TOP TAX PLANNING OPPORTUNITIES FOR 2023

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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.

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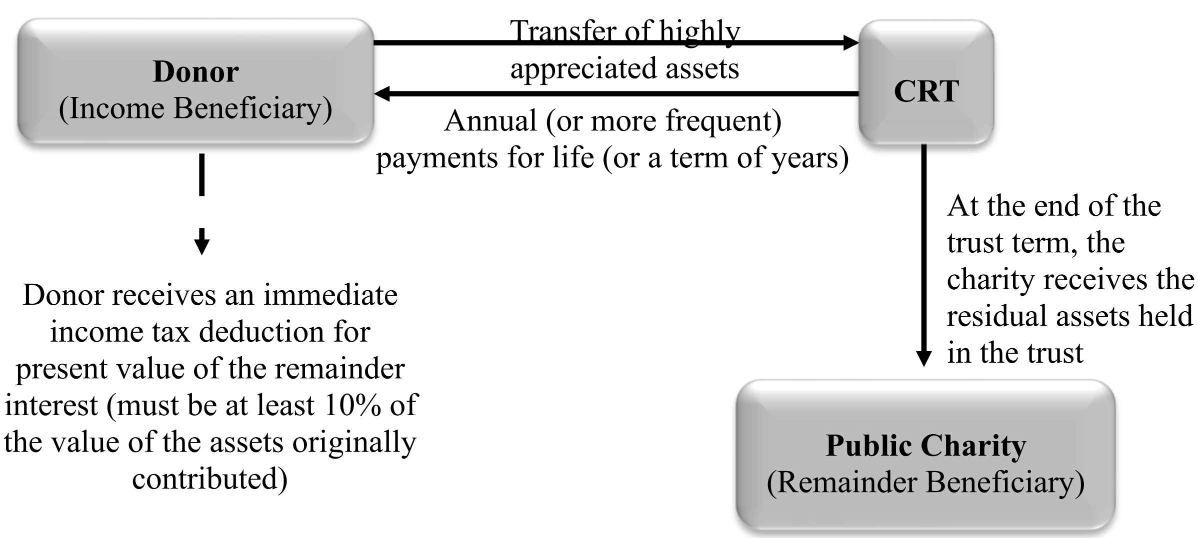
Chapter 1: Income Smoothing Strategies

#1: 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 2023 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 $292,300 @ 18.8% (15% rate, 3.8% NIIT)	$54,952
Last $357,700 @ 23.8% (20% rate, 3.8% NIIT)	$85,133
Total Tax Paid on Gain	$147,585

This leaves Cindy with $652,415 after tax.

Example 2. Now suppose that instead of selling the land herself, Cindy contributes it to a 20-year CRAT in December 2022 when the Section 7520 rate is 5.2%. 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 $58,758 per year.

N	I	PV	PMT	FV
20 years	5.2%[1]	$720,000 (800,000 - 80,000)	$58,758 (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 12. Because Cindy's income stays below her $200,000 applicable threshold amount for the NIIT and the $492,300 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 $42,585 less than the tax paid in the previous example ($147,585 - $105,000). The tax is not only lower, there is substantial tax deferral.

Caveat

Notwithstanding the significant income tax savings, a CRAT may or may not the taxpayer more after tax value than an outright sale of the property.. 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, if the the IRC § 7520 rate might be too low to produce an adequate annual payout.. 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

[1] Example Section 7520 Rate.

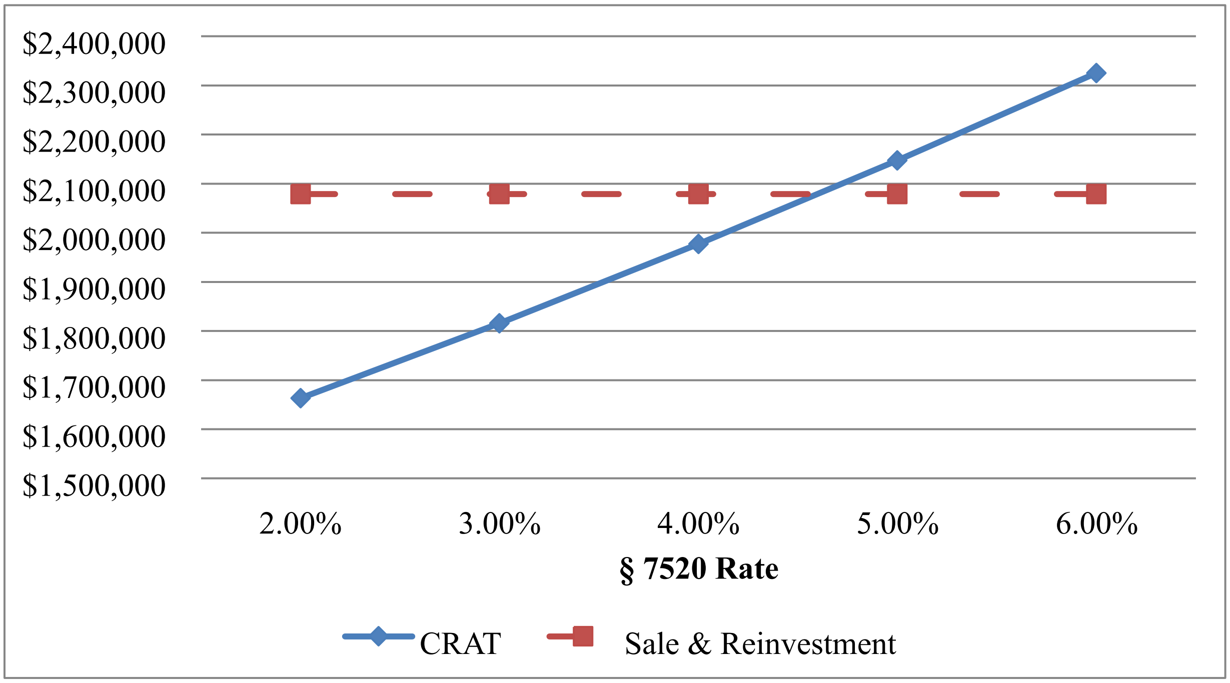
wealth they would have if they used the CRAT strategy given the 5.2% IRC Section 7520 rate for December 2022.

> ***Example 3.*** Assume the same general fact pattern as in Examples 1 and 2. If Cindy reinvested the after-tax sale proceeds, she would have $2,092,383 after 20 years ($652,415 appreciated @ 6% for 20 years). By contrast, if Cindy transferred Blackacre to the December 2022 CRAT she would receive the following payments after tax—

	Calculation	**After Tax**
Years 1-11	$58,758 x 0.85	$49,944
Year 12	($53,662 x. 0.85) + $5,096	$38,107
Years 16-20:		$58,758
FV of payment stream:	TVM @ 6%	$1,925,245
FV of charitable deduction:	TVM: $80,000 @ 6%, 20 years	$256,571
Total wealth accumulation:		$2,182,245

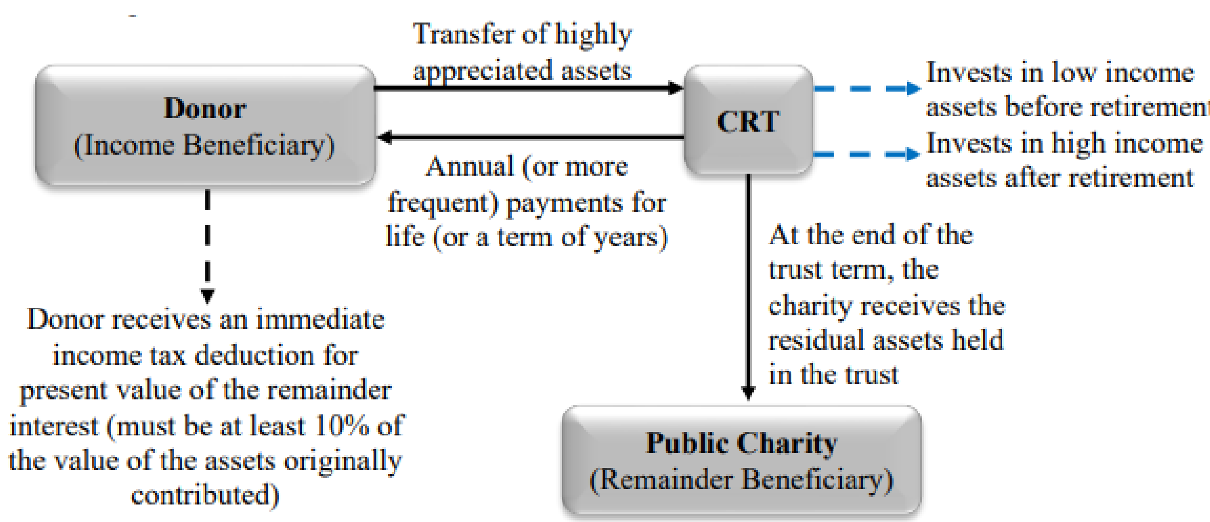
Under these facts, Cindy ends up with $89,862 more after 20 with the CRAT than with an outright sale. Note, however, that whether the strategy will work and how well it will work depend on the current 7520 rate. The higher the 7529 rate, the larger the annuity payouts will be. With a low Section 7520 rate, the strategy will only make sense if the taxpayer has strong charitable intent. If the Section 7520 rate continues to rise, the strategy will become even more favorable. 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	$1,414,953	$1,671,524	$2,087,165
3.0%	$48,395	$1,559,339	$1,815,910	$2,087,165
4.0%	$52,979	$1,720,835	$1,977,406	$2,087,165
5.2%	$58,758	$1,925,674	$2,182,245	$2,087,165
6.0%	$62,773	$2,068,698	$2,325,269	$2,087,165



#2: 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[2]	Make-Up "Payout"[3]	Actual Payout[4]	End. Bal. Make-Up Fund[5]	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).

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[2] Calculated by taking the 5% interest rate times the $100,000 of trust principal.

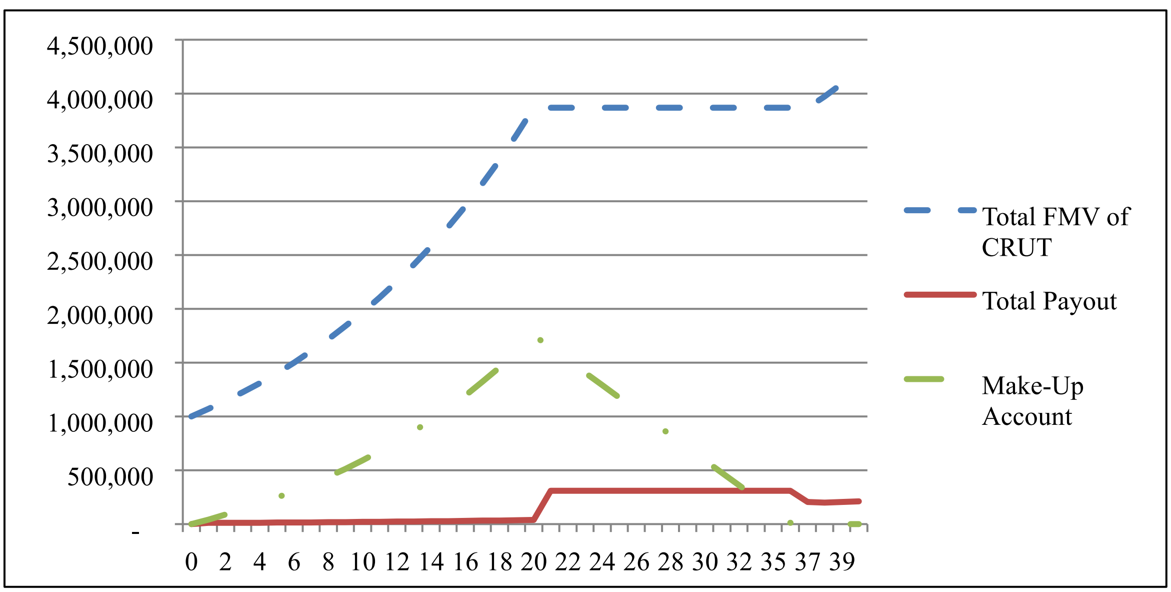
[3] If the trust income exceeds the stated 5% payout and there is an accumulated amount in the Make-Up Fund, then the amount that the trust income exceeds the stated 5% payout will be a Make-Up Payout.

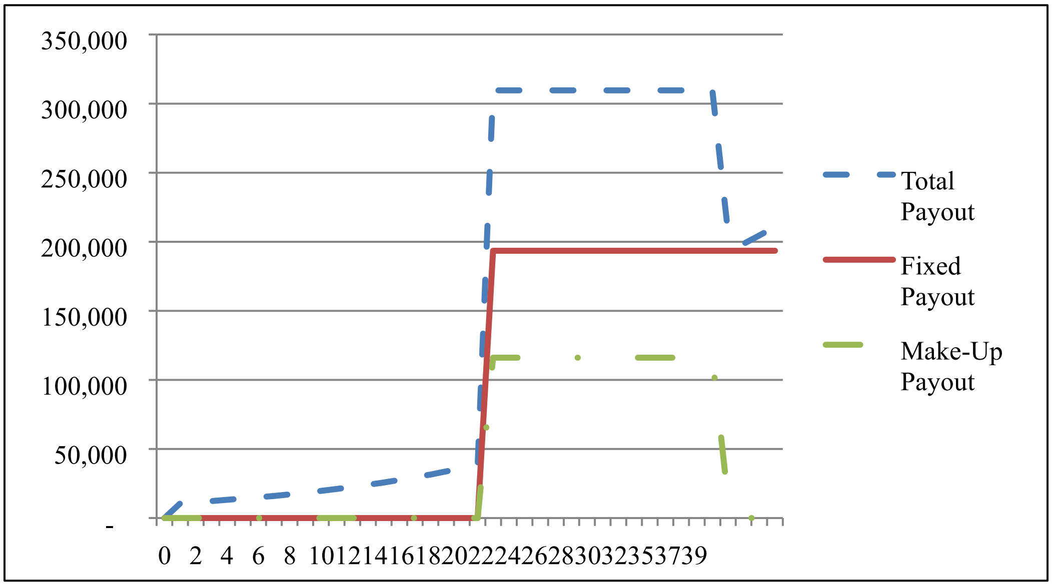
[4] The lesser of trust income or the stated 5% interest rate payout (plus any amount in the Make-Up Fund).

[5] 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.

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.

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.[6]

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

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[6] 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.

#3: 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 2023. 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 carryforwards, 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).

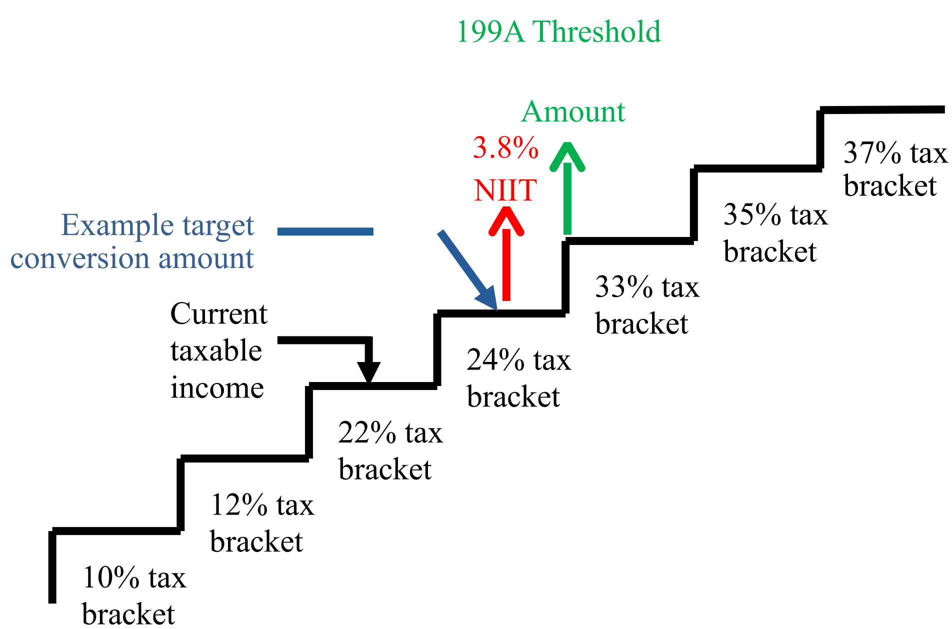
Distributions from a traditional IRA are not considered NII, but they do increase MAGI. Thus, they could create or increase a taxpayer's NIIT. By contrast, a Roth IRA distribution is neither NII nor MAGI, so it does not create or increase a taxpayer's NIIT. Therefore, a taxpayer can use a Roth IRA conversion 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 recharacterize.

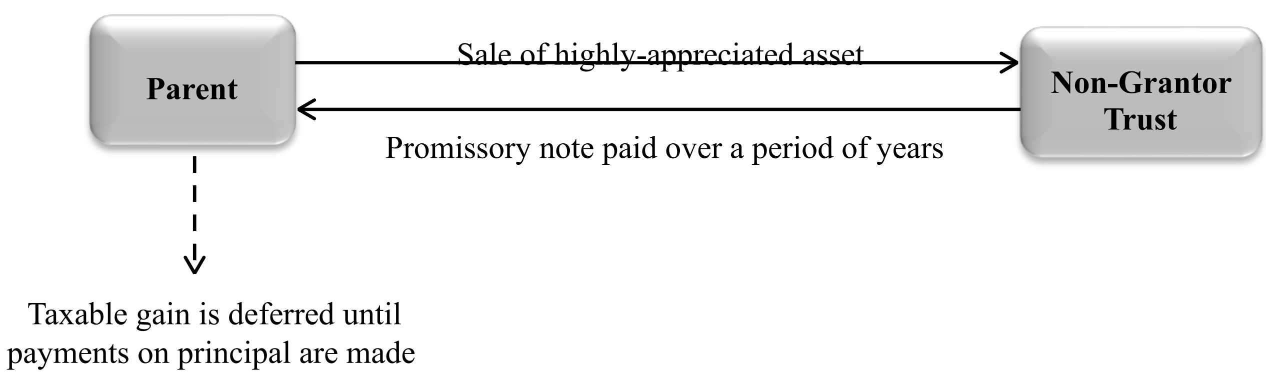
Much of the Roth IRA conversion planning discussed above can be done with Keebler & Associates, LLP's Tax Rate Evaluator and Roth Conversion Software.

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.

#4: 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.[7]

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.[8] 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.

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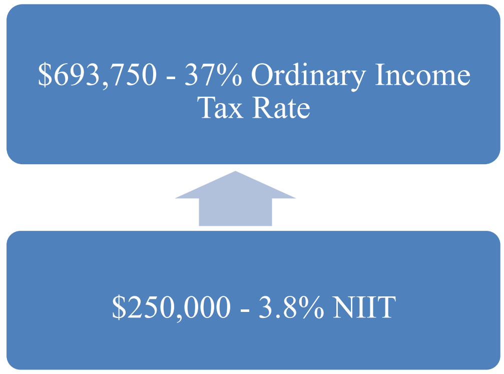
[7] IRC § 453(f).

[8] 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:

<u>Scenario 1</u>: 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%	<u>$48,409</u>
Total After-Tax Gain ($500,000-$102,270)	<u>$397,730</u>

<u>Scenario 2</u>: 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	<u>$75,000</u>
Total After-Tax Gain	<u>$425,000</u>

Two traps for the unwary should be noted. First, IRC § 453(e)(2) suspends the running of the twoyear 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, 2022. On June 1, 2024 T enters into a contract to sell Brownacre to an unrelated buyer on December 1, 2024. The six months from June 1, 2022 to December 1, 2022 do not count towards the two-year requirement. Thus, on December 1, 2024, T is treated as selling Brownacre only 21 months after the original sale by P, triggering application of IRC § 453(e).

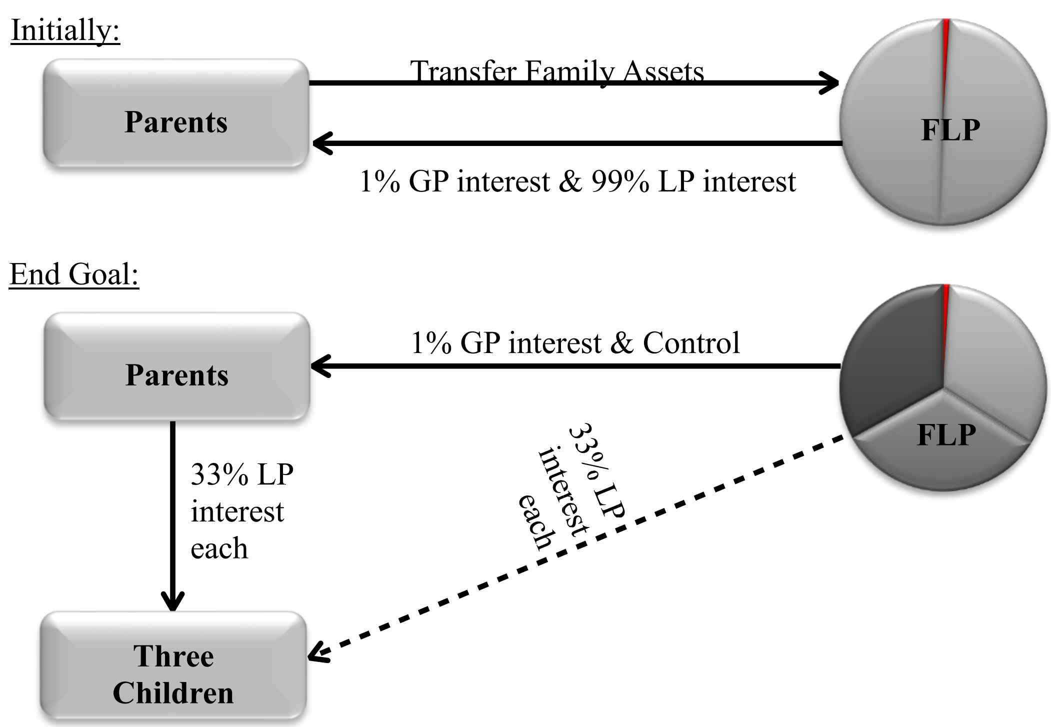
Second, there is no two-year limitation period for a sale of marketable securities. Assuming that the original seller has not yet received all payments from the related party, IRC § 453(e) applies regardless of the time period between the two sales.

Chapter 2: Income Shifting Strategies

#5: 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 ($17,000 per donee in 2023).

> ***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 $34,000 per year to each child (2023 annual gift exclusion of $17,000 x 2 parents). Therefore, in the first year, Parents will transfer 3.4% of the FLP in limited partner interests to each child (3.4% x $1,000,000 = $34,000 for each child, a total of 10.2%). That accounts for10.2% 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 10 years to transfer the entire limited partner interest to their children tax-free (99% / 10.2%). 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 2023, this amount is set at $12,920,000 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 $34,000 per year to each child, they will be able to gift $48,571,857 per year to each child ($34,000 / (1 - .3)). That accounts for 12% of the FLP in limited partner interest per year. Assuming everything else stays equal, it will take Parents 7 years to transfer the entire limited partner interest to the children tax-free (99% / 14.57%).

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 applicable exclusion amount (AEA). Again, assuming a 30% valuation discount, the value of each AEA increases to $18,457,143 ($12,920,000 /.7) and the total AEA for both parents becomes $36,914,286. If Parents transfer limited partner units with a discounted value in excess of $36,914,286, 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 2023, parents have $443,750 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 $90,000/year. 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).

Scenario 2: 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 $443,750 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 $693,750 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% marginal bracket 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 nonmanaging 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.

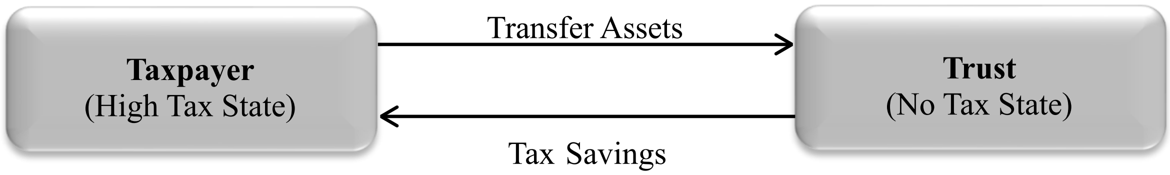
Estate Tax Advantage. Using an LLC will generally make it possible to do a postdeath, non-taxable liquidation of the entity.

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 3: Reducing Taxable Income Strategies

#6 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.[9]

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

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

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

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 $12,920,000 (2022 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*."

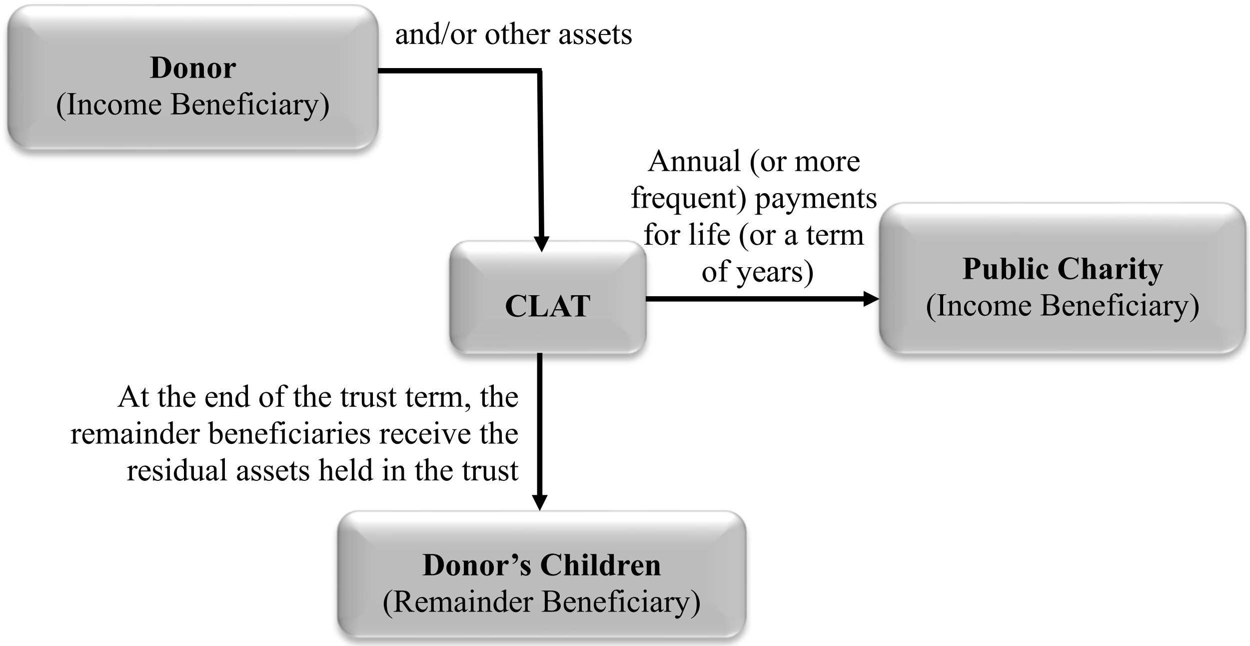
The 2017 Tax Cuts and Jobs Act enhanced the tax benefit of ING trusts by limiting the federal tax deduction for state and local taxes to $10,000. The reduced deduction makes avoiding state income tax even more important. Note that ING trusts have been approved in numerous private letter rulings including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

Chapter 4: Specific Net Investment Income Tax Strategies

#7: 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 noncharitable remaindermen, generally the donor's children.

Transfer of cash, stock



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 in December 2022 when the most favorable § 7520 rate available is 4.0%.[10] The CLAT pays an annual annuity of $74,502 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 $138,120. Suppose that the CLAT produces a return of 10% and T

[10] 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.

> dies 21 years later after reaching T's Table 2000 CM life expectancy. The amount left in the CLAT when T dies is $2,631,949 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 14.244%. 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 $74,502 annuity payments before T dies. Again assuming a 10% growth rate, the value of the CLAT is $1,084,399 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 $910,482 as of the time of the gift. Thus, the effective gift tax rate on the transfer is only 7.06% ($64,239 / $910,482).

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.

T transfers $1,000,000 to a zeroed out CLAT at a time when the most favorable IRC Section 7520 rate is 4.0%. Assume the the trust produces a total return of 10%. With level annuity payments the

---

CLAT will produce a tax-free transfer of $628,803. With 20% increasing payments the tax-free transfer increases to $785,088. What would happen with maximum backloading-- a single payment at the end of the CLAT term. Given the 10% return the value of the trust assets would be $2,593,742 after 10 years ($1,000,000 appreciated at 10% for 10 years). The amount of the balloon payment at the end of the term would be $1,480,244 ($1,000,000appreciated at 4% for 10 years. This would leave a tax-free transfer of $1,113,498 ($2,593,742 - $1,480,244).

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.

#8: 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 nonpassive 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.[11]

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

[11] The ATAs are $200,000 for single taxpayers, $250,000 for married taxpayers filing jointly and $125,000 for married taxpayers filing separately. [56] Reg. § 1.469-4(c)(1).

operation into a single activity to achieve the requisite hours of participation needed to make the activity non-passive.[56] 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:

(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.[12]

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.[13]

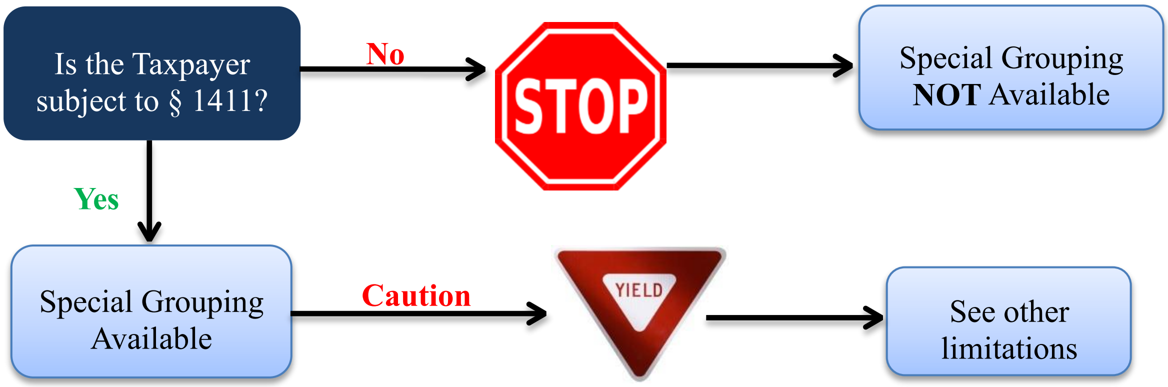
(2) Real property rental activities cannot be grouped with personal property rental activities.[14]
(3) The following activities cannot be grouped with any other activity:
   1. Holding, producing, or distributing motion pictures;
   2. Farming;
   3. Leasing an IRC § 1245 property;
   4. Exploring for, or exploiting oil and gas resources; and
   5. Exploring for, or exploiting geothermal deposits.[60]

Special Planning Opportunity

Taxpayers generally have only one chance to group activities. Once made, the grouping election ordinarily cannot be changed.[15] 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

[12] Reg. § 1.469-4(c)(2)(i)-(v).
[13] Reg. § 1.469-4(d)(1)(i).
[14] Reg. § 1.469-4(d)(2).
[60] Reg. § 1.469-4(c).
[15] Reg. § 1.469-4(e)(1).

is subject to the NIIT. Only one regrouping is allowed, and once made, the regrouping applies to all subsequent years.[16]



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. § 1.4694(d)(1) and the grouped activity is a non-passive activity.[17]

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,

[16] Reg. § 1.469-11(b)(3)(iv).

[17] See Reg. § 1.1411-4(g)(6). [64]

See Reg. § 1.1411-4(g)(7).

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. [64]

#9: 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 2023:

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).[18]

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.

Chapter 5: Wealth Transfer Strategies

#10: 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.

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

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.

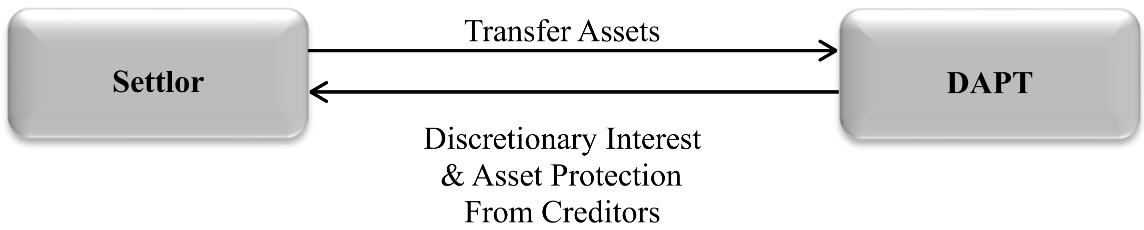
Trusts could always be used to provide creditor protection for beneficiaries. A spendthrift provision could be included in the trust to prevent attachment of trust assets by creditors or assignment of trust assets by beneficiaries. Discretionary distribution provisions provided the same creditor protection. 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.[19]

[19] *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.[20] The argument can be avoided, however, by creating the DAPT and making transfers before the transferor has any current or foreseeable creditor problems.

Full Faith and Credit Clause of the U.S. Constitution[21]

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.

[20] *See* 11 U.S.C. § 548(e) (allowing courts to look back 10 years for fraudulent transfers).
[21] Article IV, Section 1.

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 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.[22] 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.[23]

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.

Chapter 6: IRC Section 199A Planning

#11: 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

[22] See, for example, *Estate of Wells*, TC Memo 1981-574.

[23] *Estate of Uhl*, 241 F2d 867 (7th Cir. 1957); *Estate of German*, 7 Cl. Ct. 641 (1985).

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.[24] The deduction isn't allowed in computing adjusted gross income (AGI), but rather is applied against *taxable* income.[25]

Calculation of the Deduction

The statute begins with a relatively straightforward computation of the deduction.[88] 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 2022 from the business and no other income. Cindy claims the $12,950 standard deduction for single taxpayers giving her $142,050 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 $142,050 x 20% = $28,410, so her § 199A deduction is reduced from $31,000 to $28,410.

<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

(2) 25% of the taxpayer's allocable share of wages plus 2.5% of the unadjusted basis of qualified property owned by the business.[26]

[24] IRC § 199A(f)(3).
[25] New IRC § 62(a), as added, by Act Sec. 11011(b). [88] IRC § 199A.
[26] IRC § 199A(b).

The W-2 wage/unadjusted basis limitation begins to be phased in when taxable income reaches \$364,200 in 2023 for married taxpayers filing jointly and \$182,100 for all other eligible taxpayers. In 2023, the phase-in is complete for married taxpayers filing jointly at \$464,200 and for all other taxpayers at \$232,100.

> *Example 2*. Joe and Brenda own a restaurant that produces \$500,000 of taxable income each year. In 2023, they have another \$44,000 of ordinary income and claim the standard deduction of \$27,700. Ward and Joyce purchased the restaurant building for \$600,000 and they paid \$120,000 of W-2 wages in 2023. Because their taxable income exceeds \$464,200, 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 (.2 x \$516,300 = \$103,260) 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.

<u>Specified Service Trade or Business (SSTB) Limitation</u>

Under the general rule, the § 199A deduction doesn't apply to SSTBs.[27] 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.[28]

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[27] IRC § 199A(d)(2).

[28] 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 2023, the threshold level for married taxpayers filing jointly, is $364,200 and for all other taxpayers, $182,100. 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 $464,200 and for all other taxpayers at income of $232,100.

Definitions

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

QBI

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.[29]

W-2 Wages

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.[93]

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

[29] IRC §§ 199A(c)(3) and 199A(c)(4).
[93] IRC § 199A(b)(4).

individuals over wage earners. To obtain a deduction, employees must either become independent contractors or own or invest in a business.

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.[30]

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 noncooperative buyer; and
(7) Aggregation of trades or businesses.

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

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[30] Prop. Reg. § 1.199A-2(c)(1)(ii).

Chapter 7: Ten More Must Know Strategies

#12 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 noncharitable 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. taxexempt 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.[31] 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.[32]

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).[33] 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.

[31] IRC §408A(c)(3).

[32] IRC §408A(d)(1).

[33] IRC §408A(d)(2).

- 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 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-ofstate 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.[34] Moreover, there is generally no income tax payable when the insured dies.[35] Thus, as a general rule, the insurance proceeds are never subject to income tax.[36]

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[34] IRC §§7702(g); 72.

[35] 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)).

[36] 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.

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
- 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.[37] 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.

[37] IRC § 2042.

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 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;[38]
2. The trust is irrevocable or will by its terms become irrevocable upon the death of the employee;[39]
3. The beneficiaries of the trust can be identified from the trust instrument;[40] and
4. Proper documentation has been provided to the plan administrator.[188]

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.

Naming an Accumulation Trust as the IRA Beneficiary Following the SECURE Act

Although accumulation trusts increase costs and add complexity, they also create important nontax 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 2022, all trust income above $13,450 is taxed at the top rate of 37%. By contrast, married taxpayers filing jointly aren't subject to the 37% rate until income exceeds $647,850.

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

[38] Reg. § 1.401(a)(9)-4, Q&A 5(b)(1).
[39] Reg. § 1.401(a)(9)-4, Q&A 5(b)(2).
[40] Reg. § 1.401(a)(9)-4, Q&A 5(b)(3). [188]
Reg. § 1.401(a)(9)-4(b)(4).

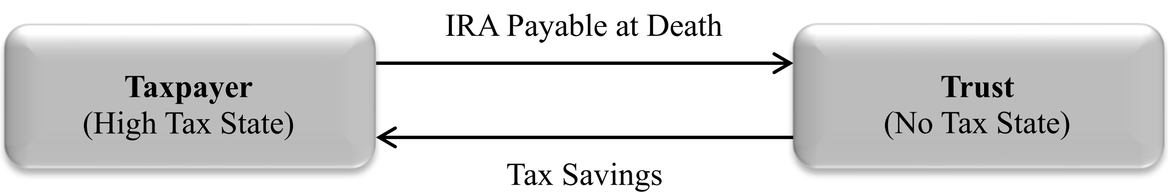
tax obligations. Thus, a spray trust could be used to combine the tax benefits of low tax rates with the non-tax advantages of an accumulation trust..

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.

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 (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.[189]

Location of Trust

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-

[189] A detailed analysis on NING trusts is beyond the scope of this booklet. For further information see Steven J. Oshins, "NING Trusts Provide Tax and Asset Protection Benefits," CCH Estate 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.

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.[41]

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.

[41] Tennessee and a few other states may also qualify. [191]
IRC § 1014.

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.[191]

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 at the high trust tax rates. For 2022, 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.

> <u>Example.</u> 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).

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