA conversions, (3) buying life insurance, (4) multi-generational spray trusts, (5) incomplete gift non-grantor trusts and (6) IRC § 678 trusts.

Charitable Remainder Trust as IRA Beneficiary

A charitable remainder trust (CRT) is a split interest trust that pays an amount to lead beneficiaries for a specified term with the remainder interest passing to charity. The lead beneficiaries are typically either the donor or the donor and the donor's spouse, but could also be other non-charitable beneficiaries like the donor's children. It is also possible to give a portion of the lead interest to charity, provided that there is also at least one non-charitable beneficiary.

CRAT

A CRAT pays a fixed percentage of the trust's initial value annually or at more frequent intervals (IRC § 664(d)(1). The amount of the payout doesn't change from one year to the next.

CRUT

A CRUT pays a fixed percentage of the trust assets recalculated annually (IRC §§ 170(f)(2), 2055(e)(2)(B), 2522(c)(2)(B)). Thus, the amount of the payments varies depending on the total return produced by the trust assets (appreciation plus income).

Spreading out Distributions

If a CRT is named the beneficiary of a traditional IRA, there is no tax when the funds in the IRA are distributed to the trust. Tax is only payable when the beneficiaries receive distributions from the CRT. These distributions can be spread out over a term of years not to exceed 20 or for the life or lives of a named individual or individuals. The character of these payments is determined under the ordering rules of IRC § 664, first, as ordinary income, to the extent the trust has realized current or accumulated ordinary income, then as capital gains, then as other income (e.g. tax-exempt income) and finally as tax-free return of corpus.

Comparison with Outright Distributions

If we compare the wealth accumulated for the IRA owner's heirs by using a CRT as the IRA beneficiary with the wealth accumulated for heirs with outright distributions to them over five or 10 years, we find that the results are fairly comparable even though using a CRT significantly increases the deferral period. The reason is that IRC Sections 664(d)(1)(D) and 664(d)(2)(D) require that the present value of the charitable remainder interest must be at least 10% of the initial value of the trust assets.

Charitable Intent

If the IRA owner has charitable intent, however, and the amounts accumulated for the charity are added to the amounts accumulated by the heirs, the CRT strategy can be quite favorable.

Mortality Risk

The amount of wealth a CRT transfers to beneficiaries will depend on how long the beneficiaries live. If they die well before reaching their life expectancy, the CRT will transfer far less wealth to the beneficiaries than the other strategies. This risk might be hedged against by purchasing life insurance. On the other hand, if the beneficiaries live well beyond their life expectancy, the CRT strategy may prove to be very favorable.

CRAT vs. CRUT

Given the current low IRC Section 7520 rates, CRUTs will generally be more favorable than CRATs, although CRATs do have some advantages. The advantages of each type of CRT are summarized below.

Advantages of CRUTs

- A longer stretch-out period is possible for life CRUTs because the 5% probability of exhaustion test doesn't apply to CRUTs

- Given the low current Section 7520 rates, CRUTs can make substantially higher annual payouts to the non-charitable lead beneficiary

- Unitrust payouts provide a hedge against inflation

- CRUTs are more flexible, providing different payout options— Unlike a CRAT, a CRUT can have net income, net income with make-up or flip provisions.

Advantages of CRATs

- Some beneficiaries like the assurance of having the same payment each year regardless of investment performance. A CRAT has the same payout each year regardless of investment performance

- Ease of administration—no need for annual revaluations

With a CRAT, the charitable remainderman bears the investment risk. With a CRUT, the investment risk is split between the lead and remainder beneficiaries.

ROTH IRA CONVERSIONS

A Roth IRA is generally subject to the same rules that apply to a traditional IRA except that contributions to the IRA aren't deductible and qualified distributions are tax-free.[173] A "qualified distribution" is a distribution that occurs after a five-year holding period and is made on or after the day the beneficiary reaches age 59½, after the owner dies, after the owner becomes disabled or is a qualified special purpose distribution.[174]

The conversion of a traditional IRA to a Roth IRA is treated as a distribution in which the taxpayer recognizes taxable income. When an IRA conversion is done during life, the timing of the distributions is important. The conversion can be done in steps to prevent income from going into a higher tax bracket. However, this staged conversion strategy isn't available for converting an inherited non-spousal IRA after the death of the owner. If the conversion is to be done in steps, it must be done during the IRA owner's life.

An important advantage of a Roth IRA is that there are no required minimum distributions (RMDs).[175] This enables the entire value of the IRA to grow tax-free until the beneficiary's death, facilitating accumulation of wealth for the family. If the beneficiary doesn't need distributions, the Roth IRA could be viewed more as a wealth transfer tool than as a retirement income vehicle.

Pre-SECURE Act Roth Conversion Decision

There is a tradeoff between paying current tax on the amount transferred and avoiding tax on later distributions from the account. In deciding whether to do a Roth IRA conversion, taxpayers must analyze this tradeoff. The analysis begins with a comparison of the taxpayer's marginal income tax rate at the time of the conversion and the taxpayer's expected marginal income tax rate when distributions are received.

We could draw the following general conclusions about the Roth conversion decision:

- If the tax rate is lower at the time of conversion than at the time distributions are received, a Roth conversion will be favorable.

- If the tax rate is higher at the time of conversion than at the time distributions are received, a Roth conversion will be unfavorable.

- If the tax rate is the same at the time of conversion and the time distributions are received, a Roth conversion will be neutral.

There are other factors that might favor a Roth conversion, however. If the conversion tax can be paid with outside funds instead of funds from the IRA, the conversion tax can be offset by favorable tax attributes like NOL carryovers, unused charitable deductions, AMT carryovers, or current year ordinary losses, or the beneficiary expects to have a taxable estate, a Roth conversion will generally

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[173] IRC §408A(c)(3).
[174] IRC §408A(d)(1).
[175] IRC §408A(d)(2).

be favorable even if the tax rate on the conversion is moderately higher than the tax rate when distributions are made.

Different Comparison after the SECURE Act

Note that the Roth conversion decision is different in the context of an inherited IRA following the SECURE Act. The tax rate at the time of the conversion is still important, but the assets can only stay in the IRA for a maximum of 10 years after the IRA owner dies. Instead of comparing a Roth conversion with leaving the money in a traditional IRA where it would continue to grow at a pre-tax rate of return in either case, we would be comparing it with other alternatives—distribution to a taxable account, CRT, to an out-of-state trust, to a multi-generational spray trust or to a Section 678 spray trust. Another possibility would be investing the IRA assets or distributions in life insurance.

Roth IRA Conversion vs. Other Strategies

It appears that unless a very substantial increase in ordinary income tax rates is expected, a Roth conversion would ordinarily be superior to transferring traditional IRA funds to a taxable account. If the beneficiary can pay the conversion tax with outside assets instead of assets from the traditional IRA, the economics of the conversion are even more favorable. In effect, the beneficiary can pack more value into the Roth IRA. There would be a shift of assets from a taxable account to the tax-free Roth IRA.

A Roth conversion also has important advantages over other potential strategies. Investing traditional IRA assets in life insurance would provide continued tax-free growth, but returns inside the policy would typically be lower than returns inside the Roth IRA. Moreover, there is less mortality risk with the Roth IRA. If the beneficiary lived well beyond life expectancy, life insurance would prove to be a less desirable investment. On the other hand, if the beneficiary died early, investing IRA funds in life insurance would prove to be the best strategy for passing wealth on to heirs.

An advantage of a Roth conversion over a transfer to a CRT is that there is no need to transfer 10% of the value to charity. The full value can go to heirs.

Transferring assets to a multi-generational spray trust would enable the family to spread out distributions, but the assets wouldn't grow tax-free like they would in the Roth IRA. On the other hand, if the beneficiary has a taxable estate, the estate planning advantages of a multi-generational trust might outweigh the income tax benefit of the Roth IRA.

The advantage of transferring the IRA assets to an irrevocable non-grantor (ING) trust would be that distributions to beneficiaries could be spread out and state income tax could be avoided. The Roth IRA could not only avoid state income tax, but also federal income tax.

Whether a Roth conversion will be more favorable than one of these other alternatives will depend on the facts of the case. A detailed quantitative analysis is necessary to determine whether it provides an overall economic benefit for a specific taxpayer. This sensitivity of the economic result to the facts of the case highlights the need for tools to analyze the best strategy for a client's specific situation.

LIFE INSURANCE

Beneficiaries who don't need to consume the required minimum distributions they receive from their inherited IRAs during the 10-year SECURE Act period may be able to increase the amounts that can be accumulated by heirs by using some or all of the distributions to buy life insurance. The proceeds of the policy would be paid income tax-free to the beneficiary's heirs or to a trust for their benefit.

Buying life insurance with the distributions would have no effect on the traditional IRA. The same amount could stay in the IRA, the required minimum distributions would be the same and the same amount would still pass to a taxable account, CRT, etc. at the end of the 10-year period.

An investment in life insurance has two advantages over a taxable investment. First, assuming that the contract meets the definition of life insurance, there is no tax on the build-up of the policy's cash surrender value.[176] Moreover, there is generally no income tax payable when the insured dies.[177] Thus, as a general rule, the insurance proceeds are never subject to income tax.[178]

On the other hand, a taxable investment will generally produce a higher pre-tax return because the insurance company has to make a profit, pay commissions and cover overhead. Thus, whether investing distributions in life insurance will be a favorable strategy depends on whether its tax advantages outweigh the lower pre-tax return. Since buying life insurance is a bet-to-die strategy, this will depend in large part on how long the insured lives. Whether the life insurance strategy will be favorable will depend on the facts of the case—

- The after-tax rate of return on a taxable investment;
- How long the insured will live; and

[176] IRC §§7702(g); 72.
[177] IRC § 101(a)(1). There is an important exception for transfers for value. If there has been a transfer of the policy for valuable consideration, the amount excluded from income can't exceed an amount equal to the sum of actual value of such consideration and the premiums and other amounts subsequently paid by the transferee (IRC § 101(a)(2)).
[178] This is generally true even if amounts are withdrawn from the policy. The only time a cash withdrawal is taxed is if the amount withdrawn exceeds your basis, i.e. how much premiums you have paid into your policy.

- The effective rate of return on the life insurance policy

Depending on how these variables play out, the life insurance strategy could either be very favorable or very unfavorable. For example, if the life insurance policy provided a favorable return and the IRA owner lived only a short time after buying the policy, the family would receive an economic windfall. On the other hand, if the IRA owner could invest the RMDs to produce an after-tax return substantially higher than the rate of return for the life insurance policy and lived well beyond life expectancy, the life insurance strategy would turn out to be highly unfavorable. The rate of return for the insurance policy given various life spans could be determined. The rate of return on the taxable reinvestment account and how long the IRA owner would live couldn't be determined precisely, but reasonable estimates would ordinarily be possible.

Timing of the Life Insurance Purchase

If tax rates stay the same throughout the 10-year period, it probably wouldn't make sense to take a distribution from the IRA at the beginning of the period and use the money to buy life insurance. Although the funds would grow tax-free in the life insurance policy, they would also grow tax-free if left in the traditional IRA and perhaps produce a better return. If tax rates were expected to be higher at the end of the 10-year period than at the beginning, the benefit of the lower rate would have to be weighed against the lower expected return. It might also be a good idea to stage the life insurance purchases to manage tax rates, depending on the facts of the case..

Estate and Gift Tax Considerations

Investing in life insurance would have an important advantage for taxpayers with taxable estates. The value of the taxable account will be included in the IRA owner's gross estate when he dies, but the life insurance generally won't be included unless the owner had incidents of ownership in the policy.[179] Thus, the life insurance scenario is both income tax and estate tax-free. Given the current high applicable exclusion amounts, however, there would be estate tax consequences for only a small percentage of taxpayers.

Joint and Survivor Life Insurance

Investing in a joint and survivor life insurance policy might be better than investing in a single life policy. The benefit of a second-to-die policy is the lower "mortality drag" which results in a higher return on investment (ROI) on the insurance design.

Life Insurance Hedge

The 10-year rule, creates new actuarial risk of early death. Under prior law, qualified accounts could be drawn-down over decades after death capturing deferral and virtually assuring bracket arbitrage. However, a 10-year distribution requirement will unfairly tax those who die when their

[179] IRC § 2042.

savings peaks around retirement age or shortly thereafter. Life insurance could offset this risk that family wealth will be lost to tax.

Multigenerational Spray Trusts

Prior to the SECURE Act, IRA owners often named trusts as beneficiaries of their IRAs. Two kinds of trusts were used, a conduit trust and an accumulation trust. Conduit trusts no longer provide favorable results following enactment of the SECURE Act because all assets received from the IRA have to be distributed within 10 years. Naming accumulation trusts structured as multigenerational spray trusts might still be a good strategy, though.

Accumulation Trust

With an accumulation trust, the trustee must take required minimum distributions (RMDs) each year, but has discretion to decide how much, if any, to pay to the beneficiaries and how much to keep in the trust. If the funds are retained, they will be taxed to the trust at trust tax rates. If they are distributed, the trust will generally get a DNI deduction and the amounts will be taxed to the beneficiaries at their personal tax rates.

Assuming that the trust qualifies as a designated beneficiary, the IRA funds must all be distributed to the trust within 10 years after the IRA owner dies. If the trust doesn’t qualify as a designated beneficiary, the IRA must be paid out within five years (if the IRA owner died before reaching his required beginning date) or over the participant's “ghost” life expectancy (if the owner died after reaching her RBD). The ghost life expectancy RMD is calculated using the life expectancy factor for the decedent’s age at death.

A trust is treated as a designated beneficiary if four requirements are satisfied:

(1.) The trust is valid under state law, or would be but for the fact that there is no corpus;[180]

(2.) The trust is irrevocable or will by its terms become irrevocable upon the death of the employee;[181]

(3.) The beneficiaries of the trust can be identified from the trust instrument;[182] and

(4.) Proper documentation has been provided to the plan administrator.[183]

Both the Five-Year rule and the “Ghost” Life Expectancy rule appear to have survived the Secure ACT for non-designated beneficiaries. Note that the ghost life expectancy rule may be more favorable for IRA owners in the 71-82 year-old age range than the 10-year rule because they have a life expectancy of greater than 10 years.

[180] Reg. § 1.401(a)(9)-4, Q&A 5(b)(1).
[181] Reg. § 1.401(a)(9)-4, Q&A 5(b)(2).
[182] Reg. § 1.401(a)(9)-4, Q&A 5(b)(3).
[183] Reg. § 1.401(a)(9)-4(b)(4).

Naming an Accumulation Trust as the IRA Beneficiary Following the SECURE Act

Although accumulation trusts increase costs and add complexity, they also create important non-tax advantages for a family. They limit beneficiary access to funds, protect assets from creditors, provide professional management of trust assets and may enable the trustee to manage tax brackets. They may also provide divorce protection and dead-hand control and facilitate estate planning and planning for special needs beneficiaries.

If an accumulation trust is the beneficiary, all the IRA funds would have to be paid to the trust by the end of the 10-year period, but the trustee wouldn't have to pay out all the funds to the trust beneficiaries. As a result, trust funds could remain in the trust after the end of the 10-year period and accumulate on a tax-deferred basis for the trust beneficiaries. The problem with retaining the IRA funds in the trust, however, is that they will generally be taxed at a much higher rate than amounts that are distributed to beneficiaries. For 2020, all trust income above $12,950 is taxed at the top rate of 37%. By contrast, married taxpayers filing jointly aren't subject to the 37% rate until income exceeds $622,050.

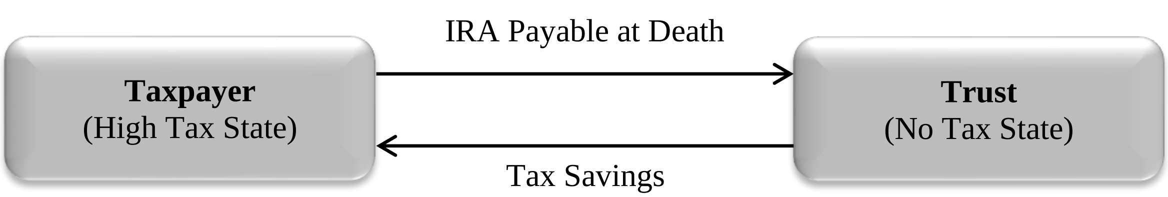
An accumulation trust should be structured as a spray trust. A "spray" trust names a broad group of family members as beneficiaries and sprays distributions across the group according to the instructions provided by the grantor to the trustee. In this way, the family has the flexibility to vary the amount of IRD recognized across the trust and the trust beneficiaries in order to minimize income tax obligations. Thus, a spray trust could be used to combine the tax benefits of low tax rates with the non-tax advantages of an accumulation trust..

Dynasty Trust

For very wealthy taxpayers with wealthy children and very large IRAs, transferring the IRA to a dynasty trust might be considered for its estate planning advantages. Dynasty trusts are explained at Opportunity #21 above

Incomplete Gift Non-Grantor (ING) Trusts

The benefits of using a multigenerational accumulation trust as a beneficiary of an IRA can be enhanced by making the trust an incomplete non-grantor (ING) trust in a state that doesn't tax trust income. The leading states for creating these trusts are Delaware, Nevada and Wyoming. In Delaware they are called DING Trusts, in Nevada, NING Trusts, and in Wyoming WING Trusts. They can also be created in several other states.



IRA distributions received by the trust will be taxed to the trust beneficiaries to the extent they are distributed and to the trust to the extent they are retained. In most cases, the trustee will try to distribute most or all the amounts received from the IRA because the beneficiaries will typically be in lower tax brackets than the trust. If the beneficiaries are in the 37% tax bracket, don't need current distributions and live in a high tax state, however, accumulating the IRA distributions in the trust might save significant amounts of tax.

> ***Example.*** T dies owning a large IRA and names an ING trust as the beneficiary. Assume that the trust receives $300,000 per year from the IRA. The beneficiary lives in a high tax state and has a combined federal and state tax bracket of 45%. Because the trust isn't subject to state tax it pays 37% on the trust income. This saves $24,000 per year in state tax (.08 x $300,000). If we assume that the tax savings can be invested at 6%, they will grow to $316,339 after 10 years and $882,854 after 20 years.

<u>Mechanics of the Strategy</u>

To accomplish the desired results, the transaction must be carefully structured to meet all of the following requirements:

(1) The trust must be created in a state that (a) does not tax trust income, (b) allows domestic asset protection trusts (DAPTs) and (c) allows the grantor to retain inter vivos and testamentary special powers of appointment

(2) The income from the trust must not be taxable by the grantor's home state.

(3) The trust cannot be structured as a grantor trust.

(4) The trust must allow discretionary distributions to the settlor without making the trust a grantor trust; and

(5) Transfers to the trust must be incomplete gifts for federal gift tax purposes without making the trust a grantor trust.[184]

<u>Location of Trust</u>

The ING trust must be set up in a state that (1) doesn't tax trust income, (2) has a domestic asset protection trust (DAPT) statute, and (3) allows the settlor to retain a lifetime and testamentary non-general power of appointment. Nevada has perhaps become the most popular state for ING trusts. Other states that work include Alaska, Delaware, Ohio, South Dakota and Wyoming.[185]

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[184] A detailed analysis on NING trusts is beyond the scope of this article. For further information see Steven J. Oshins, "NING Trusts Provide Tax and Asset Protection Benefits," CCH Estate Planning Planning Review - The Journal (Aug. 20, 2013); Steven J. Oshins and Brian J. Simmons, "Save State Income Taxes using a Nevada Incomplete Gift Non-Grantor Trust," The Trust Advisor (Dec. 2013); Robert S. Keebler, *Using Incomplete Gift Nongrantor (ING) Trusts to Reduce State Income Tax*, Taxes, July 2015.

[185] Tennessee and a few other states may also qualify.

Trust Not Taxable in Grantor's Home State
Locating the trust in one of the states listed above does not necessarily mean that the trust income won't be taxed by the grantor's home state. For example, some states treat a trust as a resident trust if the grantor was a resident of the state when the trust became irrevocable or if the trust has in-state beneficiaries even if the trust is administered in one of the states listed above

The Trust Can't be a Grantor Trust

If the trust is a grantor trust, all income will be reported on the grantor's Form 1040 and be subject to tax in the grantor's home state.

Discretionary Distributions to the Settlor

Grantors typically don't want to give up the possibility of receiving trust income. Thus, the trustee must be given the power to make discretionary distributions to the settlor without causing the trust to be a grantor trust. If the trust is structured as a domestic asset protection trust (DAPT), however, allowing discretionary distributions does not make the trust a grantor trust

Incomplete Gift

Historically, most taxpayers who transferred assets to a state income tax saving trust didn't want the transfer to be subject to the gift tax. Thus, they needed to retain enough control over the transferred assets to avoid making a completed gift subject to the federal gift tax and without creating grantor trust status. This was accomplished by (1) giving the settlor both an inter vivos and a testamentary special power of appointment over the trust assets, and (2) requiring the consent of a distribution committee for any distributions to the settlor. The testamentary special power of appointment made the transfer to the trust an incomplete gift and the consent requirement allowed the trust to avoid grantor trust status.

Following recent increases in the applicable exclusion amount, settlors wish to avoid making a taxable gift for a different reason. Assuming that they are among the 1/10 of 1% of decedents who don't have a taxable estate, they want the transferred assets to be included in their gross estate when they die so their heirs can get a stepped-up basis.[186]

Section 678 Trust

Naming an accumulation trust as the beneficiary of a traditional IRA provides important non-tax benefits for a family. Trusts can protect assets from creditors, and provide professional management of trust assets, divorce protection and dead hand control of the assets. They may also facilitate estate planning.

To get these advantages, however, the assets must stay in the trust instead of being distributed to the trust beneficiaries. Unfortunately, any amounts retained in the trusts would ordinarily be taxed

[186] IRC § 1014.

at the high trust tax rates. For 2020, all trust income above $12,950 is taxed at the top individual income tax rate of 37%. By contrast, if the RMDs are distributed to the trust beneficiaries, they will be taxed at the beneficiaries' individual tax rates, which might be substantially lower than 37%.

If the individual beneficiaries don't all the money from IRA distributions, it is possible to obtain the benefits of a trust without the high trust tax rates. Under IRC Section 678, a person other than the trust's grantor is treated as the owner of a trust if that person is given a power to withdraw trust assets without the consent of any other person. If a trust beneficiary is treated as the owner of a trust under Section 678, all items of income, deductions, and credits against tax of the trust would be reported on the beneficiary's Form 1040 instead of on the trust's tax return.

If the trust named as the IRA beneficiary was a Section 678 trust, the trustee could retain the RMDS, but they would be taxed at the beneficiaries' rates, say 24%, instead of the trust's 37% tax rate. The family of the IRA owner would get the best of both worlds, the advantages of leaving the assets in the trust listed above, with the lower tax rates of the individual beneficiaries.

Note, however, that the beneficiaries of the trust would be paying tax on income they wouldn't receive, perhaps causing a cash flow problem. To address this potential difficulty, the trust could distribute enough trust income to the beneficiaries to pay the tax on the trust income and leave the rest in the trust.

> Example. F dies and transfers $2,500,000 to an accumulation trust, $1,000,000 of which is a traditional IRA. The beneficiary of the trust is F's daughter (D), who is treated as the owner of the trust under Section 678. The trust takes a $100,000 distribution from the IRA and has $25,000 of other income. Because D is treated as owning the trust, she reports the $125,000 of income on her form 1040. Assume that D is in the 24% marginal tax bracket and that the tax payable by her on the trust income is $30,000 (.24 x $125,000). The trust distributes $30,000 to D to pay the tax liability for the trust income and retains the remaining $95,000. If the $100,000 IRA distribution had been made directly to D, the tax payable would have been $37,000 instead of $24,000

There is one caveat for beneficiaries who expect to have a taxable estate. The beneficiary's right to take assets from the trust would be treated as a power of appointment and leaving assets in the trust would be treated as a lapse of the power of appointment resulting in a taxable gift from the beneficiary to the other trust beneficiaries. This rule only applies, however, to the extent the lapse exceeds the greater of $5,000 or 5% of the trust's value at the time of the lapse. In the example above, this amount would be the greater of $5,000 or $125,000 (.05 x $2,500,000).