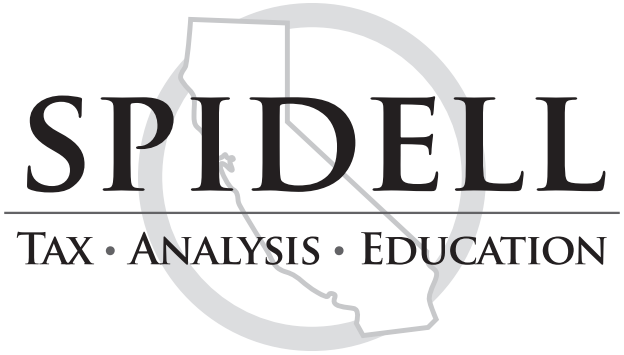
Tax Planning Strategies for Trusts and Estates



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TAX PLANNING STRATEGIES FOR TRUSTS AND ESTATES

Course objectives: This course provides practical strategies on proper planning to reduce tax on an estate and its beneficiaries. Topics discussed include: gifting; family limited partnerships or LLCs; valuation of estate assets; portability; the deceased spouse unused exclusion (DSUE); applicable exclusion amount; estate allowable deductions; charitable deduction; irrevocable life insurance trusts (ILITs); Crummey powers; IRC §645 election; bypass trust; qualified terminable interest property (QTIP) trust; unfunded trusts; generation-skipping trusts; dynasty trusts; S corporation shares in trusts; distributable net income (DNI); new inherited IRA rules; and much more.

After completing this course, you will be able to:

- Determine the accurate calculation of a taxable estate considering the value of a taxpayer's lifetime gifts
- Determine how to plan ahead for when the estate tax exclusion amount is reduced
- Recall how valuation discounts in estate planning will reduce the net taxable estate
- Identify how ***Crummey*** powers can solve the issue of not having a present interest in a gift for purposes of avoiding gift tax
- Recall how making the IRC §645 election provides tax benefits for a trust electing to be taxed as an estate
- Recall the formula for calculating correct distributable net income

Category: Taxes

Recommended CPE Hours: CPAs — 2 Tax
EAs — 2 Federal Tax
CRTPs — 2 Federal Tax

Level: Intermediate

Prerequisite: A basic knowledge of types of trusts is required.

Advance Preparation: None

Expiration Date: November 2022

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TAX PLANNING FOR TRUSTS AND ESTATES

KEY TERMS

- **Trust:** A property interest held by one person for the benefit of another
- **Trustee:** A natural or legal person to whom property is legally committed to be administered for the benefit of a beneficiary
- **Estate:** The assets and liabilities left by a person at death
- **Executor:** The person appointed by a testator to execute a will
- **Will:** A legal declaration of a person's wishes regarding the disposal of his or her property or estate after death

Regardless of whether they are wealthy, poor, or somewhere in between, everyone will have an estate upon their death. Not all estates however will be taxable. There are various options individuals may choose to minimize or avoid estate and or gift tax entirely.

Comment

For an in-depth explanation of estates and trusts, see Spidell's "Overview of Trusts" on-demand webinar, available at www.caltax.com.

GIFTING CONSIDERATIONS

APPLICABLE CREDIT AMOUNT (UNIFIED CREDIT)

The applicable credit amount is allowable credit against estate and gift taxes. It is figured by determining the tentative tax on the applicable exclusion amount, which is the amount that can be transferred before an estate tax liability will be incurred. (IRC §2055) The cumulative gift and estate taxes are intertwined; therefore the maximum lifetime exclusion and applicable credit amount are equal. If a taxpayer uses part of their lifetime exclusion against gift taxes, their available estate tax exclusion is reduced. (Treas. Regs. §20.2010-1) For persons dying in 2021, the maximum lifetime exclusion is $11.7 million.

Example of exclusion calculation

Darren was an original investor in a social media platform. When the application hit the market, Darren became an instant millionaire. During his lifetime, he gifted $7 million dollars in cash, stocks and property to his family and friends. When Darren died in early 2021, his gross estate was valued at $5 million. Using the required ordering rules, Darren's executor calculated his taxable estate as follows:

Total exclusion available	$11,700,000
Less the value of his lifetime gifts	(7,000,000)
Exclusion available after gifts	4,700,000
Date of death gross estate value	5,000,000
Taxable estate	$ 300,000

☑ Planning Pointer

Clients are often shocked to learn that large gifts made during their lifetime are not necessarily "tax-free." These lifetime gifts must be considered when evaluating the overall taxability of the estate for planning purposes.

GIFT TAX

Gift tax is a federal tax on an individual's ability to transfer property during their lifetime to another individual without the expectation that it is for compensation. There is an annual gift exclusion where an individual may make unlimited gifts as long as the amount of each gift does not exceed the annual exclusion. (IRC §6019) There is no gift tax return filing requirement or gift tax liability for the annual exclusion gifts, and they do not reduce the applicable lifetime exclusion.

The 2021 annual gift tax exclusion is $15,000 per recipient ($30,000 for a married couple). (Rev. Proc. 2020-45) Fair market value of the property on the date of transfer is the gift value. To qualify for the annual exclusion, the gifts must be present interest gifts, not gifts of future interests in property. Present interest gifts are available for the recipient's immediate use, possession, or enjoyment. (Treas. Regs. §25.2503-3(b))

Practice Pointer

Caution clients that gifts made by check close to the end of the year must be negotiated by December 31. Until the check is paid, certified or given to a third party, the donor has the power to stop payment on the check until it is cashed. If the check is cashed in the following year, the current year's annual exclusion could be challenged. (***Estate of Dillingham v. Comm.*** 88 T.C. 1569 (1987))

Individual gifts that exceed the annual exclusion or that are not present interest gifts are reported on Form 709, United States Gift (and Generation-Skipping Transfer) Tax Return. The taxpayer has the option to pay the gift tax liability with the return when it is filed on or before the original due date, or use some or all of their gift tax unified credit.

The 709 must be filed by April 15 of the year after the gift was made. There is no automatic extension of time to pay the gift tax. There is only an extension of time to file the return that is made separately on Form 8892 or as a part of the individual tax return extension, Form 4868. A separate extension to pay the gift tax must be requested. (Treas. Regs. §25.6161-1)

Form 709 recalculation

Both Forms 709 and 706, United States Estate (and Generation-Skipping Transfer) Tax Return, require a prior year's credit recalculation of gifts already reported and any gift tax paid. The recalculation requires a separate computation of gifts made prior to 1977 and then after. The instructions for Form 709 have an example of a detailed worksheet that can be used for the computation.

Practice Pointer

Don't be surprised when an estate tax audit occurs and prior gifts from years ago were not reported on the Form 706 you prepared. It is a good idea to be proactive. If you have clients that could potentially have an estate tax return filing requirement in the future, especially when the lifetime exclusion amount is reduced, request IRS transcripts of gift tax returns previously filed. In all likelihood, the client probably did not keep return copies or even remember if any gift tax returns were filed. Hearing about a missed gift tax return from an IRS auditor is not welcome news.

Consider large gifts now

Due to the fact that the unified exclusion is scheduled to revert back to $5 million (plus inflation from 2011) after December 31, 2025, the IRS already issued helpful guidance for us to plan ahead for a reduced exclusion. Final regulations issued by the IRS in 2019 provide that individuals taking advantage of the increased gift and estate tax exclusion amounts currently in effect will not be adversely impacted when the exclusion amount is reduced. (IR-2019-189; Treas. Regs. §§20.2010-1, 20.2010-3; TD 9884)

Comment

The latest version of the Build Back Better Act (BBBA), currently making its way through Congress, if passed, would effectively sunset the TCJA's unified exclusion increase early. For taxable years beginning after December 31, 2021, the BBBA would set the unified exclusion back to $5 million (plus inflation from 2011).

The potential problem

The temporary increase in the unified estate exclusion amount contained in the TCJA generated questions about what will happen if individuals made gifts in excess of $5 million but die after 2025 when the exclusion amount is decreased.

For purposes of calculating estate tax at an individual's death, lifetime exclusion gifts are added back into the estate, and the estate tax is based on the total of the gifts plus any remaining assets.

Example of taxable estate

John made lifetime gifts of $7 million to his children, filed gift tax returns when required, and applied $7 million of his exclusion amount to those gifts. As a result, no gift tax was paid on any of the transfers.

At John's death in 2021, he has $6 million in assets remaining. His estate tax will be approximately $520,000.

Lifetime gifts	$ 7,000,000
Remaining assets at death	$ 6,000,000
Taxable estate	13,000,000
Exclusion amount	(11,700,000)
Subject to estate tax	$ 1,300,000
Estate tax (40%)	$520,000

If the individual dies after the exclusion is reduced, under this basic calculation, the decreased exclusion amount will greatly increase the estate tax liability.

Example of death after exclusion is reduced

Assume the facts are the same as the previous example, except that at John's death, the lifetime exclusion is $5.5 million. Without regard to the relief provided in the regulations, his estate tax would be approximately $3 million, assuming a 40% tax rate at the time of his death.

Lifetime gifts	$ 7,000,000
Remaining assets	6,000,000
Taxable estate	13,000,000
Exclusion amount	(5,500,000)
Subject to estate tax	$ 7,500,000
Estate tax (40%)	$3,000,000

The fix provided in the regulations

The regulations provide a special rule that allows the estate to compute its estate tax credit using the higher of the exclusion applicable to gifts at the time the gifts are made or the exclusion applicable on the date of death. (Treas. Regs. §20.2010-1(c))

As a result, if an unmarried individual made gifts of $9 million, all of which were sheltered from gift tax by the exclusion amount allowable on the dates of the gifts, and the individual dies when the basic exclusion amount is reduced, the special rule would allow the applicable credit amount against estate tax to be based on the higher exclusion applicable to gifts made of $9 million.

Example of death after exclusion is reduced with fix

Once again, assume the facts are the same as the previous example, except that John's estate applies the fix provided in the regulations. Remember, at John's death, he has $6 million in assets remaining and the lifetime exclusion is $5.5 million. His estate tax will be approximately $2.8 million, assuming a 40% tax rate at the time of his death.

Lifetime gifts	$ 7,000,000
Remaining assets	6,000,000
Taxable estate	13,000,000
Exclusion used during life	(6,000,000)
Subject to estate tax	$ 7,000,000
Estate tax (40%)	$2,800,000

Without the fix provided in the regulations, it's possible that taxpayers could end up with a tax liability greater than the assets remaining in their estate, as the following example illustrates.

Example of estate tax greater than assets

Jane made a gift of $11 million to her daughter in 2018, when the exclusion amount was $11.18 million. She applied $11 million of her exclusion amount to the gift, and no gift tax was paid on the transfer.

Jane dies in 2026, when the exclusion amount is reduced to $5 million, and she has $3 million of assets remaining in her estate. Without the fix provided in the regulations her estate tax would be approximately $3.6 million.

Lifetime gifts	$11,000,000
Remaining assets	3,000,000
Taxable estate	14,000,000
Exclusion amount	(5,000,000)
Subject to estate tax	$ 9,000,000
Estate tax (40%)	$3,600,000

This, in effect, would impose estate tax on the portion of the 2018 gift that was previously sheltered from gift tax by the increased exclusion that was available at the time of the gift.

Selection of gift property

Many people think about a gift as an act of generosity between two individuals because they have a genuine affection for each other. A gift is often to celebrate an occasion. Gifting as part of an estate plan takes on a different purpose. There are two main objectives with a gifting strategy in an estate plan. One is the transfer of wealth through a gift of appreciating property to avoid estate tax on the appreciation and reduce estate tax. The second is to shift income producing assets to individuals who are taxed at a lower rate.

Several factors should be considered prior to the gifted transfer:

- If the primary reason for the gift is to reduce estate taxes, the taxpayer should gift real or personal property with a current low fair market and high potential for future appreciation;
- Highly appreciated property should not be gifted because when the property is sold there will be capital gains for the recipient. Transferred property prior to death maintains the owner's basis. If held by the owner, the estate/beneficiary will receive a basis-step up when the owner dies;
- If the primary reason for the gift is to transfer property to a lower income tax bracket, then high income-producing property should be considered;
- Property that is difficult to value or heirloom property, for example, art, antiques, jewelry, and sports memorabilia, make good lifetime gifts. There is no squabble as to the disposition of the property after death if given while the owner is still alive. Heirs do in fact argue over whether the property should be sold or kept, especially if it is sentimental to one individual and not another, and if not sold who gets to keep it;
- Property that may be needed for the owner's basic needs or future security should not be gifted;
- Assets whose value decreases over time should not be gifted. These may include patents, copyrights, royalties, and mineral rights;
- Property gifted to an irresponsible individual may have an adverse effect on their life. For example, for a person with a substance abuse addiction, marital woes, a gambling problem, etc., or who has significant debts and liens, the sudden large influx of cash or property will be subject to collection of these debts. A special needs trust would be a better option here; and
- Careful consideration should be given outright to a minor child who has the ability to access the gifts prior to their financial maturity, which is often years after they turn age 18.

Payments for education or medical purposes

Not all "gifts" are necessarily made directly to an individual. Amounts paid for the benefit of a recipient in certain instances may not be actual gifts at all. Those disbursements are not subject to the gift tax rules.

Amounts paid on behalf of an individual directly to an educational organization for tuition costs are not treated as gifts subject to gift taxes and reporting. (Treas. Regs. §25.2503-6(b)(2)) Only tuition expenses of full-time or part-time students are excluded. The exclusion is unlimited. It is in addition to any other gifts that qualify for the annual exclusion. Books, supplies, and other fees are not applicable. For this purpose, an educational organization is defined as one that maintains a regular faculty and curriculum. It normally has regularly enrolled students in attendance at the place where its education activities are carried on. (IRC §170(b)(1)(A)(ii))

Likewise, direct payments made on behalf of an individual for medical care are not treated as reportable taxable gifts. (Treas. Regs. §25.2503-6(b)(3)) Medical care expenses are defined as those incurred for the diagnosis, cure, mitigation, treatment, or prevention of disease. They also include transportation, qualified long-term care services, and medical insurance premiums. The unlimited exclusion does not apply to any amounts reimbursed by a recipient's insurance company.

> ***Example of gift that isn't***
>
> Lucy is attending UC San Diego for her medical degree. Her grandparents can pay her $75,000 in tuition directly to the school and still give her $30,000 each year tax-free without affecting their lifetime exclusion and without the requirement to file a gift tax return.

Kiddie tax benefits and pitfalls

For individual income tax returns filed for tax years 2020 and beyond, a child's unearned income is taxed using the same tax brackets as a parent. (IRC §501 (c)) Parents may use Form 8814, Parents' Election To Report Child's Interest and Dividends; however this could result in the tax on the child's income being higher than filing a return for the child and paying tax at the parent's rate.

When looking at tax rates:

- If the child received qualified dividends or capital gain distributions, you may pay up to $110 more tax if you make this election instead of filing a separate tax return for the child. This is because the tax rate on the child's income between $1,100 and $2,200 is 10% if you make this election.
- However, if you file a separate return for the child, the tax rate may be as low as 0% (zero percent) because of the preferential tax rates for qualified dividends and capital gain distributions.

Other benefits and pitfalls include the effect of reporting the child's unearned income on the parents' return.

Reporting on the parents' return will increase AGI, which will:

- Increase net investment income tax calculation and the 0.9% Medicare tax;
- Reduce certain deductions or eliminate certain benefits subject to thresholds; and
- Increase the possibility of parents being subject to alternative minimum tax.

Example of NIIT

Over the years, Cindy's parents have gifted large blocks of Disney stock to her child Ariel, who is age 12. Ariel's dividends in 2020 were $50,000. Cindy's income subject to NIIT is $175,000 and her MAGI is $190,000. On her own, she is not subject to NIIT because her AGI is under the $200,000 threshold for a head of household filer. However, if we add the $50,000 of Ariel's dividends, her MAGI is now $225,000 ($175,000 + $50,000), and her NIIT is $950 (($225,000 - $200,000) × 3.8%).

Gifting tax-exempt assets to kiddies

A parent should consider the transfer of tax-exempt assets to their child, thus reducing their own taxable estate and providing the child a tax-exempt or tax-deferred annual income. Good investments may include U. S. savings bonds and municipal bonds.

For older children (not subject to kiddie tax), they may also transfer low dividend growth stocks, discounted business interests, or rental property to their child. In doing so, their taxable estate is reduced, the liability for the asset has shifted, and so has their income. The child reports the investment or business or rental income most likely at a lower tax rate. Once transferred the assets are shielded from the parent's creditor claims, a new spouse, or any other reason the parent may have to gift the assets.

VALUATION DISCOUNTS FOR PROPERTY AND BUSINESS INTERESTS

Utilizing discounts in gift and estate planning and estate tax calculations will reduce the net taxable estate and subsequent estate and gift tax.

Valuations begin with a compilation and appraisal of underlying assets in a business entity or of real property. Once the fair market value is established, it may be reduced or discounted for several reasons. Gifted limited partnership and LLC interests are most often discounted.

Minority interest discount

The minority or noncontrolling discount takes into consideration the level of control or lack thereof in an entity's interest. A minority interest discount in a closely held business can be based on the capitalization of earnings, book value, adjusted book value, or the trading prices of publicly held stocks with similar operations. (IRC §§2701, 2704; Treas. Regs. §25.2701-0)

Lack of marketability discount

The lack of marketability discount is dependent on the limited liquidity of a business interest as well as the availability to convert it quickly to cash. Real estate holdings may receive a greater discount due to problems related to the management and operation of the property.

Appraisals

Only appraisers skilled in business valuations who have appropriate current knowledge of tax laws and court cases should be retained. On occasion two or more appraisers may be required to establish value and determine the discount. The Internal Revenue Service has historically taken a hard look at valuation discounts.

The penalties assessed by the Internal Revenue Service for zealous discounts can be as much as 40% of the understatement of the tax due. The appraiser may be called upon to justify their valuations,

so workpapers and any other support used in their determination should be kept and readily available in the event of an audit. There is no standard formula used to calculate a discount. However, the Internal Revenue Service does have requirements for the establishment of discounts and the contents of the appraisal report. (***Holman v. Comm***. 130 T.C. 170 (2008); ***Astleford v. Comm.***, TCM 2008-128)

Fractional interest: recent case

Gifts made by a donor to his two sons were valued separately at the time of the transfers, and the court allowed a fractional interest discount.

Over several years, the donor purchased nearly $83 million in tracts of timberland and then gifted a 48% interest to each of his two sons.

The donor valued the gifts using a fractional interest discount of over 50%, resulting in a gift to each son of about $18.5 million. The government argued that a fractional interest discount was not applicable when the donor did not hold the interest in a fractional form before the gift.

In essence, the IRS argued that the two gifts should be aggregated, and no discount would apply.

The court ruled that because gifting a fractional interest could create issues with control, marketability, and costs of partition, a fractional interest discount was not prohibited because IRC §2512(a) requires that a gift is valued at the time it passes from the donor to the donee.

Although the donor gave away 96% of his interest in the timberland, he made two separate gifts of 48% each to his sons. As a result, the gifts were valued separately at the time of the transfer. (***Peter Buck v. United States of America***, U.S. District Court, D. Connecticut; 3:18-cv-1253 (AWT), September 24, 2021))

FAMILY LIMITED PARTNERSHIPS OR LLCs

A family limited partnership (FLP) or family limited liability company (FLLC), if established for a legitimate business purpose, not only saves on estate taxes but is also a prudent income and gift tax savings vehicle. (IRC §704(e)) An elder family member contributes assets to a partnership or LLC. Those assets can include rental property, stocks, bonds, business interests, or even cash. The contributing family member, through a general partner or managing member interest, maintains control of the transferred assets. Gifts of limited partnership or LLC interests, usually discounted, are given to the remaining family members. (IRS Rev. Ruling 93-12)

While in operation, the entity income is split *pro rata* among all of the partners/members, thus shifting it from the elder partner/member who is presumably in a higher tax bracket. Using an FLP or FLLC makes the transfer of assets at death much easier, and any future growth in interests gifted to the heirs stay out of the estate.

Need legitimate business purposes

One of the benefits of these entities is that the value of the assets owned by the entity may be subject to a valuation discount for estate tax purposes if the decedent owned less than a 100% interest in the FLP or FLLC. The reduced valuation takes into account minority interests, marketability, and contract restrictions.

Using the discounts reduces estate tax, but there are other benefits to the FLP, including:

- The ability to maintain control over gifted assets; and
- Protecting the assets from the liabilities of the partner/beneficiaries.

However, for the taxpayers to take advantage of the valuation discount, the FLP or FLLC must have a legitimate business purpose.

Donors' failure to respect the business character of the entity has resulted in most of the adverse decisions against the FLP or FLLC concept. The result of an adverse finding is that the entity is voided, and the full value of the entity's assets must be included in the estate.

Cases

A decedent's executor was able to exclude the value of stock transferred to an FLP from the decedent's estate and take the valuation discounts on the decedent's FLP interest because the entity had a legitimate business purpose. (***Estate of Black*** (December 14, 2009) 133 TC 15)

The decedent was a former employee, officer, and director of a successful insurance company, and held a substantial amount of valuable company stock.

However, he was concerned that his family would not follow his conservative investing methods and wanted to ensure that they kept the insurance company stock in the family.

The decedent and his advisors created an FLP to prevent his grandsons from selling their shares of stock and protect his son's shares from potential claims incident to divorce. The protection from creditors and potential dissipation was a legitimate and significant nontax reason for the creation of the FLP.

The IRS argued that the full value of the decedent's stock should be included in his estate, not the reduced value of his partnership interests. However, the Tax Court held that because the decedent had legitimate goals for establishing the entity that were not tax-related, and the entity was created through an arm's-length transaction, the discounted value of the decedent's partnership interest was included in his estate (not the full value of the shares).

In another case, however, assets that a taxpayer (decedent) transferred to an FLP were included in the value of her estate because neither the IRS nor the court was convinced there was a legitimate nontax reason for forming the FLP. (***Estate of Holliday v. Comm.***, TCM 2016-51)

The Tax Court believed there was an implied agreement that the decedent retained the right to "the possession or enjoyment of, or the right to the income from, the property." Further, the partnership agreement unconditionally provided that the decedent was entitled to receive distributions from the partnership in certain circumstances. Under IRC §2036(a), a decedent's gross estate includes transfers during their lifetime under which they retained the possession or enjoyment of, or the right to the income from, the transferred property.

Also, the court found that the FLP failed to maintain books and records other than brokerage statements and ledgers, the partners did not hold formal meetings, no minutes were kept, and various parts of the limited partnership agreement were ignored.

ESTATES

VALUATION OF ESTATE ASSETS

Date of death value

Unless the executor makes an election to use an alternate valuation date or a special-use valuation, the gross estate is based on the fair market value of includible assets on the decedent's date of death. (IRC §2031) The gross estate includes all property the decedent had an interest in including real property located outside the United States.

Alternate valuation date election

Under IRC §2032, an executor may make an irrevocable election at the time the estate tax return is filed to value the gross estate exactly on the date six months after the date of death or the date title passes as a result of its sale, exchange, or other disposition, if prior to six months. However, the alternate valuation date election may only be made if both the value of the gross estate and the sum, reduced by allowable credits, of the estate and GST taxes payable are decreased. The alternate valuation must be applied to all property included in the gross estate.

Example of alternate valuation

Arthur King died in December of 2019. Guinevere King, his daughter and executor, was heartbroken, and when two subsequent tragedies occurred, hired professionals to appraise her father's extensive assets. When it was time to file the estate tax return, she filed an extension of time to file the Form 706, made an estimated tax payment on the appraised value, and an alternate valuation election.

Asset	DOD appraisal	Other date appraisal	Difference
House and land on cliff overlooking Pacific Ocean	$ 7,000,000	$ 5,000,000	Small landslide six weeks after death
Bitcoin	1,000,000	1,250,000	Increase in value
Stock	3,000,000	2,000,000	Stock market decline
Jewelry, artwork, and other personal property	1,000,000	1,000,000	
Restaurant business	5,000,000	2,000,000	COVID-19–related
Total	$17,000,000	$11,250,000	

Value of Arthur's gross estate at date of death	$17,000,000
Less applicable exclusion	(11,400,000)
Taxable estate	$ 5,600,000

In August of 2020, Guinevere filed an extension for the 706, and paid an estimated estate tax liability of $2.24 million ($5,600,000 × 40%).

However, the alternate valuation date six months later is $11.25 million, which is less than his applicable exclusion amount of $11.4 million. Thus there will be no estate tax due by choosing the alternate valuation date. (**Note:** The value of the bitcoin increased from the date of death, and when using the alternate valuation date, you must use the higher amount for the bitcoin.)

Guinevere filed the extended Form 706 with the alternate values and no estate tax due. She received a refund of the $2.24 million estimated tax previously paid.

Practice Pointer

Given the future income tax and basis ramifications of an alternate valuation election, it may be prudent to extend the filing of the estate tax return until a full analysis of the election's consequences has been completed. The extension to file the return is not an extension to pay the estate and gift tax due. (Treas. Regs. §§20.6075-1, 20-6081-1)

Special-use valuation election for farms and closely held business property

An executor may elect to value certain farm and closely held business real property at its use value rather than the fair market value. (IRC §2032A) The total value of the property may not be decreased from fair market value by more than $1.19 million for decedents dying in 2021. The maximum limit is annually increased for inflation.

There are restrictions on the property. Real property that qualifies for the IRC §2032A election may be included if:

- The decedent was a citizen or resident of the United States at the time of death;
- The real property is located in the United States;
- The real property, at the time of death, was used by the decedent or a family member for farming or in a trade or business or was rented for that use by either the surviving spouse or a lineal descendant to a family member on a net cash basis;
- The real property was acquired or passed from the decedent to a qualified heir of the decedent;
- The real property was owned and used in a qualified manner during five of the eight years prior to the decedent's death. Material participation by the decedent or a family member is required;
- Ownership may be direct or indirect such as through a corporation, trust, or partnership; and
- The property meets certain percentage of value requirements:
    - At least 50% of the adjusted value of the gross estate must consist of the adjusted value of the real or personal property that was being used as a farm or in a closely held business and that was passed or acquired from the decedent to a qualified heir; and
    - At least 25% of the adjusted value of the gross estate must consist of the adjusted value of qualified property. Qualified property does not apply to passive investments or passive rental property to a nonfamily member.

Protective election

A protective election to specially value qualified real property, whether or not ultimately used, may be made on Schedule A-1 of the initial Form 706. Even though the election is made, the executor must still use the fair market value on the original return. If the estate qualifies for the special-use valuation based on values finally determined on an amended Form 706 with a complete IRC §2032A election, the form must be filed within 60 days after the date of the determination.

Determining the value of estate assets

Estate valuations can be complicated and if done incorrectly will have expensive consequences. Executors have options other than relying on Zillow or Redfin for real estate appraisals, a business's tax practitioner for a business valuation, and a pawn shop or thrift store for the value of jewelry and other personal property. Using these methods could result in an incorrect valuation that could either increase or decrease the estate tax, or result in an argument between beneficiaries.

Examples of bad valuations

Aunt Mathilda passed away leaving her house and $1 million in the bank. Her beneficiaries were two nieces. Geraldine was the successor trustee of the trust, and the assets were to be split equally between Geraldine and her sister Annabel. Geraldine went to Zillow and Redfin to determine the value of the house and determined it to be $800,000. So Geraldine kept the house and $100,000 of the cash for herself, and the remaining $900,000 cash went to Annabel.

Everyone was happy until six months later, when Geraldine sold the home for $1.1 million. A lawsuit ensued, and they argued over what the actual value was at the date of death and why the price had increased. After $50,000 in legal fees, Geraldine had to pay part of the difference to Annabel.

Geraldine should have paid $500-$1,000 for an appraisal.

Uncle Will passed away leaving three pieces of rental property in Santa Monica to his nephew and successor trustee Eric. According to Zillow and Eric's realtor friend, the value of the properties was $11.1 million. Eric did not file an estate tax return because Will's estate was under the threshold. However, Eric sold all three properties in the first six months to finance his newly acquired lifestyle. The total sales price was $18 million.

It appears the thing Zillow didn't consider was that the properties were exempt from rent control, greatly increasing their value. The IRS assessed estate tax of 40% of the taxable estate along with late-filing penalties. Poor Eric had to stop eating at Spago and go back to McDonald's for his evening meal.

PORTABILITY

The American Taxpayer Relief Act of 2012 (ATRA '12) made permanent the portability of the deceased spouse's unused exclusion (DSUE) amount for deaths after December 31, 2010. (IRC §2010(c)) This provision allows a surviving spouse to use the unused estate tax exclusion of his or her predeceased spouse by electing to carry it forward for the surviving spouse's benefit.

The surviving spouse can now inherit the deceased spouse's exemption along with the deceased spouse's assets. Accordingly, a bypass trust is no longer required to shelter assets from estate taxes. The only thing necessary at the first death, for estates that will be worth more than $5 million (indexed for inflation) at the second death, is the filing of an estate tax return when the first spouse dies.

While the question of whether it is better to use a bypass trust or take advantage of a portability election is not entirely settled, it is important for tax practitioners to understand the portability election. Failure to make the election in a timely manner when appropriate can lead to expensive consequences because not making the election on the death of the first spouse will preclude taking advantage of the deceased spouse's unused exclusion when the surviving spouse dies.

DSUE

The portability election is made for the DSUE of the first spouse to die. It may not be made if the decedent was a nonresident alien. It is in general terms the amount of the decedent's exclusion that was not needed to protect the first spouse's estate from the estate tax.

The DSUE is the lesser of:

- The basic exclusion amount effective in the year of death; or
- The excess of the decedent's applicable exclusion amount over the sum of the amount of the taxable estate and the amount of the adjusted taxable gifts of the decedent.

Example of DSUE calculation

In 2018, Mason made a taxable gift valued at $1 million and reported the gift on a timely filed gift tax return. Mason used $1 million of his applicable gift tax exclusion amount, reducing his gift tax liability to zero.

Mason dies in 2019 and is survived by his wife, Deborah. Mason's taxable estate is $2 million. The executor of Mason's estate computes his DSUE amount to be $8.4 million.

The lesser of:	
The 2019 basic exclusion amount	$11,400,000
Or:	
Mason's applicable exclusion amount	$11,400,000
Minus his $2 million taxable estate and $1 million of exclusion applied to taxable gifts	- $3,000,000
Total	$8,400,000

Applicable exclusion amount (AEA)

The applicable exclusion amount is the total of the decedent's basic exclusion amount plus any DSUE amount from a predeceased spouse. Thus, if a decedent was predeceased by a spouse for whom a portability election was made, the applicable exclusion amount of the decedent is likely to be greater than whatever the basic exclusion amount is at the time of the decedent's death.

Example of AEA upon Deborah's death

Deborah passes away in 2021, and the basic exclusion amount has been inflation-adjusted to $11.7 million. She has not used any of Mason's DSUE. Her applicable exclusion amount will be $20.1 million ($11,700,000 + $8,400,000).

Portability is designed so that it will not carry forward benefits to unlimited future spouses. It limits the amount carried forward by comparing the surviving spouse's basic exclusion amount to the DSUE the surviving spouse is carrying forward from a prior spouse and allowing the lesser of the two amounts to be carried forward by election in the surviving spouse's estate.

Example of DSUE in Deborah's estate

Deborah remarries, and when she dies she leaves her entire estate to her new husband. Because the DSUE cannot exceed the lesser of the basic exclusion amount or the amount of her AEA after subtracting the amount of her taxable estate and taxable gifts, her DSUE that can be carried forward to a new husband will be $11.7 million.

Last spouse to die

IRC §2010(c)(4)(B)(i) states that a decedent may use the unused exclusion amount of his or her "last spouse to die." This prevents surviving spouses from using the DSUE of multiple predeceased spouses.

The regulations clarify that a surviving spouse will not lose the DSUE by simply remarrying. (Temp. Treas. Regs. §20.2010-3T(a)(3)) However, if a surviving spouse remarries, he or she loses any unused exclusion amount from the first deceased spouse if he or she also outlives the second spouse.

This is the case even if there is no DSUE from the new spouse.

> ***Example of remarriage***
>
> Henry died in 2011 with a taxable estate of $1 million. The executor of Henry's estate made an election on his estate tax return to permit his wife, Wanda, to use his DSUE of $4 million.
>
> Wanda married Joe in 2013. If Joe predeceases Wanda in 2021 and leaves his entire $12 million estate to his children from a prior marriage, Wanda will have no DSUE from Joe and receives no DSUE from Henry.

The regulations also clarify that if the surviving spouse marries again and that marriage ends in divorce or an annulment, the subsequent death of the divorced spouse does not end the status of the prior deceased spouse as the last deceased spouse of the surviving spouse. They must be married at the time of death for a subsequent spouse to become a "last deceased spouse." (Temp. Treas. Regs. §§20.2010-1T(d)(5), 20.2010-3T(a)(3))

> ***Example of divorce***
>
> Assume from the above example that Wanda and Joe divorce shortly before Wanda's death. Their marriage has no effect on Wanda's DSUE; that is, she keeps Henry's DSUE.

Making the election

The election must be made on a timely filed estate tax return. (Treas. Regs. §20.2010-2(a)) This means the executor must file a return making the election within nine months of the decedent's date of death, unless an extension is requested, which would give the executor an additional six months. (IRC §§2010(c)(5), 6018(a), 6075(a))

Use Form 706 to elect portability of a DSUE.

The current version of the form is designed to allow estimated values of the gross estate rather than the detailed valuations that are typically involved when filing Form 706. Using the Table of Estimated Values included in the Form 706 instructions, the executor is permitted to estimate the value of the decedent's estate using $250,000 increments.

Timeliness of filing

Estates that are filing an estate tax return only to make a portability election have until the second annual anniversary of the decedent's date of death to make the election on the estate tax return. (Rev. Proc. 2017-34) However, estates that miss this deadline must request a private letter ruling to make the portability election. (Rev. Proc. 2017-3; Treas. Regs. §301.9100-3) The fee for these letter rulings is currently $10,900. (Rev. Proc. 2019-1)

Foreign spouses

The final regulations provide a new rule allowing the decedent's unused exclusion amount to be used by a surviving spouse who becomes a U.S. citizen after the decedent's death. In such a case, so long as the executor makes the DSUE election, the surviving spouse, after becoming a U.S. citizen subject to U.S. taxes, will be able to utilize the DSUE amounts. (Treas. Regs. §§20.2010-3, 25.2505-2)

Opting out

If an estate would be required to file a Form 706, but the personal representative does not wish to make a portability election, there is a checkbox in Section A of Part 6, Form 706, which will allow the personal representative to opt out of the automatic application of portability.

Applying the DSUE to gifts

If the executor of the predeceased spouse's estate elects portability of the DSUE amount, the surviving spouse can apply the DSUE against any tax liability arising from subsequent lifetime gifts in addition to transfers at death. (IRC §§2010, 2501, 2502) The Form 706 on which the deceased spouse's estate made the election must be attached to the Form 709 reporting the gift.

Form 709, United States Gift (and Generation-Skipping Transfer) Tax Return, Line 19, on Part I of the form, asks the donor whether he or she has applied a DSUE amount received from a predeceased spouse to a gift or gifts reported on the present or a previous Form 709.

Donors who answer in the affirmative must complete Schedule C, Deceased Spousal Unused Exclusion (DSUE) Amount, to determine the DSUE amount and applicable credit received from prior spouses. This will determine the amount of DSUE that may be used to reduce the donor's gift tax.

Any DSUE carried to a surviving spouse is used first before using the surviving spouse's own basic exclusion amount.

> ***Example of lifetime gift***
>
> Henry died in 2019 with a taxable estate of $10 million. The executor of Henry's estate made an election on his estate tax return to permit his wife, Wanda, to use his DSUE of $1.4 million.
>
> In 2021, as part of her estate plan, Wanda makes a $12 million lifetime gift to their children. Wanda can make that gift without being subject to gift tax because she can use her $1.4 million DSUE from Henry and $10.6 million of her own exclusion amount.

Note that although a surviving spouse may only carry forward the DSUE from the last deceased spouse, there may be cases where prior gifts used in completing a Form 709 came from more than one predeceased spouse.

DSUE after exclusions are reduced

The regulations also clarify that where a DSUE amount is preserved through a portability election from 2018 to 2025, that amount will not be reduced if the estate tax exclusion amounts are reduced after 2025. (Treas. Regs. §§20.2010-1(d)(4), 20.2010-2(c)(1))

Example of portability election

Mary's spouse, Charles, died in 2021, when the estate tax exclusion amount was $11.7 million. Charles made no taxable gifts and had no taxable estate. The executor of his estate made a portability election to preserve his $11.7 million DSUE for Mary to use at her death.

Mary made no taxable gifts and did not remarry. Mary dies in 2026, when the estate tax exclusion amount is $6.8 million ($5 million indexed for inflation).

The estate tax exclusion available at Mary's death is calculated as follows:

DSUE from Charles	$11,700,000
Mary's exclusion amount	6,800,000
Total applicable exclusion amount	$18,500,000

For couples with assets in excess of $5 million, consider the benefit of using portability elections to preserve DSUE at the death of the first spouse. Although those estates would not be subject to estate tax using today's exclusion amounts, reduced exclusion amounts could result in unnecessary estate tax at the death of the second spouse.

ESTATE TAX ALLOWABLE DEDUCTIONS

Marital deduction

There is an unlimited deduction for interspousal transfers both prior to and after death. This post-death deduction allows married couples to avoid estate tax when the first spouse dies. (IRS §2056) If the marital deduction property is still in the hands of the surviving spouse when they die, it is included in their gross estate and subject to estate tax at that time. In order for the marital deduction to be permitted, the following qualifications apply:

- The recipient must be married to the decedent on the date of death;
- The transferred property must be included in the decedent's gross estate;
- The spouse must survive the decedent; and
- The spouse must be a U.S. citizen.

Were they still married?

A recent Tax Court case regarding a sizable marital deduction took an interesting turn:

- The taxpayer married wife #1 in 1955, both of whom were Jewish;
- He obtained a divorce in Mexico in 1967;
- He married wife #2, who was not Jewish, later that year. That marriage ended in 1974;
- Wife #1 filed suit in the New York Supreme Court alleging the second marriage was null and void because the Mexican divorce did not legally dissolve the first marriage. The court agreed. The taxpayer found love a third time;
- He asked wife #1 to obtain a "get" (a religious divorce) under rabbinical law, which she did;
- He married wife #3 in Israel in 1987; and
- The taxpayer and wife #3 were New York residents at the time he died in 2014. (***Estate of Grossman v. Comm.***, TCM 2021-65)

The IRS disallowed the marital deduction on the grounds they were not legally married for estate tax purposes and therefore his estate was not entitled to the marital deduction. The IRS

assessed $35 million in estate tax and $7 million in penalties. His estate representative argued that wife #3 is the surviving spouse because New York applies a "place of celebration" law, and the marriage was valid in Israel, the place of celebration.

The Tax Court agreed with the estate. The Court also noted wife #1 never challenged the third marriage coupled with the fact she filed her tax returns as single and not married filing separate. The saying must be true that the "third time is a charm."

Charitable deductions

IRC §2055 states a charitable deduction is allowed for the value of property in the decedent's gross estate that was transferred by the decedent by will or trust to or for the use of any of the following:

- The United States, a state, a political subdivision of a state, or the District of Columbia, for exclusively public purposes;
- Any corporation or association organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes, including the encouragement of art, or to foster national or international amateur sports competition (but only if none of its activities involve providing athletic facilities or equipment, unless the organization is a qualified amateur sports organization), and the prevention of cruelty to children and animals;
- A trustee or a fraternal society, order, or association operating under the lodge system, if the transferred property is to be used exclusively for religious, charitable, scientific, literary, or educational purposes, or for the prevention of cruelty to children or animals. No substantial activity may be undertaken to carry on propaganda or otherwise attempt to influence legislation or participate in any political campaign on behalf of any candidate for public office;
- Any veterans organization incorporated by an act of Congress or any of its departments, local chapters, or posts, for which none of the net earnings benefits any private individual;
- Qualifying conservation easements granted after the decedent's death;
- Transfers to a charitable organization as a result of a qualified disclaimer;
- Employee stock ownership plans, if the transfer qualifies as a qualified gratuitous transfer of qualified employer securities within the meaning provided in IRC §664(g); and
- Certain Indian tribal governments are treated as states and transfers to them qualify as deductible charitable contributions for this purpose.

Bequests to individuals are not deductible charitable bequests. Unlike individual income tax deductions, there are no limitations on the percentage or amounts donated.

Example of charitable deduction on the Form 706

When Flynn, a single man, died in 2021, his gross estate was valued at $14 million. After the applicable exclusion amount of $11.7 million, his taxable estate was $2.3 million.

Flynn was a rocket scientist who worked for several large companies throughout his long career. He often said he owed his success to his university and his professors.

Flynn's trust specified that upon his death 25% of his gross estate was to be donated to his alma mater to establish a scholarship fund.

The charitable contribution reduced his estate to $10.5 million, and there was no longer an estate tax liability. The charitable contribution saved $920,000 in estate tax.

Comment

In the previous example, had Flynn made similar contributions during his lifetime, his charitable contribution deductions may have been limited by AGI and carried over. At death the tax benefit of any carryover contributions would have been lost. Also, his tax rate may have been lower than the 40% charged to the estate.

Practice Pointer

Do not confuse charitable contributions made from the estate with contributions made via the decedent's trust. You may not take charitable contributions required in the will/trust on the Form 1041, even if there is not enough money in the estate to owe a tax. To be deductible on Form 1041, the contributions must be made from income or corpus of the trust pursuant to the trust, not the will.

Administrative and miscellaneous deductions

There are other numerous deductions an executor may utilize to reduce the taxable estate and estate tax. (IRC §2053) Deductible costs include:

- Executor fees — often family member executors do not want to charge the estate for their fees. The tax effects should be reviewed before a final decision is made as to whether the executor is compensated. For a taxable estate, the tax savings could be substantial if fees are paid;
- Costs for storing or maintaining estate assets; and
- Unreimbursed casualty losses.

Example of executor fees

Michael handled all of the father's estate without compensation because he believed it was his family duty. Upon meeting with the father's accountant and attorney, he was advised to take trustee fees equal to 1% of his father's $25 million gross estate as well as reimbursement for approximately $100,000 in estate-related expenses he had paid for personally. After consulting with his sisters, they all agreed he should take the money because of the estate tax savings.

Gross estate	$25,000,000
1% deductible trustee fees	$250,000
Reimbursed expenses	$100,000
Total deductible expenses	$350,000
Estate tax savings, at 40%	$140,000

In many cases, the other beneficiaries may grumble about the fee but should not have a problem with reimbursing out-of-pocket expenses.

Miscellaneous itemized deductions

The elimination of miscellaneous itemized deductions that are subject to the 2% floor under the TCJA applies to estates and trusts.

This includes:

- Tax preparation fees (unless they can be allocated to Schedule C, E, or F);
- Fiduciary fees; and
- Investment advisor fees and/or asset management fees.

However, IRC §67(e) provides an exception to the 2% floor for administrative costs paid or incurred by an estate or trust that would not have been incurred if the property were not held in such estate or trust. This is an important distinction because tax preparation fees and fiduciary fees can be large expenses incurred in the management of estate or trust assets.

Example of deductible fees

ABC Trust incurs the following expenses:

	Pre-TCJA	**Current law**
Trust accounting fees	$ 15,000	$15,000
Fiduciary fees	5,000	5,000
Tax preparation fees	5,000	5,000
Brokerage account management fees	40,000	0*
Property management fees	6,000	6,000
Total	$116,000	$76,000

* Not deductible, as it's an investment expense and a 2% itemized deduction

The IRS has confirmed in proposed regulations that the TCJA elimination of miscellaneous itemized deductions under IRC §67(g) does not eliminate those items that were previously deductible under IRC §67(e). (Notice 2018-61) This clarifies that for taxable years beginning after December 31, 2017, administrative expenses are still fully deductible on the fiduciary returns.

The regulations also specifically state that the appropriate portion of bundled fees are still deductible. As a result, if a portion of the fee is attributable to administrative expenses, they are still deductible.

Excess deductions for beneficiaries

Prior to the enactment of the TCJA, in the final year of an estate or trust, beneficiaries were also permitted to take deductions on their individual returns for deductions in excess of gross income (excluding charitable deductions and the exemption available on the fiduciary return). (IRC §§67(e), 642(h)(2))

However, these were miscellaneous itemized deductions subject to the 2% limitation on the beneficiary's 1040. For taxable years beginning after December 31, 2017, these deductions were eliminated by the TCJA.

Trustees and executors must carefully consider when to pay expenses in order to avoid lost deductions. For example, it may be beneficial to pre-pay the cost of preparing the final trust tax return in a year prior to final distribution if the deduction for that expense would otherwise be lost.

In 2020, the IRS released final regulations regarding excess deductions upon the termination of an estate or trust.

The 2020 Schedule K-1 (Form 1041) instructions provide new reporting rules in light of the final regulations. Under the final regulations, each excess deduction on termination of an estate or trust retains its separate character as either:

- An amount allowed in arriving at adjusted gross income (an above-the-line deduction) — these are also known as IRC §67(e) expenses;
- A non-miscellaneous itemized deduction; or
- A miscellaneous itemized deduction.
  (TD9918)

IRC §67(e) expenses

Expenses classified under IRC §67(e) are those items that are paid or incurred in connection with the administration of an estate or a nongrantor trust and that would not have been incurred if the property was not held in an estate or trust. An example of an IRC §67(e) expense would be trustee fees.

When determining whether an expense is classified under IRC §67(e), the tax professional preparing the Form 1041 must determine whether the expense would be commonly or customarily incurred by a hypothetical individual owning the same property.

The following chart provides the Schedule K-1 (Form 1041) and Form 1040 reporting for each of these items:

Reporting Trust and Estate Deductions		
Character of excess deduction on termination of estate or trust	**Schedule K-1 (Form 1041)**	**Beneficiary's Form 1040 reporting**
IRC §67(e) expenses	Box 11A	Schedule 1, line 22. On the dotted line next to line 22, write "ED67(e)"
Character of excess deduction on termination of estate or trust	Schedule K-1 (Form 1041)	Beneficiary's Form 1040 reporting
Non-miscellaneous itemized deductions	Box 11B	Reported on Schedule A. The line used on Schedule A depends on the nature of the expense. A statement on Schedule K-1 should list and describe the character of the expenses that make up Box 11B
Miscellaneous itemized deductions	N/A	N/A

It is strange that the instructions to Schedule K-1 (Form 1041) state that non-miscellaneous itemized deductions can be deducted on Schedule A of the beneficiary's Form 1040, but that excess miscellaneous itemized deductions upon the termination of an estate or trust should not be reported on the K-1 because they are not deductible by the beneficiary. The reason given in the draft instructions to Schedule K-1 as to why miscellaneous itemized deductions are not deductible on the beneficiary's Schedule A is because the TCJA suspends miscellaneous itemized deductions that are subject to the 2% floor.

But what about miscellaneous itemized deductions that are not subject to the 2% floor? Those miscellaneous itemized deductions (e.g., casualty and theft losses from income-producing property or federal estate tax on income of decedent) are still deductible on Form 1040, Schedule A. We believe that despite the confusing language in the draft Schedule K-1 instructions, Box 11B should also include miscellaneous itemized deductions that are not subject to the 2% floor because such items are still deductible.

FUNDING THE ESTATE TAX WITH AN ILIT

An irrevocable life insurance trust (ILIT) is an irrevocable trust that owns insurance on the life of the grantor or the grantor and spouse. Insurance policies usually are the sole assets of the trust while the insured is alive.

The trust is designed to avoid federal estate taxation of the insurance proceeds on the deaths of the grantor(s), and the proceeds are often used to pay the estate tax. When premium payments or other gifts to the trust are made, the trust instrument grants specified beneficiaries Crummey withdrawal rights over the gifts so that they will qualify for the federal gift tax annual exclusion.

The typical purpose of creating a life insurance trust is to keep the proceeds of the policy out of the grantor's estate. Since this requires that the grantor not own the policy, the trust will always own the life insurance policy and usually is the beneficiary. Upon creation, funds sufficient to satisfy the premiums are transferred to the trust, or an existing policy is transferred to the trust.

Irrevocable trust

The ILIT must be an irrevocable trust, where the grantor does not have the ability to alter, amend, revoke, or terminate the trust, otherwise transfers to the trust do not constitute completed gifts.

For this reason, irrevocable trusts are used to accomplish the goal of removing the life insurance asset from the grantor's estate.

Although the trust is irrevocable and will, when properly drafted, keep the proceeds of the insurance out of the grantor's estate, the trust is generally a grantor trust for income tax purposes by virtue of IRC §677. This may have little practical significance because a life insurance trust rarely has much in the way of taxable income.

Gift tax consequences

Transfers to an irrevocable trust are generally subject to gift tax. The gift tax would be based upon the value of the asset transferred to the irrevocable trust.

If a life insurance policy is transferred to the trust, the current value of the policy (generally the "cash surrender value") would be the taxable base for purposes of computing the gift tax liability.

Additionally, any funds contributed by the grantor, to purchase policies and/or pay premiums on policies, to an irrevocable trust would also be taxable gifts.

Grantors may use their annual (or lifetime) gift tax exclusion amounts to make transfers to the trust and avoid gift tax. (IRC §2503) However, to qualify as a current gift, the recipient must have the unrestricted right to the immediate use, possession, or enjoyment of the transferred asset. (Treas. Regs. §25.2503-3(b))

Under general terms, a gift of a life insurance policy to a trust would not qualify for the annual exclusion because the policy does not produce income until the death of the grantor. Under those terms, the gift would be a future interest gift, rather than one with a present interest. (Treas. Regs. §25.2503-3(c))

To solve the present interest gift issue, the trust must grant the beneficiaries with "***Crummey***" withdrawal powers. ***Crummey*** powers provide the beneficiaries with the unrestricted right to withdraw amounts contributed to the trust for a specified period of time following the contribution. (***Crummey v. Commissioner*** (1968) 397 F.2d 82)

If the beneficiaries hold ***Crummey*** powers, the transfers to the trust qualify as present interest gifts, which qualify for the annual gift tax exclusion.

The unrestricted right to the immediate use, possession, and enjoyment of the contribution, whether or not exercised, qualifies as a transfer of a present interest for the annual exclusion under IRC §2503(b). (Rev. Rul. 80-261) To qualify, the beneficiary must be given prompt notice of his or her right of withdrawal and a reasonable opportunity to exercise the power before it lapses. (Rev. Rul. 81-7)

The IRS has determined that 30 days constitutes a reasonable period of time between notice of the withdrawal right and its lapse. (PLR 9030005)

If the beneficiaries of the trust are minors, appointment of a guardian for the minors should be considered for purposes of receiving notice of the withdrawal right.

Example of ILIT with Crummey powers

James' estate is well in excess of the estate tax exclusion but much of it is not liquid, and he is concerned about his heirs having the cash available to pay that estate tax.

He forms an ILIT, which takes out a term life insurance policy with the children as beneficiaries. The premiums are $6,000 per year for a $2 million policy. He pays the premium with gifts to each of his two children of $3,000 each. They have the right to use the funds for other purposes within 30 days. He is not deemed to have paid for the policy.

However, the gifts of the premium to the children are included in his annual $15,000 gift tax exclusion.

When James dies, the children get the insurance money, and it is not included in the estate.

Sample Crummey power language

Each beneficiary shall have the right to withdraw the amount equal to the aggregate of the amounts transferred and delivered to the trustee by each trustor and each donor, which are excludible from taxable gifts pursuant to the provisions of IRC §2503(b), or any comparable provision thereof during any calendar year for a period of 45 days (hereinafter referred to as the "withdrawal period"), it being the intent of the trustors and, unless otherwise specified by any donor, shall be presumed to be the intent of such donor, to qualify any such transfer as a gift of a present interest as described in IRC §2503(b). Upon receipt of any asset transferred to the trust, the trustee shall immediately notify each beneficiary of the amount, if any, subject to their withdrawal right, and the date upon which such right shall lapse. Each beneficiary desiring to exercise their right to withdrawal shall notify the trustee, in writing, of such desire prior to the expiration of the withdrawal period. If any beneficiary is under any legal disability, the guardian or conservator of their estate may exercise such beneficiary's right to withdraw by so notifying the trustee, and such right shall be deemed to have been exercised within the withdrawal period, whether or not such guardian or conservator has been appointed.

ILIT — bring-back rule

If the grantor owned the life insurance policy at any time during the three years prior to their death, the "bring-back" rule applies. The bring-back rule simply means the life insurance death benefit proceeds will be brought back into the grantor's gross taxable estate. To avoid this problem, a trustee — who is not the insured person — applies for the life insurance on behalf of the trust. The trust is the owner from the outset. The insured must not retain any incident of ownership or rights to receive dividends. (Treas. Regs. §20.2042-1(c)(2))

Third-party beneficiary

Absent the use of an ILIT, the estate owner's children or other party are named as the life insurance beneficiary. If the decedent owned the policy, the death benefits are includible in their

gross taxable estate. If another party owned the policy, there is no estate tax consequence to the decedent. Death benefit proceeds are not taxable income to the beneficiary. (IRC §101(a)(1)) Cash from the proceeds can be lent to the estate to pay the estate tax. The proceeds can also be used to purchase nonliquid assets from the estate so the estate taxes can be paid with the infused cash. The cost to purchase a life insurance policy sufficient to cover the estate tax liability is generally less than half of the total proceeds received.

Term insurance vs. whole life or permanent insurance

Factors to consider when shopping for a life insurance policy held in the ILIT are:

- The age and life expectancy of the insured;
- Whether to purchase a term or whole life policy; and
- Whether the policy is renewable.

The term policy is less expensive and easy to understand. However, the lack of cash value build up means they are not as good an investment as a whole life policy.

Maybe the largest disadvantage is that the policy may not be guaranteed renewable, and the cost can increase as the individual reaches certain ages.

Whole life policies can be attractive to high-net-worth individuals who want to reduce their gross estate by gifting the maximum annual exclusion amount. The funds necessary to pay the higher premiums are covered while building a cash reserve in the trust and in the policy.

The premiums for a whole life policy are 5% to 15% higher than term insurance premiums and are level throughout the duration of the policy. A portion of the premium goes to build cash value in addition to the death benefit.

As cash value grows in the policy, the premiums can be paid out of the policy earnings. Thus, it is less likely the policy would be cancelled due to nonpayment of premiums than a term policy.

At death, when the policy is cashed out, the earnings are taxable as ordinary income to the beneficiaries.

Installment payments

Federal estate taxes attributable to a certain qualified business interest may be eligible for an installment payment agreement that ranges up to a maximum of 15 years. (IRC §6166) The executor may elect to defer payments, not interest, for up to five years from the original payment due date. A 2021 maximum deferral for estate taxes is available on the first $1.59 million of the taxable value of a closely held business. (Rev. Proc. 2020-45) The deferral amount is adjusted annually for inflation. The calculation is based on the ratio of tax owed for the business interest to the total tax as applied to the same ratio of the business value to the gross estate. A special annual interest rate on the unpaid balance can be as low as 2%.

Caution

The interest paid on installment payments is not a deductible administrative expense although is paid out of the estate. To qualify for installment payments, the value of the closely held business must be more than 35% of the adjusted gross estate. If there are two or more businesses, they are treated as a single business if at least 20% of each of their respective values is included in the gross estate.

Maintain liquidity

The least desirable way to pay estate taxes is with liquid assets. Liquidity is the ability to quickly convert investment assets to cash with little or no effect on the value. Money market and savings accounts offer the most liquidity. Given the low interest rates paid on those accounts, the cost to maintain liquidity can be staggering compared to higher rates of return with more aggressive investments. An ILIT is a good way to provide the liquidity to pay estate taxes.

Selling nonliquid assets may generate some cash but at a high cost as well. Estate sales, usually conducted under pressure to liquidate as much and as fast as possible, will see that the proceeds are far less than fair market value. Unless the executor is experienced in these types of sales, there is an additional cost associated with the event.

The last option to produce liquid cash is for the estate to borrow funds. That requires the executor to find a bank willing to lend money to the estate usually at an above-market interest rate if the estate does not have sufficient collateral or an immediate source of repayment. The cost associated with this solution includes interest expense and loan fees.

Graegin loans

Bank loans, loans taken from a family business, a life insurance trust, or other third party are known as ***Graegin*** loans. (***Estate of Graegin v. Comm.*** 56 T.C.M. 387 (1988)) While they are under intense scrutiny from the IRS, they do serve a purpose. This type of borrowing allows for an immediate deduction of all of the interest due on the loan. Thereby it reduces the estate tax liability. To be deductible, the interest must be reasonably estimated, have a fixed interest rate, and the loan document must prohibit any prepayment. In audit, an analysis of proof of illiquidity may be required to substantiate the need for a ***Graegin*** loan.

TRUSTS

LIVING TRUSTS

Trust uses

Avoid probate and provide privacy

Living trusts or family trusts are formed for several different reasons. The most common reasons are to avoid a lengthy and expensive probate and privacy concerns. However, other reasons include the ability to distribute assets without court supervision, the prevention of outright distributions to beneficiaries who might not be able to manage trust assets, the flexibility to modify amend or revoke the trust, and to provide for dependents with special needs.

With the use of additional specific trusts, some that are active during the grantor's lifetime and others that become operational upon the grantor's death, numerous options are available to fulfill the grantor's wishes. For example the grantor may establish and fund an education trust to provide educational assistance to beneficiaries, which may become operational immediately. A special needs trust established to provide financial support to individuals with impaired physical or mental health problems can be a living trust or a testamentary trust operational upon the grantor's death.

With a living trust, during the grantor's lifetime, the trust is a disregarded entity so long as the grantor is treated as the owner of the trust. All income, deductions, and credits are reported on the grantor's individual tax returns. (IRC §671, et seq.) There is no requirement to file a separate

fiduciary income tax return. Living trusts do not provide any current income benefit, and they do not provide asset protection.

At the grantor's death, the terms of the trust will direct the disposition of assets for the benefit of their heirs and name a successor trustee to carry out the provisions listed in the trust document. The trust will dictate when distributions will be made, often at such time a beneficiary reaches a certain age or meets stated criteria. Some of the more common criteria seen in trust documents are:

- The beneficiary receives the inheritance at 25 years of age;
- Partial distributions to be made annually beginning at age 25 with full distribution at age 40.
- The beneficiary must have completed their education or at least achieved a bachelor's degree; or
- The beneficiary must be able to pass routine drug tests.

Comment

The ages in this list are examples of commonly made choices. The beauty of the living trust is that the grantor can chose the age or criteria that they feel best fits their needs.

Funding the trust

When the trust is formed, the most important step is to title the assets in the name of the trust, rather than in the owner's name.

Put these assets in the trust

Assets that should generally be put in the trust include:

- Real property, including the residence and second homes;
- Bank accounts;
- Brokerage accounts;
- Rental property;
- Investments such as partnerships, LLCs, corporate stock; and
- Personal property — generally only if the decedent specifically wants a beneficiary to receive that asset.

Comment

If the personal property is not of significant value, it is often best not to include that property in the trust but to have the grantor make a list to give to the successor trustee.

In smaller estates, where the main goal is probate avoidance (and not asset control after death), a grantor can use a beneficiary designation rather than put an asset in the trust.

Example of beneficiary designation

Josie wants her estate to be as simple as possible. She has two adult children. She has bank accounts where she has put money she wants to give to each child. She can name each child as a beneficiary on an account.

By giving a beneficiary designation rather than including the accounts in the trust, the children will get quick access to the funds in the account, without any restrictions.

As discussed above, bank accounts have a beneficiary designation, and there are many reasons to use this method of transfer at the death. For real property, joint tenancy or tenants-in-common with rights of survivorship can also be used. However there are gift tax consequences and basis step-up issues to consider here.

Another consideration is a revocable transfer on death, which is also a method to transfer real property at death and avoid probate.

Pension plans and IRAs can have either the individuals or a trust as the beneficiary. There are many benefits either way.

Life insurance

Life insurance death benefits typically pass to a named beneficiary. Therefore it is not necessary to change the ownership to avoid probate. The only time life insurance may go through probate is if there are no living beneficiaries when the insured dies, and the proceeds go to the estate.

An advantage to the trust being the designated beneficiary, however, is to provide asset protection for other beneficiaries. For example, if one or more of the beneficiaries are minors, if they have a spending problem, have a drug habit, or are incarcerated, it may be prudent to name the trust as the beneficiary. If the trust provides for a spendthrift clause and discretionary distributions, which are contained in most trust documents, the life insurance proceeds are protected, for example, from any beneficiary's lawsuits, divorces, and excessive spending.

However, putting the life insurance in a living trust would mean it will be included in the taxable estate of the decedent. For clients who potentially have a taxable estate, a life insurance trust is a better option. It keeps the assets out of the taxable estate, while also allowing the grantor to restrict access to the funds after their death. See page 20 for a discussion of life insurance trusts.

Retirement accounts

Before the enactment of the SECURE Act, there were specific provisions required to prevent accelerated distributions of inherited IRAs when the trust was the named beneficiary. For this reason many advisors would recommend that a separate trust (not the living trust) be named as the IRA beneficiary, to ensure those requirements were met.

Prior to the SECURE Act, trusts that met the requirements to be treated as designated beneficiaries could defer IRA distributions based on the life of the trust beneficiary, in the same manner as if that beneficiary had been named individually. Under the SECURE Act, however, for accounts inherited after 2019, even if the trust qualifies as a designated beneficiary, the assets must be distributed under the new 10-year rules. (SECURE Act §401; IRC §401(a)(9))

This means that placing the IRA assets in the living trust won't accelerate distributions, but there are still some planning aspects to consider. See page 47 for a discussion of planning for these new inherited IRA rules.

Transfer assets

The most important component of a revocable living trust is the funding. Unless assets are actually transferred to the trust with their ownership titled in the name of the trust, they are not considered trust assets and may still be subject to probate. The ongoing process can be lengthy and time-consuming; however, necessary. In addition to the initial funding of the trust, at the death of any grantors, it is the responsibility of the successor trustee to ensure that any subtrusts created at death are properly funded. See page 29 for a discussion of what happens if assets are not properly transferred at the death of a grantor.

REVIEW QUESTIONS

Under the NASBA-AICPA self-study standards, self-study sponsors are required to present review questions intermittently throughout each self-study course. Additionally, feedback must be given to the course participant in the form of answers to the review questions and the reason why answers are correct or incorrect.

To obtain the maximum benefit from this course, we recommend that you complete each of the following questions, and then compare your answers with the solutions that immediately follow. *These questions and related suggested solutions are not part of the final examination and will not be graded by the sponsor.*

1. What is true about gift tax?

    a) There is a gift tax filing requirement whenever there is a transfer of property without the expectation that compensation is involved
    b) A person may make unlimited gifts as long as each gift is not more than the exclusion amount
    c) A gift may be a future interest in property and qualify for the gift tax exclusion
    d) Clients making gifts at the end of the year to be included in the current year's exclusion must make sure that the checks are dated by December 31

2. Which statement is true regarding the current gift and estate tax exclusion amounts and what happens when the TCJA is no longer in effect?

    a) The current exclusion amount is $10 million, adjusted for inflation, through December 31, 2026
    b) The estate tax is based on whatever assets are left in the estate at the time of the individual's death
    c) For years when the TCJA is no longer in effect, the final regulations allow an estate to calculate its estate tax credit using the increased exclusion that was available at the time of the gift
    d) The Build Back Better Act currently being debated in Congress would end the increased TCJA unified exclusion in 2023

3. Which choice accurately describes features of family limited partnerships or family LLCs?

    a) One of the benefits of these entities is that valuation discounts may apply for estate tax purposes
    b) Family limited partnerships do not need a business purpose
    c) With these types of entities, an elder family member usually contributes assets that they will no longer control when transferred
    d) Using an FLP will not protect assets from a beneficiary's liabilities

4. As it pertains to portability and the deceased spouse's unused exclusion (DSUE) amount, which choice is correct?

    a) The DSUE is the basic exclusion amount or the deceased spouse's applicable exclusion amount, less any amount of that exclusion that was used to avoid estate or gift tax, whichever is more
    b) Surviving spouses can use the DSUE from multiple spouses who have died
    c) The portability election is made on Form 706, U.S. Estate (and Generation-Skipping Transfer) Tax Return
    d) Estates that file an estate tax return only for the purpose of making a portability election have until the first annual anniversary of the date of the decedent's death to make the election on the return

5. Which of these statements accurately describes details of an irrevocable life insurance trust (ILIT)?

    a) Using an ILIT will not keep the insurance proceeds out of the grantor's estate
    b) Only whole life insurance may be transferred to an ILIT
    c) With an ILIT, the grantor owns the policy
    d) An insurance policy transferred to a trust is subject to gift tax

SOLUTIONS TO REVIEW QUESTIONS

1. What is true about gift tax? **(Page 2)**

    a) Incorrect. There is no filing requirement if the gifts are not more than the annual exclusion amount.
    b) Correct. For 2021, that amount is $15,000, or $30,000 for a married couple.
    c) Incorrect. Only gifts with a present interest qualify for the current year's gift tax exclusion.
    d) Incorrect. The checks must be cashed by December 31 to be included in the current year's exclusion.

2. Which statement is true regarding the current gift and estate tax exclusion amounts and what happens when the TCJA is no longer in effect? **(Page 4)**

    a) Incorrect. The increased exclusion is in effect for years 2018-2025.
    b) Incorrect. Any lifetime gifts must be added back into the estate and included with the remaining assets.
    c) Correct. Any estate making a lifetime gift through 2025 will benefit from the higher exclusion amount.
    d) Incorrect. If passed, the increased exclusion would end after December 31, 2021, and the exclusion amount would revert back to $5 million adjusted for inflation.

3. Which choice accurately describes features of family limited partnerships or family LLCs? **(Page 8)**

    a) Correct. The valuation discounts will lower estate tax.
    b) Incorrect. Both FLPs and family LLCs must have a business purpose or the entity will be voided and the assets will be included in the estate.
    c) Incorrect. With a general partner or managing member interest, the elder family member maintains control of the assets.
    d) Incorrect. There is asset protection against a partner's/beneficiary's liabilities.

4. As it pertains to portability and the deceased spouse's unused exclusion (DSUE) amount, which choice is correct? **(Page 14)**

    a) Incorrect. It is 1) the basic exclusion amount or 2) the excess of the decedent's applicable exclusion amount over the sum of the amount of the taxable estate plus the amount of the decedent's adjusted taxable gifts, whichever is less.
    b) Incorrect. The surviving spouse cannot use the DSUE from multiple spouses but may use the unused exclusion amount of their last spouse to die.
    c) Correct. Making the election will preserve the DSUE.
    d) Incorrect. The estate has until the second anniversary of the decedent's date of death.

5. Which of these statements accurately describes details of an irrevocable life insurance trust (ILIT)? **(Page 21)**

    a) Incorrect. The purpose of the ILIT is to keep the proceeds out of the estate.
    b) Incorrect. The policy could also be term insurance.
    c) Incorrect. The policy is owned by the trust, which is typically the beneficiary.
    d) Correct. The cash surrender value is considered the taxable base when computing the gift tax.

IRC §645 ELECTION

Upon the grantor's death, the trust becomes a separate taxable entity, and the trust cannot be amended. (IRC §645) Though the assets in the trust are part of the decedent's estate, for income tax purposes, a trust has less flexibility than an estate. However, an irrevocable election pursuant to IRC §645 provides for a qualified revocable trust to be treated as an estate until such time as all the assets have been distributed. There are a number of tax benefits to electing to be taxed as an estate but maybe the most common are:

- Electing a fiscal year;
- A two-year exemption on paying estimated taxes;
- Waiver of the active participation requirement for passive losses for two years following the decedent's death;
- Ability to take a charitable deduction for amounts permanently set aside for charity (without paying those amounts first);
- Extending the time the estate can hold S corporation stock; and
- Deducting losses for pecuniary bequests of noncash assets (trusts cannot recognize these losses).

Once the election is made, all electing trusts and the related estate, if any, file one combined income tax return even though legally, the trust, rather than the estate, continues to hold the assets.

☑ Planning Pointer

Keep in mind that the election is irrevocable, and potential conflicts could arise between beneficiaries of the trust and estate if they are different. Consideration should be given to the long-term ramifications of this election, beyond the short-term tax savings, before the election is made. For example, additional administrative costs, one tax return means less income taxed at lower brackets, etc.

Election

File Form 8855, Election to Treat a Qualified Revocable Trust as Part of an Estate, on or before the due date (including extensions) of the estate's first income tax return. If there is no probate estate, the election must be made by the due date (including extensions) of the trust's first income tax return. (IRC §645(c))

Practice Pointer

When the election is made, the trustee and executor agree to allocate the tax burden of the combined trust and related estate.

Fiscal year allowed

By making the election, the trust may elect to use a fiscal year that will enable it to shift income to a more favorable tax year. This is especially helpful if a decedent dies close to the end of a calendar year. Without an IRC §645 election, the fiduciary income tax return would be due on April 15 of the following year. If the estate is small and with the election in place, it may be possible to settle the estate within the elected fiscal year and file a simultaneous single initial and final return.

Example of a fiscal-year election

Harold died on November 1, 2021, with his living trust named as the beneficiary of his 401(k) retirement account. The funds that were disbursed immediately to his trustee produced a sizable tax bill that would normally be due on April 15, 2022. However, the trustee makes an IRC §645 election and also elects an October 31, 2021, fiscal year-end.

During the following months, the trustee is able to settle Harold's estate. He utilizes a charitable contribution deduction, the deduction for his trustee fees, and real estate losses to eliminate most of the tax bite from the retirement distribution. He then files a single initial and final tax return for Harold with minimal tax liability.

BYPASS TRUST AKA CREDIT SHELTER TRUST

Estate plans, whether utilizing only a will or using a revocable living trust often contain instructions requiring the trustee or executor to fund various trusts upon death of a married individual who leaves a surviving spouse. For a married couple, a bypass trust allows property to pass to heirs other than the surviving spouse, while allowing the surviving spouse to have the use of the income (and even limited amounts of principal) during his or her lifetime.

By diverting assets to a bypass trust instead of leaving them to the surviving spouse, the decedent's exemption credit is not wasted. In addition, the assets in the bypass trust are not included in the surviving spouse's estate (hence the term bypass), meaning that those assets will not be subject to estate tax in either the decedent's or survivor's estate.

Traditionally, standard estate planning for higher net worth clients creates a trust equal to the exemption amount that intentionally does not qualify for the unlimited marital deduction. Although the current estate tax provisions allow spouses to "share" estate tax exemptions, it may still be beneficial to use the traditional bypass trust using the full exemption of the first spouse to die. We will discuss this in more detail below. First, let's review the structure and benefits of the bypass trust.

The assets in this trust will avoid inclusion in the estate of the surviving spouse no matter how much they are worth when the surviving spouse dies. They are said to "bypass" the estate of the survivor.

This bypass trust has many names, including the B trust, credit shelter trust, exemption equivalent trust, and just about any other name that the drafter chooses.

Practice Pointer

While most of our married clients may not currently need a bypass trust due to the high estate tax exclusion amounts, if Congress greatly reduces the threshold, they will become invaluable again.

Death of the first spouse

Often estate plans require that two or more trusts be created upon the death of the first spouse. Those trusts may be called by many different names, but they have certain traits in common.

Survivor's trust

The survivor's trust contains the surviving spouse's separate assets and the surviving spouse's share of the community property. It may be called the survivor's trust, the A trust, etc.

This trust is usually revocable by the surviving settlor. As a revocable trust, it is to be treated the same as any other living trust for income tax purposes.

The surviving spouse usually has unlimited discretion as to the disposition of these assets at death. This trust will sometimes receive the assets of the first spouse to die for which a marital deduction would be available. In other cases, assets for which a marital deduction is claimed will create a third trust known as a marital trust.

Decedent's trust

The decedent's trust contains the decedent's separate property assets and the decedent's half of the community property, but typically only up to the amount of the available exemption in the decedent's estate. It may be called the decedent's trust, the B trust, the bypass trust, the credit shelter trust, the exemption equivalent trust, the exemption trust, etc.

This trust is irrevocable and therefore falls under the income tax rules of irrevocable trusts, which means that it will require its own tax return as it will likely not qualify as a grantor trust. It is important to follow the rules for creation of these separate and distinct trusts in order to avoid problems that can arise from unfunded trusts.

Comment

When these trusts are created between married couples, they are often referred to as A-B trusts. But which one belongs to the survivor and which one to the decedent? A good way to remember is:

- The A trust is the trust for the survivor because he/she is Above Ground; and
- The B trust is the trust for the decedent because she/he is Below Ground.

Dividing the revocable trust into new subtrusts

The decedent's trust

The decedent's trust, aka bypass trust, should be funded with the decedent's separate property and the decedent's half of the community property. When allocating community property, it is not necessary to allocate 50% of each and every community asset between the decedent and the survivor, as long as the total value of community property is divided between decedent and survivor.

If there is community property life insurance payable to the original trust (usually called the family trust), allocate 50% to the decedent and 50% to the survivor.

If this trust is funded with more than the applicable exclusion amount (AEA), an estate tax will be payable. However, assets in this trust will not be included in the estate of the surviving spouse when the survivor dies, no matter how large it becomes in the intervening years. Therefore, this trust is said to "bypass" the survivor's estate. Further, the well-planned estate will likely claim a marital deduction for any excess over and above the applicable exclusion amount and shift that amount of assets to a marital trust or directly to the survivor.

The surviving spouse's future creditors cannot attach assets of the bypass trust because they do not belong to the surviving spouse, who may however:

- Be the trustee of the trust;
- Be the sole income beneficiary of the trust;
- Have a testamentary limited power of appointment over the assets; and
- Receive principal of the trust when needed for health, education, maintenance, or support.

All of those powers together do not add up to ownership! Note however that creditors could reach any required distributions (such as income).

The survivor's trust

The survivor's trust, aka the A trust, should be funded with the survivor's separate property and the survivor's half of the community property. In some cases, the estate plan will also add any of the decedent's property on which a marital deduction is claimed, but no separate marital trust will be created.

There is no limit to the size of this trust. All assets in this trust will be included in the estate of the surviving spouse when the survivor dies.

If the survivor becomes mentally or physically disabled so as to be unable to resist undue influence, this trust usually provides that the successor trustee(s) can take over without court approval and manage the trust for the benefit of the survivor until the disability ends.

This trust, like the original revocable living trust, avoids probate administration when the surviving spouse dies.

Should the survivor remarry, by keeping his or her own premarital assets in this trust, the trust assets are protected against claims of commingling by the new spouse.

Portability

The American Taxpayer Relief Act of 2012 (ATRA '12) made permanent the portability of the deceased spouse's unused exclusion (DSUE) amount for deaths after December 31, 2010. (IRC §2010(c)) This provision allows a surviving spouse to use the unused estate tax exclusion of his or her predeceased spouse by electing to carry it forward for the surviving spouse's benefit.

The surviving spouse can now inherit the deceased spouse's exemption along with the deceased spouse's assets. Accordingly, a bypass trust is no longer required to shelter assets from estate taxes. Currently, the only thing necessary at the first death, for estates that will be worth more than $5 million (indexed for inflation) at the second death, is the filing of an estate tax return when the first spouse dies.

While the question of whether it is better to use a bypass trust or take advantage of a portability election is not entirely settled, it is important for tax practitioners to understand the portability election. Failure to make the election in a timely manner when appropriate can lead to expensive consequences because not making the election on the death of the first spouse will preclude taking advantage of the deceased spouse's unused exemption when the surviving spouse passes.

The end of the bypass trust?

Because ATRA '12 made portability of the estate tax exemption between married couples permanent for 2013 and beyond, in 2021 a married couple can pass on $23.4 million to their heirs free from federal estate taxes without the need for any special estate planning.

With the retention of portability, the surviving spouse can now inherit the deceased spouse's exemption along with the deceased spouse's assets. Accordingly, a bypass trust is no longer required to shelter assets from estate taxes. The only thing necessary at the first death is the filing of an estate tax return when the first spouse dies.

Other bypass trust disadvantages

Bypass trusts and QTIP trusts are further encumbered by the various costs involved in creating, funding, maintaining, and ultimately distributing these trusts. Initially, there is the cost associated with drafting complex estate planning documents that provides for the creation of these trusts when the first spouse dies. Then there are costs of administering each subtrust, including the potential fees of a trustee.

Additionally, bypass trusts come with certain income tax implications. Assets in a bypass trust are eligible for a step-up in basis at the death of the first spouse. However, they do not receive a new basis on the death of the surviving spouse, as these assets are not included in the survivor's estate at the time of his or her death.

Furthermore, a bypass trust and a QTIP trust require the filing of annual income tax returns for all taxable income produced by the trust's assets. Additionally, this income is subject to the 3.8% Medicare surtax on investment income. Even if the trust distributes all of its income, it is still necessary to file the Form 1041 and provide beneficiaries with Schedules K-1.

In light of the important changes in the applicable law, as well as the significant negative implications of bypass trusts, it is important to now re-assess estate plans. Such a re-evaluation can result in substantial cost savings and can insure the increased wealth of the estate.

For example, a plan that calls for a division into subtrusts can be restated into a simple probate-avoiding trust without losing any of the originally intended tax benefits. This option is available as long as both spouses are alive.

The restated trust will retain the same name and the same date as it has now, meaning the trust assets will not be disturbed by the changes, and accounts do not need to be changed. It can continue to provide benefits for children, parents, people with special needs, etc.

When to use a bypass trust

Bypass and QTIP trusts are still appropriate in some cases. The subtrusts offer built-in asset protection against lawsuits after the first spouse dies. Because the survivor does not receive these assets, they are not subject to creditors.

QTIP trusts and QDOTs (qualified domestic trusts, for a noncitizen spouse) provide all the income to the surviving spouse and principal to no one else while postponing estate tax until the second death. Portability eliminates these problems but creates another one: It allows the survivor to designate the beneficiaries when the surviving spouse dies.

This means that portability removes that protection for the children of a prior marriage. This is contrary to the wishes of most individuals who remarry, as the first spouse usually wants to control the disposition.

In joint estates in excess of $10 million, it is beneficial tax-wise to find ways to reduce the value of the assets. Bypass trusts and QTIP trusts can be funded at the first death with portions of assets, such as 50% of an apartment complex into the survivor's trust, 25% into the bypass trust, and 25% into the QTIP trust.

This permits the executor of the estate of the second spouse to apply fractional share discounts and minority interest discounts in determining the value of the estate for estate tax purposes. At a 40% flat tax rate, that can amount to a sizable savings.

In addition, because assets placed in a bypass trust will escape tax upon the survivor's death, it is possible to achieve overall estate tax savings if the bypass is funded with highly appreciating assets that could not be achieved using the portability election.

Accordingly, before changing from a trust that creates subtrusts to a simple probate-avoiding trust, it is important to ask a key question: "Do you trust your spouse to leave the assets to the people who are important to you?" A negative answer means that there should be no change to the existing plan. However, a positive answer means that changes to the estate plan could result in substantial savings.

Additionally, the last spouse to die limitation means relying on portability would jeopardize the DSUE inherited by the surviving spouse if he or she remarries.

Funding the bypass trust

Assets used to fund the bypass trust should be the decedent's separate property and the decedent's one-half of the value of the community property. If the assets transferred are in excess of the applicable exclusion amount, then an estate tax on the excess will be due. With proper planning an executor can claim a marital deduction for any excess and transfer the amount of those assets to a marital trust or directly to the surviving spouse. It is important for the estate attorney, executor, accountant, surviving spouse, and beneficiaries to meet and carefully discuss all aspects — advantages and disadvantages — of funding the trusts.

Ideally the bypass trust would be funded with liquid assets such as cash and other assets that can be converted to cash with little or no loss of value. It is best to avoid funding the bypass trust with appreciated assets that will continue to appreciate because these assets will not get a second step-up at the death of the surviving spouse.

It is also best to avoid placing the principal residence in the bypass trust if it is possible the property will be sold during the surviving spouse's lifetime. Placing the residence in the bypass trust means that the surviving spouse is no longer the owner of the property, and it does not qualify for a §121 exclusion if it is sold.

Though we often think in terms of ideal situations for asset placement, there will be a number of real world issues that must be considered when making these decisions:

- Are the beneficiaries of both trusts the same? If not, you must balance the desire to preserve a second step-up in basis with the need for equal appreciation for all beneficiaries.
- Is the principal residence one that has been in the family for generations?
- Is this a second marriage situation with children from both marriages?
- Is there a family business involved?

Example of real property used to fund the bypass trust

Raul and Mary Lou lived in a beautifully restored Victorian style home in San Francisco for more than 40 years. Their children were raised in the home. As they all had fond memories, no one intends to sell the property. The home was a community property asset, so it got a full step-up in basis at the first spouse's death. When their living trust was drafted, the couple agreed to place the residence in the bypass trust at the first spouse's death. They knew the children would never sell it, so they weren't concerned that they would lose the second step-up in basis at the second death, and placing the home in the irrevocable bypass trust ensured that it ultimately went to the children

Raul died in 2015 when their estate consisted of the home, which was valued at $4 million, their stock portfolio valued at $6 million, and $1 million of cash in the bank. The AEA was $5.43 million in 2015. The home was placed in the bypass trust, along with $1 million in stocks and $430,000 cash. At Mary Lou's death, unless she needs to invade the trust principal, the home will pass to the children with a basis of $4 million, and the stocks will have a basis of $1 million.

Mary Lou signed a lease with the bypass trust to pay fair market value rent. The responsibility for the home's upkeep and major repairs fell on the bypass trust assets. She didn't worry about having to take care of the property, and the children knew their ultimate ownership was secure. As the income beneficiary of the bypass trust, Mary Lou could receive an income distribution equal to the net of the fair market value rent she paid less trust expenses.

When Mary Lou dies, the remaining stock portfolio will receive a second step-up in basis, so if the children decide to liquidate those assets, they will pay little to no tax on those sales.

QUALIFIED TERMINABLE INTEREST PROPERTY TRUST

The QTIP trust (IRC §2056(b)(7)) is an effective means of protecting a surviving spouse who is unable to handle the finances or has no business skill, or for marriages where both spouses have assets that they want to control after the death of a spouse.

The estate gets an estate tax marital deduction for assets that go into the trust, the surviving spouse gets lifetime income, and the decedent gets to control the disposition of the assets from the grave. In other words the trust defines the final beneficiaries while protecting their inheritance. The two important concepts of a QTIP trust are qualified and terminable.

Qualified assets placed in this type of trust while not actually transferred to the surviving spouse "qualify" for the marital deduction as if they had been transferred. (Treas. Regs. §25.2523(f)-1) The ownership interest is less than complete and "terminates" at some point in time. (IRC §§2056(b)(7), 2523(f)) The surviving spouse cannot sell or give away assets that belong to the trust either during their lifetime or at death per the terms of the trust. The surviving spouse does, however, have access to all income produced by the trust assets. Under certain circumstances trust corpus may be distributed to the spouse.

Generally, a QTIP trust has the following characteristics:

- The decedent's spouse must be entitled to all income from the property for life. The income must be distributed at least annually;
- The decedent's spouse may also receive principal from the trust as necessary for his or her medical care, education, maintenance, and support;
- When determining whether principal is paid to the surviving spouse, the trustee may consider all other income known to be available to the surviving spouse;
- The decedent controls the disposition of the remaining trust principal upon the death of the surviving spouse;
- Property allocated to the QTIP trust qualifies for the unlimited marital deduction. The decedent's executor makes the QTIP election on the estate tax return (IRS Form 706) by entering the property in Part A of Schedule M; and
- The value of the QTIP trust remaining at the death of the surviving spouse is included in his or her estate for tax purposes.

Example of a QTIP trust

Chip and Dale were a married couple who both had successful careers and were the parents of three grown children. Unfortunately, not long after they retired, Chip became a widower after Dale's short illness. However, Chip found love again with Daisy, a woman with two children of her own.

Given their age difference, Daisy would most likely outlive Chip. Chip's concern was that his three boys would not inherit the assets both of their parents worked hard to obtain. He feared Daisy and her two young children would inherit all of his wealth with nothing left for his children. By utilizing a QTIP trust, Chip can relax his fears and still provide a nice lifestyle for Daisy.

Comment

The unlimited marital deduction, and therefore a QTIP, is available only if the survivor is a U.S. citizen at the time the estate tax return is filed.

Funding the trust

The most favorable assets placed in a QTIP trust are those that are income-producing and will generate a sufficient and lengthy income stream to the surviving spouse. Often rental real estate, dividend paying stocks, and bonds, especially those that are tax-free, are assets chosen to be transferred to the trust.

Estate tax consequences

While a QTIP trust does not escape a potential estate tax assessment, it does prolong it. All QTIP assets will remain with the trust and subsequently pass to the beneficiaries upon the death of the second spouse. The fair market value at the date of death will be included in the second spouse's gross estate and is subject to estate tax. The assets will receive a basis set-up or possibly a step-down.

Portability

Rev. Proc. 2016-49 clarifies that otherwise nontaxable estates have the flexibility to elect portability and make a qualified terminable interest property trust (QTIP) election.

While a QTIP election can have the benefit of reducing a decedent's taxable estate, it can also increase the deceased spouse's unused exclusion (DSUE) available to the surviving spouse. (IRC §2010(c)) For this reason, the executor of a decedent's estate may want to make a QTIP election regardless of whether the election is necessary to reduce the estate tax to zero.

Since the enactment of the portability provisions, some practitioners have been concerned about the effect Rev. Proc. 2001-38 may have on nontaxable estates wishing to make QTIP elections.

Rev. Proc. 2001-38 allowed the IRS to treat QTIP elections as null and void for estate and transfer tax purposes if the election was not necessary to reduce estate tax liability. Would the IRS recognize the election for what would otherwise be an unnecessary QTIP election to maximize the DSUE?

Rev. Proc. 2016-49 clarifies that the executor can use the QTIP election to maximize the unused exclusion amount. It also provides procedures to continue to disregard unnecessary QTIP elections, which was the original purpose of Rev. Proc. 2001-38.

WHAT IF THE TRUST ISN'T FUNDED?

The bypass trust is irrevocable, and it cannot be changed, amended, or terminated by the surviving spouse. Also, the creation and funding with assets is mandatory. Although the trust itself can allow income and principal distributions to the surviving spouse, they don't allow distributions for other than the purpose stated in the trust. Here are some of the problems when not funding the trust:

- If the surviving spouse ignores the provision for any reason, a disgruntled beneficiary can sue the surviving spouse at nearly any time to enforce the creation and funding of the bypass trust. This can even be done after the surviving spouse dies in an attempt to recoup the assets lost to the bypass trust;
- The children may argue that a distribution taken by the surviving spouse was not really necessary if the surviving spouse has his/her own assets; and
- The bypass trust is irrevocable. The survivor cannot simply use the assets for any reason or give them away. There are legal restrictions placed over the money to protect the named beneficiaries.

If you don't do things properly with a bypass trust, there will be a nasty lawsuit in your future if the beneficiaries choose to fight.

Unfunded trust

Lee died in 2009 (prior to portability) and was survived by Jenny, his second wife. His share of the community property was worth $4 million. His revocable living trust stated that upon his death, a credit shelter trust (aka bypass trust) should be funded with the maximum amount that would not produce an estate tax — then $3.5 million. The remainder went to his wife Jenny, so there was no estate tax liability.

Normally, following a short administration, the trust would be set up. But it never was. This creates several issues:

- In 2020 Jenny died, with all of their property which had increased in value to $16 million still in the name of the joint family living trust. If all of the property was owned by Jennie at her death, there is an estate tax because her estate is in excess of $11.58 million. At 40%, that would produce an estate tax of $1,768,000 (($16 million - $11.58 million) × 40%).
  The estate tax would be zero if the bypass trust had been funded and her estate reduced by the assets placed in the bypass trust. In that case, her estate would only have been $9 million, well under the 2020 exemption of $11.58 million.
  Even if the estates have the same beneficiaries who share in the same percentages, $1,768,000 in estate taxes is due unless Lee's exemption trust can be retroactively funded under the Internal Revenue Code;
- In addition, Lee's children could sue for breach of the trustee's fiduciary duty to fund the exemption trust according to the terms of his revocable living trust or his will (a case that involved similar issues was remanded back to the bankruptcy court: ***Jacobs v. Pierce*** (1994) U.S. District Court, Massachusetts. Case No. 89-13609). The children would ask the state court to issue orders requiring that the assets held in the living trust be used to fund the exemption trust for their benefit; and
- Lee's estate and third parties in possession of misappropriated trust property could also be sued for monetary damages, or ordered to turn over the misappropriated property using various equitable remedies including the imposition of liens, constructive trusts, and tracing.

Taking it to court

Each case will be decided based on its unique facts and the applicable state law. Even if heirs settle their disputes in a manner that appears to avoid estate tax, the IRS may disagree. That is because the IRS is not required to follow their settlement even if it is approved by a state trial or appellate court. (***Comm. v. Estate of Bosch*** (1967) 387 U.S. 456 cf. Rev. Rul. 73-142)

In effect, the IRS for tax purposes can contest the estate's settlement if they believe state law dictates a different result, unless it was the decision of the state's highest court. (***Comm. v. Estate of Bosch*** (1967) 387 U.S. 456)

The judge in the tax case must decide what the state court would have decided had it decided the case. "While Federal law … designates what interest or rights shall be taxed, Federal courts look to state law to determine what property interests or rights were possessed by the decedent at the time of her death." (***Estate of Sholes v. Comm.***, TCM 1981-455)

Many practical problems arise when trusts are not properly and timely funded. For example, how does the estate or the IRS determine which property should fund the retroactive bypass trust?

If the estate consisted entirely of ABC stock and it has appreciated 50%, a retroactive trust of $12 million would have a basis of $18 million and unrealized gain of $6 million.

If the estate consisted solely of taxable bonds and the son's trust is funded with $12 million of bonds, would the retroactive trust receive interest subject to tax or would it get the net interest after tax, since the interest had already been reported and the tax paid by the original recipient?

The best time to fund a credit shelter or QTIP trust is as soon as possible. Waiting 20+ years as in the cases above is probably too long. At least that is what the defendant will claim — and what the IRS may claim if it is to their advantage.

GENERATION-SKIPPING TRUSTS

Even for those with modest estates, one available planning option that is growing in popularity is the legally binding, irrevocable family legacy trust, aka the generation-skipping trust or the dynasty trust because it is intended to provide a source of funds for the grantor's family for years to come. A grantor, usually a grandparent, however not always, establishes and funds the trust. As the name suggests, the assets skip the next generation and are passed to the grandchildren, or an individual at least 37½ years younger than the grantor.

Over time, the value of these funds is likely to increase substantially. For example, a trust initially funded with $500,000 and growing untouched at 7% annually would be worth more than $1.9 million after 20 years, approximately $7.5 million after 40 years, and nearly $29 million after 60 years. Because of this dramatic growth potential, creating such a trust requires careful planning to address a variety of important issues.

When properly prepared, the family legacy trust serves as a barrier to insulate assets from the reach of outsiders. In this manner, the trust property will be protected from the claims of creditors, such as a former spouse or litigants in a lawsuit against the parents.

Similarly, the assets of the trust are exempt from future estate tax upon the death of a beneficiary. The general rule is that family wealth is taxed at the end of each generation. This means that the assets you leave to your children will be taxed as part of the children's estate when they die. A way to avoid this double taxation is by using the family legacy trust.

Children are often puzzled when they learn that their inheritance was left in a generation-skipping trust. The name of this trust implies that the decedent skipped the children. In fact, however, the decedent left the assets in a way to skip generation of estate taxes when the children later die and to provide protection for the children during their lifetime. They receive the income from the trust and may invade the principal. The children can consume their legacy trust if they want.

The following illustrations demonstrate the powerful economic effect of skipping one or more generations of estate tax.

Most states have a "rule against perpetuities (RAP)" statute that limits the duration of dynasty trusts to between 90 and 120 years. However, Wyoming's RAP statute extends that period to 1,000 years. (Wyo. Stat. §34-1- 139(b)(ii)) This allows a taxpayer to establish a Wyoming Close LLC, coupled with a Wyoming Dynasty Trust, to give the family 1,000 years of tax-protected, creditor-protected, failed-marriage-protected wealth.

Example of a dynasty trust

Frank and John both want to pass wealth on to their heirs. They are both golfers, and each has a portion of his wealth in a golf course. John establishes California Golf LLC, transfers his ownership in the golf course to the LLC, and then gifts discounted interests in the LLC directly to his heirs using his lifetime and annual exclusion amounts.

Frank has established Wyoming Golf, LLC, and he transfers ownership of his California golf course to the LLC. However, Frank gifts the discounted interests in the Wyoming LLC to a Wyoming Dynasty Trust using his annual and lifetime exclusion amounts and with his heirs as the beneficiaries. Frank also allocates his generation-skipping transfer (GST) tax exemption to the trust so that his heirs in the distant future will not have to pay the GST tax or estate taxes at each generation.

John believes that his heirs are getting a better deal than Frank's heirs because they own California Golf LLC while Frank's heirs only get to enjoy and control Wyoming Golf LLC. Frank's heirs don't own the LLC; the trust does.

What John does not understand is that the assets inherited by his heirs are potentially subject to estate tax as they pass from generation to generation.

To further complicate matters, if any of John's family members become involved in a lawsuit, their inheritance is in jeopardy because the family members own it. Additionally, if any of the family members marries and is not careful to keep the inherited property separate from marital property, an ex-spouse can claim half of the golf course in a divorce.

Not only do the assets in Frank's dynasty trust continue to pass through to generations of his family without being subject to estate tax, the assets are also protected from the claims of creditors or ex-spouses because Frank's family members do not own the trust assets.

In order to establish a Wyoming Dynasty Trust, some or all of the assets must be in Wyoming. This is why the taxpayer needs to establish a Wyoming LLC, transfer the out-of-state assets to the LLC, and then gift interests in the LLC to the Wyoming Dynasty Trust. Some or all of the administration of the trust must also take place in Wyoming.

The Wyoming Dynasty Trust can protect your client's heirs from creditors and estate taxes for 1,000 years, allowing the trust assets to continue to grow with all of the growth passing from generation to generation without estate tax. Any growth related to assets that heirs hold as individuals will be taxed each time it is passed to the next generation.

Contingencies must be placed on the trust that sufficiently limit the heirs' access to the trust as well as designate future beneficiaries. These contingencies will ensure that the trust assets continue to be owned by the trust rather than by the heirs.

Income tax treatment of generation-skipping trust

Because the generation-skipping trust is irrevocable, it is a separate taxable entity. All income that remains in the trust will be subject to tax on the fiduciary tax return. Income that is distributed to the beneficiaries will be tax on their individual returns.

S CORPORATION SHARES IN TRUSTS

Generally speaking an S corporation may not have a trust as a shareholder. However, there are two exceptions to this rule: electing small business trusts (ESBT) and a qualified Subchapter S trust (QSST).

Comment

Grantor trusts are permitted as S corporation shareholders because the grantor, not the trust, is treated as the shareholder. However, after the grantor dies, the trust may only continue as a shareholder for two years. (IRC §1361(c)) After that period, the shares must be distributed to the beneficiaries or held through a QSST or a ESBT.

Qualified subchapter S trust (QSST)

A qualified subchapter S election also allows a trust to become an S corporation shareholder. (IRC §1361(c)(2)(A)) The trust can be established during the grantor's lifetime or at their death. The current income beneficiary makes the QSST election. Because the QSST is a simple trust with all of the income required to be distributed annually, there is little opportunity for strategic income tax and estate planning.

Practice Pointer

The QSST is a solution to the problem that arises if the shareholder dies and the estate or trust becomes the S corporation shareholder, which is generally not allowed. It provides an opportunity for the estate to be finalized prior to distributing the shares of stock to the beneficiaries.

The current income beneficiary is treated as the S corporation's shareholder. All of the trust items attributable to the S corporation stock held by the QSST must be reported. The QSST is required to file a Form 1041.

A QSST may be a good vehicle for a minor beneficiary to hold S corporation stock. Even though income is distributed annually, it can be deposited into a Uniform Transfer to Minors Account (UTMA) and managed until the child reaches the age of majority, which is usually age 18-21.

One advantage of a QSST is that upon the death of the income beneficiary, there may be a minority discount available for estate tax purposes.

See page 52 for a sample QSST election.

Electing small business trust (ESBT)

An electing small business trust is treated as two separate trusts when there is S corporation stock in the trust. (IRC §1361(e)) The portion of an ESBT that consists of stock in one or more S corporations is treated as one trust, while the remainder of the assets of the trust are treated separately. An ESBT must meet certain criteria, can have multiple beneficiaries, and the trust income can be sprinkled among multiple beneficiaries. (IRC §1361(c)(2)(A)(v)) The election to become an ESBT is made by the trustee. The benefits of the trustee's election are:

- Discretionary trust income distributions may be made; and
- There are no restrictions on distributions of corpus, and there may be unlimited current income beneficiaries.

The downside is an S corporation's income is recognized at the trust level and taxed at the highest marginal trust tax rates.

In order for the trust to be considered an ESBT, the following requirements must be met:

- The trust beneficiaries must be individuals, estates, or charitable organizations that are eligible to be S corporation shareholders:
    - Nonresident aliens may be contingent beneficiaries and not potential current beneficiaries; and
    - State governments, U.S. possessions, political subdivisions of states or U.S. possessions, and the U.S. and the District of Columbia may also be ESBT beneficiaries, but they may only hold contingent interests and may not be potential current beneficiaries; and
- No beneficiary can acquire a trust interest by purchase.

See page 53 for a sample ESBT election.

Comparing QSST and ESBT

The qualified subchapter S trust (QSST) has the following requirements and differences from an ESBT:

- There can only be one income beneficiary during the lifetime of the grantor who is a U.S. citizen or resident; an ESBT may have numerous income beneficiaries;
- All of the income is distributed or required to be distributed currently to the income beneficiary; an ESBT has no requirement to distribute income;
- The trust can only distribute principal to the current income beneficiary during their lifetime; an ESBT may make discretionary distributions of principal;
- The current income beneficiary's interest must terminate at the earlier of their death or the termination of the trust;
- If the trust terminates during the lifetime of the current beneficiary, all trust assets must be distributed to the current income beneficiary;
- At the end of two years, the QSST must be dissolved and assets distributed to the beneficiaries, or it can become an ESBT; and
- For the QSST, all income is taxable to the trust, whereas an ESBT's income is taxed separately from the trust income.

MULTIPLE TRUST RULES

Two or more trusts are treated as one trust if they have substantially the same grantor or grantors and substantially the same primary beneficiary or beneficiaries, and a principal purpose of such trusts is the avoidance of the tax imposed pursuant to IRC §§641-692. A husband and wife will be treated as one person for this purpose.

The IRS has issued a number of private letter rulings on this subject. The main theme across the favorable rulings is that the trusts' assets were separately managed and administered. In one case the trust beneficiaries could not agree on an investment strategy. In a different case the beneficiaries could not agree on the charitable gifting strategy. In both cases they were granted the right to have multiple trusts. It is important to document the nontax reason for the creation of multiple trusts. In another situation that is more common in estate planning, one trust that was for the benefit of all of the grantor's descendants was divided into separate trusts for each of his children. The IRS agreed that as long as each of the trusts was managed separately, splitting a single trust into separate trusts for the siblings did not violate the multiple trust rules. (PLR 201709020; PLR 200209008; PLR 201928004)

DISTRIBUTABLE NET INCOME

DNI calculation

Estates and trusts are allowed to take a tax deduction on their Form 1041 for certain income that is distributed to the beneficiaries and reported on their respective Forms K-1. Distributable net income (DNI) is not always the amount the beneficiary received.

The calculation of DNI is not complicated; however, one must follow the formula to arrive at the correct DNI to be used in the determination of the income distribution deduction on Form 1041. The income distribution deduction is the lesser of DNI or the amount actually distributed or required to be distributed under the terms of the trust. (Treas. Regs. §1.643(a)-0)

Start with taxable income (Form 1041, line 23).

Additions:

- Distribution deduction (Form 1041, line 18);
- Exemption deduction (Form 1041, line 21);
- Qualified business income deduction (§199A) (Form 1041, line 20)
- Tax-exempt interest, adjusted by the allocable expenses that were not deducted in arriving at taxable income; and
- Capital losses deducted and not paid, credited, or required to be distributed.

Subtractions:

- Capital gains, if allocated to corpus. The Uniform Principal and Income Act (UPIA) provides that capital gains are allocated to principal, rather than income. Although capital gains are generally taxable to the trust, there are exceptions:
    - If the trust document specifies that capital gains are to be considered income, the trust document would overrule the UPIA;
    - In some cases, a distribution might be required that would include capital gains. In that case, capital gains would be considered income;
    - Where the trustee has followed a practice of distributing the gains from sales of trust assets, capital gains will be included in DNI (Treas. Regs. §1.643(a)-3(a)(3); and
    - Capital gains are not subtracted from taxable income in the final year of the trust (Treas. Regs. §1.643(a)-3(d); and
- Extraordinary dividends and taxable stock dividends are excluded for simple trusts, if allocated to corpus. (Treas. Regs. §1.643(a)-4)

The trust document dictates what can and cannot be distributed, and the rules are different for simple and complex trusts. In calculating DNI, however, it makes no difference whether you have a simple trust, complex trust, or an estate. That distinction may affect the distribution deduction but not DNI.

Distributable Net Income Worksheet — Form 1041 Computation		
Taxable income (Form 1041, line 23)		$_____
Add:		
Distribution deduction (Form 1041, line 18)		_____
Qualified business income deduction (IRC §199A) (Form 1041, line 20)		_____
Exemption deduction (Form 1041, line 21)		_____
Tax-exempt interest	$_____	
Less: Related nondeductible expenses	(_____)	_____
Capital losses deducted		_____
Subtract:		
Capital gains allocated to fiduciary		(_____)
Extraordinary dividends and taxable stock dividends are excluded for simple trusts if allocated to corpus		(_____)
Distributable net income		$_____

Allocations and who pays the tax

The trustee and tax practitioner should work together throughout the year to strategically plan the year-end taxable outcome. The trust document establishes the terms for how the trustee is to allocate receipts and disbursements between income and principal. Absent that in the document, the trustee most often assumes broad discretionary powers to make the allocation decision. The trustee is supposed to prepare an annual trust accounting that reports the cash receipts and disbursements of the trust during the year.

A simple trust document requires that all its trust accounting income be distributed annually. (Treas. Regs. §1.651(a)-1) The income distribution deduction is the lesser of the trust accounting income required to be distributed and the distributable net income. With the limitation on state and local taxes and the elimination of miscellaneous itemized deductions, DNI for simple trusts will be increased. Therefore unless the trust accounting income closely mirrors DNI, taxable income that remains in the trust will be higher. Trusts are subject to the highest marginal tax rates at a much lower threshold than some beneficiaries.

A complex trust is permitted to accumulate accounting income. It is not required to make income distributions. It can make distributions from corpus. It can make charitable contributions. The income distribution deduction is equal to the total of any amount of income and corpus distributed plus any other amount actually paid. Should the distributions exceed DNI, then only the DNI amount may be deducted.

A trust can be a simple trust one year and a complex trust in another year. (Treas. Regs. §1.651(a)-1) The trustee checks a box on Form 1041 as to the trust's designation for that year. The designation is based on the income required to be distributed in a taxable year.

The trustee must examine ways to mitigate the tax by shifting income to beneficiaries who are presumed to be in lower income tax brackets. Beneficiaries who are in higher income tax brackets

may want the income and tax liability to stay with the trust. Increased adjusted gross income for the beneficiary as a result of income passed through from the trust could be detrimental by effectively increasing their marginal tax rates. Certain itemized deductions based on AGI may be reduced, alternative minimum tax exemptions may be phased out, and the net investment income tax (NIIT) could be applied.

Beneficiaries/trustees have an opportunity to reduce the income subject to the NIIT by taking reasonable trustee fees deductible by the trust. If the trust has a lot of tax-exempt income, some of the fees may be disallowed to the extent allocable to the tax-exempt income. The beneficiary/trustee would still be required to include all of the trustee fees received in their taxable income regardless of the deduction on the trust return.

Example of trustee fees

The Children's Trust has five siblings as beneficiaries. Mom provided that one of the siblings would be the trustee of the trust. The proceeds of the trust were to be divided five ways, and Ethel is the successor trustee of the trust. Ethel is entitled to a trustee fee. For 2020, that fee was $50,000. The total income prior to the $50,000 was $200,000. Children's Trust will have a deduction of $50,000, and Ethel must report the $50,000 as income on her return.

Let's assume that Ethel enlists Barrie to assist her in managing the rental property. Ethel is in the top tax bracket and is extremely busy in her job as a tax professional. Barrie was unemployed due to COVID-19 and offered to assist Ethel. Ethel pays $30,000 of the trustee fee to Barrie for her help. The trust has a deduction of $50,000, Ethel reports $20,000 less on her return, and Barrie pays very little tax on the $20,000.

Another possibility is that Ethel can hire Barrie to manage the property for $20,000 and continue to take her $50,000 in trustee fees. Barrie would still report the property management fee on her 1040 tax return.

Presumably, to prevent family strife, Ethel will get the okay from the other siblings to this arrangement.

Capital gains and losses

Unless provided for in a trust document, gains from the sale or exchange of capital assets are generally not included in DNI and not considered as paid, credited, or required to be distributed. However in some circumstances capital gains may in fact be used in the DNI calculation. Capital gains may be included in DNI as described in Treas. Regs. §1.643(a)-(3)(b). The regulations state that capital gains may be included in DNI to the extent that such gains (under the governing instrument and applicable law, or by a reasonable and impartial exercise of discretion by the fiduciary) are:

- Allocated to income;
- Allocated to corpus but treated consistently by the fiduciary on the trust's books, records, and tax returns as part of a distribution to a beneficiary; or
- Allocated to corpus but actually distributed to the beneficiary or utilized by the fiduciary in determining the amount distributed or required to be distributed to the beneficiary.

Example of capital gain distributions

Assume the trust has $20,000 of interest income. The trust owns a partnership interest, and their distributive share of the income is $30,000 of dividend income and $50,000 of long-term capital gains. If the trustee uses the proportionate share rules, 20% of the distribution will be interest income, 30% dividend income, and 50% capital gain income. The beneficiary receives a $50,000 distribution allocated accordingly — $10,000 interest income, $15,000 dividend income, and $25,000 long-term capital gain. The trust will be taxed on the remainder of the income in the same proportion as the beneficiary.

In the same scenario as above, if the trustee has been given the power to control the capital gain distribution, then the trustee can, on an annual basis, selectively include what capital gains are includible in the DNI calculation.

65-DAY RULE

A trustee may elect, on an annual basis, under IRC §663(b) to treat any amount or portion thereof that is properly paid or credited to a beneficiary within the first 65 days following the close of the taxable year as an amount that was properly paid or credited on the last day of such taxable year. The amount to which the election applies shall not exceed either the amount of income of the trust for the taxable year or the amount of DNI for the taxable year if greater. The 65-day rule only applies to complex trusts. The rule is a great tax planning strategy and can provide some administrative relief to the trustee.

Example of 65-day rule

The trustee for the Cows R Us Trust, which operated a lucrative farming business, received an unexpected automatic $10,000 deposit on December 29, 2020, for the sale of hay. He knew the sale had been made; however, he did not anticipate that the proceeds would arrive in the current year. As a result, he prepared draft fiduciary income tax returns without the recent hay income included. He wanted to determine the amount of a distribution he would need to make to take full advantage of the DNI deduction. Once the hay income was factored in, he made a tax deductible $9,000 DNI distribution to the beneficiary on March 1, 2021, which was five days prior to the deadline.

WHERE TO DEDUCT ESTATE-RELATED EXPENSES

There are some expenses that can be deducted from either the Form 706 estate tax return, the Form 1040 individual return, or the Form 1041 estate or trust return.

Comment

In this material we refer to the tax form number: 706, 1041, and 1040 because the 1041 can be used for either a probate estate or a trust, whereas a 706 is used only for the computation of the estate tax itself.

When choosing where to report expenses that could be reported on more than one return, consider:

- What is the taxable estate?
- What is the tax rate of the individual or trust, and what is the difference between the two rates?
- If reporting expenses on the individual or trust return, what will be the tax benefit? For the individual return what is the exact tax impact considering increase in income. For example, the taxable income may be increased by NIIT or AGI reductions based on income.
- Is the taxpayer married, and how would reducing or eliminating the estate tax compare with the marital deduction?
- What are the tax rates now for individual versus estate tax?
- Where will tax rates and the exclusion be in future years?
- What effect will the marital exemption have on the decision?
- What are the other medical expenses for the taxpayer and spouse that were paid before death? and
- For medical expenses, what is the 7.5% AGI reduction going to be?

Let's talk about some choices.

MEDICAL EXPENSES

If medical expenses for the decedent are paid out of the estate during the one-year period beginning with the day after death, you can elect to treat all or part of the expenses as paid by the decedent at the time they were incurred. If you make the election, you will claim all of the expenses on the decedent's 1040 rather than the 706. Medical expenses may not be deducted on the 1041.

Example of medical planning for single individual

When he died in 2020, Rae's gross estate was $5 million. He was single. His medical expenses paid within one year of his death were $50,000 and, after the 7.5% AGI reduction, his expenses were $30,000. His tax rate was 32%.

Claim the expenses on Rae's 1040, and he will have a $9,600 tax savings ($30,000 × 32%).

Instead, assume all facts are the same but Rae's taxable estate was $15 million, not counting medical expenses. It's best to deduct the medical expenses on the estate tax return because the tax rate is 40%, rather than his individual rate of 32%. Thus, there is a $2,400 tax savings ($30,000 × (40% - 32%).

Example of medical planning for married individual

Yves died in 2020 and was married at his death. He and his spouse Bill's total joint assets are $23 million. His medical expenses were $50,000, and $30,000 would have been deductible on their final joint return.

Different from Rae in the above example, using the marital exemption, they can reduce Yves' estate below the $11.58 million exclusion, and there would be no estate tax due. The choice is not so simple here because at Bill's death, his estate would be $23 million, above the current projected estate tax exclusion. And, consider that current law returns the estate tax exclusion to below the TCJA change, likely in the $6 million range. Or, the current Congress could reduce the exemption even further. Increasing DSUE for Bill won't save tax today, but it could in the future.

ADMINISTRATION EXPENSES

Here is how you would handle various expenses:

- Accounting fees and tax preparation fees are deductible on the return prepared;
- Fees for the estate such as attorney fees, executor fees, and appraisals are deductible on the 706. However, some fees could be allocated. For example:
    - The asset appraisal would be used on both the 706, if there is one, to value assets and also on the trust return to determine basis in real or tangible personal property for depreciation and gain or loss on disposition;
    - If the executor is also the trustee, it may be difficult to determine which fees go where, and the attorney fees should be divided between work for the estate and the trust. The trust can only deduct payments for services rendered by a trustee to a trust, but not payments for services rendered by the same fiduciary in that fiduciary's capacity as executor to the estate (***Com. v. Burrow, Mary E. Trust***, (1964, CA10) 13 AFTR 2d 1783, 333 F2d 66, 64-2 USTC ¶9554, affg(1963) 39 TC 1080);
- Expenses to maintain the property:
    - For estate tax (Form 706) purposes, under Treas. Regs §20.2053-3(d)(1), deductions for expenses of administering an estate that are incurred to preserve and distribute the estate, *including the cost of storing or maintaining the estate property if it is impossible to immediately distribute it to the beneficiaries, are deductible;*
    - However, the same is not true regarding improvements to the property, which would not be depreciable and should be added to the property's corpus (principal) basis. These expenses would be deductible on the 1041 because they are not expenses that would not have been incurred if the trust or estate didn't exist. The expenses are "reasonable and necessary administrative expenses of a trust or estate" and are therefore deductible on the 1041 (Treas. Regs. §67-4a);
- Amounts owed at death, including mortgages are only deductible on the 706;
- Probate costs are only deductible on the 706; and
- Estate administration expenses can generally be deducted either on Form 706 or 1041, but not both.

REVIEW ESTATE PLANS AFTER SECURE ACT

Your clients should review their estate plans to ensure that the accelerated distributions of inherited IRAs won't alter the results of their planned asset distributions.

All taxpayers should review their IRA beneficiary designations and be sure they understand who is inheriting the funds, and when they can or must take distributions from the account. There are a couple of planning techniques that might help to defer the distribution of IRA assets to beneficiaries.

NEW INHERITED IRA RULES

Under the SECURE Act, IRA beneficiaries of taxpayers who pass away after December 31, 2019, must distribute the entirety of their inherited IRA by the end of the year that contains the tenth anniversary of the IRA owner's date of death unless the beneficiary is one of the following:

- Surviving spouse;
- Minor child of the decedent;
- A person who is not more than 10 years younger than the decedent;
- A person who is disabled; or
- A person who is chronically ill.
  (Treas. Regs. §§1.401(a)(9)-4, 1.408-8)

Minor children of the decedent take distributions based on their life expectancy until reaching the age of majority (age 18 in some states, age 21 in others). Once they reach the age of majority, the remaining balance of the inherited IRA must be distributed within 10 years. (Treas. Regs. §§1.664-2(a)(5)(j), 1.664-3()(5)(i))

REVIEW TRUST TERMS

Prior to the SECURE Act, trusts that met the requirements to be treated as designated beneficiaries could defer IRA distributions based on the life of the trust beneficiary, in the same manner as if that beneficiary had been named individually. (SECURE Act §401; IRC §401(a)(9)) Under the SECURE Act, for accounts inherited after 2019, even if the trust qualifies as a designated beneficiary, the assets must be distributed under the new 10-year rules.

CONDUIT VERSUS ACCUMULATION TRUST

Once the IRA assets are passed to the trust, the trust can either distribute the income to the beneficiary each year (a conduit trust), or hold the distributions until the beneficiary reaches a certain age or some other triggering event occurs (an accumulation trust). These planning decisions are particularly important for young beneficiaries or those who require help managing their money.

If the trust was a conduit trust designed to take advantage of life expectancy distributions, the IRA assets must now be distributed using the accelerated 10-year rules. This exposes plan assets to the possible imprudence of the beneficiary, as well as the beneficiaries' creditors or divorcing spouses. As a result, your clients may want to consider converting conduit trusts to accumulation trusts to maintain control over the trust assets. Although the trust will pay tax at a higher rate than an individual, the trust can be used to protect and control the after-tax assets.

The accumulation trust can be used to distribute funds based on any factors that the grantor chooses. For example, the trust could distribute funds when the beneficiary reaches a certain age, for education, housing, or medical expenses. The trust could also be drafted to provide specific annual distributions, with other distributions based on age or other needs. Unlike a conduit trust, the accumulation trust is not required to distribute the funds to the beneficiary within 10 years.

Example of amending trust

Frank has a son, Cody, who is age 19 (and not considered a minor in his state). Frank's estate includes an IRA with $1.5 million in assets.

Frank's estate plan is currently drafted so that the IRA beneficiary is a trust. The trust is a conduit trust, which will distribute the IRA distributions to Cody each year. This allows Cody to benefit from the inherited funds without having complete control over the $1.5 million.

Prior to the SECURE Act, when Frank drafted the plan, the annual IRA distributions to the trust would have been based on Cody's life expectancy. Using the current life expectancy tables, Cody has a life expectancy of 64 years, meaning he would receive annual distributions of approximately $23,500.

Under the SECURE Act, the IRA distributions must now be made within 10 years. If Frank does not amend the trust, Cody will receive approximately $150,000 annually from the trust.

Instead, Frank amends the trust to accumulate the IRA distributions. He directs the trustee to make annual distributions of $20,000, plus any necessary amounts for education or medical expenses. When Cody reaches age 40, the remaining trust assets will be fully distributed to him.

CONSIDER A CHARITABLE REMAINDER TRUST

Trust tax rates are higher than those applied to individuals. To reduce the tax that will be paid on trust income in an accumulation trust, some taxpayers might consider a charitable remainder trust. With a charitable remainder trust, the IRA funds are distributed to the trust at the donor's death; the trust pays the donor's beneficiary a certain amount each year for a specified period; and at the end of the term of the trust, the remaining trust assets are distributed to a charitable organization.

There is no tax on the IRA assets when they are distributed to the charitable remainder trust, and the trust does not pay tax annually. The beneficiaries do pay tax on the income distributed to them, but those distributions are made over an extended term, which reduces the tax burden. Depending on the value of the IRA assets, this plan can sometimes save hundreds of thousands of dollars when compared to leaving the IRA outright to the beneficiaries.

The trust pays at least 5% annually to the noncharitable beneficiaries for the term of the trust, which can be:

- A term not to exceed 20 years; or
- A term measured by the life or lives of the designated recipients.
  (IRC §401(a)(9)(E)(iii))

This allows the donor to create a distribution stream much like they had under the pre-SECURE Act rules, while avoiding the higher tax rates of the accumulation trust.

Example of charitable remainder trust

Harold has an IRA with $1 million in assets. His sole beneficiary is his daughter Irene.

At Harold's death, his IRA assets will be contributed to a charitable remainder trust, which will provide Irene with an annual unitrust payment of 7% for her lifetime. That means that the trust assets will be valued each year, and she will receive 7% of that value annually.

No tax will be paid on the assets when they are contributed to the trust at Harold's death, but Irene will pay tax on income distributed to her.

Because no tax is paid on the assets at Harold's death, the full $1 million can be invested and continue to grow. Irene's distributions will be based on the value of the assets each year.

If the assets are valued at $1 million, Irene's unitrust payment will be $70,000 ($1 million × 7%). If the value increases to $1.2 million, her unitrust payment will increase to $84,000 ($1.2 million × 7%). If the value of the assets drops to $800,000, her unitrust payment will decrease to $56,000 ($800,000 × 7%).

At Irene's death the remaining assets will pass to the charity that Harold chose when he established the trust.

Advantages and disadvantages

- **Advantage:** This strategy works particularly well when the beneficiary is younger, as distributions will continue for many years. Also, for an individual who wants to make a large charitable bequest, this can be a tax-efficient way to leave part of the money to friends and family and also support the charity.
- **Disadvantage:** If the grantor chooses the life expectancy structure, the trust distributions end at the beneficiary's death. Unlike an IRA, where a secondary beneficiary can be designated, the trust beneficiary may not designate an individual to benefit from trust distributions at his or her death. As a result, for individuals who may not be in good health or who do not have an anticipated life expectancy of greater than 20 years, the grantor may want to choose a trust structure that provides benefits for a set number of years, rather than the life of the beneficiary.

PRACTICE TIPS

Many practitioners have compared the preparation of a Form 706 and subsequent Forms 1041 to putting together a jigsaw puzzle. In a way, it is exactly that. You assemble all of the pieces of a decedent's estate then put them together into one large, finished product. A successful estate and trust practice can yield profitable revenue. It is not for the faint of heart or those without a thorough understanding of the complex laws that accompany this area of practice.

PERIODICALLY REVIEW THE ESTATE PLAN AND TRUST DOCUMENTS

At least annually review your clients' estate plan documents. Many clients will ask you to keep a copy in your office anyway. Ask for amendments or codicils at that time and especially prior to the preparation of any tax return. Engage the services of an attorney as your advisor so you don't run

afoul of any federal and state laws or testy beneficiaries. Some of the items to discuss with your clients include:

- A change in family dynamics, i.e., marriage, divorce, death of a spouse, and the birth or adoption of a child;
- A change of residence or the purchase of a second home;
- The death of an heir, trustee, or business associate;
- Significant changes in assets either increased or decreased including the acquisition of assets acquired by inheritance;
- Bankruptcy;
- A change in business interests, e.g., a new partnership or corporation;
- Retirement; and
- Disability or terminal illness.

It has been suggested that the failure to adequately prepare yourself for the engagement including the review of any documents can bring a potential malpractice suit. Feuding beneficiaries, business associates, ex-spouses, and the decedent's disinherited heirs can and do create litigation nightmares.

DRAFT RETURNS — ASAP AND EXTEND

Provide beneficiaries and authorized interested parties a draft of any estate or fiduciary tax return as soon as possible. Estate tax returns can be extended; however, the tax is due when the extension is filed. It may take a while to gather appraisals and other pertinent data, so definitely plan on a Form 706 extension of time to file.

The fiduciary tax returns should be extended too. In that way, when the beneficiaries and trustee or executor receive a draft, there is sufficient time to make any corrections. Keep in mind the ability to make distributions 65 days past the year-end. The trustee with a draft tax return in hand will be able to make any decisions that will benefit the trust and perhaps the beneficiary.

ESTATE TAX AUDIT RESULTS

In the event an estate tax audit is conducted and that results in different asset values than were reported, any related individual or fiduciary tax returns that were filed before the audit was complete must be amended to reflect the different basis assigned to the revalued asset. Any changes to asset values would impact taxable gains on assets sold or the depreciation deduction for business property. An ongoing estate tax audit is another good reason to extend returns for the year of death and at least the year after.

ESTATE TAX CLOSING LETTER

The IRS is no longer issuing estate tax closing letters unless requested. With a power of attorney, a request for an estate tax transcript will indicate the date the return was finalized. Because certain elections like the IRC §645 election hinge on the closing date, it is a best practice to always send a written request for a closing letter.

ANNUAL LETTER TO BENEFICIARIES AND ACKNOWLEDGEMENT

Unless beneficiaries waive their right to an annual trust accounting, it is the trustee's responsibility to provide a full and complete accounting of all of the income items, disbursements

for expenses, and distributions during the year. The probate court will occasionally request one. There is a prescribed format that is used. Unless a trustee is knowledgeable in this type of accounting, it is a good practice builder to provide those services.

If engaged to prepare and submit the accounting, the trustee or you should send the accounting electronically with a receipt or by certified mail with a return receipt to each beneficiary with a letter they must sign that they acknowledge the receipt of the trust accounting. In addition the trustee may wish to include in their annual notice a copy of the fiduciary income tax return, copies of brokerage statements, the trustee's investment policy, and potential upcoming events that may change the operations of a business, rental property, or investment strategy.

COVER YOUR OWN ASSETS

It has been said repeatedly that there is nothing worse than a litigious beneficiary. Families have been torn apart because of the mistrust of siblings who perceive their trustee sibling is stealing from the estate. Do not get caught in the middle and end up being sued. An engagement letter for each separate tax return, trust accounting, or consulting engagement is absolutely necessary. Keep detailed workpapers. Document all conversations and correspondence. A follow-up e-mail recalling the facts discussed in a telephone conversation or meeting is advised. It is OK to be a friend as long as you don't become a foe!

APPENDIX

QUALIFIED SUBCHAPTER S TRUST ELECTION

Internal Revenue Service Center
RE: QUALIFIED SUBCHAPTER S TRUST ELECTION

The current income beneficiary of the _____Trust hereby elects under IRC §1361(d)(2) to treat the trust as a qualified Subchapter S trust pursuant to IRC §1361(c)(2)(A)(i). The following information is provided:

Current income beneficiary:
- Name
- Address
- Taxpayer identification number

Trust:
- Name
- Address
- Taxpayer identification number

S Corporation:
- Name
- Address
- Taxpayer identification number

This election is made under IRC §1361(d)(2) to be effective as of [date] _____. On [date]_____ the stock of _____ was transferred to the _____ Trust, which meets all of the requirements of Treas. Regs §1.1361-1(j)(6)(ii)(E)(1), (2), and (3) as follows:

a. All trust income will be or is required to be distributed currently to one individual beneficiary who is a citizen or resident of the United States.
b. During the life of the current income beneficiary, there is only one income beneficiary of the trust.
c. Any corpus distributed during the life of the current income beneficiary may be distributed only to that income beneficiary.
d. The current income beneficiary's income interest in the trust terminates on the earlier of that beneficiary's death or the termination of the trust.
e. If the trust terminates during the life of the current income beneficiary, the trust will distribute all of its assets to that income beneficiary.
f. No distribution by the trust (income or corpus) will be in satisfaction of the grantor's legal obligation to support the income beneficiary.

_____

Signature of beneficiary Name of beneficiary Date

ELECTING SMALL BUSINESS TRUST ELECTION

Internal Revenue Service Center
RE: ELECTING SMALL BUSINESS TRUST ELECTION

The trustee of the _____Trust hereby elects under IRC §1361(e)(3) to treat the trust as an electing small business trust pursuant to IRC §1361(c)(2)(A)(v). The following information is provided:

Potential current beneficiary(ies):
Name
Address
Taxpayer identification number
(May be continued on supplemental attached pages)

Trust:
Name
Address
Taxpayer identification number

S Corporation:
Name
Address
Taxpayer identification number

This election is made under IRC §1361(e)(3) to be effective as of [date] _____. On [date]_____ the stock of _____ was transferred to the _____ Trust, which meets all of the requirements of Treas. Regs §1.1361-1(m)(2)(ii).

a. The trust meets the definitional requirements of IRC §1361(e)(1)
b. All potential current beneficiaries of the trust meet the shareholder requirements of section 1361(b)(1); for the purpose of this paragraph (m)(2)(ii)(E)(2), a nonresident alien potential current beneficiary does not violate the requirement under section 1361(b)(1)(C) that an S corporation cannot have a nonresident alien as a shareholder.

_____

Signature of trustee Name of trustee Date

REVIEW QUESTIONS

Under the NASBA-AICPA self-study standards, self-study sponsors are required to present review questions intermittently throughout each self-study course. Additionally, feedback must be given to the course participant in the form of answers to the review questions and the reason why answers are correct or incorrect.

To obtain the maximum benefit from this course, we recommend that you complete each of the following questions, and then compare your answers with the solutions that immediately follow. *These questions and related suggested solutions are not part of the final examination and will not be graded by the sponsor.*

6. Details of making an IRC §645 election are correctly stated in which choice?

    a) By making the election, trusts will be required to adopt a fiscal year
    b) Under this code section, the executor of an estate and the trustee of a qualified revocable trust may elect to have the decedent's trust treated and taxed as part of the estate and not as a separate trust
    c) The election under IRC §645 is revocable
    d) By making the election, charitable deductions will be allowed only for amounts actually paid

7. What are among the features of a bypass trust?

    a) By putting assets in a bypass trust, none of these assets will be subject to estate tax for either the decedent's or the surviving spouse's estate
    b) Assets in a bypass trust do not get a step-up in basis when the first spouse dies
    c) The bypass trust should be funded only with the decedent's separate property
    d) A bypass trust is also known as an A trust

8. Which statement best describes if and when to use a bypass trust and its possible benefits?

    a) Because portability of the estate tax exemption was made permanent between married couples, a bypass trust is not a practical option
    b) Assets in the bypass trust will be taxed upon the survivor's death
    c) The survivor doesn't receive the assets, so creditors can't get to them
    d) It is best to fund the bypass trust with appreciated assets that will continue to appreciate

9. Based on a comparison of a qualified subchapter S trust (QSST) and an electing small business trust (ESBT), which of these statements is correct?

    a) An ESBT can have only one income beneficiary during the lifetime of the grantor, but a QSST may have multiple beneficiaries
    b) Neither a QSST nor an ESBT are required to distribute income
    c) A QSST can become an ESBT
    d) For both a QSST and an ESBT, income is taxable to the trust

10. How did the SECURE Act affect inherited IRAs in a trust?

    a) When the IRA assets are passed to the trust, the trust must hold the distributions until the beneficiary reaches a specified age
    b) If the trust is a designated beneficiary, IRA distributions must be distributed under the 10-year rule
    c) If the trust is an accumulation trust, the IRA assets must be distributed under the 10-year rules
    d) Both conduit trusts and accumulation trusts are required to make distributions to the beneficiary within 10 years

SOLUTIONS TO REVIEW QUESTIONS

6. Details of making an IRC §645 election are correctly stated in which choice? **(Page 27)**

    a) Incorrect. Trusts are required to adopt a calendar year, but by making the election, they may choose a fiscal year.
    b) Correct. The election is made by filing Form 8855, Election to Treat a Qualified Revocable Trust as Part of an Estate, on or before the due date, with extensions, of the estate's first income tax return.
    c) Incorrect. The election is irrevocable.
    d) Incorrect. The charitable deduction will be allowed for money that is permanently set aside for charity, not necessarily paid.

7. What are among the features of a bypass trust? **(Page 28)**

    a) Correct. Assets from a bypass trust are not included in the surviving spouse's estate so they will not be subject to estate tax.
    b) Incorrect. The assets are eligible for a basis step-up when the first spouse dies.
    c) Incorrect. It should include the decedent's separate property and one-half the value of the community property.
    d) Incorrect. A bypass trust is referred to as the B trust or credit shelter trust or another name.

8. Which statement best describes if and when to use a bypass trust and its possible benefits? **(Page 31)**

    a) Incorrect. Bypass trusts are appropriate in some cases, and it is likely that the exclusion amount will be significantly reduced in the upcoming years.
    b) Incorrect. They escape taxation when the survivor dies.
    c) Correct. The bypass trusts provides asset protection after the first spouse dies.
    d) Incorrect. These appreciated assets won't get a step-up in basis when the surviving spouse dies.

9. Based on a comparison of a qualified subchapter S trust (QSST) and an electing small business trust (ESBT), which of these statements is correct? **(Page 40)**

    a) Incorrect. It's the opposite. A QSST can only have one income beneficiary, while an ESBT can have numerous.
    b) Incorrect. Only a QSST is required to distributed income annually.
    c) Correct. At the end of two years, a QSST must be dissolved and assets distributed to the beneficiaries, or the QSST can become an ESBT.
    d) Incorrect. Income is taxable to the trust only for a QSST. For an ESBT, income is taxed separately from trust income.

10. How did the SECURE Act affect inherited IRAs in a trust? **(Page 47)**

    a) Incorrect. If the trust holds distributions until some triggering event, this is known as an accumulation trust. The trust may also distribute its income to the beneficiary each year. This is a conduit trust. Conduit trusts are required to distribute funds within 10 years, but accumulation trusts have no such requirement.
    b) Correct. Under the SECURE Act and after 2019, distributions are accelerated. Prior to the SECURE Act, IRA distributions could be deferred based on the life of the beneficiary.
    c) Incorrect. With an accumulation trust, funds may be distributed based on the grantor's preference.
    d) Incorrect. An accumulation trust is not under the 10-year rules.

GLOSSARY

Applicable exclusion amount: the amount that can be transferred before an estate tax liability will be incurred. It is the total of the decedent's basic exclusion amount plus any deceased spouse's unused exclusion (DSUE) amount

Beneficiary: the person for whose benefit the trust property is held by the trustee

Bypass trust: a type of irrevocable trust most commonly used to pass assets from parents to children when the second parent dies. The use of a bypass trust allows a first spouse to die to carve out the amount equal to the applicable exclusion amount and place it in a trust that is not included in the survivor's estate. Also known as a credit shelter trust, exemption trust, decedent's trust, or B trust

Charitable remainder trust (CRT): works in reverse of a CLT. The noncharitable beneficiaries are the current beneficiaries, and the remainder interest goes to charity

***Crummey* powers**: provide beneficiaries with the unrestricted right to withdraw amounts contributed to a trust for a specified period of time following the contribution

Decedent's trust: an irrevocable trust that contains the decedent's separate property assets and the decedent's half of community property. Also known as the B trust, bypass trust, or credit shelter trust

Distributable net income (DNI): a calculation for computing how much taxation passes out of Form 1041 on Schedule K-1 to the beneficiary. DNI serves as a limitation on the size of the distribution deduction that trusts and estates can claim when computing the taxable income of the trust

Dynasty trust: also known as the family legacy trust or generation-skipping trust; intended to provide a source of funds for the grantor's family through many generations and to protect assets from creditors or litigants

Electing small business trust (ESBT): a trust where the beneficiaries are essentially the shareholders of an S corporation. The trust will file a return calculating tax on the portion of income attributable to its interest in an S corporation under special rules

Estate: the assets and liabilities left by a person at death

Executor: the person appointed by a testator to execute a will

Family limited partnership (FLP): a limited partnership like all other limited partnerships, with both general and limited partners, which in this case are members of a family. Allows for the transfer of property to the next generation while maintaining some control over the management of the real estate itself

Gift tax: a federal tax on an individual's ability to transfer property during their lifetime to another individual without the expectation that it is for compensation. There is an annual exclusion amount where a person may make unlimited gifts as long as the amount of each gift does not exceed the annual exclusion. For 2021, the annual gift tax exclusion is $15,000 per recipient

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***Graegin* loan:** bank loan, or loan taken from a family business, a life insurance trust, or other third party. Allows for an immediate deduction of all the interest due on the loan thereby reducing the estate tax liability

IRC §645 election: an election by both the executor (if any) of an estate (the related estate) and the trustee of a qualified revocable trust to have the QRT treated and taxed as part of the related estate and not as a separate trust

Irrevocable life insurance trust (ILIT): an irrevocable trust that owns insurance on the life of the grantor or the grantor and spouse. Usually insurance policies are the only assets of the trust while the insured is alive

Irrevocable trust: a trust that cannot be modified or terminated without the permission of the beneficiary. Once assets have been transferred into the trust, the grantor has removed all rights of ownership

Joint tenancy: shared ownership of property by two or more persons with the right of survivorship, where each owner has an equal and undivided interest in the property. When a joint tenant dies, the other tenants automatically absorb the deceased person's interest

Kiddie tax: a special tax on a person under age 17 who has earned income above an annually determined threshold. Income above the threshold is taxed at the parent's or guardian's rate. The tax deters shifting income to children in hopes of paying tax at the child's lower tax rate

Net investment income tax (NIIT): a 3.8% Medicare surtax on certain net investment income of individuals, estates, and trusts that have income above a statutory threshold amount. A child's income is included in the parent's computation of NIIT

Portability: allows the deceased spouse's unused exclusion amount ((DSUE) to be transferred to the surviving spouse. This is accomplished by an election by the executor on Form 706 within nine months of the decedent's date of death, unless an extension is requested, which would give the executor an additional six months

Power of attorney (POA): a legal document that authorizes an individual to act on someone else's behalf in legal and private matters. A "nondurable" power of attorney does not allow the agent to act on behalf of the principal if the principal becomes incapacitated

Probate: a court proceeding to determine the validity of a deceased person's will, to identify and appraise the person's property, to pay debts and taxes, and to distribute the remaining property as the will directs

Qualified domestic trust (QDOT): a trust that enables a non-U.S. citizen spouse to qualify for the unlimited marital deduction

Qualified subchapter S trust (QSST): a trust eligible to hold stock in an S corporation where there can be only one beneficiary, and all income must be distributed annually

Qualified terminable interest property trust (QTIP): a type of trust that takes advantage of the unlimited marital deduction while still controlling the distribution of assets after the death of the surviving spouse. The surviving spouse must be a U.S. citizen at the time the estate tax return is filed

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Rule against perpetuities: a statute that limits the duration of dynasty trusts to between 90 and 120 years

Survivor's trust: a trust that contains the surviving spouse's separate assets and the surviving spouse's share of community property. Also known as the A trust

Tenancy-in-common (TIC): shared ownership of property by two or more persons in which each individual owns a share that may be unequal in size to shares owned by other tenants-in-common (or cotenants), unlike joint tenancy. All owners have the right to occupy and use all of the property. The shares may be transferred to other owners during life or through a will

Trust: a fiduciary relationship with respect to specific property to which the trustee holds legal title for the benefit of beneficiaries, who hold equitable title

Trustee: the person that manages the trust and holds legal title

Valuation discount: a reduced value that is estimated for a business asset or real property when compared to its peers. When a transferred asset reflects a minority interest in a business, for example, a reduced value is allowable (minority discount)

Will: a legal declaration of a person's wishes regarding the disposal of their property or estate after death

65-day rule: a rule whereby a fiduciary of a trust or an estate executor can elect to have any portion of the trust's or estate's distributions made within the first 65 days of any tax year characterized as paid or credited to the beneficiary on the last day of the prior tax year

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TAX PLANNING STRATEGIES FOR TRUSTS AND ESTATES
Course description and study guide

Course objectives: This course provides practical strategies on proper planning to reduce tax on an estate and its beneficiaries. Topics discussed include: gifting; family limited partnerships or LLCs; valuation of estate assets; portability; the deceased spouse unused exclusion (DSUE); applicable exclusion amount; estate allowable deductions; charitable deduction; irrevocable life insurance trusts (ILITs); Crummey powers; IRC §645 election; bypass trust; qualified terminable interest property (QTIP) trust; unfunded trusts; generation-skipping trusts; dynasty trusts; S corporation shares in trusts; distributable net income (DNI); new inherited IRA rules; and much more.

Completion deadline and exam: This course, including the examination, must be completed within one year of the date of purchase. In addition, unless otherwise indicated, no correct or incorrect feedback for any exam question will be provided.

Category: Taxes

Recommended CPE Hours: CPAs — 2 Tax
EAs — 2 Federal Tax
CRTPs — 2 Federal Tax

Level: Intermediate

Prerequisite: A basic knowledge of types of trusts is required.

Advance Preparation: None

Course qualification: Qualifies for QAS and NASBA Registry CPE credit based on a 50-minute per CPE hour measurement

CPE sponsor information: Spidell Publishing, Inc. (Registry ID: 104931)

Expiration Date: November 2022*

*Exam must be completed within one year of the date of purchase

Learning assignment and objectives

As a result of studying the assigned materials, you should be able to meet the objectives listed below.

Assignment:

At the start of the materials, participants should identify the following topics for study:

- Gifting considerations
- Estates
- Trusts
- Where to deduct estate-related expenses

Learning Objectives:

After completing this course, you will be able to:

- Determine the accurate calculation of a taxable estate considering the value of a taxpayer's lifetime gifts
- Determine how to plan ahead for when the estate tax exclusion amount is reduced
- Recall how valuation discounts in estate planning will reduce the net taxable estate
- Identify how Crummey powers can solve the issue of not having a present interest in a gift for purposes of avoiding gift tax
- Recall how making the IRC §645 election provides tax benefits for a trust electing to be taxed as an estate
- Recall the formula for calculating correct distributable net income

After studying the materials, please answer exam questions 1-10.

Course Evaluation for Spidell Publishing, Inc.

Program title: **Tax Planning Strategies for Trusts and Estates**

If applicable, program instructor: _____

Program date: _____ Participant name (optional): _____

Instructions: Please comment on all of the following evaluation points for this program and assign a number grade, using a 1-5 scale, with 5 as the highest rating.

1. Were the stated learning objectives met? _____
2. If applicable, were prerequisite requirements appropriate and sufficient? _____
3. Were the program materials accurate? _____
4. Were program materials relevant, and did they contribute to the achievement of the learning objectives? _____
5. Was the time allotted to the learning activity appropriate? _____
6. If applicable, were the individual instructors knowledgeable and effective? _____
7. Were the facilities and/or technological equipment appropriate? _____
8. Were the handout and/or advanced preparation materials satisfactory? _____
9. Were the audio and visual materials effective? _____

IRS Course Number (if applicable): CRA7E-T-00550-21-S

TTP (CTEC) Course Number (if applicable): 1019-CE-1116

Date course completed: _____

Number of hours it took to complete the course: _____

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Examination for Spidell's Tax Planning Strategies for Trusts and Estates

PLEASE: Place the correct response for each question on the attached answer sheet and retain this examination for your records. If you purchased the online version, or would like to complete your exam online, please log-in to your SpidellCPE online account to submit your answers to the exam. 70% or more (7 of 10) correct responses are necessary to receive credit for this course. This course must be completed within one year of the date of purchase.

Final Exam Questions

1. The person to whom property is legally committed to be administered for the benefit of a beneficiary is the:

   a) Executor
   b) Grantor
   c) Trustee
   d) Settlor

2. Under IRC §2302, an executor may make an irrevocable election when the estate tax return is filed to value the gross estate exactly on the date _____ after the date of death or the date title passes after its sale, exchange, or other disposition, if prior to that alternative date.

   a) One year
   b) Nine months
   c) Six months
   d) Three months

3. There is an unlimited deduction for transfers between spouses both before and after death, but in order for the deduction to be allowed, all of these qualifications must apply except:

   a) The recipient must be married to the decedent on the date of death
   b) The spouse may be a U.S. citizen or a noncitizen
   c) The spouse must survive the decedent
   d) The transferred property must be included in the decedent's estate

4. Which of these administrative fees and/or costs are not deductible by an executor to reduce estate tax?

   a) Brokerage account management fees
   b) Executor fees
   c) Costs for maintaining trust assets
   d) Unreimbursed casualty losses of the trust

5. What is it that provides beneficiaries with the unrestricted right to withdraw amounts contributed to a trust for a specified period of time following a contribution?

   a) The trust document
   b) ***Cohan*** rule
   c) Probate code
   d) ***Crummey*** powers

6. Which of the following may happen upon the death of the first spouse?

   a) A survivor's trust may be created, which is also known as the irrevocable A trust
   b) The decedent's trust is the bypass trust, which is funded just with the decedent's separate property
   c) Two or more trusts may be created, e.g., the A trust for the survivor and the B trust for the decedent
   d) The surviving spouse may not receive principal from the decedent's trust

7. Accurate details of a qualified terminable interest property trust include:

   a) Assets placed in the trust do not qualify for the marital deduction
   b) The decedent is able to control the disposition of assets
   c) The trust corpus may not be distributed
   d) The income from the trust must be distributed yearly to the spouse and/or the designated beneficiaries

8. What are among the estate tax consequences of a QTIP trust?

   a) The trust escapes estate tax assessment
   b) The fair market value of the trust when the second spouse dies is subject to estate tax
   c) There is no basis adjustment at the death of the second spouse
   d) The unlimited marital deduction is available to the survivor whether or not they are a U.S. citizen

9. A trustee may annually elect to treat any amount that is properly paid or credited to a beneficiary within the first _____ days following the close of the taxable year as an amount that was properly paid or credited on the last day of such taxable year.

   a) 30
   b) 45
   c) 65
   d) 75

10. For reporting estate-related expenses upon the death of the decedent, which of the following applies?

    a) Mortgages and other amounts owed at death are only deductible on Form 1040
    b) Probate costs are only deductible on Form 1041
    c) Medical expenses must be reported on Form 706
    d) Estate administration expenses may be deducted on Form 1041 or Form 706

Name _____

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Final Exam Questions

1. ☐ **a)** Executor
   ☐ **b)** Grantor
   ☐ **c)** Trustee
   ☐ **d)** Settlor

2. ☐ **a)** One year
   ☐ **b)** Nine months
   ☐ **c)** Six months
   ☐ **d)** Three months

3. ☐ **a)** The recipient must be married to the decedent on the date of death
   ☐ **b)** The spouse may be a U.S. citizen or a noncitizen
   ☐ **c)** The spouse must survive the decedent
   ☐ **d)** The transferred property must be included in the decedent's estate

4. ☐ **a)** Brokerage account management fees
   ☐ **b)** Executor fees
   ☐ **c)** Costs for maintaining trust assets
   ☐ **d)** Unreimbursed casualty losses of the trust

5. ☐ **a)** The trust document
   ☐ **b)** ***Cohan*** rule
   ☐ **c)** Probate code
   ☐ **d)** ***Crummey*** powers

6. ☐ **a)** A survivor's trust may be created, which is also known as the irrevocable A trust
   ☐ **b)** The decedent's trust is the bypass trust, which is funded just with the decedent's separate property
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   ☐ **d)** The surviving spouse may not receive principal from the decedent's trust

7. ☐ **a)** Assets placed in the trust do not qualify for the marital deduction
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   ☐ **d)** The income from the trust must be distributed yearly to the spouse and/or the designated beneficiaries

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