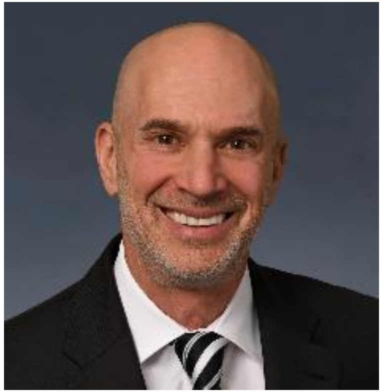
# Trust and Estate Income Tax Issues

INDEPENDENT TRUSTEE ALLIANCE

# Presenter



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# Agenda

- Fundamental Concepts Essential to Fiduciary Income Tax
- Types of Trusts
- Income Tax Treatment of Distributions from Non-Grantor Trusts & Estates
- Depreciation, Depletion and Amortization; Treatment and Allocation of Deductions
- Charitable Income Tax Deduction Available to Estates and Non-Grantor Trusts
- Application of Passive Activity Rules to Trusts & Estates

# Agenda, cont'd.

- Income Tax Deductions for Administration Expenses
- Special Elections Available to Non-Grantor Trusts & Estates
- Tax Reporting Methods for Grantor Trusts
- Net Investment Income Tax
- State Return Filing Factors
- Recent Developments

# Status of Tax Legislation

- The Infrastructure Investment and Jobs Act (IIJA) was signed into law November 15, 2021
  - This is the bill that focuses on “hard infrastructure” initiatives such as roads, bridges, and airports
  - The IIJA also contains a few tax provisions, such as:
    - Ending the Employee Retention Credit early by making the fourth quarter of 2021 ineligible
    - Imposing new information reporting requirements for cryptocurrency transactions, beginning in 2023 and 2024
- Congress is continuing negotiations over the Build Back Better Act (BBBA)
  - Passed the House on November 19, currently with the Senate
  - The following slides detail some of the major provisions within the BBBA, and compare them with previous plans and proposals

# Fundamentals of Income Taxation of Trusts and Estates

# Fundamentals Essential to Fiduciary Income Tax – Taxable Income

- Similar to computation for an individual's taxable income, with notable exceptions with respect to deductions.
- Key points:
  - The income reportable by a trust or an estate is the same as that for an individual.
  - Allowable deductions include:
    - real estate taxes,
    - state and local taxes,
    - investment interest,
    - charitable contributions,
    - net operating losses,
    - administration expenses (e.g., fiduciary commissions, and accounting and legal fees), and
    - a distribution deduction for amounts paid to beneficiaries.
  - Special rules, unique to trusts and estates, apply to:
    - Depreciation, depletion and amortization deductions, and;
    - Charitable deductions

# Fundamentals Essential to Fiduciary Income Tax – Taxable Income, cont'd.

- Exemption (§642(b)):
  - Complex trust: $100
  - Simple trust: $300 (even if a complex trust due to principal distributions)
  - Estate: $600
  - Qualified disability trust: Individual's personal exemption ($4,400 for 2022).
- Once taxable income exceeds $13,450 (2022):
  - 37% income tax rate
  - 20% long-term capital gain / qualified dividend rate
  - 3.8% net investment income tax
  - Potentially alternative minimum tax
- Taxable Year (§644):
  - Trust – must be calendar year-end
  - Estate – may be fiscal year-end

# Fundamentals Essential to Fiduciary Income Tax – Distributable Net Income (“DNI”)

- DNI generally refers to taxable income (without taking into account the distribution deduction and the personal exemption) plus net tax-exempt income; it typically does not include capital gains and losses (§643(a)).
- Determines how much of a distribution is deductible by a trust or an estate, and is taxable to the beneficiary who receives the distribution. Generally:
  - Distributions up to and not exceeding DNI are deductible by the trust or estate, and are taxable to the beneficiary.
  - Distributions that exceed DNI are not deductible by a trust or an estate and not taxable to the beneficiary.

# Fundamentals Essential to Fiduciary Income Tax - Fiduciary Accounting Income ("FAI")

- FAI refers to the "income" of a trust or an estate as defined under state law or the governing instrument (§643(b); Reg. §1.643(b)-1).
- Generally includes interest and dividends and cash distributions from partnerships and S corporations (that are not liquidating distributions or distributions in redemption of a holder's interest), whether or not these items are taxable.
- These income items are then reduced by any allocable expenses.
- Generally, capital gains/losses are considered principal (not income) items and are therefore not included in this definition, subject to the terms of the governing instrument.

# Fundamentals Essential to Fiduciary Income Tax

- Taxable income, DNI and FAI chiefly differ as described below:

| | TI | DNI | FAI |
|---|---|---|---|
| Capital Gains/Losses | X | | |
| Tax Exempt Income | | X | X |
| Cash Distributions from Partnerships / S corps | | | X |
| K-1 Income from Partnerships / S corps | X | X | |

# FOUR LAWS OF ACCOUNTING

1. Trial balances don't.
2. Bank reconciliations never do.
3. Working capital does not.
4. Return on investments never will.

# Types of Trusts

# Types of Trusts – Simple Trust

- Requirements (Reg. §1.651(a)-1):
  - All of the trust's income must be distributed currently (i.e., at least annually),
  - No other amounts are distributed during the year, and
  - The trust does not provide for any amounts to be paid or permanently set aside for charity.
- "Income" Required to be Distributed (IRC §643(b); Reg. §1.643(b)-1):
  - FAI as determined under applicable local law and the trust agreement
  - Not DNI or taxable income
- Income Tax Treatment:
  - DNI passes out to the beneficiaries up to the amount of FAI.
  - To the extent DNI exceeds FAI, the DNI will not pass out to the beneficiaries and will be taxable to the trust.
  - Any income required to be distributed during the year, but that is not distributed, is deemed distributed on the last day of the tax year (IRC §652(a), Reg. §1.652(a)-1).

# Misconception About Simple Trust

- A simple trust is only ever taxable on capital gains because all DNI passes out to the beneficiaries
- **FALSE** – FAI is the income that must be distributed, not DNI, and these are not necessarily the same
- Why?  FAI includes partnership/S corporation cash distributions while DNI includes K-1 income

# Types of Trusts – Complex Trust

- Definition (Reg.§1.661(a)-1):
  - All other trusts (other than a grantor-type trust) that do not meet the requirements of a simple trust (e.g., income is not required to be distributed currently and/or principal distributions are made during the year).
- A simple trust that makes a principal distribution during the year is a complex trust for that year
  - Trust still entitled to a $300 exemption.
- Income Tax Treatment:
  - Generally taxed on all of its income unless it makes distributions.
- If a complex trust (or an estate) is required to distribute income currently, DNI is allocated (IRC §662(b); Regs. §1.662(a)(2) and §1.662(a)(3)):
  1. To the beneficiaries who are entitled to the income (“tier one” beneficiaries), regardless of whether the distribution is actually made
  2. Any remaining DNI is allocable among the other beneficiaries (“tier two”) beneficiaries, who received discretionary distributions.

# Types of Trusts – Grantor Trust

- Characteristics:
  - The grantor (or persons related to him/her) has certain rights and powers which cause the trust to be deemed owned by the grantor for income tax purposes (See IRC §§671-679).
  - One of the most popular grantor trust provisions empowers the grantor, in a non-fiduciary capacity, to reacquire the trust property by substituting other property of equivalent value (IRC §675(4)(C)).
- Income Tax Treatment:
  - All the trust's income, losses, deductions and credits are reported by the grantor, rather than the trust (IRC §671).
  - The trust may not even be required to file an income tax return (Reg. §1.671-4).

# Comment About Trust Classification

The tax character of a trust can change from year to year. Thus, the trust agreement and circumstances should be reviewed annually to determine if there have been any changes which would affect the income tax treatment of the trust (e.g., grantor's death, change of trustee, etc.).


"I understand where you're coming from, but I don't think the government will recognize your brother-in-law as a charity."


"Even if your dog does do 'his business' in your basement, you still can't deduct it as office space."

# Income Tax Treatment of Distributions from Non-Grantor Trusts & Estates

# General Rule

- Distributions are deductible to the trust and taxable to the recipients (on a proportionate basis) to the extent of DNI. (IRC §651 and §652(a); IRC §661(a) and §662(a))
- The income tax character of the distribution to the beneficiary depends on the items of income included in DNI, and is the same as it would be if these items were taxable to the trust. (IRC §652(b) and §662(b))
  1. A pro rata share of each class of income included in DNI reduced by an allocable share of the deductions is treated as passing out to the beneficiary. Expenses that are not directly allocable to any income class (e.g., trustee commissions, state income tax) can be deducted against any income class included in DNI (after an allocation is made to tax-exempt income). (Reg. §1.652(b)-3)
  2. It is advisable to allocate indirect expenses to the income included in DNI that will be taxed at the highest rate in the hands of the beneficiary. Typically, this means not allocating deductions to qualified dividends to the extent there is other income.
     - If the beneficiary is a nonresident alien, it may be preferable to allocate indirect expenses to qualified dividends subject to U.S. income tax rather than other income, such as U.S. bank interest, which is typically not subject to U.S. income tax when paid to a nonresident alien.

# Distributions of In-Kind Property

- The amount of the distribution is the lesser of (IRC §643(e)(1) & (2)):
  - the property's adjusted basis in the hands of the trust (adjusted for any gain or loss recognized on the distribution), or
  - its fair market value.
- Such a distribution still carries out DNI to the beneficiary, even though the beneficiary is not receiving cash.
- Distribution of in-kind property generally is not considered a sale or exchange that triggers a gain or loss.

# Special Rules Applicable to Pecuniary Distributions

- Deemed Sale or Exchange Treatment
  - When a trust satisfies a beneficiary's right to a pecuniary amount (i.e., a fixed dollar amount that can also be stated as a formula) with in-kind property, there is a deemed sale or exchange of the property, and the trust realizes gain or loss. (Reg. §1.661(a)(2)(f))
  - A deemed sale or exchange triggering gain or loss also occurs when a specific bequest of property is satisfied with other property or a beneficiary's right to income is satisfied with property in-kind.
    - Related party rules bar a trust from deducting the loss incurred when it satisfies a pecuniary amount with depreciated property, but an estate can deduct such a loss when it satisfies a pecuniary bequest. (IRC §267(b)(13))
- Beware: When a pecuniary bequest is satisfied with a right to income in respect of a decedent ("IRD"), the IRD becomes taxable to the estate even if the IRD has not yet been received. Examples of common IRD items that would trigger income recognition if used to satisfy a pecuniary bequest include installment notes, stock options and retirement plans.

# Separate Share Rule

- DNI generally passes out to the beneficiaries on a proportionate basis when they receive a distribution. However, if a trust has separate shares, this will not be the case.
  - Rule: If a trust has more than one beneficiary, and those beneficiaries have substantially separate and independent shares, those shares are treated as separate trusts for purposes of determining:
    a) how much DNI is allocable to the respective beneficiary, and
    b) the appropriate distribution deduction of the trust or estate. (IRC §663(c); Reg. §1.663(c)-1)
  - <u>Separate Share In the Case of Trusts</u>: The rule generally applies when trust distributions are required to be made in substantially the same manner as if separate trusts had been created. (Reg. §1.663(c)-3(a))
    - Example: Under the terms of a trust, the assets are divided into separate shares (but not separate trusts) for each of the grantor's children, and the trustee has discretion to distribute income and principal to the children from their respective share.

# Separate Share Rule

- Separate Share in the Case of Estates: Applies when the governing instrument and applicable local law create separate economic interests in one beneficiary or a class of beneficiaries. (Reg. §1.663(c)-4(a)) A separate share ordinarily exists if the economic interests of one beneficiary or a class of beneficiaries neither affect nor are affected by the economic interests accruing to another beneficiary or class of beneficiaries.
  - Examples include:
    1. income on bequeathed property if the recipient of the bequest is entitled to such income,
    2. a surviving spouse's elective share that under local law is entitled to income and shares in appreciation (and depreciation), and
    3. a qualified trust for which a §645 election was made to treat it as part of a decedent's estate.
- The DNI allocable to any share is computed as if each share was a separate trust or an estate. (Reg. §1.663(c)-2(b)) Once the DNI allocable to a separate share is determined, that creates the ceiling for how much will be taxable to the beneficiary (and deductible by the trust or estate) with respect to distributions to that beneficiary.
- The separate share rule is mandatory, not elective. Reg. §1.663(c)-1(d))

# Separate Share Rule, cont'd.

- Comment: The separate share rule prevents a beneficiary from being taxed on a disproportionate share of trust or estate income when a distribution is made to him.
  - Example:
    - A decedent's two children are each entitled to 50% of his $10 million estate
    - Child A receives his half of the estate in Year 1
    - Child B receives his half of the estate in Year 2
    - Without the separate share rule, assuming the estate has $50,000 of DNI in Year 1, all of that DNI would be taxed to Child A, even though Child A is only entitled to 50% of the estate and its income. The effect would be that Child A is taxed on Child B's income.
    - The separate share rule ensures that only $25,000 of the estate's DNI is taxed to Child A, with the rest taxed to the estate, thereby reducing Child B's share.


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I think a trust is a good idea. My son is a little bit of a party animal...
Wild Turkey

# Depreciation, Depletion and Amortization

# Treatment and Allocation of Deductions

# General Rules

- **Estate:** Depreciation, depletion and amortization ("DD&A") are allocated between an estate and its beneficiaries on the basis of how much of the estate's FAI is allocable to each. (IRC §167(d), §611(b)(4), and §642(e). See also Reg. §1.167(h)-1(c) and §1.611-1(c)(5))
- **Trust:** DD&A are allocated between a trust and its beneficiaries on the basis of how much of the trust's FAI is allocable to each, unless the governing instrument (or state law) requires or permits a trustee to maintain a reserve. (IRC §167(d), §611(b)(3), and §642(e). See also Reg. §1.167(h)-1(b) and §1.611-1(c)(4))
- If all FAI is distributed to its beneficiaries, all of the DD&A passes out to the beneficiaries even if it is more than the FAI.
  - Even if a simple trust does not have any FAI, all of the DD&A passes out to the beneficiaries. (Rev. Rul. 74-530)
- Typically, DD&A are not reported as separate items on a partnership K-1. Even so, it appears that if an estate or a trust is a partner, its share of the partnership's DD&A still must be allocated between the estate or trust and its beneficiaries. (Rev. Rul. 74-71)

# Charitable Income Tax Deduction Available to Estates and Non-grantor Trusts

# General Rule

- Estates and non-grantor trusts are allowed an unlimited charitable income tax deduction for any gross income paid to charity pursuant to the terms of the governing instrument. (IRC §642(c)(1); Reg. §1.642(c)-1(a)(1))
- Any charitable contributions made from principal or tax-exempt income are not deductible. (Reg. §1.642(c)-3(b))
- An estate, unlike a trust, is also allowed a charitable deduction for any income set aside for later distribution to charity pursuant to the terms of the governing instrument. (IRC §642(c)(2); Reg. §1.642(c)-2(a))
- Example: If a trustee makes a charitable contribution of appreciated property, the trust won't be entitled to a charitable deduction because the distribution is made from trust principal. Even if the trustee makes the charitable contribution from trust income, it won't be deductible unless the trust agreement permits it.

# Application of Passive Activity Rules to Trusts & Estates

# Lack of Clarity

- Currently, there aren't any regulations under IRC §469 that address when a trust or an estate is deemed to materially participate in an activity for purposes of the passive activity rules. (See Reg. §1.469-5T(g))
- According to the Committee Reports for the 1986 Tax Reform Act, a trust or an estate is deemed to materially participate in an activity if its executor or trustee, in its fiduciary capacity, materially participates in that activity. (S. Rept. No. 99-313 (Pub. Law 99-514) p. 735)
- Only current guidance are a couple of court cases and a few rulings.

# The Mattie K. Carter Trust v. U.S., 2003-1 USTC 50,418

- Carter involved a trust that operated a working ranch.  The trust hired a number of employees, including someone to manage the day-to-day operations of the ranch and make all the important managerial and operational decisions, subject to the trustee's approval.  Although the trust deducted the losses generated by the ranching activity, the IRS disallowed them, asserting that they were passive activity losses.
- The Service argued that the material participation of a trust in a trade or business for purposes of IRC §469 should be determined by evaluating only the activities of the trustee, and in this case, those activities did not rise to the level of material participation. The taxpayer argued, and the District Court agreed, that because the trust (and not the trustee) is the taxpayer, material participation should be determined by assessing the activities of the trust.   Furthermore, since a trust can only participate in an activity through its fiduciaries, employees and agents, their activities as a whole should be considered in determining the trust's level of participation.  Applying this standard, the District Court held that the trust's activities rose to the level of material participation. Furthermore, the Court concluded that the trustee's activities alone with respect to the ranching operations were such that even under the IRS standard, the trust materially participated in the ranching activities.

# TAM 200733023

- A trust owned an interest in a limited liability company that engaged in an active trade or business. The trust had special trustees in addition to regular trustees. The issue was whether the losses generated by the limited liability company were passive activity losses.
- The Service held that a trust is treated as materially participating in an activity if its trustee, in its fiduciary capacity, so participates. Furthermore, the Service concluded that the activities of the special trustees should not be taken into account in determining whether the trust materially participated in the activity of the limited liability company. Even though the special trustees were heavily involved in the operational and management decisions of the business, they could not do anything without the regular trustees' consent. Thus, they were not fiduciaries of the trust and their activities did not count in determining whether the trust materially participated in the business. As to the regular trustees, their activities did not rise to the level of material participation.
- PLR 201029014 confirmed the IRS position taken in TAM 200733023 by concluding that a trust materially participates in a business activity only if its trustee materially participates.

# TAM 201317010

- The IRS once again took the position that whether a trust materially participates in an activity depends upon the level of activity of its trustees in their fiduciary capacity. The Service concluded that because the trusts in this TAM did not materially participate in the activities of its S corporation, they would have to amortize their share of the S corporation's research and development expenses over ten years for AMT purposes.
- Two identical trusts owned stock in an S corporation. The trusts had a regular trustee and a special trustee. The special trustee, who was one of the trust beneficiaries, was also the president of the company's subsidiary and a shareholder. As special trustee, he controlled all decisions regarding the disposition of the company stock and voting of such stock, but did not have any control over the company's management or operations. Nevertheless, as the subsidiary's president, the special trustee was involved in the subsidiary's day to day operations.
- The IRS took the position that only the special trustee's activities in his fiduciary capacity should be considered in determining the trust's material participation. Thus, it refused to count the work performed by the special trustee as the subsidiary's president, and concluded the activities, as special trustee, did not rise to the level of material participation. In addition, the regular trustee did not participate in the company's day to day operations so his activities, as well, did not rise to the level of material participation.

# Frank Aragona Trust v. Commissioner, 142 T.C. No. 9 (2014)

- The Tax Court held that a trust can qualify as a real estate professional and, as such, materially participate in rental real estate activities. This is significant because any rental activity is considered per se passive unless the owner qualifies as a real estate professional under IRC §469(c)(7). To qualify as a real estate professional, the taxpayer must perform more than one-half of his personal services (and more than 750 hours) in real property trades or businesses in which he materially participates.
- The IRS asserted that a trust could not qualify as a real estate professional because a trust cannot render “personal services,” as required by the statute, because it is not an individual (the regulations define such services as any work performed by an individual). The Court disagreed and held that if the trustees are individuals, their work can be considered personal services rendered by an individual, whereby the trust will satisfy the requirements of a real estate professional.

# Frank Aragona Trust v. Commissioner, 142 T.C. No. 9 (2014), cont'd.

- Next, the Court considered whether the Aragona Trust qualified as a real estate professional. The Aragona Trust owned rental real properties directly and also through entities, some of which were wholly owned and others through entities in which it owned majority interests. The trust had six trustees: the grantor's five children and an independent trustee. The trustees acted as a management board for the trust and made all major decisions regarding the trust property. Three of the trustees worked full time for the wholly owned limited liability company that managed most of the trust's rental real estate properties. Two of these same trustees also owned minority interests in some of the other trust-owned real estate entities. The other three trustees were involved in the trust's activities on a limited basis.
- Based upon the different roles of the trustees – namely, as fiduciaries, as employees of the wholly owned real estate management company, and as co-owners of some of the real estate entities – the Court held that the trustees materially participated in the trust's real estate activities. Counting the trustees' activities in other capacities is notable since it seems contrary to the ruling in TAM 201317010. Considering that only three of the six trustees were involved in the trust's day-to-day activities, this could mean that a trust can be deemed to materially participate in an activity even if fewer than a majority of its trustees participate.

# Special Rule for Grantor Trusts

- In the case of a grantor trust, material participation is determined by the activities of the grantor or beneficiary to the extent either is treated as the owner of the trust for income tax purposes. (50 S. Rept. No. 99-313 (Pub. Law 99-514) p. 735; General Explanation of the Tax Reform Act of 1986 (Pub. Law 99-514) p. 242; See also Temp. Reg. §1.469-1T(b)(2) and FSA 200035006)
- Similarly, in the case of a Qualified Subchapter S Trust that is treated as a grantor trust with respect to the sole beneficiary, material participation is determined by the activities of the beneficiary. (General Explanation of Tax Reform Act of 1986 (Pub. Law 99-514) p. 242)

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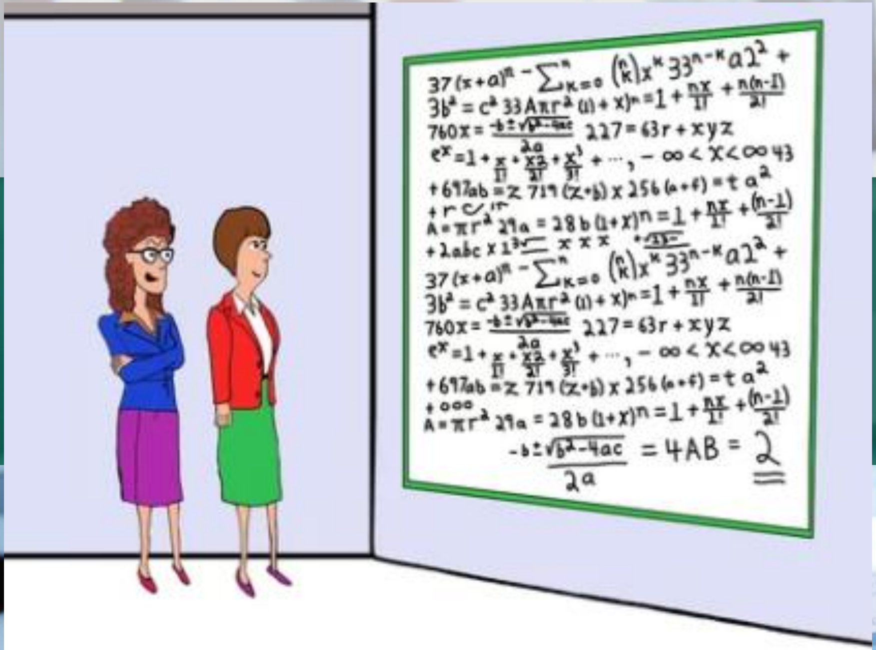
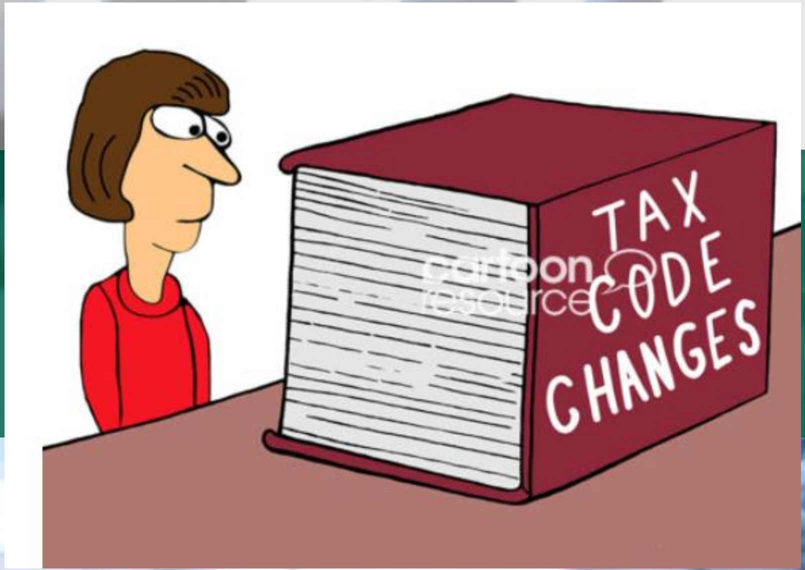


"This is the most straightforward tax plan I've ever seen."



# Income Tax Deductions for Administration Expenses

# General Rules

- Administration expenses incurred by an estate or trust typically include:
  - legal fees,
  - trust accounting fees required by the trust agreement,
  - trust tax return preparer fees,
  - investment advisory fees,
  - appraisal fees,
  - selling expenses & commissions,
  - management services, and
  - fees paid to a trustee or executor.
- To be fully deductible (without the 2% limitation) in arriving at adjusted gross income, administration expenses must meet two requirements under IRC. § 67(e):
  - the cost must be paid or incurred in connection with the administration of the estate or trust; and
  - the cost would not have been incurred if the property were not held in such trust or estate.
- If an expense does not meet these requirements it is not deductible as a miscellaneous itemized deduction as miscellaneous itemized deductions were suspended by the 2017 Tax Act.

# General Rules, cont’d.

- Estate administration expenses are deductible only to the extent they are not deducted on the estate tax return (Form 706).
- Expenditures incurred for the benefit of the beneficiaries or heirs, rather than being essential to the settlement of the estate or the purpose of the trust, are not deductible.

# General Rules – Grantor Trusts

- Items of income and expense pass through to the grantor, and the trust is disregarded as a separate entity.
- Administration expenses for a grantor trust are attributed to the grantor/owner and will be treated as expenses subject to the 2% of AGI limitation at the grantor/owner level and thus not deductible under the 2017 Tax Act.

# No Double Deduction for Administration Expenses

- Estate administration expenses and casualty and theft losses allowed as estate tax deductions under IRC. § 2053(a)(2) and 2054 cannot be claimed as deduction on both the Form 706 and Form 1041 [ IRC § 642(g)].
- Without a special election, estate administration expenses are deductible on Form 706.
- The executor or administrator may elect to claim the deduction (or a portion thereof) against gross income on Form 1041 (§642(g) election).

# Attorney, Accountant, and Return Preparer Fees

- Expenses paid by an estate or trust for work performed by an attorney, accountant, or tax return preparer are deductible without regard to the 2% of AGI limitation when such expenses would not be incurred if the property were held outside the trust. (IRC § 67(e); Reg. 1.212-1(l))
  - Regulations specifically include the preparation of fiduciary income tax and estate tax returns as an example of an expense considered to be unique (and thus, fully deductible).
- For an estate, these fees are administration expenses. Without a special election, estate administration expenses are deductible on Form 706.

# Allocations to Tax Exempt Income

- When a trust or estate has tax-exempt income, a reasonable allocation of administration expenses not directly attributable to any certain class of income must be made to the tax-exempt income (and is therefore not deductible). (Reg. 1.265-1(c))

# Deducting Investment Advisory Fees

- When the 2% Limitation Applies
  - Investment advisory fees incurred in administering the estate or trust are generally treated as miscellaneous itemized deductions reduced by 2% of AGI and thus not deductible under the 2017 Tax Act.
  - If such fees would not have been commonly incurred if the property had been held outside the estate or trust, the 2% floor limitation does not apply. (IRC. §67(e)(1))
  - Unfortunately, this test is not easy to qualify and quantify because it requires that  an expense would not be commonly incurred if the property had not been held in trust or by an estate.
  - If an expense would be incurred regardless of whether the property is held in trust or by an estate, if fails the “not commonly incurred” test and is subject to the 2% AGI limitation and is not deductible.

# Deducting Investment Advisory Fees, cont'd.

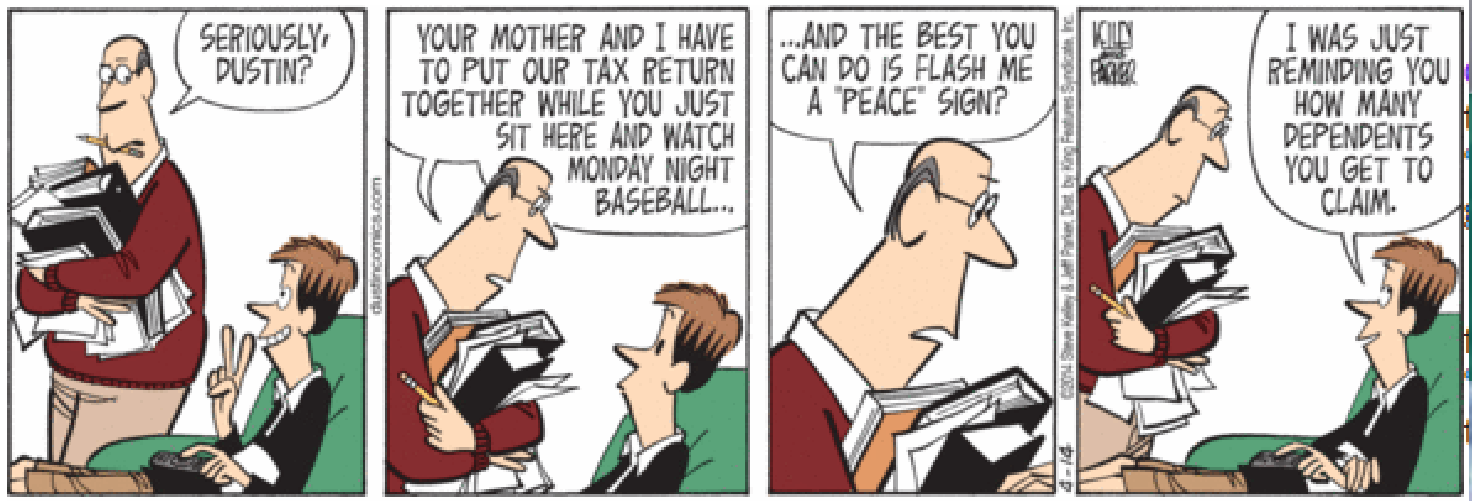
- In January 2008, the Supreme Court ruled in *Knight v. Com'r, 2008-1 USTC ¶50,132* that §67(e)(1) provides an exception from the 2% limitation only for costs that would be uncommon (or unusual, or unlikely) for a trust to incur if the property was held by an individual, rather than by a trust.
- In response, IRS issued proposed regulations in 2011 that would require estates and non grantor trusts to be subject to the 2% limit if the cost was a miscellaneous itemized deduction under §67(b) that would be "commonly" or "customarily" incurred by a hypothetical individual holding the same property.
- Final regulations issued in May of 2014 largely followed the requirements in the proposed regulations (*i.e.*, that miscellaneous itemized deductions incurred by an estate or trust are subject to the 2% floor if commonly or customarily incurred by a hypothetical individual holding the same property).

# Deducting Investment Advisory Fees – Reg. §1.67-4

- Costs included within the definition of miscellaneous itemized deductions and commonly or customarily incurred by individuals are subject to the 2% floor and thus not deductible include:
    1. **Ownership Costs**. Costs that are chargeable to or incurred by an owner of property simply by reason of being the owner of the property. Such costs include, miscellaneous itemized deductions passed through by a partnership to a partner, condominium fees, insurance premiums, maintenance and lawn services, and automobile registration and insurance costs.
    2. **Tax Preparation Fees**. Costs incurred for the preparation of gift tax returns or other returns commonly filed by individuals. Importantly, the regulations specifically state that the costs incurred for the preparation of the following four types of returns are not ones commonly incurred by individuals and, thus, are not subject to the 2% floor: estate and generation skipping transfer tax returns, fiduciary income tax returns, and the decedent's final income tax returns.
    3. **Investment Advisory Fees**. Investment advisory fees charged to an estate or non-grantor trust that do not exceed those customarily charged to an individual investor are subject to the 2% floor. Any additional fees are not subject to the 2% floor if they are attributable to special, additional charges that are added solely because the investment advice is rendered to an estate or trust. Also, additional fees due to the estate's or trust's unusual investment objective or a specialized balancing of the interests of various parties (beyond the usual balancing of the varying interests of current and remainder beneficiaries) are also exempt from the 2% floor. If a portion of an investment advisory fee relates to tax-exempt income , that portion of the fee is not deductible at all.

# Deducting Investment Advisory Fees – Reg. §1.67-4

- Costs included within the definition of miscellaneous itemized deductions and commonly or customarily incurred by individuals are subject to the 2% floor and thus not deductible include:
  4. **Appraisal Fees**. Appraisal fees incurred in connection with an insurance policy or to secure a loan or with respect to other situations commonly encountered by individuals, are subject to the 2% floor (or must be capitalized, as appropriate based on the reason for incurring the cost). However, appraisal fees are not subject to the 2% floor if incurred by an estate or non-grantor trust to determine the fair market value of assets (a) as of the decedents date of death (or alternated valuation date); (b) for purposes of making distributions; or (c) as otherwise required to properly prepare the estate's or trust's tax returns, or a generation-skipping transfer tax return.
  5. **Fiduciary Expenses**. Fiduciary expenses are not incurred by individuals and, thus, are not subject to the 2% floor. Such costs include, without limitation: probate court fees and costs; fiduciary bond premiums; legal publication costs of notices to creditors or heirs; the cost of certified copies of the decedent's death certificate; and costs related to fiduciary accounts.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I WAS JUST REMINDING YOU HOW MANY DEPENDENTS YOU GET TO CLAIM.

# Bundling of Fiduciary Fees – Reg. §1.67-4(c)

- It is not unusual for fiduciary fees to be bundled into a single fee that includes some costs that are subject to the 2% floor and others that are not. In this situation, an allocation may be required.
- The portion of a bundled fee attributable to investment advice (including any related services that would be provided to any individual investor as part of the investment advisory fee) is subject to the 2% floor and thus not deductible. However, if a bundled fee is not computed on an hourly basis, only the investment management component of the fee is subject to the 2% floor and thus not deductible. The remaining portion is fully deductible.
- Any reasonable method can be used to allocate a bundled fee between those costs that are subject to the 2% floor and thus not deductible and those that are not. Factors that can be used in making a reasonable allocation can include, but are not limited to:
  - the percentage of the value of the principal subject tot investment advice,
  - whether a third party advisor would have charged a comparable fee for similar advisory services, and
  - the time the trust or estate's fiduciary devotes to investment advice as compared to other fiduciary functions, such as dealings with beneficiaries and distribution decisions.

# Bundling of Fiduciary Fees – Reg. §1.67-4(c)

- Certain payments made from a bundled fee that are readily identifiable without the fiduciary’s or tax preparer’s discretion are subject to the 2% floor and thus not deductible in their entirety, rather than being reasonably allocated between those that are subject to the floor and those that are not. Such expenses include: [Reg. 1.67-4(C)(3)]
  - Payments made from the bundled fee to third parties that would have been subject to the 2% floor if paid directly by the estate or trust.
  - Fees or expenses separately assessed against the fiduciary or other payee of the bundled fee (in addition to the usual or basic bundled fee) for services rendered to the estate or trust that would commonly or customarily be incurred by an individual.

# Special Elections Available to Non-grantor Trusts & Estates

# Election To Treat Revocable Trust as Part of Estate

- Eligibility
  - Pursuant to IRC §645, the executor of an estate and the trustee of a "qualified revocable trust" (i.e., a trust treated as owned by the decedent under IRC §676 because the decedent had the power to revoke the trust) can elect to have the trust treated and taxed as part of the decedent’s estate for income tax purposes.
    - Even if there isn't a probate estate or an executor, the trustee of a qualified revocable trust can still elect to treat the trust as an estate for income tax purposes.
    - Foreign estates and trusts are not precluded from making an IRC §645 election.
- Duration of Election Period
  - The election is effective for the period that begins on the date of the decedent's death and terminates on the earlier of: (i) the day on which the electing trust and the related estate, if any, have distributed all of their assets, or (ii) the day before the "applicable date."
- Applicable Date, defined:
  - If a federal estate tax return (Form 706) is not required to be filed, the applicable date is 2 years after the decedent's date of death.
  - If a federal estate tax return (Form 706) is required to be filed, the applicable date is the later of: (a) 2 years after the decedent's date of death, or (b) 6 months after the final determination of liability for the estate tax.

# Election To Treat Revocable Trust as Part of Estate, cont'd.

- Advantages of Making IRC §645 Election, cont'd.
  - The losses and deductions (e.g., passive activity losses, net operating losses, capital losses, and investment interest expense) of the estate and electing trust can be used to offset each other's income during the Election Period.
  - The combined entity can recognize loss upon the satisfaction of a pecuniary bequest under §267(b)(13). This exception to the rules, which disallow losses between related parties, applies to estates not trusts. Thus, an electing trust can take advantage of this related party rule exception by funding pecuniary bequests during the Election Period.

# Election To Treat Revocable Trust as Part of Estate, cont'd.

- Disadvantages of Making IRC §645 Election
  - Depending upon applicable state law, this election could inadvertently subject a qualified revocable trust to state income tax. For example, if an estate is subject to state income tax by reason of the decedent's state of domicile, a qualified revocable trust that is treated as part of that estate for income tax purposes will also be subject to state income tax. However, this might not be the case if a §645 election is not made and the stand alone trust's state income tax nexus therefore is not tied to the decedent's domicile.
  - Treating the estate and trust as one entity for income tax purposes may complicate the fiduciary accounting for both the estate and trust, especially with respect to allocating their respective income tax burden.

# 65-Day Election

- Pursuant to IRC §663(b), a trust or an estate can elect to treat any amount paid or credited to a beneficiary within the first 65 days of its tax year as paid or credited on the last day of the preceding tax year.
  - The election need not apply to the entire amount distributed, but can apply to only a portion of the amounts distributed during the 65-day period.
  - The election cannot be made for an amount greater than the FAI or DNI of the trust or estate, whichever is more. Furthermore, it must be reduced by any amounts paid, credited, or required to be distributed in the tax year for which the election is made, other than amounts treated as paid or credited in a preceding year by reason of a 65-day election.
- Making the Election
  - The election is made by checking the §663(b) box in the "Other Information" section on page 2 of a timely filed Form 1041 (including extensions).
  - When a return is not required to be filed, the election is made by filing a statement with the Internal Revenue Service office where the trust or estate would have been required to file a return if it were necessary.
  - The election becomes irrevocable after the last day prescribed for filing a return, including extensions, regardless of whether a return is required to be filed.
  - Best Practice: Attach a statement to the Form 1041 indicating the details of the distribution for which the election applies.

# 65-Day Election

- Planning Opportunities
  - Trust and estate tax rates are highly compressed. If the beneficiaries are in a lower tax bracket (taking into consideration the kiddie tax or AMT), use this election to shift more income to them so that the income will be taxed at a lower bracket.
  - If a beneficiary has a significant net operating loss that could absorb income that would otherwise be taxed to the trust or estate, use this election to shift income to the beneficiary.
  - If the trust or estate will be subject to an estimated tax penalty, this election could be used to reduce the entity's taxable income. However, the beneficiary's tax circumstances need to be considered, since additional income might trigger an underpayment penalty for him or her.
- Other Considerations
  - The 65-day election in most cases is not applicable to simple trusts because the FAI of a simple trust is deemed to be distributed during the year whether or not it is actually distributed.  Nevertheless, if the trust's DNI exceeds its FAI, then the trust can make a 65-day election with respect to any amounts distributed in excess of its FAI but not exceeding its DNI. In this case, the election would make the trust a complex trust.

# Election to Treat Estimated Tax as Paid by Beneficiary

- Pursuant to IRC §643(g), a trustee can elect to treat any portion of a trust's estimated tax payment as made by a trust beneficiary for any tax year.
- The fiduciary of an estate can make the same election to allocate the estate's estimated tax payments to a beneficiary, but only for the last tax year of the estate.
  - There is no authority with respect to whether the estimated tax must be allocated proportionately among the beneficiaries. Therefore, it appears that a disproportionate allocation is permissible.
  - This election applies only to estimated tax payments, not income tax withheld.

# Election to Recognize Gain on Distribution of In-Kind Property

- General Rule
  - Under IRC §643(e), the general rule is that when a trust or an estate distributes property in-kind, the distribution is taxed to the beneficiaries to the extent of the trust's or estate's DNI and the trust or estate is entitled to a distribution deduction in the same amount. Accordingly, the beneficiaries receive a carryover basis in the property.
- Election
  - IRC §643(e)(3) provides that a trust or an estate can elect to treat a distribution of property in-kind as a sale of the property at fair market value to the beneficiary, and recognize gain or loss on the distribution.
    - This rule implies that a trust or an estate can recognize a loss if an election is made. However, §267 disallows losses from the sale or exchange of property between "related parties," which trustees/executors and beneficiaries are deemed under §267. Thus, gains on property distributions cannot be netted with losses on such distributions.
    - An election under IRC §643(e)(3) applies to all distributions made during the tax year. Thus, there should be careful planning so that a trust or an estate does not recognize more gain than intended.

# Election to Recognize Gain on Distribution of In-Kind Property

- Other Tax Implications
  - The beneficiary receives a fair market value basis in the property, and is taxed on the entity's DNI; correspondingly, the trust or estate deducts the fair market value of the property to the extent the entity has DNI.
  - If  distributed property will be depreciable in the hands of the beneficiary, any gain realized on the deemed sale will be treated as ordinary income rather than capital gain.
  - Even without an election, a trust or an estate will recognize gain when it makes an in-kind distribution of appreciated property to satisfy a beneficiary's right to a pecuniary amount, because it's deemed to be a sale or exchange under Reg. §1.661(a)- 2(f).
- Planning Opportunity
  - If a trust or an estate has a large capital loss, the entity should consider making this election when it distributes appreciated property.  However, if the entity will be terminating imminently, whereby the capital loss will carry out to the beneficiaries, the beneficiaries' ability to utilize this loss needs to be considered.


Day 487: No word of any rescue, but I am receiving notices from the Internal Revenue Service reminding me that I'm late on my taxes."

# Dan's 2022 Summer Book List

- Mind Gym by Gary Mack & David Casstevens
  - Gary Mack, sports psychologist consultant, explains how your mind influences your performance as much as your physical skills. He teaches how important it is to exercise your mental muscle.
- Switch by Chip Heath & Dan Heath
  - Chip and Dan Heath is geared to improve the likelihood of change in your organization by appealing to people's emotional and rational thought processes. They teach the importance of using rational and emotions in unison to produce valuable change.
- Blockchain The Next Everything by Stephen P Williams
  - As cryptocurrencies continue to develop in a rather complex field, Stephen P. Williams explains aspects of these transforming currencies in an easily-digestible manner. His explanation of block chains and their widespread effects on banks, governments, and ordinary citizens is as  fascinating as it is informative.
- Traction by Gino Wickman
  - As an entrepreneur or business leader Gino Wickman teaches the six key components of running a powerful business and overcoming frustrations of personal conflict, profit woes, and inadequate growth.

# Tax Reporting Methods for Grantor Trusts

# Background

- Code Sections 674 through 679 describe when a trust is treated as a grantor trust. When these rules apply the grantor (or in the case of code section 678, the beneficiary of the trust) is required to report all items of income, deduction, and credit on their personal income tax return.
- There are different methods of tax reporting available to grantor trusts.

# Traditional Method

- Available to all types of trusts
- File Form 1041
- Fill in only the entity information
- Do not show dollar amounts on the 1041
- Do not prepare a schedule k-1
- Attach a statement to the Form 1041 reporting the name, identifying number, address of grantor, and all items of income, deductions, and credits (grantor trust letter)
- Grantor trust letter is provided to grantor

# Traditional Method – Required for Certain Trusts

- All trusts can use the traditional method; however there are certain trusts that must use this method. Those trusts include:
  - Qualified Subchapter S trusts
  - Trusts that have situs or assets located outside the U.S.
  - Trusts that are treated as owned by a single owner whose tax year is a fiscal year (in which case, the trust needs to file based on the this fiscal year).
  - Trusts all of which are treated as owned by one or more owners, one of whom is not a U.S. person ( note that married persons are considered one grantor for this purpose).

# Traditional Method – Best Practices

- If assets are titled under an EIN (rather than the grantor's SSN), use this method.
- If the trust invests in multiple flow through entities, hedge funds and/or publicly traded partnerships, it is recommended that the K-1(s) from the entities be attached to the grantor trust letter provided to the owner. The following is sample language that can be added as a footnote to the grantor letter
  - See attached K-1(s) from the following entities to be used in preparing your individual income tax return

    *ABC Partnership – EIN XX-XXXXXX*

    *DEF Partnership – EIN XX-XXXXXX*
- Details relating to capital gain transactions should be provided to the grantor as they should be separately reporting each of those transactions.
- Preferred method for most types of grantor trusts. This clearly shows that the assets are separate from the grantors other assets.

# Optional Method No. 1

- Available to trusts with only one grantor
- Income is reported on the grantor's 1040 as if the trust did not exist
- The assets are titled under the grantor's social security number
- If the grantor is NOT the trustee, the trustee must issue a detailed tax statement annually to the grantor
- Best Practice – This is most commonly used for Revocable Living Trusts
- Best Practice – If the grantor is not the trustee, may be easier to prepare the 1041 with the grantor trust letter to ensure that this is done

# Optional Method No. 2

- Available to trusts with only one grantor
- Income is reported on the grantor’s 1040 as if the trust did not exist
- Trust uses its own taxpayer ID number
- Trust issues 1099s each year to report income and gross proceeds to grantor
- If the grantor is NOT the trustee, the trustee must issue a detailed tax statement annually to the grantor
- Best Practice -- May be easier to prepare the 1041 with the grantor trust letter to ensure that this is done

# Optional Method No. 3

- Available to trusts with more than one grantor
- Income is reported on the grantor’s 1040 as if the trust did not exist
- Trust uses its own taxpayer ID number
- Trust issues 1099s each year to report income and gross proceeds to grantor
- The trustee must issue a detailed tax statement annually to the grantor
- Best practice – may be easier to prepare the 1041 with the grantor trust letter to ensure this is done


Mr. Frosty,
it's March.
Time to talk
estate planning.
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# 3.8% Net Investment Income Tax (NIIT)

# Income is taxed to either the trust/estate, the beneficiary or the grantor

- Grantor Trust - income taxed to grantor, trust not subject to NIIT
- Simple Trust - typically pays NIIT on capital gains and beneficiary pays tax on ordinary income
- In general, if income is accumulated, income taxed to the trust/estate
- If income distributed, the trust/estate gets an income tax deduction and beneficiaries report taxable income limited to DNI
- DNI determines the character (e.g. interest, dividends, etc.) of the taxable income in the beneficiaries' hands
  - NOTE:  DNI for regular tax purposes will likely be different than DNI for NIIT purposes.

# Calculating the NIIT

- 3.8% of the lesser of:
  - Undistributed net investment income, or
  - AGI over the amount at which the highest tax bracket is applicable ($13,450 for 2022)
    - This threshold is inflation adjusted
    - Note the amount compared to threshold amount is AGI (as adjusted by Reg. § 1.1411-10(e)(2)) – not MAGI (as it is for individuals)
    - See Reg. § 1.1411-3(a)

# Planning Strategies to Reduce NIIT

- Consider distributions to beneficiaries
  - Be careful of non-NIIT considerations
    - GST status of trust
    - Protections afforded by maintaining assets in trust
      - Assets already outside the estate/gift tax system
        - Distributions to children that could remain in Dynasty Trust
        - Distributions to surviving spouse from credit shelter trust may increase survivor’s estate
      - Creditor protection
    - Will current distribution change ultimate beneficiaries?
      - Discretionary current income beneficiaries versus remainder beneficiaries
    - Appropriateness of distributions to beneficiaries

# Planning Strategies to Reduce NIIT, cont'd.

- Consider distributions to beneficiaries, cont'd.
  - Consider impact on beneficiaries' tax liability:
    - Impact on phase-outs
      - personal exemptions; ROTH IRA contribution limitations; traditional IRA contributions limitations; passive loss from real estate for active taxpayers; contributions to Coverdell education savings accounts; etc.
    - Other items impacted by AGI
      - Itemized deductions; medical expenses; taxability of SS benefits; Medicare premiums for Parts B and D are increased when AGI exceeds certain limits; etc.
    - Positive tax consequences to beneficiaries
      - Increase in ability to deduct charitable contributions, larger deduction for investment interest expense if distribution includes net investment income; if beneficiary is in AMT, the DNI may be taxed at 28% instead of higher trust bracket; etc.
  - 65 day rule
    - Trustee/executor may elect to treat a distribution made within the first 65 days of the tax year as if made on the last day of the preceding year
    - Opportunity to make an informed decision whether to make distributions to minimize the tax
    - Year by year election; election made by checking the box on page 2 of 1041; once made, the election is irrevocable

# Planning Strategies to Reduce NIIT, cont'd.

- If distributions made, determine if capital gains can/should be included in DNI
- Consider in kind distributions of appreciated assets
- If trust/estate holds S corp. stock, consider QSST election
  - QSST portion is treated as owned by the beneficiary
- Consider Trustee fees if they result in overall reduction of tax
  - Can impact NII distributed by allocation of trustee fees and other indirect expenses
  - May result in less NII at trust level but is not NII to Trustee

# Planning Strategies to Reduce NIIT, cont'd.

- Many of strategies for individuals are applicable to trusts:
  - Shift investments to growth securities or other investments that don't produce dividends- e.g. tax exempt bonds, insurance, annuities, etc.
  - If invested in properties that generate passive income, consider new investments that will generate passive losses
  - Consider deferring capital gains
    - Scan portfolio for securities with built-in losses that can be sold to offset other capital gains
    - Consider investment objectives – remember tax consequences are only part of the investment decisions

# State Filing Factors

# Factors that Determine if State Tax Returns are Required

- Where did the trust originate
  - Where was the Grantor domiciled at death if created at death
  - Where was the Grantor domiciled when the trust became irrevocable
- Where is the trust property located or the source of the income
- Where is the trust located
- Where is the trust administered
  - Be careful of advisors who may be fiduciaries but who do not have the “trustee” title
- Where do the beneficiaries live
- What does the governing instrument say about the governing law


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WHAT ABOUT THE HOCKEY PLAYER WHO ONLY SCORES GOALS ON DEFLECTIONS?
LET'S CALL IT "TIP INCOME"!
AND THE SPEED EATER WHO CONSUMES DOZENS OF HOT DOGS IN MINUTES?
WELL, THAT'S "REALLY GROSS INCOME."
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# Recent Developments

# Federal Developments

- Relevant Valuation Decisions

| Case | Year | Assets | Court | Discount from Net Asset Value (NAV)/Proportionate Entity Value |
|---|---|---|---|---|
| Strangi I | 2000 | Securities | Tax | 31% |
| Knight | 2000 | Securities/Real Estate | Tax | 15% |
| Jones | 2001 | Real Estate | Tax | 8%; 44% |
| Dailey | 2001 | Securities | Tax | 40% |
| Adams | 2001 | Securities/Real Estate/Minerals | Fed. Dist. | 54% |
| Church | 2002 | Securities/Real Estate | Fed. Dist. | 63% |
| McCord | 2003 | Securities/Real Estate | Tax | 32% |
| Lappo | 2003 | Securities/Real Estate | Tax | 35.40% |
| Peracchio | 2003 | Securities | Tax | 29.50% |
| Deputy | 2003 | Boat Company | Tax | 30% |
| Green | 2003 | Bank Stock | Tax | 46% |
| Thompson | 2004 | Publishing Company | Tax | 40.50% |
| Kelley | 2005 | Cash | Tax | 32% |
| Temple | 2006 | Marketable Securities/Ranch/Winery | Fed. Dist. | 21.25%; 38%; 60% |
| Astleford | 2008 | Real Estate | Tax | 30% (GP); 36% (LP) |
| Holman | 2008 | Dell Stock | Tax | 22.50% |
| Keller | 2009 | Securities | Fed. Dist. | 47.50% |
| Murphy | 2009 | Securities/Real Estate | Fed. Dist. | 41% |
| Gallagher | 2011 | Publishing Company | Tax | 47% |
| Koons | 2013 | Cash | Tax | 7.50% |
| Richmond | 2014 | Marketable Securities | Tax | 46.5% (37% LOC/LOM & 15% BIG) |
| Giustina | 2016 | Timber Company | Tax | 25% LOM |
| Streightoff | 2018 | Marketable Securities | Tax | 18% LOM |
| Grieve | 2020 | Marketable Securities | Tax | 35% (98.8% Non-Vot. LLC Int.) |
| Nelson | 2020 | Equipment Company | Tax | 40.5% (Stock); 31.6% (LP) |

# Federal Developments – cont'd

- Other Inflation-Adjusted Amounts for 2022
  - Gift Tax annual exclusion increased from $15,000 to $16,000
  - Generation-Skipping Tax (GST) exemption increased from $11,700,000 to $12,060,000

# Federal Developments – cont'd

- The New RMD Trust Rules
  - Adopt as official terms See-Through Trust, Conduit Trust, and Accumulation Trust
    - A See-Through Trust is a trust that is designated as the beneficiary under a plan and which meets the requirements of Prop. Reg. § 1.401(a)(9)-4(f)(2).
    - A Conduit Trust is a see-through trust that provides that all distributions will be paid directly to, or for the benefit of, specified beneficiaries.
    - An Accumulation Trust is any see-through trust that is not a conduit trust.

# Federal Developments – cont'd

- The New RMD Trust Rules
  - Highlights
    - The post-death minimum distribution rules depend on who is the deceased's beneficiary. The 10-year rule and the life expectancy payout and only available to designated beneficiaries and eligible designated beneficiaries who must be individuals.
      - Task for see-through trusts will be to look through and determine whether the countable beneficiaries are individuals or not, which depends on whether the see-through trust is a conduit trust or an accumulation trust.
    - For purposes of the 50% excise tax on missed RMDs, the trustee will be responsible for paying that tax as the beneficiaries are deemed to be beneficiaries of the retirement plan.
    - The 4 trust rules – the requirement of identifying the beneficiary with the shortest life expectancy has been eliminated.
    - Three-tier system in place for determining which trust beneficiaries are countable.
      - First tier: Beneficiary(ies) eligible or entitled upon participant's death. (Always countable)
      - Second tier: Will or may inherit what is not distributed to the first tier. (Countable in an accumulation trust)
      - Third tier: Will inherit only upon death of a second tier. (Always disregarded)

# State Developments

- Considerations for New Trusts
  - State fiduciary income tax implications should be considered in the planning stage.
  - The planner should determine which state tax statutes apply, whether imposition of tax violates the state’s or US constitution, and whether trust assets generate income taxable by one or more states.
- Considerations for Existing Trusts
  - Trustees should review the trusts they administer to identify all trusts that are paying state income tax to determine if the tax can be reduced or eliminated. Refunds should be requested for any taxes paid erroneously.

# State Developments – cont’d

- Classification as a resident or nonresident for state income tax purposes applies to trusts and can make a huge difference.
  - States do not have free rein as to how a resident trust is defined. Due to limits on their ability to tax, some states do not tax trusts that meet the definition of a resident trust.
- Trustees should factor in the state income tax treatment of trusts into estate planning if not already doing so.

# Notable 2021 Cases

- *Estate of Calvin*, 2021 SD 45 (2021). Trustee is proper party to bring claims that beneficiary lied to induce improper trust distributions.
- *Breslin v. Breslin,* 2021 Cal. App. LEXIS 288 (2021). Beneficiaries that fail to participate in court ordered mediation are bound by settlement that eliminates their interests.
- *Estate of Johnson*, 2021 Tex. LEXIS 426 (Texas S. Ct. 2021). Acceptance of benefits under will bars contest to will.
- *Davidson v. Karimipour,* 2021 Mich. App. LEXIS 266 (2021). Trustees not required to reimburse beneficiaries for unified credit used when beneficiaries appointed trust assets to their descendants.
- *Traettino v. Woolschlager*, 2021 Md. App. LEXIS 744 (2021). Person never appointed as trustee cannot sue on behalf of trust.


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POTENTIALLY EXEMPT TRANSFERS
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# Tax Legislation & Regulation – Proposed & Final

- Proposed Regulations
  - The IRS has issued proposed regulations implementing RMD rules for retirement plans included in the Secure Act.
    - Proposed to be effective on or after January 1, 2022.
    - RMDs required by April 1 of the calendar year following the calendar year in which the account owner reaches age 72.
    - RMDs where the account owner dies before required beginning date:
      - No qualified designated beneficiary – 5-year rule applies.
      - Designated beneficiary is eligible designated beneficiary other than a minor child – life expectancy rule applies.
      - Designated beneficiary is account owner's child under age 21 – life expectancy rule applies.
      - Designated beneficiary is not an eligible designated beneficiary – 10-year rule applies.
      - Defined contribution plan may allow eligible designated beneficiary to choose life expectancy rule or 10-year rule where account owner dies before required beginning date.
    - RMDs where the account owner dies on or after the required beginning date must begin by the end of the calendar year following the year of death in all cases.
      - This is contrary to the current interpretation and explanation of the 10-year rule in the 2021 IRS Publication 590-B.

# Tax Legislation & Regulation – Proposed & Final – cont'd

- Final Regulations
  - The IRS issued new life expectancy tables for determining RMDs from employer sponsored retirement plans and IRAs. These updated tables should be used in calculating 2022 RMDs.

# Tax Legislation & Regulation – Green Book

- Proposed Trust Tax Changes for Fiscal Year 2023
  - GRATS
    - Require that the remainder interest in a GRAT have a minimum value for gift tax purposes equal to the greater of 25% of the value of assets transferred or $500,000 but not more than the value of the assets transferred.
    - Prohibit any decrease in the annuity of the GRAT term and prohibit the grantor from acquiring an asset held in the trust without recognizing gain or loss for income tax purposes.
    - Require that a GRAT have a minimum term of ten years and a maximum term of the life expectancy of the annuitant plus ten years.

# Tax Legislation & Regulation – Green Book – cont’d

- Proposed Trust Tax Changes for Fiscal Year 2023
  - Grantor Trusts
    - For transactions between a grantor trust and its deemed owner after enactment, treat the transfer of an asset for consideration as one that would result in the seller recognizing gain on any appreciation in the transferred asset.
    - Securitization transactions would not be subject to this new provision.
    - Treat payment of the income tax on the income of a grantor trust as a gift occurring on December 31 of the year in which the income tax is paid unless reimbursed by the trust that same year. The amount of the gift is the unreimbursed amount of the income tax paid.

# Tax Legislation & Regulation – Green Book – cont'd

- Proposed Trust Tax Changes for Fiscal Year 2023
  - Generation-Skipping Tax (GST)
    - Modification to the generation-skipping provisions so the benefit of the GST exemption would not last as long as the trust.
    - Shield trust assets from GST tax only as long as the life of any trust beneficiary who either is no younger than the transferor's grandchild or is a member of a younger generation but who was alive at the creation of the trust.
    - Applicable on or after the date of enactment to all trusts subject to the GST tax regardless of the trust's inclusion ratio on the date of enactment.

# Business Planning

# Dispositions of Business Property

- Installment Sales
- Like-Kind Exchanges
- Related Party Transactions

# Installment Sales – Points to Remember

- Unless one elects out, gain (not loss) is reported under the installment method by default
- Not available for sales of inventory, partnership interests or publicly traded securities
- Depreciation recapture recognized in year of sale
- Sales to related parties may result in ordinary income or acceleration of gain
- Disposition of installment note will accelerate gain
- Large installment notes outstanding at year end (over $5 million) subject to additional interest charge

***Planning Point:* *When multiple business assets are sold and some have less gain potential, an agreement to specifically allocate installment payments to particular assets can maximize tax deferral***

# Like-Kind Exchange Changes

- The TCJA limited the like-kind exchange rules under Section 1031 to exchanges of *only* real property
- Deferral under Section 1031, however, is not allowed for an exchange of real property held primarily for sale
- In addition, as under pre-enactment law, real property located in the United States is not considered like-kind to real property located outside the United States

***Planning Point:* *Under 2022 final regulations, MACRS depreciation classifications have no bearing on identifying real property for section 1031 purposes. The final section 1031 regulations instead provide real property identification rules that are discrete from the MACRS classifications***

- ***Real property includes "inherently permanent structures" and certain "structural components," where these determinations are made using a given list of factors***

# Like-Kind Exchange Strategies

- Sell your property before identifying replacement property
- Qualified intermediary "buys" property you want before yours has sold
- Park replacement property before yours is transferred
- Acquire interest as a tenant in common
- Use a related party to accomplish exchange

***Tax Trap:* Like-kind exchange rules are very form specific and any strategy should be reviewed by your advisor before you begin to implement it**

***Tax Trap:* Losses are also deferred along with gain. Can hurt you if asset values are depressed (basis exceeds value)**

- ***Sell the property outright***
- ***Make sure the transfer doesn't qualify for like-kind exchange treatment (e.g., fail identification or replacement periods)***

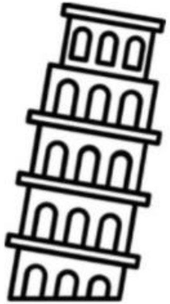
# Related Party Transactions

- Definition of “related party” varies by transaction
- Usually includes:
  - Corporation and its > 50% owner
  - Partnerships and partners
  - S corporations and shareholders
  - Corporations with > 50% common ownership
  - Corporation and partnership with > 50% common ownership
  - Trusts and estates with common grantors or beneficiaries
  - Constructive stock ownership by such entities attributed to owners of such entities
  - Constructive stock ownership by an individual’s family attributed to individual

# Related Party Transactions – Impact on Dispositions

- Losses on sales between related parties disallowed or deferred
- Ordinary income on sales of depreciable property instead of capital gain
- Gain recognized when property transferred in like-kind exchange is sold within two years
- Gain recognized when property sold in an installment sale is resold within two years

# Why couldn't they sell the Tower of Pisa?



There was a "lien" on it

# Entity Structuring and Succession Planning

# Choosing the Right Entity for Your Business

# Choosing the Right Business Entity

- Impact
  - Profitability and operations
  - Tax
  - Benefits
  - Risk exposure
- Types of Business Entities
  - C Corporation
  - S Corporation
  - Partnership
  - Limited Liability Company (“LLC”)

# Common Entity Considerations

| |
|---|
| Pass-through taxation vs. double taxation |
| Flexibility to allocate tax items among owners |
| Flexibility to make distributions other than pro rata |
| Flexibility in the types of owners (*e.g.*, corporate, foreign)<br>Flexibility in methods of providing capital |
| Owner participation in management |
| Liability protection for owners |
| Tax rates |
| 20% deduction against Qualified Business Income |
| Treatment of liabilities for tax purposes |
| Type of property to be held inside entity |
| Ability to compensate employees with equity participation |
| Exit strategies |
| Ability to use losses |
| Employment tax consequences |
| Employee benefits |
| Impact of state taxes |
| Estate and gift taxes (*e.g.*, valuation of business interests) |

# Opportunities and Pitfalls – C Corporations

- Subject to "double taxation"
  - Corporate level on net profits and Shareholder level tax on dividends
- Net operating losses (NOLs) can be carried forward to offset future income
  - Under TCJA, only available to offset 80% of taxable income
- Shareholder-employees receive income from salary or dividends
  - Wages are taxed at ordinary income tax rates (currently 37% maximum) (subject to employment taxes)
  - Qualified dividends taxed at 15% / 20% (no employment tax)
- Insolvency determined at corporate level to determine eligibility for cancellation of debt rules under IRC §108

# Opportunities and Pitfalls – C Corporations (cont'd)

- Subject to penalty taxes
  - Accumulated earnings tax (AET) of 20% for earnings and profits (E&P) accumulated beyond reasonable business needs
  - Personal Holding Companies (PHC) are taxed at dividend rate on undistributed PHC income
    - Refers to closely held corporations with at least 60% of income from passive sources (*e.g.*, dividends, interest, rent)
    - Exceptions: banks, financing companies

***Tax Trap:* Some companies unknowingly became PHC during a wind down phase following a reorganization or sale of assets**

# Opportunities and Pitfalls – Personal Service Corporations

- Corporation performing services in fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting
- Taxed at flat 21% rate
- Subject to a “minimum distribution requirement”
- Can use cash method of accounting (C Corporation, which can only use the accrual method)
- If on accrual method, permitted to reduce accrued service income by amount that, based on experience, will not be collected

# Opportunities and Pitfalls – S Corporations

- Maintain corporate form but generally subject to only one level of tax
- Special rules on eligibility, shareholder basis, distributions, and maintaining S Corp status
- S Corp can only have up to 100 shareholders and only one class of stock (can be voting or non voting)

***Tax Trap:* *Certain transactions may terminate S status:***

- ***Shareholder distributions and income allocations that do not match share ownership percentages***
- ***Options and warrants to purchase common stock***
- ***Buy/sell arrangements that cause S Corp to have an ineligible shareholder***
- ***LLC taxed as S Corp does not amend LLC agreement that continues to refer to §704(b) rules***

# Eligibility for S Corporation Status

| Corporate Requirements | Eligible Shareholders |
|---|---|
| Must be domestic corporation | Individuals must be U.S. citizens or resident aliens |
| Cannot have more than 100 shareholders | Estates |
| Insurance companies are not eligible | Grantor trust with eligible grantor |
| Financial institutions cannot be on reserve method of accounting | Electing small business trust (ESBT) |
| | Qualified Subchapter S trust (QSST) |
| | Another S corporation (if sole shareholder – a “QSSS”) |
| | Certain tax exempt organizations |
| | Certain retirement plans |

# Opportunities and Pitfalls – S Corporations (cont'd)

- Insolvency determined at corporate level to determine eligibility for cancellation of debt rules under IRC §108
- Stock Basis and Distributions
  - Tax free distributions are allowed to extent of shareholder's stock basis
  - Shareholders must have basis in stock and loans and must be "at risk" to take advantage of pass through losses
  - Loan repayments may be taxable
  - For capital gain treatment, advances to corporation should be documented and repaid more than 12 months after loan

***Tax Trap:* *If debt basis has been reduced by losses, repayment on debt will result in income unless basis has been fully restored***

# Opportunities and Pitfalls – S Corporation Pitfalls

- Excessive Passive Investment Income
  - If accumulated E&P and substantial "passive" income (exceeding 25% of gross receipts) prior to becoming S Corp, subject to highest corporate tax rate of 21%
  - If S Corp has net excessive passive income for 3 consecutive years, S status terminates as of first day of following year
- Built-In Gains (BIG) Tax
  - Imposes corporate level tax on gains inherent in assets held by C Corp at time it is converted to S Corp
  - Also imposed on assets acquired in certain tax deferred transactions
    - PATH Act permanently set BIG recognition period to 5 years subsequent to S election

# Opportunities and Pitfalls – Partnerships & LLCs

- Pass-through tax treatment and additional flexibility
- Income allocations must have substantial economic effect
  - More flexible than S Corps which generally require pro rata allocations
- Profits interest – interest received in future profits of Partnership/LLC in return for services rendered
  - Given by partnership/LLC without requiring contribution to capital, and generally not subject to tax upon grant
  - Currently, law provides for subsequent sale by holder at capital gains tax rates

# Opportunities and Pitfalls – Partnerships & LLCs

- Changes in liabilities and loss allocations may trigger income
  - IRS closely scrutinizes whether LLC liabilities should be taken into account when determining whether member is "at risk". If member is not "at risk," losses are not deductible.
  - New regulations issued recently that curtail the use of "bottom-dollar" guarantees by a partner/member on the partnership's/LLC's debt
- Partner contributions, distributions to partners and transfers of partnership interest may also trigger income and gain recognition

***Planning Point:* *Tax election available to increase basis in partnership assets so that such basis is equal to buyer's investment basis (or equal to seller's gain)***

# Opportunities and Pitfalls – Pass-Through Entities

- Qualified Business Income Deduction
  - Tax deferral strategies must be balanced against ability to claim new 20% deduction calculated off of Qualified Business Income
  - Need for high-level review of entity relationships, intercompany charges, and management agreements to ensure maximization of deduction

# Opportunities and Pitfalls – Rental Real Estate

- "Real estate professionals" – spend more than 750 hours and more than 50% of time, and materially participate in real estate business
  - Escape limitation on passive losses
  - For material participation, each rental real estate interest generally treated as separate activity
  - May elect to treat all interests in rental real estate as single activity; election irrevocable and is permanent

***Tax Trap:* Operating businesses usually hold real estate in a separate entity. If partnership rents property to a separate business, rental income may be re-characterized from passive to active income, while rental losses remain passive losses. Lose ability to offset losses (self-rental trap).**

# Opportunities and Pitfalls – Single Member LLCs

- When owned by a corporation, can be taxed as part of corporate owner or as separate corporate subsidiary
- When owned by a individual, can be taxed as sole proprietor (report as business activity on owner's Form 1040) or as a corporation
- Disregarded entity for federal income tax unless box checked to treat separately

***Tax Trap:* *Still subject to employment, excise tax, and state franchise tax obligations***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Let's just round this column off to the nearest nickel.
REBEL ACCOUNTANT
S.BURNS


THE LOOK YOU GET ON YOUR FACE
WHEN EVERYTHING BALANCES IN ALL YOUR FINANCIAL STATEMENTS

# Transition Planning and Exit Strategies

# Exit Strategies

- Mergers and Acquisitions
- Noncompete, Consulting & Employment Agreements
- Business Succession Planning

# Ancillary Considerations of Mergers and Acquisitions

| |
|---|
| Whether transaction costs are capitalized or deducted |
| Whether and to what extent tax attributes (such as losses or accounting methods) carry over |
| The rights of minority interest shareholders who may not want to continue with the business |
| The holding periods of assets or ownership interests |
| Restrictions caused by the involvement of related parties |
| The effect of the business structure or ownership on contracts, licenses and registrations |
| Depreciation recapture |
| The effects on qualified and non-qualified retirement plans or compensation |

# Mergers and Acquisitions - Reorganization

- Seller receives stock of Buyer instead of cash
- Qualified transactions defer taxation on sale until Seller disposes of Buyer's stock received as part of sale price
- Entity structure impacts qualification
  - Most easily achieved with C corporations
  - Partnerships can incorporate prior to transaction
  - S corporations may lose S status

# Mergers and Acquisitions – Avoid reorganization if:

- Seller is concerned about quality or marketability of Buyer’s stock
- Buyer demands step-up in basis on assets
- Buyer does not want continued involvement of Seller
- Parties want to keep transaction costs to a minimum
- Seller wants to take advantage of lower tax rates in advance of future rate increases

# Noncompete/Consulting/Employment Agreements

- Consider these agreements to:
  - Protect the Buyer from the Seller competing
  - Transition knowledge and relationships from Seller to Buyer
  - Compensate Seller for the above

***Planning point:* *Allocate reasonable amount of the purchase price to the agreements to prevent IRS from valuing agreements***

***Tax Trap:*  *IRS has subjected income from noncompete agreements to self-employment tax when parties sign one agreement for consulting and noncompete, without allocating amounts to each component***

# Tax Consequences of Sales Agreements

| Type of Agreement | Buyer Treatment | Seller Treatment | Employment Taxes |
|---|---|---|---|
| Consulting Agreement | Ordinary Deduction | Ordinary Income | Self-employment (S/E) tax |
| Employment Agreement | Ordinary Deduction | Ordinary Income | Payroll tax |
| Noncompete Agreement | 15 year amortization | Ordinary Income | Possible S/E tax |
| Personal Goodwill | 15 year amortization | Capital Gain | None |

# Business Succession Planning - Tools

- Buy/Sell Agreement
  - Locks in a buyer for a departing owner’s interest
  - Fixes the method of determining the price for the interest
  - Restricts transferability of ownership interests to outside parties
  - Helps establish value for gift and estate purposes
- Life insurance
  - Provides liquidity to pay estate taxes
  - Fund purchase of decedent’s ownership interest
  - Pay decedent’s debts
- Employee Stock Ownership Plan (ESOP)
  - Shares sold to ESOP for benefit of employees
  - Gain deferred if invested in qualified investments

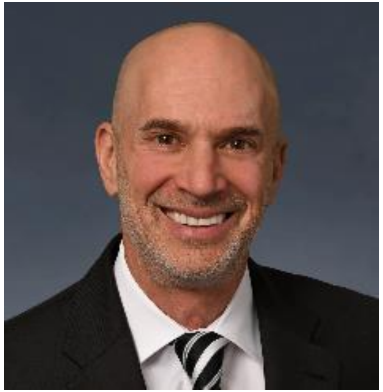
# Highlights

- Trust or Estate is a Separate Taxable Entity
- Income is Taxed to Either Estate/Trust or Beneficiary
- Concept of "Distributable Net Income" (DNI) Determines
  - Amount of Distribution Deduction
  - Amount Included in Beneficiary's Income
  - Character of Income
- DNI affected by
  - Tier System of Allocating DNI
  - Separate Share Rule
  - 65 Day Rule
  - Section 663(a)(1) for Specific Bequests
  - Section 643(e) Rules for Distributions in Kind

# Highlights

- Application of Passive Activity Rules
  - Material participation
- Administration Expenses and other Income Tax Deductions
  - Fully Deductible Administrative Expenses
  - Miscellaneous itemized deductions subject to 2% limitation suspended 2018-2025
  - Allocation to Tax-Exempt Income

# Presenter

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*Dan is the Senior Managing Director of the CBIZ & MHM Colorado office and a member of the MHM Board of Directors. He is responsible for the overall management of the Colorado market, including financial performance, strategic planning efforts, and client satisfaction. A Certified Public Accountant and Certified Valuation Analyst, he has been providing tax, accounting and consulting services to middle-marketing companies and their owners for over 30 years.*


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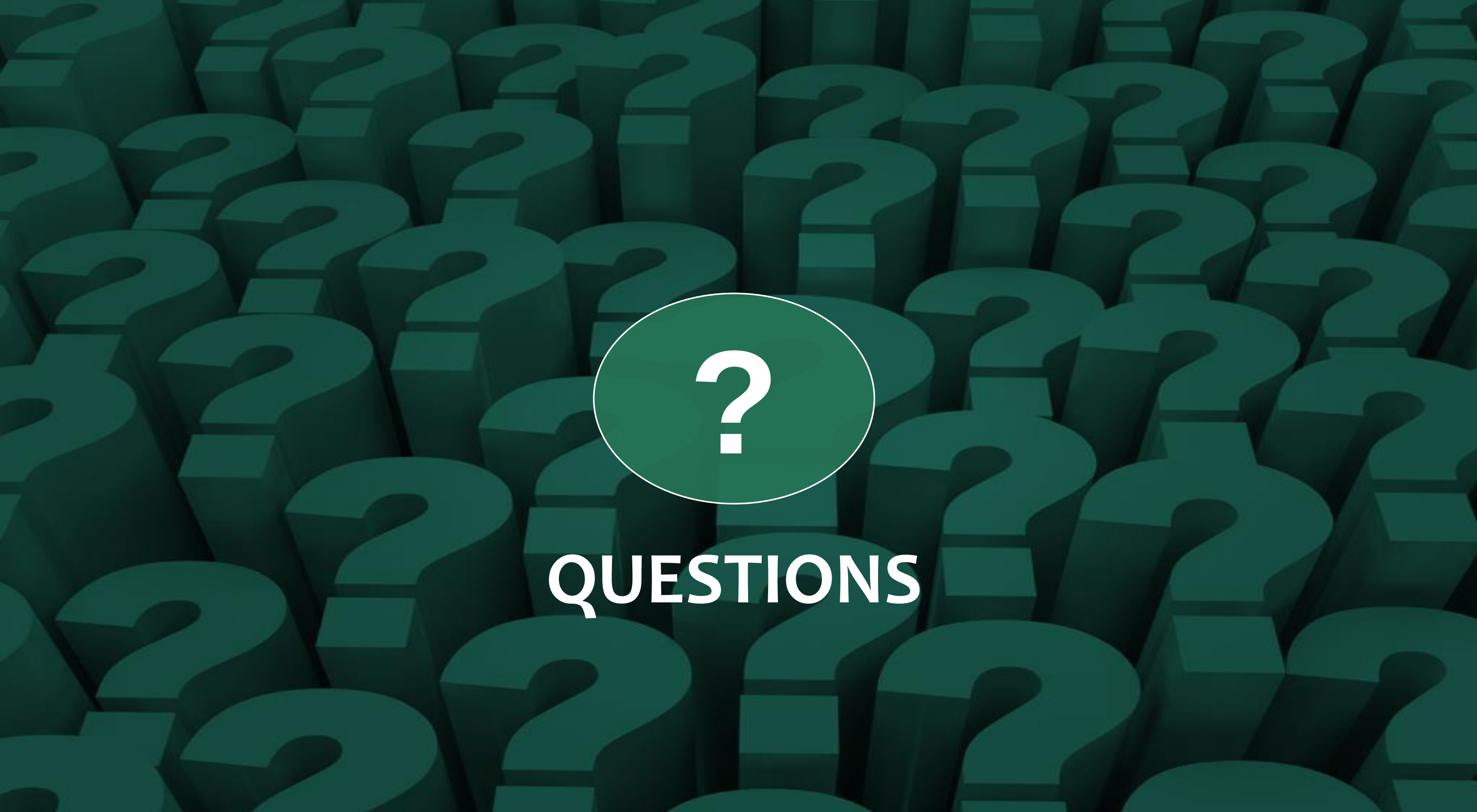

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# QUESTIONS