Issue 38 – November, 2021

NAEPC Journal of Estate & Tax Planning

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Initially published on Forbes.com
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Author: Mary E. Vandenack, JD, CAP® , COLPM

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Editor's Note

Bracing for Changes…Still

Ryan P. Laughlin, CPA, MST, JD, AEP®
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October is home to National Estate Planning Awareness Week. If you watch and read the news, though, you may think that October is actually National Estate **Tax** Planning Awareness Month! Will November be any different? In February, I wrote **in this column** that: "As estate planners, we face constant change and uncertainty." We all expected tax legislation and changes to come at some point. The Biden administration handed out talking points in the Spring, and the Ways and Means Committee gave us actual text to review, debate, and ponder last month. Yet, November is right around the corner and can anyone say with certainty what the law will look like next year…or even this year? We are all bracing for that inevitable change no matter when it comes.

Taxes no doubt play an important role in our clients' estate plans and how they conduct their affairs. We need to be aware of pending changes and the impact they have on our clients' families, businesses, charities, etc. This issue of the Journal provides some of the best content available on the overall proposals for change and on specific areas that need special attention (e.g. valuation discounts, disregarded trusts, and others).

However, since National Estate Planning Awareness Week recently occurred and because estate planning encompasses far more than just taxes, we also provide our readers with valuable content on topics that will apply to clients regardless of what tax laws look like or which political party is in charge now, next year, or after the next election cycle. The material includes timeless reminders that our client's goals and objectives always come first, regardless of their net worth or tax picture.

This is exactly what NAEPC is about – all of the professionals connected to estate planning. Next week is our **58th Annual NAEPC Advanced Estate Planning Strategies Virtual Conference**. The event features nationally-recognized speakers on advanced topics of interest to allied professionals and provides opportunities for attendees to cultivate multi-disciplinary relationships while collaborating on cutting edge ideas and trends. The conference educational sessions are for ***every member of every estate planning council and all estate planning professionals.*** Please take a moment to check out the conference information; we would love to see you there!

Happy Reading!

Email me at **editor@naepcjournal.org** with your comments and suggestions.

Steve Leimberg's Estate Planning Email Newsletter - Archive Message #2911

Date:	**29-Sep-21**
From:	**Steve Leimberg's Estate Planning Newsletter**
Subject:	**Barry Nelson, Jennifer Okcular & Cassandra Nelson: How Your Estate Plan May Be Affected by Potential Changes to Income and Transfer Taxes under the House Ways and Means Committee Tax Proposal**

Barry A. Nelson, **Jennifer E. Okcular** and **Cassandra S. Nelson** provide members with a letter they recently sent to clients about the House Ways and Means Committee Tax Proposal.

Barry A. Nelson, a Florida Bar Board Certified Tax and Wills, Trusts and Estates Attorney and author of ***Estate Planning and Asset Protection in Florida: A Plan to Survive Unexpected Financial Threats***, is a shareholder in the North Miami Beach law firm of **Nelson & Nelson, P.A.** He practices in the areas of tax, estate planning, asset protection planning, probate, partnerships and business law. He provides counsel to high net worth individuals and families focusing on income, estate and gift tax planning, and assists business owners to most effectively pass their ownership interests from one generation to the next. As the father of a child with autism, Mr. Nelson combines his legal skills with compassion and understanding in the preparation of Special Needs Trusts for children with disabilities.

Mr. Nelson received the Distinguished Planner Award 2021 presented by the Estate Planning Council of Greater Miami. Mr. Nelson is a Fellow of the American College of Trust and Estate Counsel and served as Chairman of its Asset Protection Committee from 2009 to 2012. Mr. Nelson is named in Business and HNW Guide as a Tier 1 leading estate planning attorney in Florida. Mr. Nelson has been listed in The Best Lawyers in America since 1995 and is a Martindale-Hubbell AV-rated attorney. Mr. Nelson was named by Best Lawyers in America as the 2015 Trusts and Estates "Lawyer of the Year" in Miami.

As the founding chairman of the Asset Preservation Committee of the Real Property, Probate and Trust Law Section of the Florida Bar from 2004-2007, Mr. Nelson introduced and coordinated a project to write a treatise authored by committee members entitled Asset Protection in Florida

(Florida Bar CLE 2008, 5th Edition 2017). Mr. Nelson wrote Chapter 5 of Asset Protection in Florida, entitled “Homestead: Creditor Issues.” Mr. Nelson is a co-founder and current board member of the Victory Center for Autism and Behavioral Challenges (a not-for-profit corporation) and served as board chairman from 2000-2008 and from 2020 to current.

Jennifer E. Okcular, is a shareholder in the law firm of Nelson & Nelson, P.A. in North Miami Beach, Florida, practices primarily in the areas of tax, estate planning, asset protection planning and probate administration. Jennifer is Board Certified by the Florida Bar in Wills, Trusts and Estates. Jennifer graduated first in her class from Stetson University College of Law in 2004 and received her LLM in Taxation at the University of Florida Graduate Tax Program. Jennifer received her B.A. from the University of Florida. Jennifer is an active in the local community as a sustainer of the Junior League of Miami, Inc., a women’s organization that promotes volunteerism and as a member of the Ambassador’s Legacy Council for the Miami Children’s Hospital Foundation.

Cassandra S. Nelson, an associate in the law firm of **Nelson & Nelson, P.A.** in North Miami Beach, Florida. Cassandra is recognized in Ones to Watch in the practice area of Trusts and Estates in the 2022 edition of The Best Lawyers in America. She practices primarily in the areas of estate planning, asset protection, tax, special needs trusts, guardianships, and probate administration. She has co-authored articles published by Trust & Estates, ActionLine (Florida Bar), and Leimberg Information Services and has been a co-contributor on several chapters published in Mr. Nelson’s treatise, ***Estate Planning and Asset Protection in Florida: A Plan to Survive Unexpected Financial Threats***. Cassandra received her B.A. from the University of Miami in 2013 and her J.D. from Emory University School of Law in 2017. Cassandra Nelson is involved with The Victory Center for Autism and Behavioral Challenges (a not-for-profit corporation). As the older sister of a 23-year-old brother with severe autism, Cassandra has a unique interest in assisting children with disabilities and their families. As an attorney, she does so by counseling on the creation of special needs trusts and establishing guardianships for such children.

Here is their commentary:

COMMENT:

We are publishing this letter a bit later than some excellent summaries that were issued over the last week or so by other publications and/or professionals after the House Ways and Means Committee released its tax law proposal to be incorporated in the budget reconciliation bill on Monday, September 13, 2021 (referred to hereinafter as the "House Proposal"). The House Proposal now has a number HR 5376 (which can be found at: **H.R.5376)**, and a Report (which can be found at: **H.R.5376 Report**).[1]

We wanted to absorb the House Proposal and determine if there would be any clarification as to areas that have caused confusion, as described below. Based upon our review of the House Proposal, helpful analyses by other professionals, and commentary from peers, we are providing this letter that is up to date as of September 22, 2021. The legislative review process will be multi-step and it is likely that many substantive changes will be made before any legislation becomes law. It is possible that some (if not all) of the tax law changes described herein will never be enacted. We are certain many more changes will be forthcoming, so seek legal or CPA advice before taking any action.

Very Truly Yours,

Barry Nelson
Jennifer E. Okcular
Cassandra S. Nelson

Summary of Potential Changes as a Result of the House Proposal

Based upon the House Proposal, the current $11.7 million gift and estate tax exemption could be reduced to approximately $6.03 million after December 31, 2021. As we prepare this letter, I grow increasingly concerned that trusts to be created to take advantage of the current gift and estate tax exemption must be executed before enactment of the House Proposal in its final form, which could possibly be much earlier that December 31, 2021 (as soon as the House and Senate agree on the House Proposal and the President signs it). Of course, the process could drag on, but nobody knows. As a result, a prudent approach is to have any new grantor trusts, such as SLATs or QTIPs (as described below) be created and funded as soon as possible. Estate planning attorneys may not have the capacity to prepare all of the documents their clients may need before enactment of the House Proposal. We are aware that the House

Proposal is only proposed legislation and that this could be a “fire drill” if Congress is unable to agree on a final bill. We are also aware that if Congress does agree on a final bill, it may differ significantly from the House Proposal. However, all we, as advisors, can do at this time is explain the House Proposal in its current form so that those that may be affected by it can consider their immediate options.

The good news is that the House Proposal does not: (i) address the elimination of the step-up in income tax basis from cost to fair market value at death; (ii) tax unrealized appreciation at death; or (iii) raise the current 40% estate, gift, and generation skipping transfer tax rate.

This summary only covers portions of the House Proposal that are most relevant to our clients. For example, any foreign tax issues will not be covered in this letter. The effective dates in the House Proposal differ. For example: (i) the reduction of the current $11.7 million gift and estate tax exemption to about $6.03 million will be effective January 1, 2022, (ii) capital gains increases will be effective for tax years ending after September 13, 2021 (when the House Proposal was introduced) and (iii) the grantor trust limitations described below will be effective upon the date of enactment. The Report provides the following effective date provisions with respect to grantor trusts (page 1282-1283 (top page numbers) and page 324-325 (bottom page numbers) of the Report): “The provision is generally effective for (1) trusts created on or after the date of enactment and (2) any portion of a trust established before the date of enactment that is attributable to a contribution made on or after such date. The portion of the provision relating to sales and exchanges between a deemed owner and a grantor trust is intended to be effective for sales and other dispositions after the date of enactment.” Although the effective date provision of the Report provides that the “any portion of a trust established before the date of enactment that is attributable to a contribution made on or after such date” it is unclear whether such provision applies to sales and exchanges for a grantor trust created before enactment.
A summary of the parts of the House Proposal that we believe are most relevant to our clients is below:

Individual Taxes

Tax rates: The top marginal individual income tax rate would increase from 37% to 39.6%. This marginal rate would apply to married individuals filing jointly with taxable income over $450,000; to heads of household with taxable income over $425,000; to unmarried individuals with taxable income over $400,000; to married individuals filing separate returns with taxable income over $225,000; and to estates and trusts with taxable income over $12,500.

High-income surcharge: The House Proposal would impose a surcharge tax equal to 3% of a taxpayer's modified adjusted gross income (MAGI) in excess of $5 million (or in excess of $2.5 million for a married individual filing separately). For this purpose, modified adjusted gross income means adjusted gross income reduced by any deduction allowed for investment interest (as defined in section 163(d)).

Capital gains: The House Proposal would increase the 20% tax rate on capital gains to 25%, effective for tax years ending after September 13, 2021 (note that President Biden had considered a 40% capital gains tax). However, a transition rule would provide that the current statutory rate of 20% would continue to apply to gains and losses for the portion of the tax year prior to September 13, 2021 and gains recognized after September 13, 2021 that arise from transactions entered into before September 13, 2021 pursuant to a written binding contract (and which is not modified thereafter in any material respect). **Note:** Most capital gains are also subject to an additional 3.8% tax.

Estate and Gift Tax Provisions

Gift, Estate, and Generation Skipping Transfer Tax Exemptions (effective for decedents dying and gifts made after December 31, 2021): The House Proposal would reduce the current $11.7 million exemption from gift, estate, and generation skipping transfer taxes (which is currently scheduled to sunset on December 31, 2025) to approximately $5 million per taxpayer, adjusted for inflation since 2011. In 2022, the exemption will be $6,030,000. This produces a $5,670,000 exemption drop from 2021 to 2022. While this is a substantial drop, future indexation effectively restores part of this $5,670,000 of “bonus exemption” for a taxpayer who did not fully utilize the current $11.7 million unified credit and lives beyond 2022. Taxpayers who feel comfortable making outright gifts of their remaining gift, estate, and generation skipping transfer tax exclusions should do so before January 1, 2022. However, gifts in trust, especially to grantor trusts (as described below) need careful analysis. **Note:** For reasons beyond the scope of this letter, taxpayers will only fully benefit from current exemptions by using their entire $11.7 million exemption (reduced by prior taxable gifts) as compared to making a gift of, for example, $5,670,000, which will not result in the effective use of the current $11.7 million exemption. This computation should be reviewed with taxpayer's tax advisor or with our firm if you are our client.

New Grantor Trust Rules Could Eliminate Benefits – General Explanation: While some of the House Proposal provisions are simple to comprehend and planning options are relatively clear, the House Proposal creates some confusion by eliminating the benefits of grantor trusts created and/or funded after enactment. Grantor trusts have been a significant planning technique for many of our clients for over 20 years.

Grantor trusts allow the creator (also commonly referred to as the settlor or grantor) to make a gift to a trust that, with proper planning, will be excluded from the creator's estate, and also allows the creator to pay income tax on all trust income without such payments being considered a gift to the trust or its beneficiaries. The rationale is that the trust creator is considered the owner of the trust income for income tax purposes, but not for gift or estate tax purposes because the trust provides the creator with one or more retained power, such as the power to substitute the creator's other assets for trust assets of equivalent value. As a result, the creator of the trust is obligated to pay income tax on trust income (both ordinary and capital gains) and because of such obligation, payment of income tax by the creator is not a gift to the trust or its beneficiaries.

An important benefit of grantor trust status is the ability of the creator during his or her lifetime to take the creator's high income tax basis assets and substitute such high basis assets for low or even negative basis assets of equivalent value that are owned by the grantor trust. Assets held in such a grantor trust do not benefit from a step up in income tax basis to fair market value upon the death of the creator whereas the law currently in effect allows a step up in basis to fair market value for assets owned by a person upon death. The House Proposal does not currently eliminate step up in income tax at death. Accordingly, as of the date of this letter, grantor trusts are a great estate planning techniques as they allow taxpayers who create grantor trusts to: (i) pay the trust's income tax and (ii) maximize income tax basis planning for assets owned by the grantor trust at the creator's death by allowing the creator to substitute the creator's high income tax basis assets for low or even negative basis assets of equivalent value before the creator's death and thereby the creator's beneficiaries benefit from a step up in income tax basis at death as to the low income tax basis assets owned by the creator as of his or her date of death.

As stated above, the House Proposal eliminates the ability to take advantage of grantor trust planning for any trust created or funded after enactment. However, trusts created before enactment should maintain full grantor trust benefits so long as the trust is not modified after enactment and there are no contributions to such trust. Grantor trust status will be eliminated, at least to some degree, based upon the value of post enactment contributions in the event contributions are made to the trust after enactment. As indicated above, the House Proposal is unclear as to whether a grandfathered trust will lose its grantor trust status if assets are substituted by the creator or sold by the creator to the trust subsequent to enactment. We expect the rules to be clarified in the future as to sales and substitutions of assets as to grantor trusts created and funded before enactment. However, we anticipate a race to create and fund new grantor trusts before enactment to take advantage of the grantor's ability to pay income tax on grantor trust income and based upon the possibility that the law may be clarified to allow sales and substitutions for grandfathered trusts.

Based upon the House Proposal, it is also unclear whether modification of an existing grantor trust will result in loss of grantor trust status. Thus, for clients that have existing grantor trusts that may have outdated provisions including dispositive provisions, the best option may be to decant such trusts (based upon applicable state law and with care to maintain generation skipping transfer benefits after consulting with their attorney) into a new updated grantor trust and fully fund the new trust before enactment of the House Proposal. This may not be easy especially since it is unclear when enactment will occur. **Note:** The grantor trust provision will eliminate the benefits of techniques such as GRATs and inter vivos QTIP trusts as well as most life insurance trusts created or funded after enactment, and to a more limited extent, even pre-enactment life insurance trusts funded after enactment.

Grantor Trust Provisions in House Proposal - Estate Tax Inclusion (effective date: trusts created on or after the date of enactment (or to any portion of a trust that was created before the date of enactment

which is attributable to a contribution made on or after the date of enactment)): The House Proposal would essentially eliminate grantor trusts as a planning vehicle for any trusts created after enactment. Specifically, the House Proposal would add new Section 2901 to the Code, which:

- Includes in a grantor's taxable estate any portion of a grantor trust's assets of which the person is the "deemed owner" for income tax purposes.
- Treats a distribution made from a grantor trust as a gift, unless (a) the distribution is made to the grantor's spouse or (b) the distribution discharges an obligation of the deemed owner.
- Provides that if the trust's grantor status is terminated during the grantor's lifetime, the assets will be treated as being gifted at that time by the grantor. A "proper adjustment" will be made if assets of a grantor trust are included in the grantor's taxable estate to account for amounts previously treated as taxable gifts by the grantor to the trust.

Grantor Trust Provisions in House Proposal - Income Taxation on Sales to Grantor Trusts (effective date: trusts created on or after the date of enactment (or to any portion of a trust that was created before the date of enactment which is attributable to a contribution made on or after the date of enactment)): Under existing law, when a grantor sells appreciated assets to a grantor trust, no capital gain is triggered. In addition, under existing law, the "swap" or "substitution" of assets of equal value for assets in a grantor trust does not trigger capital gain. The House Proposal would add new Section 1062 to the Code, which would require gain to be recognized on sales of appreciated assets to a grantor trust, but deny the recognition of a loss. Under new Section 1062, if enacted, "swap" or "substitution" transactions would no longer be free of capital gains tax consequences as to post enactment created grantor trusts. Furthermore, if a post-enactment "contribution" is made to a grandfathered trust a portion of that trust would be subject to these new rules. The term "contribution" is not defined and has caused much confusion, especially as to existing life insurance trusts where the trust creator typically makes annual trust contributions to pay the current year's life insurance premium. It is unclear whether sales or swaps to grantor trusts created before enactment will be subject to the new rules subjecting post-enactment sales or swaps to tax and, until further guidance is provided, such post-enactment transactions should be avoided.

Family Limited Partnership and Other Valuation Discount Limits as Non-Business Assets

The House Proposal seeks to limit the estate and gift tax valuation discounts applied to transfers of closely-held non-business assets. This provision is designed to limit the strategy of creating family limited partnerships to hold passive assets (i.e., a portfolio of stocks, bonds, mutual funds, any like type assets), and have the partnership valued for gift and estate tax purposes at a lesser value due to discounts for lack of marketability and minority interests. The Proposal defines “non-business assets” as passive-type assets, which is held for the production or collection of income and is not used in the active conduct of a trade or business. In other words, forming a family limited partnership or limited liability company and funding it with marketable securities would no longer be a viable technique for transferring marketable securities at a discounted value. This provision, if enacted, would apply to transfers after the date of enactment. Included in the valuation discount prohibition rule is passive real estate held in partnerships and LLCs. Currently, it appears that fractional gifts of interests in real estate (not owned in a business entity) could still qualify for valuation discounts, but such transfers could create catastrophic title issues such as where one owner of a small fractional interest does not agree to a sale or if such an interest is conveyed upon divorce to an ex-spouse.

Retirement Plans

IRA and Retirement Plan Provisions: The House Proposal creates significant tax increases, accelerates taxable withdrawals, and prohibits additions to IRAs of high income taxpayers who already have retirement assets in excess of $10 million and other modifications described below. If the House Proposal is enacted, taxpayers must consult with their retirement plan advisors to make sure they are in compliance.

Contributions to IRAs: The House Proposal would prohibit further contributions to a Roth or traditional IRA for a tax year if the total value of an individual's IRA and defined contribution retirement accounts generally exceeds $10 million as of the end of the prior tax year. The limit on contributions would only apply to single taxpayers (or taxpayers married filing separately) with taxable income over $400,000, married taxpayers filing jointly with taxable income over $450,000, and heads of household with taxable income over $425,000 (all indexed for inflation) ("high-income taxpayers").

Required Minimum Distributions: For high-income taxpayers, as defined in the preceding item, whose combined traditional IRA, Roth IRA, and defined contribution retirement account balances generally exceed $10 million at the end of a tax year, a minimum distribution would be required for the following year as follows:

- If the individual's prior-year aggregate traditional IRA, Roth IRA, and defined contribution account balance **exceeds the $10 million limit, but is less than $20 million**, 50% of the value in excess above $10 million must be distributed as taxable income.
- If the individual's prior-year aggregate traditional IRA, Roth IRA, and defined contribution account balance **exceeds $20 million**, 100% of the value in excess above $20 million must be distributed as taxable income.

Roth conversions: The House Proposal would eliminate Roth conversions for both IRAs and employer-sponsored plans for single taxpayers (or taxpayers married filing separately) with taxable income over $400,000, married taxpayers filing jointly with taxable income over $450,000, and heads of household with taxable income over $425,000 (all indexed for inflation). This provision would apply to distributions, transfers, and contributions made in taxable years beginning after December 31, 2021. This provision would also prohibit all employee after-tax contributions in qualified plans and after-tax IRA contributions from being converted to Roth regardless of income level effective for distributions, transfers, and contributions made after December 31, 2021.

Moving Forward – Before a Bill Passes

There are numerous planning techniques that can be initiated now, before the House Proposal (or any negotiated revised proposal) is enacted. Specifically, clients who were considering Spousal Limited Access Trusts ("SLATs"), Grantor Retained Annuity Trusts ("GRATs"), or sales of discounted partnership or LLC interests using their remaining gift, estate, and generation skipping transfer tax exclusions, selling assets to a grantor trust, or substituting assets into a grantor trust for other assets of equivalent value (if authorized in such grantor trust), should act now before enactment. For those concerned about asset protection planning, inter vivos QTIP trusts can provide excellent results. However, creating inter vivos QTIP trusts before enactment is necessary to avoid the possibility of double estate tax inclusion should the creator die before his or her spouse.

Clients with family limited partnerships and/or limited liability companies that hold passive assets should consider whether gifts or sales of partnership or LLC interests should be made before enactment.

Clients who have used their entire gift tax exemption but have GST tax exemption remaining may make a gift equal to their remaining GST tax exemption and pay the gift tax on such gift and, provided the donor lives three years from the date of the gift, the gift tax paid will be removed from the donor's estate.

If you wish to initiate planning before the House Proposal is enacted, call your attorney, CPA, and/or financial advisor soon as there is only limited time to act before enactment.

HOPE THIS HELPS YOU HELP OTHERS MAKE A *POSITIVE* DIFFERENCE!

Barry Nelson

Jennifer Okcular

Cassandra Nelson

CITE AS:

[1] The Report, due to file size limitations, is provided in eight portions. Our link is to portion three. Portion three includes page numbers on the top and different page numbers on the bottom. The page number that deals with the explanation as to grantor trusts starts on top page number 1280 and bottom page number 322.

What the Build Back Better Act Could Mean for Life Insurance Trusts

Planners have a window of opportunity to prevent potential calamity

Lawrence Brody, Senior Counsel, Harrison & Held, LLP
Charles L. Ratner, JD, CLU®, ChFC®, AEP® (Distinguished)

Yes, it's early October as we write this. And, true, no one can predict whether there will be a new tax law in the offing for next year and, if there is, how drastically it will alter the estate planning landscape. But the Sept. 13 release by the House Ways and Means Committee of its tax proposals under the Build Back Better Act (the Act) is a clarion call for estate planners to think seriously about how profoundly some of these proposals would affect clients' estate and liquidity planning.

There are myriad aspects of planning that would be affected by these proposals. However, it can make a lot of sense to focus on irrevocable life insurance trusts (ILITs), both existing and newly contemplated, as well as how they are or will be funded. If the conversation involves the word "irrevocable," it's going to involve the word "complications." And if it involves complications, then time is of the essence.
Consider at a high level what's on the table, which includes these provisions:

- An ILIT established on or after the date of enactment of the Act that's a grantor trust will be included in the grantor's estate.
- A gift on or after the date of enactment to an ILIT that's a grantor trust established before date of enactment will cause a portion the ILIT's assets to be included in the grantor/donor's estate
- A sale on or after date of enactment to an ILIT that's a grantor trust will be considered a sale to a third-party
- The estate and gift tax exemption is (reduced to) $5 million (indexed) after 2021.
- Capital gains tax rates for high income taxpayers are increased, effective for gains incurred after Sept. 13.

Notably not on the table, at least for now, is a proposal for carryover (rather than stepped-up) basis and recognition of capital gains at death.

It's impossible to know when the date of enactment will be. However, given all that remains to be done (and no doubt changed) before the Act becomes law, there should be sufficient time for planners to react and reach out to clients.

It goes without saying that, depending on what comes to pass, many clients will have to reassess the fundamental underpinnings of their estate plans, the continued viability of their wealth transfer vehicles and, of course, their liquidity position. Many will also have to review the performance and durability of their life insurance policies. This reassessment would be challenging enough if the "only" thing clients had to deal with were a reduction in the gift and estate tax exemptions. But the change in the treatment of grantor trusts will take the conversation into uncharted territory.

Like songwriters, planners will have to compose the lyrics to some targeted alerts and memoranda that they'll send to clients, urging them to talk or meet sooner rather than later. The challenge, of course, is to make a common sense case for why clients should spend their time and money to talk about the potential implications of possible legislation. Perhaps for that reason, communications with clients should focus less on the principle of the thing than the money. If they can't see what's at stake in real dollar terms, they're a lot less likely to heed a call to action. And where applicable, let the client know that these proposals simply give them more reason to do now what they've been thinking about doing anyway.

Where to Begin?

It might make sense to start with the most proximate and problematic situations, meaning those that portend the most tax and financial harm, likely involve the most complications and require the most time to settle on and implement a course of action. A priority list might look something like this:

- Clients with existing ILITs that are grantor trusts that are being funded by some form of tax and/or economically leveraged technique.
- Clients funding grantor trust ILITs with gifts of cash. These gifts could be problematic after the date of enactment from both a gift and an estate tax perspective.
- Clients who once again have taxable estates…for now.
- Clients who would like to avoid a gift and the 3-year rule (Internal Revenue Code Section 2035) by selling their policy to a grantor trust ILIT.

ILITs Supported by a Leveraged Technique

Here we include ILITs involved in split-dollar and third-party premium financing arrangements. Split-dollar arrangements run the gamut from pre-final regulation collateral assignment equity plans (yes, there are still many of these out there) to post-final regulations non-equity collateral assignment plans under the economic benefit regime and collateral assignment plans under the loan regime. These plans can involve the client's company/employer as the party advancing the premiums and due repayment or the client as donor in that capacity.

Third-party premium financing arrangements can also involve several variations on the theme. For purposes of this discussion, the arrangements that matter are those that call for annual direct or indirect gifts to the ILIT to service the loan and/or those that will require a large direct or indirect gift to enable the ILIT to repay the loan and keep the policy more or less intact.

Why start here? Three reasons. First, many of those plans and programs of older vintage are in trouble, meaning they have no reasonable prospect of successfully completing their mission without a large direct taxable gift of cash or property or a large indirect gift. An example of an indirect gift would be employer's release for less than full consideration of the collateral assignment in termination of a compensatory split-dollar arrangement. Why are these plans in trouble? The usual suspects include an absence of an exit strategy, failure on the part of the client to follow through on the exit strategy that was planned from the outset and lagging policy performance after years of low interest rates. But the arrangements are where they are! Second, the solution to these problems will call for the input of several types of advisors and maybe the involvement of a client's company or employer and its advisors. The employer's involvement could present issues, especially if the employer is anxious to get out of the split-dollar arrangement now and has no interest whatsoever in the income, gift or estate tax cost to the client of terminating the plan. All this can take a lot of meetings/calls and a lot of time, which is now of the essence. Third, the "You'd better take a serious look at this plan" song has been on the charts for years now. But when one overlays the proposals against the dwindling exit strategies that remain, the tax and economic results to the clients are even more draconian and far-reaching than planners have been warning about for years.

Memo to Clients

Depending on the type of arrangement in place, a memorandum to clients would describe in more or less detail:

- The arrangement, that is, the parties, the tax characteristics of the ILIT, the design/structure of the plan and, based on the most recent illustrations, its current and projected economic and tax implications under current law. If the arrangement is an economic benefit split-dollar plan that covers two individuals, then the projections should include the 1-year term rates after one insured passes away (or at least periodic examples of the differences between the 2-life rates and the single-life rates). This point is a great example of the motivational power of numbers over concepts. The concept that the rates increase when the first insured dies is nowhere near as clear and motivational a message as actually seeing the numbers!
- The impact of potential tax legislation on the arrangement, that is, if the client doesn't do something about this before the date of enactment, here's how the basic elements of the arrangement such as the annual gift of the economic benefit in a split-dollar plan could have seriously negative consequences.
- The steps that the client could consider to alleviate the situation or terminate it altogether on some kind of reasonable basis, as well as the comparative, all-inclusive tax implications of those steps if taken before or after the date of enactment. Depending on the type of arrangement, this might involve additional direct or deferred gifts of cash or property to the ILIT or forgiveness by the party advancing the premiums. It might involve a life settlement. Complicating factors here can include but not be limited to the income and gift tax implications of terminating pre-final regulations collateral assignment equity plans and, in some cases, IRC Section 409A .
- Information and input needed from the insurance professional and other advisors and a request for authority to get it and talk with those advisors. The insurance professional could include recommendations for an exchange of the current policy for one that requires no further premiums.

Existing ILITs Funded by Gifts of Cash and Property

These are obviously less complex situations than those just described. However, they may call for a line of inquiry that's every bit as nuanced as those "sophisticated" situations.

The problem is straightforward but still profound. If made to grantor trust ILITs, those gifts could trigger some element of estate inclusion of the insurance proceeds. Commentators have made the very sensible suggestion that clients buy time by funding these ILITs to the extent they can in 2021 or more specifically now, before the date of enactment. But some clients may not be in a position to do that or may be reluctant to use their exemption. An alternative to gifts is a loan, meaning split-dollar or, as the technique is popularly called, private premium financing. Ah, but there's a rub or two or three.

A memorandum for these situations would describe in more or less detail:

- The arrangement and its present-day tax implications.
- Based on the most recent information/illustrations, how many more years of premium gifts are required.
- Relevant tax characteristics of the ILIT
- The impact of potential legislation on the arrangement, including gift tax implications, potential estate inclusion attributable to post-date of enactment gifts to a grantor trust ILIT, etc.
- Alternatives to consider, including:
    - Large gifts of cash or income-producing property before date of enactment. The gift can pre-fund the ILIT for a certain number of years, but it uses exemption.
    - Private premium financing, whereby the client lends the funds to the ILIT. As long as the loan is at the applicable federal rate (AFR), a well-documented, properly maintained arrangement should be respected for what it purports to be, a split-dollar loan. As long as the ILIT is a grantor trust, there will be no income tax implications to the loan. As a side note, planners could discuss a non-equity collateral assignment plan with clients. However, with interest rates so low now, a loan regime plan is more attractive.
    - So what's the rub? if the ILIT is a grantor trust, there can be no margin for error in case, sometime post-date of enactment, the arrangement doesn't pass muster as a loan and any "delta" is considered a gift with the above-described complications. If the ILIT isn't a grantor trust, then the ILIT will be responsible for the tax on any income-producing property the client transfers to it to enable the ILIT to pay some premiums. In the loan context, if the ILIT isn't a grantor trust, the interest at the AFR whether paid or accrued will be taxable to the client. In either case, what's the endgame with the loan? Assuming the policy won't be able to finance the repayment of the loan for many years if ever, how will the loan be repaid? A big gift later in life? Not if the ILIT is a grantor trust! Forgiveness? No! Uh oh, it's split-dollar deja vu all over again.
- Information, input, illustrations and more that will be needed from the insurance professional and other advisors as well as the authority to get it. As noted above, the insurance professional could include recommendations for an exchange of the current policy for one that requires no further premiums.

It's reasonable to assume that, once clients absorb the above, they'll wonder whether their ILITs have "jumped the shark, that is, the clients don't feel they're needed any more or are just plain tired of the annual rigamarole. Perhaps the ILIT could distribute the policy to the adult children beneficiaries, and they can pay for it (with an occasional contribution from the client). Yes, the protection of the ILIT for the trust beneficiaries, including creditor protection, estate tax exclusion and spendthrift tenancies will be lost but so will the complexity. And the children's stewardship of the policy will be a good test of…whatever.

Hey Look, Our Estate Is Taxable…Again!

There's a significant group of clients for whom estate taxes became irrelevant and/or immaterial after the exemptions doubled a few years ago. Now, however, an "accelerated sunset" will bring a new dawn of estate tax exposure. But will clients care? Any couples in this group who don't have to deal with ILITs crying out for attention before year-end might very well shrug off these latest developments. And why not? Their estate planning documents will still "work." There's no change to the marital deduction, so there will still be no tax when the first spouse passes away. Anyway, they've seen that the estate and gift tax laws have more turnover than a pancake griddle. Before you know it, the exemptions will be back up. So why bother?

However, for others, particularly those who won't have the benefit of the marital deduction, the new law could cause a tectonic shift in their thinking. They may be concerned enough to prepare to move before the date of enactment if that's required. And that move could certainly involve forming and funding new ILITs. It could also involve transferring (or selling) existing life policies to these new ILITs, again before date of enactment. There will obviously be a certain amount of redundancy between the planning discussions with this group and the prior group, as both have to concern themselves with trust design and long-term funding of the ILITs in a decidedly unfriendly transfer tax environment. Planners will probably also explore alternatives to ILITs altogether, such as partnerships.

Some clients will want to use split-dollar or other leveraged techniques to preserve their exemption or use someone else's money to fund their ILITs. So that they prevent the past from being prologue, planners can work with the life insurance professionals to fashion approaches to the plans and the design and funding of the policies so that clients have more control and flexibility to manage the arrangements and reduce their risk than in the past. That should be interesting!

Clients who would like to avoid the 3-year rule by selling their policy to a grantor trust ILIT

This is a common situation that could be even more so in light of the proposal to accelerate the sunset and reduce the gift and estate tax exemptions. Say a client owns a large life insurance policy. They decide that now would be a good time to "do something" to remove the policy from their taxable estate. They could simply transfer the policy to an ILIT as a gift, but as they've been told more than three times, the policy will be pulled back into his estate if they dies within three years of the transfer. Besides, they're reluctant to use more gift tax exemption. Their advisors have suggested, more than three times, that a properly designed sale of the policy to a grantor trust ILIT for full consideration won't be a gift and will avoid the 3-year rule. What's more, the sale won't be a taxable transaction under Revenue Ruling 85-13, nor will it be a transfer for value under IRC Section 101(a). Under the new proposed rule however, a grantor trust ILIT will be considered a third-party, rendering the sale a taxable event and, absent another exception, a transfer for value. This result would obtain only if the sale occurs on or after the date of enactment to a trust created then, which means that there's still time to sell the policy to an existing ILIT or establish a new one before date of enactment and then make the sale.

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Steve Leimberg's Estate Planning Email Newsletter - Archive Message #2909

Date:	**27-Sep-21**
From:	**Steve Leimberg's Estate Planning Newsletter**
Subject:	**Thomas A. Tietz, Martin M. Shenkman, and Jonathan G. Blattmachr: Recission - Considerations and Applications for Planning in 2021**

"On August 10, 2021, the Senate passed by a vote of 69-30 a $1.2 trillion infrastructure package. While this bill still has to go through the reconciliation process and approval of the House of Representatives, this reflects progress being made in Washington D.C. towards the Democratic legislative initiatives and goals that have been pushed by President Biden and his administration. Numerous plans and proposals have been put forward which include various changes to the tax structure that would significantly impact estate planning, and the Senate is currently debating an additional $3.5 trillion reconciliation-based infrastructure and social funding plan. While that blueprint does not include any specifics proposals on tax increases that would be included to pay for the cost of the bill, it is possible that it will include modified versions of several of the tax changes from previous proposals.

While it is impossible to determine exactly what, if any, changes to the tax code will be enacted, many practitioners have urged their clients to plan proactively and avoid a 'wait and see' strategy, due to the chance such a strategy would result in 'wait and pay.' However, with the fact that several of the proposals include enactment dates that are either retroactive (i.e., effective back until January 1, 2021) or on "date of announcement" of a proposal, which could be viewed to have already passed, there is a possibility that the opportunity to plan has already passed.

The amount of uncertainty in planning during this period has necessitated practitioners needing to consider ways to provide clients with the ability to plan under the current estate taxation planning environment, while also including mechanisms in that planning wherein a transaction can be either rescinded or unwound in an attempt to avoid an unfavorable tax result due to legislative changes that may or may not be enacted at a later date. There have been several techniques that have been discussed for *practitioners to consider employing, such as including a disclaimer in trust documents using formula clauses in assignment and transfer documentation, etc. Recission is an additional technique that practitioners might consider including in their toolkit to employ when trying to plan for the level of uncertainty that has to be dealt with for transactions completed before legislation is enacted. Recission may offer a means to unwind a transaction in the current tax year and thereby avoid a possible income tax consequences to a transfer. Because of the proposed retroactive effective date contained in Senator Van Hollen's proposal, recission has received more attention. This newsletter will explore the recission mechanism and raise considerations in its application in the current planning environment."*

Thomas A. Tietz, **Martin M. Shenkman** and **Jonathan G. Blattmachr** provide members with commentary that examines how the doctrine of recission could be used to unwind transactions in the current tax year and thereby avoid a possible adverse income tax consequences. Members will find their commentary most helpful as it contains specimen drafting language.

Martin M. Shenkman, CPA, MBA, PFS, AEP, JD is an attorney in private practice in Fort Lee, New Jersey and New York City who concentrates on estate and closely held business planning, tax planning, and estate administration. He is the author of 42 books and more than 1,200 articles. He is a member of the NAEPC Board of Directors (Emeritus), on the Board of the American Brain Foundation, the American Cancer Society's National Professional Advisor Network and Weill Cornell Medicine Professional Advisory Council.

Thomas Tietz, JD, is an Associate with **Shenkman Law**. He is experienced in assisting with the implementation of all facets of an estate plan, including the preparation of core documents such as the Last Will and Testament, Health Care Proxy, Durable Power of Attorney, to the more advanced techniques of an Irrevocable Life Insurance Trust, Grantor Retained Annuity Trust, self-settled Trusts, and the implementation of asset transfers to those trusts, depending on the client's needs. In addition to Estate Planning, he assists clients with estate administration, including the organization of the documentation and assets of a decedent for tax filings and disbursement, as well as assisting with corporate work, concentrating on the effects to family entities and businesses in relation to estate planning, including assisting with entity documents and complex entity ownership.

Jonathan G. Blattmachr is **Director of Estate Planning** for **Peak Trust Company** (formerly Alaska Trust Company), co-developer of **Wealth Transfer Planning**, a computer system for lawyers, published by Interactive Legal Systems and its Editor-in-Chief, director of Pioneer Wealth Partners, LLC, author or co-author of nine books and over 500 articles, and a retired member of Milbank, LLP, and of the Alaska, California, and New York Bars.

Here is their commentary:

EXECUTIVE SUMMARY:

On August 10, 2021, the Senate passed by a vote of 69-30 a $1.2 trillion infrastructure package.[i] While this bill still has to go through the reconciliation process and approval of the House of Representatives, this reflects progress being made in Washington D.C. towards the Democratic legislative initiatives and goals that have been pushed by President Biden and his administration. Numerous plans and proposals have been put forward[ii] which include various changes to the tax structure that would significantly impact estate planning, and the Senate is currently debating an additional $3.5 trillion reconciliation-based infrastructure and social funding plan.[iii] While that blueprint does not include any specifics proposals on tax increases that would be included to pay for the cost of the bill, it is possible that it will include modified versions of several of the tax changes from previous proposals.[iv]

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COMMENT:

History and Applications of Recission

Recission,[vi] the concept of treating a transaction as void ab initio, may have been first discussed as being used for tax purposes in the United States Court of Appeals decision of Penn v. Robertson,[vii] but it was in 1980 with Rev. Rul. 80-58[viii] that the IRS provided formal steps to be taken to effectuate a recission for income tax purposes, stating that a recission must:

1. Take actions that would end with “*restoring the parties to the relative positions that they would have occupied had no contract been made.*”

2. The actions must be taken within the same tax year in which the transaction initially took place.[ix]

Beyond these two requirements, the Revenue Ruling provides flexibility for how parties could go about completing a recission. For example, one does not need the consent of all involved parties to have an effective recission.[x] However, it should be noted that Penn involved a rescission due to action taken by a third party and Rev. Rul. 80-58 involved a situation where the parties agreed that, if certain events did not occur, the transaction would be rescinded. Nonetheless, private letter rulings (which under Section[xi] 6110(k)(3) cannot be cited or used as precedent) indicates that recissions, in general, will be respected if effected in the same year that the underlying transaction took place.

While the IRS currently has a no-rule policy in place for recission for private letter rulings (PLRs),[xii] before the policy was put in place numerous PLRs were provided that help illustrate the breadth of the application of recission.[xiii] Several of those PLRs include:

1. PLR 200923010 discusses the recission of a distribution of stock from a corporation to its subsidiary. The IRS allowed the recession after going into detail how the recission agreement would bring all entities and parties back to the position they were in before the distributions were made.[xiv]
2. PLR 200533002 included a sale of S-Corporation stock in a manner that without recission would have resulted in the termination of the S-Corporation status. The IRS allowed the recission of the sale and confirmed that the S-Corporation was never lost as the recission actions were taken within the same taxable year as the sale took place.
3. PLR 200911004 permitted the recission of a merger between corporations that would have caused significant adverse tax consequences[xv] and instead have a sale transaction take place between the entities.

The facts of the Rev. Rul. 80-58 included an external event trigger for the recission based upon the obtaining a zoning change and the buyer and seller agreed that a rescission could occur if the change was not obtained. In the Ruling that event was an act by an unrelated third party zoning board: "…if at any time within nine months of the date, of sale, B was unable to have the land rezoned for B's business purposes…" However, the PLRs noted above seem to suggest in some cases the IRS approves of recission simply due to adverse tax consequences for the actions taken.[xvi] Consider whether adverse tax consequences due to a change in tax laws suffice to qualify as grounds for recission? Practitioners should consider cautioning clients that include a recission trigger in documents or are considering a recission of a transaction before the end of the year, that there may be a risk the IRS might argue that a change in the tax law is not equivalent to a zoning change by a third party.

The PLRs help illustrate the flexibility of situations recission has been used in to avoid unfavorable income tax results in the past. How to apply the technique to the unique challenges of 2021 planning is an issue practitioners should consider carefully.

<u>What about the Gift Tax Effects of a Recission Provision in the Document?</u>

One issue to consider is whether a recission provision in a document renders the transfer incomplete for gift tax purposes. Although the most "direct" way to have a transaction ignored for gift tax purposes is by a qualified disclaimer defined in Section 2518, the provision is limited to wealth transfer (e.g., gift and estate) tax purposes, not income tax purposes.

It seems that a unilateral right of a donor to rescind a transfer renders the gift incomplete for gift tax purposes. Treas. Reg. 25.2511-2(b) provides, in part, "a transfer of property (whether in trust or not may be partially complete and partially incomplete, depending upon all the facts in the particular case. *** A gift is … incomplete if and to the extent that a reserved power gives the donor the power [without the consent of an adverse party] to name new beneficiaries or to change the interests of the beneficiaries as between themselves…."

Perhaps, there is “no harm” in providing that the parties can rescind a transaction including for wealth transfer tax purposes, but the provision might render the transfer at the time it is made incomplete. Allowing only one party (e.g., the donor) to rescind the transaction might, therefore, render the gift incomplete. Although it is arguable that the donee would be adverse to that, the fact that the donee agreed to allow the donor to rescind might be held to render the donee non-adverse.

Would providing that the transaction can or is rescinded only if there is (or is not) a particular tax change, e.g., a retroactive application of a deemed realization rule, suffice to deflect an argument that the transfer was incomplete for gift tax purposes? Might such a self-executing mechanism be viewed as outside of the purview of the donor as it is based on actions of Congress not the donor?

Drafting Documents Including Potential Recission Before the End of 2021[xvii]

Rev. Rul. 80-58 included a specific trigger in the sale documents for conditions under which recission would take place.[xviii] While the PLRs discussed above did not all include a trigger in the documentation for the transaction being rescinded, practitioners should consider incorporating these triggers into any future documents for clients that they believe may desire to employ recission if the tax laws are changed before the end of the year.

As another consideration, many practitioners have indicated that they are seeing a significant increase in clients wishing to complete planning before any changes to the law, and the crush of work is likely to increase significantly as year-end approaches. If legislation is passed close to the end of the year, practitioners may not have enough time to complete documentation to implement recission for all of the transactions completed before the end of the year for which clients wish to rescind. However, by including a provision for recission in the documents, practitioners will have the option to include a self-executing automatic trigger in which the transaction is rescinded if, as an example, legislation is passed that causes an adverse tax result to take place due to the transaction. However, having documents prepared ahead of time so they can be "instantly" implemented might be a "safer" approach. For example, if the property owner intends to transfer appreciated assets (by gift or by sale to a grantor trust which under current law would not trigger gain recognition by reason of Rev. Rul. 85-13 but might under legislation adopted later this year), the trust to which the transfer would take place could be transferred could be executed by the trustees and expressly provide that the trust would not be created and irrevocable unless and until the grantor signs. Similarly, the document of transfer (e.g., a stock power for shares of stock or a deed of real property) could be ready for signing by the grantor. If legislation is drafted, is virtually certain to be signed into law by the President and contains an adverse provision (e.g., gain recognition which is retroactive to the date of enactment or an earlier date), the grantor simply would not execute the documents of transfer (e.g., the trust). On the other hand, if transactions pre-dating the date the President signs the law (noting the Senator Sanders bill ["For the 99.5%"] contains provisions that would be effective as of the date of enactment (that is, the date the President signs the measure into law), the grantor could sign the documents the date before.

This, in turn, raises the question of whether the documents could effectively provide that they are revocable if the law does (or does not) contain a provision that would be adverse or not. That should not render the gift incomplete as the donor does not hold the power to rescind—it would automatically occur.

Sample Language. "***Recission of Transaction****. If, during the calendar year in which this Agreement has been signed, legislation is passed in which the Internal Revenue Code is modified which has the effect of causing the [transaction] herein to be considered a recognition event for federal income tax purposes, the Parties agree to take the following actions immediately, and within the same tax year as the Transaction was completed (and if the parties to the transaction have different tax years, the earlier of such years)[xix]: (a) the Note[xx] given by [buyer] to [seller] is thereupon voided, and (b) the assignment and transfer documents [list actual name and date] are deemed void, and (c) any down payment provided by the buyer to the seller [delete for gift] shall be due and payable to the buyer by the seller from the date of the initial transfer bearing* *interest*[xxi] *at the short term applicable federal rate from the date of the initial transfer until repaid in the current tax year. To avoid any doubt, the Parties intend for this provision to effectuate a recission of the Agreement pursuant to Rev. Rul. 80-58, 1980-1 C.B. 181 and agree to take any actions reasonable and necessary to conform the actions taken under this provision if triggered to complete the recission, with the same effect as though the transaction had never occurred.*[xxii]"

Given the potentially incredible work-load that may face practitioners at the end of 2021, why not make the recission provisions self-executing as discussed above to avoid the risk of a client contacting counsel and counsel not having time to complete the transaction?

While ideally all necessary or advisable legal documentation to unwind the transaction should all be completed, it may suffice to rely on the self-executing provisions if the supporting documents cannot be completed in time. If there is sufficient time to complete documentation confirming the recission, practitioners could consider completing the following:

1. Cancellation of any promissory notes.
2. Refund of the down payment, and any documentation prepared to reflect the return of the monies (copy of a check, confirmation of a wire transfer, etc.)
3. Payment of any interest due to the buyer from the seller for the period the down payment was held by the seller. As noted above, some may question whether the payment of interest is consistent with the recission doctrine.
4. Cancellation of the sale contract.
5. Cancellation of any guarantees, escrow agreements, pledge agreements, or other supporting documentation for a sale transaction.
6. Assignment from buyer back to seller of the entity or asset interests involved [effective as of the initial transfer date].

<u>Communicating with Clients</u>

With the significant uncertainty in what, if any, legislation will be enacted before the end of the year, practitioners should consider communicating with any clients that may be contemplating completing transactions before the end of the year. Some of the topics that can be communicated include:

1. There is no guarantee of the effect of any planning that is implemented, including the initial transaction as well as any steps taken to unwind a transaction in the event of adverse tax legislation that would affect the transaction.
2. Provide clients with options for both the kinds of transactions they can complete, as well as options for techniques they can use to unwind a transaction if needed. Appraising a client of the risks inherent in the options that they choose can assist a client with making an informed decision about what they want to do, as well as potentially protect a practitioner if planning does not achieve the results a client desired.
3. Discuss any issues or concerns each of the options provided may have in their implementation. For example, regarding recission if an automatic trigger is used as discussed above, then the transaction would be voided even if the tax changes result in a minor tax cost the client may have otherwise been comfortable bearing in order to have the transaction completed. However, if a client chooses not to have an automatic trigger, then they would have a risk of being unable to complete recission in time to meet the end of the taxable year deadline.
4. Inform clients of the potential of retroactive tax legislation, or other implementation dates such as date of announcement, which could mean that the potential for planning has already passed. Helping clients understand the uncertainty and flux that planning is in at this time will help set their expectations as we get closer to the end of the year.
5. As more information is received from Washington and any proposals include more definitive outlines of potential changes as the year moves on, communicate the effect those proposals may have on any planning they have in process or any planning they have been contemplating.

While the amount of work that may be available over the next several months is an opportunity for practitioners, it also has the risk of clients committing to planning for which they may not understand the risks and issues with. Clear communication by the practitioner may help protect that practitioner from clients who have remorse over planning they have completed, or chosen to unwind, or did not have the opportunity to unwind through the end of the year.

<u>Conclusion</u>

Clients may have opportunities to take advantage of the current tax laws before any changes are implemented. Recission is one component of the toolkit practitioners can present to clients for achieving goals in this uncertain environment.

While the volume of work that this could present is an opportunity, practitioners should be cautious to communicate to clients the options that they have, the risks with those various options, as well as options such as recission that they may have to unwind any transactions completed if the tax laws change in an unfavorable manner.

HOPE THIS HELPS YOU HELP OTHERS MAKE A *POSITIVE* DIFFERENCE!

Tom Tietz

Martin Shenkman

Jonathan Blattmachr

CITE AS:

CITATIONS:

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[i] For more information on the infrastructure package passed by the Senate, see https://www.cnn.com/2021/08/10/politics/bipartisan-plan-infrastructure-vote-congress/index.html

[ii] Senator Sanders (I. VT)proposed the "For the 99.5 Percent" Act, Senator Van Hollen (D. MD) and others proposed the Sensible Taxation and Equity Promotion (STEP) Act, President Biden's administration provided several proposals in the General Explanation of the Administration's Fiscal Year 2022 Revenue Proposals, among other proposals.

[iii] A blueprint plan for the Bill was passed on August 11, 2021. See https://www.nytimes.com/2021/08/11/us/politics/senate-budget-plan.html

[iv] For an initial analysis of some of the changes that may affect estate planning, See, e.g., Jonathan G. Blattmachr & Carlyn S. McCaffrey, “The Estate Planning Tsunami of 2020,” 47 Estate Planning 3, 10 (November 2020); Al W. King, Charlie Ratner, Richard Harris & Martin Shenkman, “President Biden's Budget Includes Big Tax Increases - What You Can Consider for Your Clients Now.”

[v] https://www.vanhollen.senate.gov/news/press-releases/van-hollen-leads-colleagues-in-announcing-new-legislation-to-close-the-stepped-up-basis-loophole .

[vi] For an in-depth review of recission as it is applied to the tax world, see “Rescission Doctrine Provides Opportunity for Tax Do-Overs” by Timothy J. McCormally, J.D., Washington, published on June 1, 2015, accessed on https://www.thetaxadviser.com/issues/2015/jun/tax-clinic-05.html.This reference and author description needs to be cleaned up.

[vii] Penn v. Robertson, 115 F.2d 167 (4th Cir. 1940).

[viii] Rev. Rul. 80-58; 1980-1 C.B. 181; 1980 IRB LEXIS 502.

[ix] Rev. Rul. 80-58 states “*the annual accounting period principle requires the determination of income at the close of the taxable year without regard to subsequent events*.”

[x] Specifically, Rev. Rul. 80-58 comments “*A rescission may be effected by mutual agreement of the parties, by one of the parties declaring a rescission of the contract without the consent of the other if sufficient grounds exist, or by applying to the court for a decree of rescission.*”

[xi] Throughout this article, “Section” refers to a section of the Internal Revenue Code of 1986, as amended.

[xii] Rev. Proc. 2012-3 (Section 5.02) initially started the no-rule policy, which was affirmed in Rev. Proc. 2014-3 and reaffirmed Rev. Proc. 2015-3. But not subsequent years?

[xiii] While a PLR is not considered binding on the IRS for anyone other than the taxpayer requesting the PLR and cannot be used as precedence (Section 6110(k)(3)), they can be used to understand the viewpoint of the IRS and practices to consider when considering using recission.

[xiv] In the representations, point 2, there was significant discussion of how exactly the parties would be brought back to their initial positions: “*Controlled has not paid any consideration other than the distributed shares of Controlled to Shareholder in connection with the distribution and Shareholder has not made any capital contribution to Controlled since the distribution. No such consideration will be paid by Controlled, and no such capital contribution will be made prior to the rescission. Therefore, no transactions between Shareholder and Controlled, as shareholder and direct subsidiary respectively, other than the distribution itself, will need to be reversed in order to effect the rescission.*”

[xv] As it is indicated in the PLR: “*Sometime in the next few months, Acquiring discovered that the merger of Target into Acquiring could yield adverse tax consequences that potentially could be devastating to the viability of Acquiring as an ongoing entity. After learning of these consequences, Acquiring, Target, and certain shareholders of Target undertook steps to rescind the merger and effect a taxable sale of the Target common stock to Acquiring*.”

[xvi] PLR 200911004. However, note that the adverse tax consequences were significant enough to endanger the continued existence of the merged entity as a business.

[xvii] The authors are simply providing recommendations for practitioners to consider and are not arguing for steps to be considered as best practices when using recission.

[xviii] The ruling included the following information on the language incorporated into the contract: "*The contract of sale obligated. A, at the request of B, to accept reconveyance of the land from B if at any time within nine months of the date, of sale, B was unable to have the land rezoned for 5's business purposes.*"

[xix] Note that a tax year may occur before the end of what would be the normal end of a taxpayer's tax year, such as in the event of death of an individual.

[xx]This section needs tailoring for the specific transaction that is contemplated for the recission provision. If there are transaction documents other than a promissory note (or in lieu of a note), they should be referenced in the provision.

[xxi] Practitioners should consider whether the payment of interest is consistent with the recission doctrine, and if they wish to have any provisions they include in transaction documents require the payment of interest.

[xxii] Evaluate the possibility of someone (e.g., a creditor) attaching a lien or judgment to the property transferred before the recission takes place.

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JUNE 1, 2021

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Introduction

One of the most common recurring tasks that estate planners regularly undertake is to advise family businesses on succession planning for the next generation of owners and leaders, which should include an honest consideration of whether the family should keep or sell the business. Obviously, the subject of family business succession planning is very broad, and entire books have been written about only certain aspects of family business succession planning.

Given the modest size of this monograph, it obviously isn’t intended to be a comprehensive treatment of the subject. However, don’t take its brevity for a lack of thorough and incisive treatment, because that would be a mistake. The aim for this monograph is to discuss important, selected topics that bear upon the subject of family business succession planning, with a bent toward the practical, all based upon my over 30 years of experience dealing with family business succession planning issues.

The topics for discussion in this monograph on family business succession planning include:

- Strengths and weaknesses of family businesses.
- The all-important keep or sell discussion.
- The 39 critical questions that a business family must answer.
- Aligning the family values with the values of the family-owned business.
- Critical points in time for frank, honest and open family conversations.
- Identifying, grooming and selecting leadership succession candidates for the family business.
- The importance and use of outside advisors and directors for the family business.
- The all-important leadership transition process.
- The employment rules of the road-do all family members have a right to work for the business?
- What about the efficacy or desirability of requiring a minimum period of work experience outside of the family business?
- The tension and importance of non-family member key employees.
- The balancing act-keeping the peace between family members who work for the family business and family members who don't.

Importance and Impact of Family Businesses

According to one study, family firms comprise 80% to 90% of all business enterprises in North America.[1] International Family Owned Businesses contribute 64% of the GDP or $5,907 billion ($5+ trillion) and employ 62% of the U.S. workforce.[2] The very oldest family-owned business in the world is Japanese temple-builder Kongo Gumi, which was founded in 578, now in its 40th generation.[3]

Advantages

As discussed in the previous section, family businesses are ubiquitous in the world. The advantages of family businesses include:

- ***Flexibility.*** Usually more nimble than businesses owned by unrelated persons, family businesses often can more quickly adapt to changes in the marketplace than comparable concerns that are owned by unrelated parties because family control, usually exercised by one person, allows for quick adaptive change compared to businesses owned by non-family members.
- ***Shared culture.*** Unlike non-family run businesses, the family aspects of a shared culture contribute to greater congruity and a lower

possibility of cultural clashes than businesses that include owners with different cultural backgrounds and traditions.

- ***Long-term relationships.*** Obviously, participants in a family business first have relationships with each other as family before becoming colleagues in the family business. Now, that family members have relationships that predate involvement in the family business also face challenges as the business relationship gets factored into the calculus.
- ***Fewer leadership changes and greater stability.*** While the average tenure of a CEO of a family business is 13 years, the average tenure of a CEO of a business not owned or controlled by a family is but five years.[4] The more opportunities for leadership changes, the greater the likelihood of picking the wrong successor leader. Of course, this advantage can also be a disadvantage for the family business, particularly if the leader is stubborn and fails to agree to adapt the company's business to changing times or circumstances.
- ***Availability of affordable and controllable labor.*** One thing that families often have is the availability of affordable and controllable labor, principally in the form of children, who could be put to work at

very young ages and worked harder and for longer hours at lower wages than the law would have permitted for an unrelated employee.

- ***Pride and shared commitment.*** Most business families take great pride in their family businesses. This pride often spurs on greater and more committed effort from a business family than businesses owned by unrelated owners. Often, a business family will remain committed to the family business long after many unrelated business owners would have thrown in the towel.
- ***Long-term commitment.*** Given the existence of the family relationships that predate the ultimate business relationships, family businesses usually enjoy a much longer term commitment to the family business than a business that isn't family owned and operated.
- ***Cost reduction.*** The most expensive operations cost for a business often is its labor costs. Because of the significant flexibility advantage that family businesses enjoy relative to labor costs, it is usually less costly to operate a family business than a similar business owned by unrelated owners.

Disadvantages

However, all that is glittery is not golden; family businesses have a number of disadvantages relative to similar businesses owned by unrelated owners. Disadvantages of family businesses include:

Complexities caused by overlapping roles and conflicting relationships. One frequent stumbling block for family businesses is confusion and tension created by the multiplicity of relationships that family member employees have with each other in both family and business roles, particularly as those roles change or evolve.

Greater likelihood of poor communication due to emotionality. While the enhanced experience in communication among business family members starts before joining the family business as an employee, the multiplicity of roles and potentiality for emotional conflict often is much higher in family businesses when compared to similar copies that aren’t family owned or run. It really depends upon the unique dynamics of the business family.

The absence or ineffectiveness of healthy boundaries between the family as a unit and the family business. It's often said that the potential for conflict is greatest when the business family either hasn't established or doesn't consistently maintain healthy boundaries. One surefire sign of a boundary problem is the fight that occurs during afamily holiday get together. Lacking the family history, businesses that aren't family owned and run usually enjoy a significant advantage here.

Overemployment Risk. If a family has more available family members who want to be employed by the family business than the family business can safely financially employ, this can endanger the very continuing existence of the family business. Family business leaders must be very careful to assess the labor needs of the family business and make tough calls on employment of family members. Nevertheless, these decisions are easier to make for non-family business leaders.

Miscast roles. Unfortunately, family history bias about family members has a far greater chance of putting family members in the wrong roles in a family business than a business owned by non-family members.

Poor choices of succession leaders. Too often, family bias causes family business leaders to make poor or less than optimal selections of future leaders for the family business. A frequently seen example is where the founder of the family business selects the wrong successor, often the oldest male child, to be the next leader of the family business instead of a more qualified child. Businesses that aren't family owned tend to make more rational and better decisions on future leaders of the business.

Death taxes and other legal restrictions. Restrictions imposed by state and federal law often negatively impact and impede family-owned businesses disproportionately than the effect on non-family owned businesses.

The All-Important Keep-or-Sell Discussion

I view a frank and honest keep-or-sell discussion involving the entire family as **perhaps the most important conversation** that too few families in business ever have. Why is that? I view such a discussion as a means of gauging the family members' individual and collective interests in continuing to be in business together. However, it's a loaded question that can open up some family wounds, so caution is in order.

Done correctly, the discussion can reinvigorate a business family's overt commitment to the business in its current form. Unfortunately, lots can go wrong and can hasten or cause loss of the family business and family relationships because the keep or sell discussion can get very emotional and bring out hidden or suppressed feelings that have been harbored in silence and allowed to simmer past the boiling point upon their invitation to the surface.

Often, things go wrong because the estate planner lacks the requisite skill and objectivity. It is imperative for the estate planner to be very circumspect regarding his objectivity. Like it or not, while the estate planner may well view himself as representing the entire family. Indeed, many estate planners labor under the assumption that they do objectively represent all family members. Unfortunately, they may well be fairly perceived as "Dad's lawyer," and actually perceived as an obstacle to improvement of the family business. Indeed, it's not unusual for a family member to view the estate planner as not being part of the family business advice team going forward due to their taint.

An abject failure to consider this perception about them has caused or exacerbated angst and difficulty in a family business. Simply put, the purposeful estate planner must tread very lightly here. Unfortunately, too many estate planners fail to heed this important admonition and possess an exaggerated view of their abilities and ability to be a good influence over the family business succession planning process.

Additionally, the estate planner must admit and acknowledge his own selfish motives in the succession planning process and must not permit his selfish desires and intentions (and those of his firm) to continue or even expand the estate planner's business in representing the business family. Unfortunately, it's been my sad experience that this mistake occurs with frightening and needless regularity.

Therefore, bringing about such a discussion requires some keen skill and awareness on the part of the estate planner, including honestly facing his own limitations in realizing that the estate planner might not be the right person to facilitate or indeed even suggest such a discussion about keep-or-sell.

For starters, and this is particularly true when the business founder is still alive, the generations simply often misunderstand each other and make misguided assumptions about the wants and requirements of the other because they've never had proper and healthy communication. Often, there is no actual consensus. The business can muddle on for decades without true resolution of this important issue.

The founder usually is much more emotionally invested in the family business and often is as proud of having younger family generations working for the company as he is of founding a successful business. However, unless the founder is careful not to force children into the family business, initially often as a result of cheap available labor, unspoken conversations on the keep-or-sell decision can and have been the undoing of many a successful family business.

Often, if the junior generations are not interested or competent to run the business, the family's wealth situation is much better off if the family business is sold while the founder is still alive, in large part because the founder's skill and counsel often is desired by the buyer for a period of time. In my experience, if the business is not sold during the founder's lifetime, the family usually suffers a substantial reduction in the price received, particularly where the family lacks a clear management succession team, when the family waits to sell after the founder's death.

This can be a particularly acute problem if the children were forced or pressured to begin working in the business at a very young age due to need for cheap labor and were sent usually subliminal messages both consciously and subconsciously that they were rightfully expected to participate in the family business, i.e., the family's business and its status as a family first and foremost were fused, i.e., one in the same.

Children who are forced into the family business without being given options or having their feelings heard and acknowledged concerning choice of place of employment often resort to acting out in sideways unproductive responses, including doing a poor job, being a disruptive force in the family business operations and even drug and alcohol abuse.

The failure to recognize a healthy boundary between the nuclear family and the family's business also is problematic because all acts contrary to the forced enthusiastic involvement in the family business often are perceived as disloyal to the nuclear family, which is unfair and just plain misguided and dangerous.

The emotional, economic and control imbalance between parents and a young child usually results in the child not only gong along with the decisions of the parents about participating in the family's business, even where the child doesn't want to work for the family business, for fear of being viewed as disloyal and shunned and rejected by the family, but she is forced to give up her own dreams and aspirations about life and often deeply resents this, which can have lifelong adverse ramifications both for the child and the business family.

The longer that the child feels powerless about being forced to work for the family business and stays there against his will, the greater the likelihood that the child is negatively impacted emotionally, psychologically and physically. It frequently leads to sudden disruptions and/or departures, often from both the family as well as the family business, particularly after the founder's death, as death releases the fetters holding the child in the family and the family business.

The problem that I experienced a few times as an estate planner is being thrown into the maelstrom that erupts after having simmered beneath the surface with little evidence of its existence, where the tension and conflict goes from zero to 100 mph almost instantaneously. Too often, the estate planner will be overwhelmed and powerless to deal with what is now a large open emotional wound that is the source of legal and financial problems caused thereby.

The key to trying to be ready is to maintain a healthy skepticism about the emotional condition of the family and the participants in the family business. But what is an estate planner to do? There aren't any easy or clear cut answers. Trying to facilitate the conversation without proper consideration of the volatility of the situation is potentially very dangerous. However, so is attempting to introduce another advisor into the mix.

All I can share is a method that I frequently employed in working with business families. It comes from a dear departed mentor of mine, the late Gerry LeVan, who was a very well known estate planning lawyer and law professor who totally transformed himself into a non-lawyer family business consultant. Gerry's story that got him to that point came from requests from two of his very best family business clients, who asked for his assistance in teaching the owner's children how to get along in the family business.

After carefully considering the legal ethics laws and other limitations that come from being a lawyer, Gerry reluctantly but bravely and I think wisely concluded that he couldn't help them as a lawyer, so he shed his lawyer's mantle.

For starters, I very rarely attempted to facilitate a discussion of family business succession planning by the business family myself. However, I also usually didn't resort to a knee-jerk referral to a family business consultant, at least not immediately.

It takes lots of patience and an ability to determine exactly the right time to introduce the business family to Gerry LeVan's 39 critical questions that he concluded that business families must face and answer in order to be successful in business succession planning.

Introduction to the 39 Critical Questions

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It's important to note that, before we review those questions, not all families will have every issue that the questions raise. In fact, in my experience, very few if any families indeed had all of these issues. Nevertheless, I presented them to my family business clients as but one of many available self-help tools that could assist the business family in helping to understand where they were and what problems were potentially in their pathway to success.

The important thing to note is that the list may present issues that the family might not be presently facing but that might be encountered in the future. I never curated or paired down the list of questions because I thought that they were well conceived. I was concerned any deletion or modification could itself be harmful to the process. I was introducing the tool as is and was one that came from a source who I deeply respected. By way of full disclosure, Gerry asked me for my input on the manuscript of his book.

With all of this as a predicate, let's consider the 39 critical questions that business families should consider. The book went through several iterations and was self-published for many years before culminating in the book that Gerry published with Routledge back in 1998. I was asked for and gave input to all of these prior iterations too.

The 39 Critical Questions

I begin with Gerry's instructions to business families before beginning to answer the 39 critical questions. Because they're of critical importance, I quote them verbatim:

- *Read each question carefully. Determine how important each question is to the survival of your family business.*
- *If the answer to that question is* ***critical*** *to the future of your family business—if your family must answer that question to get on with its future—write a "2" in the space to the left of the question.*
- *If the answer to the question is not critical, but still* ***important*** *to the future of your business, write a "1" in the space to the left.*
- *If the answer to the question is* ***irrelevant****—or if your family has already answered that question, put a "0" in the space to the left.*
- *Are we committed to the future of our family business?*

  Are we obligated to work there indefinitely, or may we pursue other careers?

- *Do we want to own the business or should it be sold?*
- *How do we decide which family members will be employed by the company?*
- *Must we offer every family member a job?*
- *Should in-laws or other relatives be invited to work in the business?*
- *What education or work preparation should be required of family members who work in the business?*
- *How do we assign titles and work responsibility?*
- *How should we evaluate and pay family members who work in the business?*
- *What should we do if a family member doesn't perform or leaves the business?*
- *How do we select the next leader of the company?*
- *When do we decide who will be the next leader of the company?*
- *When and how should leadership transition take place?*
- *How do we evaluate our new leader's job performance?*
- *How do we provide meaningful careers for other family members who are not chosen to lead?*

- *Who should serve on our board of directors? Family members? Employees? Our outside advisors? Others?*
- *How should our board of directors function?*
- *What should we expect of our directors?*
- *Who should own stock in the business?*
- *Should all children own equally, whether or not they work in the business?*
- *What dividends or perquisites (perks) should shareholders receive?*
- *How do we balance the of inside family shareholders (who work in the business) with the interests of outside family members (who don't work in the business)?*
- *What do we do if a family member wants to sell out?*
- *How do we deal with family disagreements? (Between individuals? Between members of the same or different generations)?*
- *How do we teach in-laws and younger family members about the values and tradition s of our business and our family?*
- *Who will lead family activities in the next generation?*
- *How do we help family members who are in financial distress?*
- *What other responsibilities do we have to other family members?*
- *What do we do if there is a divorce in the family?*

- *What if a family member breaks the law or is seriously irresponsible?*
- *How do we support family members in their own business ventures?*
- *How do we protect the contributions or unrelated, key employees?*
- *To what extent do we involve key employees in family disagreements?*
- *What obligations do we have to prized employees?*
- *Should key employees own stock in our family business?*
- *How do we treat loyal employees whose productivity or value to the company has declined?*
- *What are our responsibilities to the community?*
- *How do we cope with our public image and the public's expectations of us?*
- *Might one key employee be the next leader of our business?*

I don't think that I ever took individual family business members through the questions individually, or at least I don't specifically ever recall doing so. In my employment of the 39 critical questions, it was always homework to be done on their own.

Even though the family members answered the questions on their own without further guidance from me, I found that they tended to answer the questions in one of two general ways. First, some families answered the questions collectively as a family. While other families supplied separate answers from each family member. If the family members each answer the questionnaire separately, it is critically important to ascertain significant differences in the answers to specific questions as it often pointed out a potential trouble spot, i.e., where family members fundamentally disagreed over whether getting an answer to a particular question was critical to the family business. In my experience, it was not unusual for there to be two or three such potential trouble spots.

After I had the opportunity to review the answers, my next course of action often was to engage a family business consultant for input on a confidential basis for suggestions and guidance on next steps. I estimate that in over half of the cases, I eventually convinced the family to bring in a family business consultant.

Aligning the family values with the values of the family-owned business

In the most functional family businesses that I worked with, the values of the family, e.g., love, industriousness, flexibility, duty, patience and tolerance, were also the values of the family business.

However, it was not unusual to find some disparity and lack of alignment between the family's personal values and those of the family business.

In my opinion, where there is non-alignment in the values area, the family business and the business family have some work to do.

Critical points in time for frank, honest and open family conversations

In addition to the keep-or-sell discussion, other critical points in time for genuine conversations amongst the members of the business family include:

- Selection of a new leader for the family business.
- A death of a key family member, e.g., founder, etc. Gerry frequently referred to the spouse or partner of the founder as the "chief emotional officer," and I certainly include such a person in this category due to the sheer moral authority that he or he wielded.
- Changes in the hiring practices for family members.
- Changes in practices regarding the hiring of spouses of family members.

Identifying, grooming and selecting leadership succession candidates for the family business

This can be a very challenging problem for a family business, particularly if the founder has rigid and unwavering ideas about who should succeed him.

Too often, the ancient concept of primogeniture controlled the result here, i.e., the mantle was going to be passed to the oldest male heir.

I frequently found that the oldest male heir wasn't the best candidate to replace the founder. In fact, it was commonplace to find that the oldest male heir knows that he's not the best suited for the job and doesn't really want the job.

The task of bringing a recalcitrant founder to realization that he or she has better qualified heirs than his oldest male heir can be very challenging and fraught with problems, and caution is advised.

Frequently, use of independent third-party consultants who specialize in these matters can help, although caution is in order here to ensure that the proper predicate be laid with the founder first to get buy-in from the founder.

The importance and use of outside advisors and directors for the family business

I have always felt that even the most differentiated and enlightened family businesses were well served by having dome regular access to independent directors and/or advisors who weren't members of the family.

Yet, in my experience, few family businesses are quick to commit to involving outside persons as directors or advisors, often not seeing the benefits and believing that the family business's outside professional advisors served that purpose.

The limitations of the outside professional advisors include conflicts of interest, divided loyalties and lacking the business knowledge of an outside independent director or advisor.

My best advice is to start slowly here, i.e., with the creation of a family business advisory council that wouldn't have any authority or, often just as important, legal liability., before broaching the subject of bringing independent people onto the entity governing boards. Don't be shy to consider encouraging the business family to join and to be active in family business programs sponsored by higher education institutions and leadership professional groups such as Young Presidents Organization (YPO), which focus on best practices, but which also often familiarize the family members who participate in such programs with the art and benefits of consulting peers in unrelated businesses.

The all-important leadership transition process

Just because all is copacetic within the business family on the issue of who will be selected as the new leader of the family business doesn’’t mean that it will be smooth sailing when the power transition occurs because this unfortunately often is not the case.

Changes in leaders bring about sea change in the area of shifts in power and relationships that need to be carefully monitored.

This is where an estate planner can be of significant value to the new leader of the family business, who often will be transitioning into the new position and who often can benefit from your advice while the new leader grows into their new position.

The employment rules of the road-do all family members have a right to work for the business?

At the beginning of a family business, the business's needs for labor may well dictate that all family members work for the family business.

However, as the family business matures and extends into the next or a succeeding generation, it may well be that the sheer size of the family members as possible employees outstrips the economics of the family business, i.e., the family business simply can't afford to hire each and every family member who desires to be employed by the family business.

It's at this point that tempers can flare, often over decisions to hire this family member but not that one. Watch the motivations here.

What about the efficacy or desirability of requiring a minimum period of work experience outside of the family business?

This issue I usually only encountered in family businesses that were well into the second or beyond generations of family ownership.

It often arises as the family has experienced either a realization that it's slavish adherence to hiring family members who never worked elsewhere was stagnating the business.

However, this issue can be used, as I've personally witnessed on a couple of occasions, as a tool to avoid having to hire a family member who was about to finish school and be eligible for employment by the family business, so caution is in order.

All in all, I favor family businesses requiring a family member to work elsewhere first for a specified period of time to learn how it is to work without the safety net of being in the family that owned the business. Such a practice can benefit the family business greatly through the circumspection and maturity that being a naked entry level employee in someone else's business and allow them to bring fresh ideas and perspectives to the family business that they would've never gained without working elsewhere first.

In my experience, the outside work experience requirement should be a relatively short period of time that shouldn't be for longer than five years. Of course, if the family business needs the family member's immediate employment, then that need usually prevails.

The tension and importance of non-family member key employees

Many family businesses employ people in key positions who aren't formal members of the nuclear family. Don't ever underestimate or fail to carefully consider the importance of these employees in the succession planning process, particularly if their continuing assistance is important to the success of a transfer of control from one leader to the next.

Quite often, these employees are motivated by intense or unconditional loyalty to the founder.

It's not unusual for these employees to have no contractual protections with respect to their role in the family business, which means that they're exposed to immediate termination as mere at-will employees.

I found it usually of vital importance to both give them some employment protection but also to keep them in the employment of the family business through golden handcuffs contracts where they're incentivized to stay, particularly through a leadership transition process because I frequently found that they were of critical importance to the new leader, and often where the new leader either didn't value their importance or where the new leader was still not quite ready for the full brunt of leadership responsibility. I encountered several situations where the departure of a key non-family employee had a significant adverse impact on the family business going forward. Quite frequently, the new leader needs that employee, even where the new leader doesn't quite see themselves as needing the unrelated key employee.

The balancing act-keeping the peace between family members who work for the family business and family members who don't

In the first words of the title of this slide, I perhaps foreshadowed the answer to this thorny issue that has dogged and bedeviled many a business family and has torn apart many business families and their family businesses.

In my opinion, the answer is **balance**. In this case, verifiable balance often helps to solve the problem, which has at its roots, the concepts of fundamental justice and fairness. But what does that look like in successful business families?

For starters, when the ownership of a family business becomes held in any substantial part, i.e., 15-20%, by family members who aren't involved as employees of the family business, the business family is at an important and dangerous crossroads, particularly where the only people receiving monetary benefits from the family business are employees in the traditionally understood sense of the term.

In the beginning, compensation decisions, rightly or wrongly, usually were made by the founder.

Oftentimes, the income tax laws greatly influenced compensation decisions, particularly how it was paid. The tax advisors usually advised the family to accept payment as employees rather than as returns on investment, i.e., dividends, because compensation generally is tax-deductible to the business entity, while dividends aren't, despite being fully taxed to the recipients. The practice of paying monetary compensation to employed family members has two important tax-enforced limitations. First, compensation paid must be **reasonable** because the IRS will audit and adjust entity compensation deductions that are unreasonably high or, if the family buainess entity is an S corporation, unreasonably low, which avoids self-employment taxes.

The second limitation is that the family member being paid must be performing valuable services for the family business. Many family businesses have tried to pay certain family members to not work, sometimes by choice and sometimes by demand, but have failed when the practice comes to the attention of the taxing authorities. Additionally, payment of compensation to family members who aren't working for the compensation can be rightly perceived as manifestly unfair at one end and can constitute enabling in the worst case where the family member has alcohol or substance abuse problems.

This practice of only paying deductible compensation to family members who are actively employed by the company often is very difficult to revisit or to change, because the change, i.e., paying non-deductible dividends to family owners, comes with a not insignificant price tag in the form of increased income taxes, and this increase can be significant, even exorbitant. When most family business leaders receive the potential price tag for beginning to pay dividends, they seriously push back and usually attempt to derail or delay its going into effect.

Often, the family members who are employed attempt to browbeat those family members who don't work for the family business as employees into submission by attempting to force them out or by pointing out that their demands are undercut by the fact that they are being adequately compensated through the yearly increases to the value of their ownership interests in the family business entity. Then when the non-employee family members aren't persuaded by their logic, they often become incredulous and sometimes begin subtle and sometimes not-so-subtle threats to form a competing business that will cut the non-employee family members out altogether. This is a wholly unproductive and ill-advised practice, yet it's still not unusual.

Sometimes, the family business tax advisors can forestall a family war by suggesting that the family business entity, traditionally a C corporation for income tax purposes, to an S corporation. Unfortunately, many family businesses can't use the S election as a viable solution, either because the family business entity is not a C corporation for income tax purposes, but because the entity is already a flow-through entity for income tax purposes. Additionally, operation as an S corporation is much more rigid from the standpoint of the complex income tax rules of S corporations.

So that leaves many business families on the horns of a real dilemma: stay as is and run the risk of a disruptive family feud that could spill over into litigations and all of the costs associated with it, or should the business family bite the bullet and consider paying dividends to ensure peace in the valley.

However significant the tax increase may be, many business families, particularly the employed family members, fail to fully appreciate the perceived unfairness or injustice of the practice of only monetarily compensating employed family members until the tension reaches the boiling point or indeed past it. The problem often must become acute before it is ever really addressed. Irrespective of where you sit on this issue, the simple truth is that a perceived injustice or unfairness is an actual injustice or unfairness to those adversely affected by it. If buying out the interests of the non-employed family members is not feasible or even possible, then the business family usually Hs no choice but to address the problem.

What follows are some thoughts I have that come out of my experience guiding business families for over 30 years.

First, in order to address perceived problems with the level of the employed family member's monetary compensation for services rendered, I almost always recommended giving the non-employed family members, who usually represent a minority of the outstanding ownership interests, a voice in the process. By voice, I mean just that. Make the discussions about the level of compensation of family member employees open and transparent. I'm reminded of another bit of timeless wisdom by Gerry LeVan, to which I always subscribe. In matters of the level of necessary disclosure of family business financial information and decisions, start with the rigid rules of the Securities and Exchange Commission (SEC), and then disclose more.

This advice often is met with groans and disbelief. However, failure to acknowledge where trust is insufficient or indeed absent and proceeding unilaterally is almost always shortsided as the non-employee family members usually unleash the parade of horribles in their heads and often go off half-cocked and engage in unnecessary or even harmful behavior based upon assumptions that may fly in the face of reality.

Initially, the controlling family member employees significantly push back on that advice and continue to act imperiously and in private. In my experience, this usually is very problematic and results in significant disruption and even litigation. How does one fashion a solution that will appease (but probably not fully satisfy) all concerned?

For me, the answer often was employment of an independent compensation consultant, who could examine the tasks and duties of a family business owner employee and give some market-based parameters for compensation type and amount. While, as I noted, this usually is not fully satisfactory to anyone, the use of an independent consultant can give the usually distrustful and suspicious non-employee family business owners some protection and confidence. My recommendation is that the results be examined regularly, with an effective shelf life of no longer than two years, in order to prevent the conclusions from becoming stale, which puts you back at square one.

Sometimes, families suggest giving ownership of associated property used by the business that is owned by a separate entity, which the family members who are employed recommend be owned in substantial part by the non-employee family business owners. While this theoretically can work and simultaneously solve the income tax issues as rent generally is deductible, it's rarely a workable solution for several reasons. First, all it arguably does is expand the battlefield issues to include the amount of proper rent to be paid to the property-owning entity.

In my experience, for this to have any chance of success, the rent level must be fair market value and probably must be determined by an independent real estate consultant at additional expense to the operating entity.

Any such rent levels must be carefully monitored and adjusted with regularity. In my opinion, the rent level should be revisited at a maximum of every two years, because market forces can and do intervene to disrupt the results. I find it particularly inadvisable where the subject property, often real estate, is a single-use property, e.g., automobile dealership real estate, that could sit vacant or on the market for a very long time if the family entity no longer operates the business using that property, which would leave the family members who own interests in that entity at an often-significant disadvantage.

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[1] J.H. Astrachan and M.C. Shanker, "Family Businesses' Contribution to the U.S. Economy: A Closer Look," Family Business Review, September 2003.
[2] Id.
[3] https://griequity.com/resources/industryandissues/familybusiness/oldestinworld.html (accessed May 22, 2021)
[4] Josh Baron and Rob Lachenauer, Harvard Business Review Family Business Handbook (BanyanGlobal Family Business Advisors 2021), p. 11.

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A Comparison of Planning Tools for Disabled Individuals –

Special Needs Trusts: *Individual v. Pooled & First-Party v. Third-Party*

and The ABLE 529A Savings Account

By Karen Dunivan Konvicka, J.D.

Planning for those with disabilities has multiple purposes from maintaining eligibility for public benefits to financial management and oversight for the beneficiary. The traditional special needs or supplemental needs trust funded with a family member's or third party's assets is the oldest and most utilized tool for estate planners, but the landscape changed in the 1990s when an individual was allowed to establish and fund his or her own special needs trust with his or her money. More recently, a new tool has been created through the Internal Revenue Code to mimic the 529 College Savings Plan that allows families and disabled individuals to save in a similar fashion as their college bound peers without jeopardizing public benefits. This article will address the utility and limitations of each.

Third Party Special or Supplemental Needs Trusts

Third party special needs trusts are those trusts funded with the assets of a third party and that limit the trustee's authority to make distributions for the beneficiary's support and maintenance or for any purpose that would jeopardize public benefits. The typical stated purpose is to provide for the beneficiary's special or supplemental needs after taking into consideration the support provided to the beneficiary through government programs. The beneficiary cannot be the trustee and cannot have the authority to revoke or terminate the trust or direct distributions for his or her support and maintenance. See *POMS SI 1120.200 D.1.b.* Individual third party special needs trusts are administered by a trustee that may be an individual or a corporate fiduciary. The trust assets are invested and held specifically for that beneficiary with its own Taxpayer Identification Number and correlating responsibility to file a Form 1041 reporting the income thereon. Third party special needs trusts are typically "complex trusts" or "qualified disability trusts" which causes income to be taxable at the trust level unless it is "carried out" to the beneficiary. Income carried out to the beneficiary is reported to the beneficiary on a Schedule K-1. Individual third party special needs trusts can be testamentary in nature or created under an inter vivos trust agreement by a specific grantor. They are funded with lifetime gifts, estate or trust assets, qualified plans and insurance policies.

In contrast, pooled third party special needs trusts are administered by a nonprofit organization serving disabled individuals. The assets are pooled together for investment purposes with each beneficiary having an individual account within the pool. The nature of the investments allows

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pooled trusts to have lower fees and accept smaller account sizes than corporate fiduciaries would. Pooled trusts operate pursuant to one master trust agreement and the accounts for each beneficiary are created by executing a joinder agreement which is the contract "joining" the beneficiary with the pool. The account is funded by a lifetime gift, specific bequest or devise from an estate or trust, qualified plan or insurance policy. The pooled account would be designated as the beneficiary of an estate, trust, insurance policy or qualified plans. No additional trust need be created as a part of the estate plan. The trust administrator of the pooled trust is tasked with filing a Form 1041 for the entire pool and they are also typically taxed as complex trusts. The individual beneficiaries would receive a Schedule K-1 for any income carried out to the beneficiary. The joinder agreement, much like the trust document for individual trusts, specifies the remainder beneficiaries at the death of the disabled individual as well as any specific instructions to the trust administrator. When considering pooled trust options, the remainder policy must be reviewed carefully. Some pooled trusts retain the remainder at the death of the disabled individual to support its charitable purposes. Some do not and some retain a percentage. While choosing a pooled third party special needs trust is an excellent option, the remainder distinction can have enormous impact for families.

First Party Special Needs Trusts

For the first time, after the passing of the Omnibus Budget Reconciliation Act of 1993 (OBRA '93) a disabled individual was empowered to create a special needs trust and fund it with his or her own money. The new statute specifically exempted trusts that complied with the statute from being counted as a resource for public benefits purposes. *See 42 U.S.C. §1396(d)(4)(A) and (C).* Section (d)(4)(A) created the individual special needs trust, and Section (d)(4)(C) created the pooled special needs trust.[1] The statute requires that these trusts be established by the disabled individual, a parent, grandparent, guardian, or the court; and, to the extent there are assets left in the trust at the beneficiary's death, they must be used to repay the states up to the amount paid by the state agency for medical assistance provided to the beneficiary. All first party special needs trusts must be irrevocable and in the event of an early termination, Medicaid must first be repaid prior to distribution. But, "(d)(4)(A)" individual trusts and "(d)(4)(C)" pooled trusts have some differences too. The obvious difference is that individual trusts are invested and managed individually by a trusted family member, professional or corporate fiduciary. Pooled trusts, by contrast, pool the beneficiaries' assets together for investment purposes, giving each beneficiary a sub-account within the pool that reflects the balance of that account. In addition, pooled trusts must be administered by a non-profit organization and the statute allows the non-profit organization to retain the remainder for its charitable purposes without Medicaid repayment to the states.[2] Much like the previous

[1] Section (d)(4)(B) created the Income-Only Trust or Miller Trust, but it is only applicable in some states and is outside the scope of this article.

[2] Presumably, this is why third party pooled trusts have adopted this practice as well

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discussion of third party remainder policies, the remainder policies vary significantly from one first party pooled trust to the next. Layered onto the disparate remainder policies are disparate state statutes that dictate to the non-profit organizations the amounts or percentages that may be retained if not repaying Medicaid in full. The master trust agreement should describe a pooled trusts' remainder policy. Because of the Medicaid repayment requirement, no first party trust, whether individual or pooled, for a Medicaid recipient can pay for funeral expenses prior to making the repayment. It is vitally important that these expenses be paid through a pre-need arrangement prior to death.

The ABLE 529A Saving Plan[3]

After the passing of the Stephen Beck, Jr. Achieving a Better Life Experience Act of 2014, practitioners can now add the ABLE 529A Savings Plan as a third planning option for the disabled population. *See 26 U.S.C. §529A.* This plan was modeled after the 529 College Savings Plan but is utilized for disabled individuals who had the onset of a disability prior to the age of 26. The income in the account and certain expenses withdrawn from the account are not taxable and in some states an income tax deduction can be taken by the person funding the account. This tax advantaged plan has restrictions however, some of which mirror the 529 Plan. The maximum annual contribution, tied to the annual gift tax exclusion, is currently $15,000. The disabled individual may contribute a limited amount of wages earned under the ABLE to Work Act as well. An individual may only have one ABLE account and most states have imposed limits on the maximum account value. The first $100,000 is disregarded for means-tested public benefits. The value over $100,000 will be counted as a resource for Supplemental Security purposes, but it will not affect Medicaid eligibility. Just as the 529 Plan has allowable educational expenses that can be withdrawn without tax consequences, the 529A Plan has allowable "Qualified Disability Expenses" that can be paid from the account without tax consequences ***and*** without consequence to the person's public benefit eligibility. The account must be set up by the disabled individual, a parent, legal guardian or person holding power of attorney for the disabled individual. The costs associated with the ABLE account are much less than even a pooled special needs trust and the accounts can be funded by the disabled individual and any third party (including a trust). Bear in mind that funding an ABLE account with third party assets, while economical from a fee standpoint, most likely subjects those funds to Medicaid repayment whereas funding a third party pooled account or creating a third party trust would not. The IRC statute[4] requires that ABLE accounts repay Medicaid for medical assistance, but unlike the first party special needs trust, the repayment is only for the time period during which the ABLE account existed, and in several states the Medicaid agencies are

[3]Additional information on the ABLE 529A Plan can be found on the website for the National ABLE Resource Center (https://www.ablenrc.org/).

[4] 26 U.S.C. §529A(f)

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prohibited from seeking repayment at all unless required by federal mandate. In addition, the ABLE account can be used to pay funeral and burial costs prior to Medicaid repayment. Because of the autonomy the account offers to the disabled individual and the fact that some expenses can be paid from an ABLE account that cannot be paid from a trust,[5] there can be significant interplay between the two for qualifying beneficiaries.

These five options: individual third-party special needs trusts, third party pooled special needs trusts, stand alone first party special needs trusts, first party pooled special needs trusts and the ABLE account all have advantages and critical points to consider. In many cases, there is a need for more than one of these tools to adequately protect the disabled individual and meet the needs of the third party planning for a loved one.

About the Author

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[5] SSI recipients cannot receive third party assistance with food or shelter expenses; however, shelter expenses are qualified disability expenses under the ABLE act.

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House Estate Tax Proposal Requires Immediate Action

Martin Shenkman
Contributor Retirement *I write about charitable giving and estate planning ideas.*
https://www.forbes.com/sites/martinshenkman/2021/09/16/house-estate-tax-proposal-requires-immediate-action/?sh=148d18f53077

Recent Proposal

The House Democrats are proposing a $3.5 trillion spending plan. To support that package the Democrats have proposed tax increases to fund a large portion of that plan. The House Ways and Means Committee just issued statutory language for the tax increase proposal. While the tax legislative process will no doubt evolve with many twists and turns, these proposals might well be the blueprint for any final legislation. The implications of this are quite simple. Taxpayers who might be affected need to plan and take action now. If you've been sitting on the tax planning fence waiting to see what will be enacted, this proposal suggests you jump off the fence and plan with haste. This article will explain some of the "why" and "how." Keep in mind, there remains incredible uncertainty, but inaction might prove the costliest option for some.

Overview of What the House Proposal Does and Doesn't Include

This article will focus on estate planning changes, and actions you should consider with your advisory team now. But, some discussion of income tax changes is necessary as many of the income tax changes will have an impact on your estate tax planning. As expected, individual and corporate income tax rates will increase. What might be unexpected is the many different ways that taxes will be increased. The manner in which some of these changes are applied to trusts, the foundation of much of estate planning, is particularly harsh. Taxpayers contemplating immediate transfers to trusts for estate tax purposes, must also consider these income tax rules. Restrictions will affect retirement accounts as well.

Capital gains rates will be increased, but not as bad as being taxed at ordinary income rates.

From an estate tax perspective, the exemption will be cut in half, grantor trusts which have been the cornerstone of estate planning will be dramatically restricted, and valuation discounts which have been the elixir for many estate plans will be restricted.

Noticeably absent from the proposal are a host of changes that had been discussed. This includes the so-called "deemed realization" rules that would trigger capital gains tax gifts of appreciated assets, on death, or the transfer of assets from certain trusts. The adjustment of tax basis on death remains part of the law although many had anticipated its elimination. Thus, heirs who inherit appreciated assets will have that appreciation added to the tax basis so that a later sale will still not trigger gain (so long as there is no appreciation from date of death until the date of sale). That had been identified as a major loophole benefiting the wealthy, but it was not addressed. Some of the restrictions on dynastic trusts that had been included in the Sanders plan seem absent. But before wealthy taxpayers feel relief, consider that this proposal must wind its way through the Senate and any of these more restrictive changes could be added there. Easing the restrictions on deducting state and local taxes that had been introduced in the 2017 tax legislation was not included.

Effective Dates

When the proposals become effective is critical to determining if you have time to plan before the law changes, and how much time that might be. While many changes apply to tax years beginning after December 31, 2021, i.e., for most provisions they are to become effective in 2022, this is not true for all changes. 2022 is a common effective date for many provisions but caution is in order. There are significant provisions in the House proposal that have earlier effective dates. The discussions following will identify the proposed effective date of many provisions and explain the possible implications of those effective dates for planning. The bottom line for many planning steps is that you should act immediately and urgently. Uncertainly remains. Some critically important provisions to estate planning are pegged to become effective on the date of enactment. But when might that be?

Increased IRS Funding

The house proposal would appropriate nearly $80 billion to the IRS to improve taxpayer compliance with tax laws. The CBO estimates this would make the IRS's 2031 budget 90% larger than its current baseline projection and would double staffing. The CBO estimates 75% of this additional funding would be allocated to enforcement. This is estimated to increase revenue by $200 billion over 10-years. That means lots more audits, more comprehensive audits, and perhaps audits that are broader in scope looking at personal, entity, trust and gift tax returns in a holistic manner that might help examiners identify issues that are less apparent when only a single return is audited. Some have speculated that under current IRS funding only about 1-2% of gift tax returns are audited. That percentage could jump if this change is enacted. For those taxpayers who have been on the aggressive side relying on low audit rates to slip under the IRS scrutiny, it will be a new world.

Caregiver Expenses New Credit

There are several provisions in the House proposal that are helpful to taxpayers, and in particular to lower income taxpayers. This is one such example and this income tax credit could have important estate and related planning implications for lower income aging taxpayers. A tax credit will be provided, up to $4,000, for 50% of qualified expenses incurred caring for relatives living at home unable to perform the activates of daily living. This tax benefit will be phased-out if the taxpayer's income exceeds $75,000. Thus, for lower income taxpayers this will take the edge of care costs for those living with chronic illness, other health issues and the challenges of aging.

Increase in Individual Income Tax Rates

The highest or "marginal" individual income tax rate increases to 39.6%. This rate would apply to married individuals filing joint tax returns with taxable income over $450,000, and to unmarried taxpayers with taxable income over $400,000. For many of the proposed changes the $400-$450,000 level of income is the demarcation of what is considered in the proposal to be high income and thus subject to higher tax changes, not only this change in rates. While this change will no doubt raise revenue this increase in rates alone may not trigger significant planning. Although, if you were to contemplate a Roth conversion it would be advantageous to do so before this rate increase becomes effective. But this higher income tax rate is even more significant when taken together with all the other tax increases on the wealthy discussed below. The many changes overall will be substantial for many taxpayers. For example, see the 3% surtax, increase in net investment income taxes, reduction in 199A deduction, etc.

This increase in income tax rates, as well as other income tax rate changes discussed below, have critical importance to estate planning. The highest rate applies to estates and trusts with taxable income over $12,500. That is a tiny fraction of the income level at which the highest rates apply to individuals, e.g., the family members who may be beneficiaries of an irrevocable trust. For estates and trusts in 2021 it may be worth accelerating income while rates are lower. For so-called complex or non-grantor trusts that pay their own income tax (e.g., a credit shelter trust funded on the death of a spouse) distributions may carry out income to the beneficiary and thus be taxed at a lower rate. So, the benefits of a possibly lower tax rate should be weighed against the provision of funds outright to a beneficiary (is the beneficiary responsible?) and the inclusion of those funds in the beneficiary's estate if the distributed funds are not spent. Consider the implications of this to an accumulation trust created post-Secure Act. The Secure Act changed the rules applicable to retirement plans effectively eliminating the stretch-IRA. As a result, some taxpayers made funds payable to trusts to protect the beneficiaries of their plan assets. However, if all plan assets are distributed at the end of the 10th year following your death (as the plan holder) those funds are more likely to hit the new highest rate (and see the surtax discussion below).

This change applies to tax years beginning after December 31, 2021.

Sec. 138201 changing Sec. l(j)(2).

Tax Surcharge on High Income Individuals, Trusts, and Estates

A further increase in marginal income tax rates applies to certain high income taxpayers. Perhaps the idea was to make it appear, for political optics, that the maximum tax rate is only 39.6% as discussed above, when in fact the actual rate is 42.6%. This new provision imposes an additional tax of 3% of a taxpayer's modified adjusted gross income (“MAGI”) in excess of $5 million for married taxpayers filing joint returns. This provision is just another example as to the greater increase in tax rates for high income taxpayers beyond the 39.6% rate noted above.

The MAGI figure for trusts and estates is $100,000. This will thus, at a relatively low income level, subject trust income to a very high 42.6% tax rate. State and local taxes (and other changes in the House proposal) may make that effective tax rate even higher. Consider the impact of this in light of retirement assets paid to trusts. The Secure Act, as noted above, may have resulted in some plan holders changing beneficiaries to trusts because of the elimination of the stretch IRA. The Secure Act requires the payout of the full plan balance at the end of the 10th year following the death of the plan holder. That will for many plans result in a very high tax rate of 42.6% on those plan balances. If the funds were instead distributed to a beneficiary, the marginal tax bracket might be only 22% or about half. That is a tremendous difference and will require careful consideration of naming trusts as beneficiaries. That creates a particularly nettlesome dilemma for you if you want the protection a trust can provide for a beneficiary but don’t want to incur potentially a doubled income tax rate.

This increase applies to tax years beginning after December 31, 2021. This suggests for high income taxpayers realizing income in the current year before this additional change may be worthwhile. Income earned this year will be taxed at 35% instead of 42.6%.

Modifications to AGI include a reduction for investment interest.

Sec. 138206 adding new Sec. 1A.

Increase in Capital Gains Rate

The Biden administration had proposed taxing capital gains at ordinary income rates for those taxpayers with adjusted gross income of $1 million or more. That would have meant a tax rate of 39.6%. So, while the House proposal would increase capital gains rates, the change is not as costly as that initially proposed. Capital gains rate will be increased from 20% to 25%. This results in a 25% increase from the prior rate.

This change applies to taxable years ending after the date of introduction of this Act. The current capital gains tax rate of 20% will apply to gains prior to the date of introduction. It may also apply to sales that occur at a later date but based on a legally binding contractual arrangement that was in existence before the date of introduction. So, if you contracted to sell your business in March 2021 and it closes in November 2021, that should be subject to a 20% rate. But final legislative language (if this change is enacted) should be reviewed to confirm how this transition rule actually applies. What is the date of introduction? That is not the date of enactment. Could that potentially mean September 13, 2021, when the House Ways and Means Committee released their proposals? This is an important example of an effective date prior to 2022. But this effective date possibly means you can no longer trigger capital gains at the favorable old rate. So, continued planning for lower capital gains rates may no longer be possible.

Sec. 138202 changing Sec. l(h)(l)(D).

Net Investment Income Tax ("NIIT") Applies to Trade or Business Income

The NIIT tax had applied a 3.8% additional tax on certain investment income. The House proposal will substantial expanded this NIIT tax to apply to all business income for taxpayers with more than $500,000 of income on a joint return, $400,000 for a single individual. The NIIT tax is not assessed on earnings already subject to FICA tax.

The purpose of this change is to end a planning technique that many business owners had used. For example, a physician organized her practice as a S corporation. She earned profits of $1 million. She took $200,000 out as a salary subject to FICA tax and the remaining $800,000 she withdrew as S corporation distributions and avoided FICA Tax. Now, the $600,000 of profits over $400,000 will be subject to the 3.8% NIIT tax. Thus, the 3.8% tax will apply to distributions from S corporations, LLCs, and partnerships. This will eliminate the planning approach used by many of paying distributions from the pass through entity in lieu of higher salary. This change will eliminate the benefit that using an S corporation structure provided for some. So, some taxpayers may reassess the legal structure of their business entities if these changes are enacted. Since S corporations require special provisions in trust instruments (as only certain types of trusts are allowed to hold S corporation stock) those special provisions may no longer be necessary.

If there are buy sell agreements, valuations for buy out or other purposes, they may all have to be reassessed. For example, if the physician in the above example had a buyout agreement with her partner, she may have a formula for the buyout price pegged to profits. But if salary is now increased because there is no longer a benefit to making distributions instead of paying compensation, that formula may be affected. Addressing this will be important for estate planning purposes.

The change is to apply to tax years after December 31, 2021. This might suggest to some that the planning illustrated above remains viable until year end. While that may be the case, such planning is not assured as the IRS may still challenge the above on the basis of the taxpayer/owner not being paid sufficient or "reasonable" compensation.

Sec. 138203 changing Sec. 1411.

Section 199A Deduction of Qualified Business Income Restricted

This provision, enacted as part of the 2017 tax act (the Tax Cut and Jobs Act), provided a deduction of 20% of income for qualifying business income ("QBI"). That specifically excluded income earned by specified businesses such as law, medicine and others. There has been a perception that this provision provided a significant benefit to many high income business owners so that the proposal restricts that. The maximum deduction that will be permitted will be $500,000 for those filing a joint (married) income tax return and $400,000 for single taxpayers. Notably, for trusts and estates the maximum deduction is set at a mere $10,000.

This will substantially limit 199A deductions for wealthy taxpayers. The figure for trusts is incredibly harsh and will effectively eliminate the benefit for trust owned real estate and other trust owned qualifying business interests. Now you have to consider what happens when evaluating gifts to trusts of real estate rental or other business interests that would qualify for 199A deduction for qualified business income as those interests will now be subject to the severe $10,000 limitation.

This change will apply to tax years beginning after December 31, 2021.

Sec. 138204 modifying Sec. 199A.

Restrictions on Use of Business Losses

Under current law the tax code limits pass-through business net losses which can offset non-business income to $250,000 (or $500,000 for married taxpayers filing joint returns). This change, if enacted, will permanently disallow net business deductions in excess of business income for non-corporate taxpayers. You will still be able to carry losses that are disallowed to the next tax year. Thus, you will no longer be able to offset losses on one business by other losses/gains on another business.

This change will apply to tax years beginning after December 31, 2021.

Sec. 138205 amending Sec. 461(1)

Contribution Limit for Individual Retirement Plans of High-Income Taxpayers with Large Account Balances.

If your retirement plan balances exceed $10 million, and your income exceeds $450,000 (married filing jointly) you will be restricted on making contributions to regular IRAs, Roth IRAs and defined contribution plans. Also, if you have such large account balances you will be required to withdraw from your plans pursuant to new minimum distribution rules.

Sec. 138301 and 138302.

New Prohibited Investments for Retirement Plans

The House proposal would prohibit an IRA from holding investments which are only offered to accredited investors (i.e., nonregistered securities). This is intended to prohibit investments that taxpayers have used to accumulate huge sums in their retirement accounts. IRAs holding such assets after the effective date would be deemed to be distributed. A 2-year transition period is provided.

The effective date would be after the end of 2021.

IRA Self-Dealing

Under current law, an IRA cannot invest in a business entity in which the IRA owner holds a 50% or greater interest. The House proposal will reduce this threshold to 10% for investments which are not tradable on an established securities market.

Reduction in Unified Credit

The amount of wealth that can presently be transferred without any gift, estate or generation skipping transfer tax is $11.7 million. The 2017 tax act had doubled the Basic Exclusion Amount (exemption or unified credit) and GST exemption from 2018-2025 from $5 million to $10 million, inflation adjusted from 2011. The Sanders proposal had provided for a $1 million gift tax exemption and a $3.5 million exemption for estate and GST tax purposes. The House proposal accelerates the 2026 reduction to 2022 and reduces the amount to $5 million inflation adjusted which might be about $6.2 million in 2022.

This House proposal thus terminates the temporary increase in the unified credit enacted as part of the 2017 tax act. That reduction was scheduled to occur in 2026 even if no change was made. Thus, it appears that the House

Democrats may have believe that this had better optics in terms of passage than the harsher Sanders proposal as, after all, this is the eventual exemption that was provided for under the President Trump 2017 law.

Taxpayers should act immediately to endeavor to use exemption before it declines by half. For example, if a single taxpayer makes a gift of $5 million to an irrevocable trust now, and the exemption declines to $6.2 million next year, they will have done nothing to salvage any of the exemption that will be lost. So, for some wealthy taxpayers that have not yet used their exemption, planning might entail on an urgent basis (not just before end of year) using as much exemption as is appropriate. “Appropriate” requires considering of your budget and cash flow needs, sources of income and other cash inflows and the nature of the trusts. If you create a self-settled trust in a state that permits such trusts (there are now 19) that means you are a discretionary beneficiary of the trust. That might make it feasible for you to gift more assets to a trust now. Be certain to evaluate the additional risks that a self-settled trust might add to your planning, especially if you live in a state that does not permit such trusts. There are also other variations of trust planning (e.g., hybrid-DAPT, special power of appointment trust, etc.) that you might consider. Married taxpayers could create a trust of which their spouse is a beneficiary, so-called spousal lifetime access trust (“SLAT”). If you create such a trust, then you might indirectly benefit from distributions made to your spouse. But SLATs are not an assured solution to every issue. Divorce or premature death could shut off your access to such a trust creating financial issues for you. So, the decision is complicated and requires consideration for most taxpayers of several factors. As discussed below, this may be the last opportunity to create traditional SLATs as post enactment, only spousal lifetime access non-grantor trusts (“SLANTs”) may be feasible. Those will involve additional complications.

However, the effective date of this will be critical to the potential for any additional planning to succeed. This provision is effective January 1, 2022. However, other critical provisions to estate planning, such as the rules affecting grantor trusts discussed below, are effective the date of enactment. That means that for most planning that taxpayers will desire to pursue, the real effective date is not year-end, but date of enactment, which remains unknown.

Sec. 138207 modifying Sec. 2010(c)(3) and 2631(c).

Valuation Reduction for Certain Real Property Used in Farming or Other Businesses

This is one of the few taxpayer friendly provisions and it comes out of the continuing perception that family farms particularly deserve special protection from the impact of the estate tax. How many farms might really benefit may be much less than most people would expect, but this continues to have political clout.

The tax laws presently provide for special valuation rules for real property used in farms and certain other qualifying business endeavors. These rules permit you to value farm property based on its current use as farming property. This is an exception from the general rule that property has to be valued at its highest and best use. So, for example, if you have farm property but the farm could be redeveloped into a subdivision for houses which would be much more valuable, the lower farming value can be used. A drawback to this provision had been that the maximum reduction was $750,000. The new law will increase this to $11,700,000.

This may be a significant benefit to family farms and businesses. If there are no capital gains taxes on death (as noted above deemed realization has not been included in the House proposal but there is no assurance that it might not be added in the Senate), and if the step-up in income tax basis on death remains part of the law, it might make sense to evaluate what should be done with farm and qualifying business real estate. This provision might make it advantageous to retain such real property in the estate rather than use the current temporary exemption before it declines. Further, if the farming or other business owning qualifying property presently qualifies for the 199A 20% deduction for qualified business income and contributing it to a trust to use exemption would subject that business to a maximum $10,000 199A deduction. Retaining that business, or at least the real property component, in the estate may provide in some instances a better tax result.

Sec. 138208 modifying Sec. 2032A.

Restrictions on Grantor Trusts

A “grantor” trust is a trust which, for income tax purposes, the income is taxed to the settlor or person creating the trust. Under current law taxpayers can have their trust tax cake and eat it too. You can have a trust which is taxed to you for income tax purposes, and which thus provides you a host of planning benefits. Yet, that same trust can be outside of your estate when you die and thus provide significant estate tax planning benefits as well. The new rule provides that any grantor trust that is created on or after the date of enactment will be included in your estate. For grantor trusts that were created before the date of enactment they may avoid estate tax inclusion by being subject to current law (“grandfathered”). However, if you make a gift to a grandfathered grantor trust a portion of that trust will then be included in your estate.

One particularly valuable planning use of grantor trusts was for a wealthy taxpayer to create a grantor trust and then sell assets to that trust. No gain would be recognized for income tax purposes because a grantor trust was ignored for income tax purposes. This permitted tremendous wealth shifts outside of the taxpayer's estate. For example, if you have a family business that was valued at $10 million you could restructure the business into voting and non-voting interests and sell 99% non-voting interests to the trust for a note. The non-voting interests would be valued under current law at a discount for valuation purposes as they were a non-controlling equity interest. So, the value of the interest might be $6.5 million. That business interest could then grow in the grantor trust outside your estate shifting even further wealth outside the tax system. This type of planning was specifically targeted with several changes. First, if you sell assets to a grantor trust after the date of enactment income tax will be triggered. That would eliminate the use of this technique if the assets involved have appreciated. In many cases, taxpayers will not be willing to incur a current income tax, especially at the new higher capital gains and surtax rates, to shift wealth outside their estate. Note that the combination of all of these income tax increases could make the income tax cost on a sale of appreciated assets higher than the current estate tax rate. Secondly, if there is a valuation challenge by the IRS and the IRS proves that the value of the asset sold to the trust was higher than you anticipated, that would trigger an additional gift to the trust and estate inclusion. Finally, as discussed in the provision below, discounts might be reduced thereby reducing the leverage achievable on such a sale transaction.

Grantor retained annuity trusts ("GRATs") are not expressly mentioned in the House proposals but seem to be eliminated by the above changes. First, any new grantor trust created after the date of enactment will be fully included in the taxpayer's estate. Thus, if you create a GRAT to leverage wealth out of your estate after enactment of the new legislation, the entirety of the GRAT will be included in your estate if you die during the GRAT term. Under current law only a portion of the GRAT assets will assuredly be included in your estate (determined by dividing the GRAT annuity payment by the mandated federal interest rate under Sec. 7520 in the year of death). Also, distributions from grantor trusts during your life as the deemed owner of the trust for income tax purposes are taxable gifts. Finally, the assets of a grantor trust are deemed to be a gift if the grantor trust income tax status is "turned off" (e.g., by your relinquishing the right to substitute trust assets). Thus, it appears that the GRAT technique will be gone. What does that mean now? It means that this may be the last opportunity to complete GRATs if they will benefit your planning. If you have not used all of your exemption an outright gift to an irrevocable trust before enactment of the new law might be better planning to safeguard your exemption. If you have used all of your exemption, then GRATs might provide a valuable technique to leverage additional wealth out of your estate without triggering current gift tax costs (since GRATs can be "zeroed out" with no current gift value). You might consider a different type of GRAT if their demise is imminent. Perhaps a ladder of GRATs (e.g., a 4, 6, 8 and 12 year GRAT instead of the traditional 2-year GRAT) might be advantageous to lock in the GRAT technique and current historically low interest rates.

Qualified personal residence trusts ("QPRTs") special trusts intended to hold houses appear also to be eliminated post enactment for the same reasons that GRATs appear to be eliminated. It would seem that if the intent is to eliminate

GRATs and QPRTs that might be more expressly addressed in any final legislation.

Qualified Subchapter S Trust ("QSSTs") have income taxed to the beneficiary. Will these trusts if created post-enactment be included in the beneficiary's estate?

These changes apply to grantor trusts created after the date of enactment and to gifts made to grantor trusts after the date of enactment. This effective date has critical implications to current planning. If you want to use some of your remaining temporary gift and GST exemption in many perhaps most cases making gifts to a grantor trust may be your better option. If you make gifts to heirs outright those gifts will be exposed to the heirs creditors, divorce and irresponsibility. You can make gifts to benefit the same people in the protective structure of a trust. Thus, the real deadline for using exemption is not the end of the year, but rather date of enactment.

Sec. 138209 adding new Sec. 2901 and new Sec. 1062.

Grantor Trust Changes Impact on Life Insurance Planning

One of the most common irrevocable trusts used in estate planning has been the irrevocable life insurance trust ("ILIT"). These will be undermined by the House proposal if enacted as most traditional ILITs have been structured to be grantor trusts. For new ILITs that will not be feasible as it will assure inclusion in your estate. Instead, new ILITs may have to be structured as non-grantor trusts to avoid estate inclusion. That, however, will present a raft of problems. First, that will require that the trust expressly prohibit trust income being used to pay for life insurance premiums on your life as the settlor of the trust. Second, for existing grandfathered trusts no new gifts should be made to the

ILIT or a portion of the trust assets (i.e., insurance proceeds) will also be included in your estate. Thus, future premium needs will have to be addressed with loans to the trust. That will also raise other issues, such as whether the IRS will respect the transactions as loans. A series of examples will illustrate some of these points in context of the House proposal.

Taxpayer is a single working mom with five young children. She is young, not particularly wealthy, and in great health. Taxpayer purchases a $5 million 20-year term life insurance policy to make certain each of her five children are well provided for if she dies before they reach adulthood. Under current law, if Taxpayer dies no estate tax will be due unless her other non-insurance assets exceed $6.7 million (since the exemption, the amount you can bequeath without tax, is $11.7 million). If the House tax proposal is enacted before Taxpayer dies, that could reduce the exemption to $5 million inflation adjusted to $6.2 million. Then a substantial portion of the life insurance the Taxpayer hopes will protect her children could be consumed by federal estate taxes.

The simple answer for the Taxpayer in the above example is to create a trust to own her life insurance policy. Properly done, under current law, that could avoid all estate taxes on the proceeds. That type of trust is the ILIT discussed above. But does she really need to divert her attention now to create a trust for her insurance now? Yes. The House proposal would make the grantor trust changes effective date of enactment. That would have costly adverse consequences for a working parent trying to protect their children or anyone else wishing to engage in insurance planning post enactment.

Taxpayer has a life insurance policy in her name and wishes to transfer it to an ILIT to remove it from her taxable estate. If she gifts the policy to a trust, it will still be included in her estate if she dies within three years of the gift. However, if instead she sells the policy to the ILIT, the insurance proceeds will be outside her taxable estate even if she dies the next day.

But the House proposals would prevent this post enactment in many cases. A taxpayer can sell a life insurance policy that may otherwise generate gain to a grantor trust. But post enactment that will be pointless as assets of a new grantor trust will be included in the Taxpayer's estate. If instead the new ILIT is structured as a non-grantor trust it may be excluded from the Taxpayer's estate, but the sale of a policy to a non-grantor trust may trigger gain.

Valuation Rules for Nonbusiness Assets

Under current law you might transfer a marketable securities portfolio into a family limited partnership ("FLP") or a family limited liability company ("LLC") and then gift or sale non-controlling fractional interests to various trusts. When that is done the value of the non-controlling entity interest might be reduced by 15-35% or more depending on the facts, type of assets, and opinion of the qualified appraiser. That discount has been a common component of estate tax minimization planning. The IRS has long sought to restrict the use of discounts, especially on non-business assets, and Congress appears to be on board. There clearly was concern that valuation discounts in the context of cash and marketable securities, while supported by valuation theory, may not be an appropriate component of the estate tax system. The House proposal provides that there will not be any valuation discount permitted for transfer of non-business assets. Non-business assets include passive assets held for the production of income such as cash, marketable securities, triple net leased real estate and other assets not used in the active conduct of a business. Several of these terms raise definitional issues as to what is included, or not. At what point does real estate become characterized as a passive investment asset versus an active business? How does one demarcate working capital necessary to the operation of an active business versus an investment portfolio merely held in the entity solution? To minimize planning machinations these new rules on valuation discount restrictions include look-through rules that requires treating an entity as owning pro-rata the underlying asset of an entity in which it owns a 10% or greater interest.

This will eliminate the use of FLPs and LLCS for discounting marketable securities and perhaps other assets. For taxpayers who may benefit from discount planning that will be eliminated or restricted, planning should proceed on an urgent basis. As discussed for several provisions above, if the assets involved will be transferred not to heirs outright but to grantor trusts, those transfers should be completed before the date on which the new law is enacted.

Sec. 138210 modifying Sec. 2031.

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Martin Shenkman

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I am an estate planning attorney, author of 42 books, and more than 1,200 articles. I serve on the editorial boards of Trusts & Estates Magazine, CCH (Wolters Kluwer)

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Steve Leimberg's Estate Planning Email Newsletter - Archive Message #2916

Date:	**20-Oct-21**
From:	**Steve Leimberg's Estate Planning Newsletter**
Subject:	**Keith Schiller: Proposal To Eliminate Discounts for Passive Real Estate Owned by Entities Is Plain Nuts**

"Once again, tax practitioners give their attention to how clients should react to a tax proposal rather than whether that tax proposal, or key elements of it, should exist in the first place.

The House Ways and Means Committee proposal to eliminate valuation discounts with passive real estate owned by an entity eliminates valuation adjustments that were established under fundamental valuation principles, causes partial ownership in which discounts are respected when owned among co-owners to be lost once those co-owners place title in the name of an entity (corporation, LLC or partnership) and will throw into havoc the reference included in most buy-sell and other ownership agreements to fair market value as the standard for determining the payment between the buyer and seller.

We get it. Treasury and the Democrats do not like valuation discounts. After all, they worry about cash and publicly traded securities that do not receive discounts when owned directly yet do indirectly when held in an entity. Partial ownership valuation of real estate, on the other hand, applies fractional interest discounts under basic/non-tax valuation principles. The tax law has merely adopted the non-tax valuation principle. With the Democrat proposal, those discounts will be lost once the co-ownership is transferred to an entity."

Keith Schiller has authored a host of **LISI** newsletters respecting federal estate and gift tax law and the preparation of the Form 706, and returns with commentary that examines the House Ways and Means Committee proposal to eliminate valuation discounts with passive real estate owned by an entity. Keith Schiller, Esq., shareholder of the **Schiller Law Group**, a PLC, of Alamo California, has more than 46 years of experience with taxation, and estate and business succession planning. Keith works with clients, teaches and consults on estate planning, tax compliance, business succession and trust administration. Keith has contributed over two dozen newsletter for LISI. Keith is the author of the award-winning book, Art of the Estate Tax Return — Estate Planning At The Movies® ("706 Art").[i] The book reveals Keith's best practice pointers, his insights from co-teaching with the IRS for greater than thirteen years, and practical recommendations from over a dozen leading practitioners across the country who contributed to the book.

Here is Keith's commentary:

EXECUTIVE SUMMARY:

Once again, tax practitioners give their attention to how clients should react to a tax proposal rather than whether that tax proposal, or key elements of it, should exist in the first place.

The House Ways and Means Committee proposal to eliminate valuation discounts with passive real estate is owned by an entity eliminates valuation adjustments that established under fundamental valuation principles, causes partial ownership in which discounts are respected when owned among co-owners to be lost once those co-owners place title in the name of an entity (corporation, LLC or partnership) and will throw into havoc the reference included in most buy-sell and other ownership agreements to fair market value as the standard for determining the payment between the buyer and seller.

We get it. Treasury and the Democrats do not like valuation discounts. After all, they worry about cash and publicly traded securities that do not receive discounts when owned directly yet do indirectly when held in an entity. (The proposal allows discounts for any passive asset reasonably required for working capital needs of a trade or business.) Partial ownership valuation of real estate, on the other hand, applies fractional interest discounts under basic/non-tax valuation principles. The tax law has merely adopted the non-tax valuation principle. With the Democrat proposal, those discounts will be lost once the co-ownership is transferred to an entity.

Consider this simple example, four people co-own passive real estate worth $4 million total. They have a buy-sell agreement in which transactions of partial interests are at fair market value of the partial interest. Assume that a 25% fractional interest is worth $800,000 after a 20% discount. That very common result is respected under IRC Sec. 2703 since it is based on fair market value and is consistent with common real estate ownership valuation. The four owners want the property to be owned by an LLC for one of many good reasons, including but not limited to creditor protection, save property taxes under state law (such as California) on the transfer of a partial interest, avoid state law partition and keep strangers from ownership. Yet, once the co-ownership is held in an entity, the valuation discounts are lost. Under the Ways and Means proposal, each 25% membership interest is worth $1 million. The forgoing example arises because the proposal directs that (i) the non-business assets are valued without discount; and (ii) the entity value (unless actively traded) is determined without taking into account the value of the non-business assets. If the entity also owns business assets, traditional valuation rules apply to the value of the decedent's/transfer's ownership interest in the entity and traditional rules apply to the valuation of the underlying business assets.

Sour cherry on top. The entity buy-sell agreement that applies fair market value will generate a higher value for the purchase and sale than will fair market value under the bastardized definition of fair market value contained in the Ways and Means proposal. Thus, when the buy-sell entity agreement reaches a price of $800,000 for one-fourth interest in the entity yet the estate or gift tax law calls for a $1 million – non-discounted value—the following result:

1. The seller who receives less under the new proposal's definition of fair market value but identical the fair market value under normal rules for a business entity, may be held to have made a gift to the buyer (unless the ordinary course business exception applies). Anticipate that the IRS will make that argument. In a family setting, count on the IRS asserting that no such exception applies. After all, that is a natural outgrowth of the whole point of the change of the definition for passive real estate owned by an entity.
2. The buyer who pays less under traditional fair market value than the gross estate value when an estate is the seller, will now also be charged with estate tax on the "bargain sale" under traditional estate tax equitable allocation rules. This argument has been made in case law. If the estate tax is charged to the residue, the residuary beneficiaries pay the estate tax on the bargain sale.
3. Civil litigation among entity owners (whether family or not) will be encouraged because of vagueness or inconsistency as to what "fair

market value" will actually mean. Is it a normal valuation principle respected under the laws of states for decades or the new definition in an estate or gift tax setting?

Most significantly, why will real estate owned as a fractional interest (fractional ownership of tenancy in common) become worth so much less than ownership of an identical percentage interest held in an entity that owns the real property? There is no logical reason that is should be, or that it is worth less than the entity interest. In fact, in business terms, entity interests are normally worth less than identical fractional interest percentages due to impact of restrictions in the entity agreement.

This author encourages the readers of this newsletter to contact the following: (1) real estate industry lobbying groups; (2) national and state valuation associations; (3) Senator Ron Wyden, Chairman of the Senate Finance Committee; (4) Senator Joseph Manchin, the leading Democrat for moderate tax policy; (5) Senator Krysten Sinema of Arizona; (6) Senator Mark Kelley of Arizona; and (7) Ranking Senator on Senate Finance, Mark Crapo of Idaho to express their opposition to this proposal.

COMMENT:

Section 138210 of the Ways and Means proposed tax increases for 2021, adds a new subsection (d) to Internal Revenue Code (IRC) section 2031in order to eliminate discounts for certain transfers of non-business property. The new rule will apply to "non-business assets" owned by entities unless they are actively traded per IRC Sec. 1092. The definition of non-business assets under the proposal adopts the passive-asset test for income tax purposes under IRC section 469. As part of the requirements to avoid passive asset classification, the transferor must have materially participated, for which reference is made to the 750 annual hour requirement under IRC section 469(h).

Farmers receive some break in that a taxpayer shall be treated as materially participating in any farming activity for a taxable year if paragraph (4) or (5) of IRC section 2032A(b) would cause the requirements of section 2032A(b)(1)(C)(ii) to be met with respect to real property used in such activity if such taxpayer had died during the taxable year. Section 2032A establishes special-use valuation. The exceptions noted allow the estate of a decedent for special-use qualification to have satisfied the material participation rule notwithstanding inactivity by the decedent when in continued receipt of old-age social security benefits, if disabled, or when services are performed by a spouse who received the farm from a prior deceased spouse.

Also, inventory assets and notes and receivables from the sale of inventory assets are treated as assets held by a trade or business (i.e., not passive). Thus, real estate developers who recognize sales of real property as ordinary income do not appear to fall within the scope of the proposed new rule's elimination of valuation of discounts are underlying assets… at least to the extent of the foregoing exceptions.

The Problem Sought to Be Solved

Treasury has sought for years to eliminate abusive uses of entities, particularly for estate and gift tax purposes, in which passive assets (most particularly publicly traded securities and cash) are transferred to entities and deep discounts arises. The wealthy client walks into the tax professional's office with $20 million in security and cash value, forms an LLC that receives the $20 million in value; and, once minority ownership interest is achieved the underlying assets are value for a fraction (assume 60% to 75%, perhaps) of their pre- contributed value. Actual results will differ, but the point is made.

The IRS has been successful in narrowing the utility of this approach. First and foremost, the entity must have a substantial and legitimate non-tax purpose. A variety of other internal tests and checks exist, including conduct of the entity on a business-like basis, not making distributions for need and retaining substantial wealth outside of the entity. These are a few of among nearly 30 tests that apply to the successful established of an entity among family members that holds substantial passive or investment-type assets.

In addition, various court cases have made it far most risky to create entities that are challenged under the retained interest rules of IRC section 2036. The taxpayer can be worse off as a result of forming the entity and transferring assets than if that taxpayer had left well enough alone.

Nevertheless, Treasury and the reformers in Congress and the Senate have supported and continue to support a more draconian approach to eliminate the formation and funding of entities with estate or gift tax savings as an encouraged element to that planning. In 2016, Treasury issued a proposed regulatory change to IRC section 2704. That proposal ran into massive opposition (including by this author who organized an editorial published in LISI co-authored by over 20 leading practitioners across the country), over 20,000 opposition contacts from taxpayers and organizations, and even opposition by the Small Business Administration after the American Automobile Dealers Association became involved. However, the 2016 election killed that proposal throughout the prior administration.

The 2021 proposal announced by Ways and Means is the most recent attack. Passage of the tax legislation hinges on a tiny handful of Senators, with Joseph Manchin and Krysten Sinema being the most prominent.

<u>Warning!</u>

Fair market value establishes the foundation for federal estate and gift taxation. Value after all is the measure of what is being taxed. The definition of fair market value is not limited to tax law. It provides a common reference in business agreements. Other definitions of value, such as market value, fair value, book value, adjusted book value among others also exist.

Altering the definition of fair market value undermines a key foundation within tax law and business dealings. For decades, the IRS has encouraged taxpayers to apply the fair market value standard. IRC section 2703 is a prime example. That section commences:

> For purposes of this subtitle, the value of any property shall be determined without regard to—
>
> (1) any option, agreement, or other right to acquire or use the property at a price <u>less than the fair market value</u> of the property (without regard to such option, agreement, or right), or… (*emphasis added*)

This author commonly sees "fair market value" used as the measure for determining the price to be paid under a variety of business agreements. That standard normally includes input from appraisers, and perhaps resolution of differences in opinions among the appraisers. Changing the definition weakens the foundation of a key definition for business transactions and tax law.

Consider what will occur when buy-sell agreements direct use of fair market value. If the Ways and Means proposal is approved and fair market value is defined with reference to estate or gift tax law, the price just increased, yet the ownership interest is still minority. If fair market value is the standard and not referenced to the IRC or regulations, the price is discounted (per the appraisal standard of that term) and the reduced amount is paid. The estate, however, pays estate tax on the non-discounted value relative to the passive asset.

However, nothing gets around that point that when fractional interests are contributed to an entity by the various owners of the real estate, the fractional interests that applied at the pre-contribution level will be eliminated for estate and gift tax purposes relative to the real estate if classified as passive. This scheme disregards that fact that the system is not gamed by contributing the real estate since an underlying discount existed anyway. This is unlike cash or publicly traded securities being contributed. Those assets are either not discounted (cash) or the discount is built into the price (securities on the open market).

Earlier, I used the word “bastardized definition” of fair market value. Using that term in these sensitive times was done with measure and reflection. Its reference is spot on. The proposal mangles the cornerstone of estate and gift tax law and generates a collision with common business operations and sound drafting practice. After all, the selected adjective means, “change (something) in such a way as to lower its quality or value, typically by adding new elements.” That is precisely what is occurring. The foreseeable and unforeseen consequences of this alteration will be massive. It’s existence when applied to co-owned real estate is massive. The real winners will be the appraisal community (which may have to value using two different standards) and the civil and tax litigators (who now get to battle over what fair market value means and in what context).

The author also expects new attacks by the IRS arguing that a tenancy in common is actually a partnership. In Rev. Proc. 2002-22, the IRS announced its ruling standard to determine if a co-ownership was a partnership. Expect the IRS to asset that a tenancy in common is, in fact, a partnership. Is the real estate owned by an "entity" or will a tax-deemed entity rule the day?

Also, anticipate changes in leasing practice from tenant maintenance to ownership maintenance and other ways to increase management activities to achieve the business property threshold.

Entities do not exist solely for estate or gift taxation. In California, common practice is to contribute real estate to an entity, or to have an entity buy the real estate in the first place. This is done to help avoid – or at least defer— property tax increases. Moreover, entities provide a host of non-tax benefits, including privacy, avoidance of state-law partition rights, ease to keep third parties out of the business, limit voting rights, and marital property planning. The new proposal undermines these and other legitimate non-federal tax motivations.

Two movie lines come to mind that may explain why this is occurring. The first is from *Lord of the Flies*: **"**We've got to have rules and obey them." While that line was uttered in the hope of preserving civilization, the new proposal stems from institutionalized anger that generates excessive rule making. The authors and supporters of this proposal do not respect the use of entities for fundamental business purpose with most real estate holdings, including passive assets.

The other quotation is from *Good Will Hunting* when Robin Williams's character tells Will Hunting (played by Matt Damon), "You're just a kid, You don't have the faintest idea what you are talking about." Granted, Treasury and the tax authors are not kids. They are well educated adults. However, they do not know what the horrible consequences they are about to inflict. The author suspects that some in Congress and the administration are fully aware of the harm they will be doing to real estate investors and simply do not care. All they see is the elimination of valuation discounts on passive real estate held in entities. They do not understand how business agreements are established and how they operate. They do not care that property owners will be made to pay millions of additional dollars in state property taxes (at least in California) since the proposal chills the use of entity ownership of real estate. They have no regard for the real-world actual impact and application of "fair market value" to resolve pricing for the purchase and sale of entity interests in business agreements. The proposal certainly will have that impact. Worse, the proponents have taken to a harsher extreme their opposition to LLCs, corporations and partnerships that have any connection with gift or estate tax unless except to the extent that the underlying assets are held by a trade or business and material participation rules are met.

Conclusion

While practitioners are business planning and advising clients what do to before the tax law passes, our clients would be bettered if some time is spent to defeat the less reasoned elements of the tax proposal. The elimination of discounts with passive real estate for most entities presents a prime example on which reason and light must be shined.

HOPE THIS HELPS YOU HELP OTHERS MAKE A *POSITIVE* DIFFERENCE!

Keith Schiller

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Steve Leimberg's Employee Benefits and Retirement Planning Email Newsletter - Archive Message #770

Date:	**18-Oct-21**
From:	**Steve Leimberg's Employee Benefits and Retirement Planning Newsletter**
Subject:	**James M. Kane: A Novel SECURE Design for a Tax-Deferred Retirement Accounts Conduit Trust**

"This newsletter addresses a novel written irrevocable trust planning option under the current SECURE Act (effective beginning December 20, 2019). The SECURE Act eliminated the prior-law longer pay-out stretch option and, in general terms, allows only a 10-year payout period for non-spouse beneficiaries who inherit a retirement account from a deceased primary owner. There are some other limited exceptions that allow a longer payout than this 10-year period that I do not address for purposes of this newsletter."

James Kane provides members with commentary that examines a retirement account trust design for both Roth and non-Roth IRA accounts.

Attorney James M. Kane, with the Atlanta law firm **KaneTreadwell Law LLC** [www.ktlawllc.com), is primarily a tax and trust controversies/litigation lawyer. Prior to law school James was a Revenue Agent with the IRS's large-case examination division in Atlanta, This combined tax, trust, and litigation experience gives James a broad perspective for identifying, understanding, and addressing complex trust issues and disputes along with the resulting tax and non-tax factors that ideally must together be taken into account. James also assists other lawyers as both a consulting and expert witness in both tax and non-tax litigation matters where trusts are at the center of the dispute, and handles trust, estate, asset protection, and prenuptial (postnuptial) planning, with his planning work influenced heavily by the various hurdles James sees in the controversy / litigation arena. James is licensed in Georgia, North Carolina, and New York. He has 20+ years' experience previously with Atlanta law firms Sutherland, Asbill & Brennan and Chamberlain, Hrdlicka, White, Williams & Aughtry. James attended Emory University Law School and has undergraduate finance (University of Georgia) and graduate business (Georgia State University) degrees. Although he never worked as a CPA, James held a CPA certificate during his time with the IRS. James was the winner of the 2016 Heckerling Tax Court Brief writing contest. James' outside interests include studying jazz guitar. Google also: James Kane Legal Blog

Here is his commentary:

EXECUTIVE SUMMARY:

This newsletter addresses a novel written irrevocable trust planning option under the current SECURE Act (effective beginning December 20, 2019). The SECURE Act eliminated the prior-law longer pay-out stretch option and, in general terms, allows only a 10-year payout period for non-spouse beneficiaries who inherit a retirement account from a deceased primary owner. There are some other limited exceptions that allow a longer payout than this 10-year period that I do not address for purposes of this newsletter.

COMMENT:

This planning centers on both Roth *and* non-Roth income tax-deferred retirement accounts, such as, but not limited to, corporate or self-employed ("Keogh") pension, profit-sharing, defined-benefit, and stock bonus plans, SEPs, 403(b) plans, IRA and Roth IRA plans, 401(k) and Roth 401(k) plans, 457 plans. This trust design can work collectively for both Roth and non-Roth accounts.

> An Example: You have decent sized non-Roth and Roth IRAs. You presently have four children, all different ages. The SECURE Act tax-law limitations generally now eliminate — after your death — the longer life-expectancy payout periods for beneficiaries for these retirement accounts; now limited in most cases to a 10-year maximum payout period. What is an effective planning option for your retirement accounts in this situation? For purposes of this blog post, I use both a Roth IRA and non-Roth IRA as examples.

For both these Roth and non-Roth IRA accounts, I recently designed a written tax-deferred retirement accounts trust that is a good SECURE option. NOTE: this newsletter is not a primer with fundamentals on how to set-up and use a trust for retirement accounts. It merely highlights key points to consider for this recent new trust design.

The essence of this retirement account trust design is that:

> (1) The trust agreement is a sprinkle trust that allows the trustee to make trust beneficiary distributions of periodic retirement account withdrawals to and among the named class of beneficiaries, depending on their needs, own marginal income tax rates, etc., in equal, unequal, or in no amount as to the class members;
>
> (2) This is a key design point: The trust agreement must be drafted purposely so as to avoid each trust beneficiary from having substantially separate and independent trust shares. The reason is to enable trust distributions to carry out DNI *only* to those beneficiaries who, in a given year, actually receive distributions from the trust. Otherwise, for example, separate and independent shares can result in one beneficiary ending up with a trust distribution in excess of the trust's total DNI, causing the trust to be taxed on such income at the trust's substantially higher compressed marginal income tax rates. By contrast, the goal is for the trustee to sprinkle distributions from the trust to and among the class of trust beneficiaries depending on their needs, their own marginal income tax rates, etc.
> As a relevant aside, creating separate and independent trust shares for retirement accounts trusts — now and prior to SECURE — requires that the retirement account beneficiary designation itself refer to separate trusts; e.g., 1/3 of my IRA at my death is payable to the Jane Doe Trust; 1/3 to the Susan Doe Trust; and 1/3 to the Sam Doe Trust, etc. My point here is that it is not easy under my proposed SECURE trust planning simply to fall inadvertently into an independent and separate share regime for this kind of retirement trust planning (see, e.g., IRS Private Letter Ruling 200317041). But, nonetheless, one optimally needs to understand these concepts in order to avoid a separate trust share situation for this SECURE trust design.
>
> (3) In broad terms this SECURE retirement trust will be named as *the retirement account beneficiary; and treated as a* pass-through "conduit" trust. This means, again generally, that any periodic

retirement account withdrawal the trustee obtains from a retirement account must — within that same taxable year — be sprinkled on out from the trust to and among *one or more* of the trust beneficiaries;
(4) One important point ideally is that this trust should not be used to accumulate withdrawals from non-Roth retirement accounts. Otherwise, a trust's withdrawal from a non-Roth retirement account, if the trust thereafter holds and accumulates that withdrawal within the trust itself without distribution to a trust beneficiary, will cause the trust to be liable for income tax on that withdrawn amount at the trust's own substantially higher, compressed income tax rates; than if taxed to a trust beneficiary at his or her lower marginal income tax rates.

As to the above income tax, generally a trust's receipt of income is not taxable to the trust itself in situations where (under the tax law) that trust income is shifted out to a trust beneficiary by a distribution of that trust income as a trust distribution out to a recipient beneficiary. For 2021, a trust that pays its own income tax (when the trust itself holds undistributed taxable income) hits the top 37% marginal income tax rate beginning at $13,050 of trust taxable income; for a single individual, this 37% marginal rate kicks in when that individual's taxable income is more than $523,600.

(5) But, contrary to the preceding point, note the following Roth account exception is important for this SECURE trust design: As stated above, the trust is a "conduit" trust for non-Roth tax-deferred retirement accounts. However, the trust also includes an express exception clause that allows the trustee to accumulate (thus disregard the conduit mandate) for any Roth account distributions the trustee receives. The trustee can accumulate and invest these Roth distributions for later distribution to the trust beneficiaries, well outside the 10-year SECURE distribution period;

(6) Back to broader comments. This SECURE trust design must still meet the requirement that all beneficiaries are qualified beneficiaries so as to avoid application of the five (5) year payout no-beneficiary distribution rule, rather than the 10-year rule;

(7) As to any mandated conduit distributions from the trustee to the beneficiaries, this trust design provides additional flexibility for the trustee to deal with minor-age or disabled trust beneficiaries, etc., using the following (or similar) trust provision:

> The Trustee may (without court approval) make distributions of any portion of a distribution required or permitted to be made to any person under this trust agreement in any of the following ways: (i) to the person directly; (ii) by distribution in further trust in the manner provided under section 20.1; (iii) to the guardian of the person or the person's property; (iv) as to such distribution by selecting and designating an individual or financial institution to serve as Custodian for such minor beneficiary under the Uniform Transfers/Gifts to Minors Act of any state; or (v) by reimbursing the individual who is actually taking care of such person (even though the individual is not the legal guardian) for expenditures made by the individual for the benefit of such person. Written receipts from the persons receiving such distributions (other than if held in continuing trust under section 20.1) shall fully and completely discharge the Trustee from any further responsibility for such expenditures. The Trustee shall not exercise any power under this section 17.7 in a manner that would cause any trust holding S corporation stock not to qualify as a permitted shareholder of that stock for federal income tax purposes.; and

(8) Finally, under the SECURE Act's 10-year distribution mandate, the trustee has the option to make *no withdrawals* from the retirement accounts until late in the 10th-year so as to let those accounts continue to be invested income-tax deferred within the retirement accounts until later withdrawn. In essence, this substantively allows for an accumulation of tax-deferred value continuing within the retirement accounts during the 10-year period, although this SECURE trust is ostensibly a conduit trust during that same 10-year period.

HOPE THIS HELPS YOU HELP OTHERS MAKE A *POSITIVE* DIFFERENCE!

James M. Kane

CITE AS:

Steve Leimberg's Estate Planning Email Newsletter - Archive Message #2912

Date: 01-Oct-21

From: Steve Leimberg's Estate Planning Newsletter

Subject: **Alan Gassman & Brandon Ketron: What Part of Disregarded Did You Inadvertently Disregard**

"Most tax advisors are well aware that the September 13th House Ways and Means Bill provides that the estate tax exemption amount would go to one-half of what it would otherwise be January 1st, 2022, discounting for non-business assets and entities would be unavailable after enactment, and that contributions made to irrevocable trusts that would otherwise be disregarded for income tax purposes would cause problematic results to the extent made after the date of enactment.

As a result of the above, taxpayers all over the country are considering what they should add to existing 'defective grantor trusts,' or whether they should establish new ones. In addition, those who have or are establishing irrevocable life insurance trusts are considering whether to pre-fund these trusts with cash or to pre-fund life insurance policies before the possible date of enactment in case Congress does not find a way to provide safe passage for the life insurance industry, which has historically been a sacred cow that has been milked regularly for campaign contributions."

Alan Gassman and **Brandon Ketron** provide members with commentary that examines the planning implications raised by the grantor trust provision in the Ways and Means bill.

Alan S. Gassman, J.D., LL.M., is a partner in the law firm of **Gassman, Crotty & Denicolo, P.A.**, and practices in Clearwater, Florida. He is a frequent contributor to LISI, and has published numerous articles and books in publications such as BNA Tax & Accounting, Estate Planning, Trusts and Estates, and Interactive Legal and is coauthor of Gassman and Markham on Florida and Federal Creditor Protection and several other books. His email address is agassman@gassmanpa.com. Alan is presenting with a panel at the 46th Annual Notre Dame Tax & Estate Planning Institute on the subject of termination of charitable trusts. More information on the 46th Annual Notre Dame & Estate Planning Institute, which will be held as a virtual conference on Thursday, October 29, and Friday, October 30, can be viewed by clicking Here. Please join us! Alan is also the Executive Producer of the free newsletter known as the Thursday Report, which is sometimes published on Thursdays. To obtain your free subscription, email info@gassmanpa.com and make sure the subject of the email is "Secret Decoder Ring."

Brandon L. Ketron, CPA, JD, LL.M. is a partner at the law firm of **Gassman, Crotty & Denicolo, P.A.**, in Clearwater, Florida and practices in the areas of Estate Planning, Tax and Corporate and Business Law. Brandon is a frequent contributor to LISI and presents webinars on various topics for both clients and practitioners. Brandon attended Stetson University College of Law where he graduated cum laude, and received his LL.M. in Taxation from the University of Florida. He received his undergraduate degree at Roanoke College where he graduated cum laude with a degree in Business Administration and a concentration in both Accounting and Finance. Brandon is also a licensed CPA in the states of Florida and Virginia. His email address is brandon@gassmanpa.com.

Here is their commentary:

EXECUTIVE SUMMARY:

Most tax advisors are well aware that the September 13th House Ways and Means Bill provides that the estate tax exemption amount would go to one-half of what it would otherwise be January 1st, 2022, discounting for non-business assets and entities would be unavailable after enactment, and that contributions made to irrevocable trusts that would otherwise be disregarded for income tax purposes would cause problematic results to the extent made after the date of enactment.

As a result of the above, taxpayers all over the country are considering what they should add to existing "defective grantor trusts," or whether they should establish new ones. In addition, those who have or are establishing irrevocable life insurance trusts are considering whether to pre-fund these trusts with cash or to pre-fund life insurance policies before the possible date of enactment in case Congress does not find a way to provide safe passage for the life insurance industry, which has historically been a sacred cow that has been milked regularly for campaign contributions.

FACTS:

On September 26th, the House Budget Committee released House Report No. 117-130 which is 501 pages of pleasurable reading on the intention behind the 881 pages of proposed legislation.

All of the above items are described in the House Report in the manner expected, with one unpleasant surprise - transactions between a grandfathered defective grantor trust and the person or persons considered to be the owners of that trust for income tax purposes will trigger capital gains tax when the “grantor” who is considered to be the owner transfers an appreciated asset or assets to the trust after the date of enactment.

The proposed law itself can be read to have this result, although it is somewhat confusing because of the use of the word “disregarded” in a way that is inconsistent with how the word is normally used in tax literature:

> SEC. 1062. CERTAIN SALES BETWEEN GRANTOR TRUST AND DEEMED OWNER.
>
> (a) IN GENERAL.—In the case of any transfer of property between a trust and the person who is the deemed owner of the trust (or portion thereof), such treatment of the person as the owner of the trust shall be disregarded in determining whether the transfer is a sale or exchange for purposes of this chapter.
>
> (b) EXCEPTION.—Subsection (a) shall not apply to any trust that is fully revocable by the deemed owner.

(c) DEEMED OWNER.—For purposes of this section, the term 'deemed owner' means any person who is treated as the owner of a portion of a trust under subpart E of part 1 of subchapter J.

EFFECTIVE DATE.—The amendments made by this section shall apply—

(1) to trusts created on or after the date of the enactment of this Act, and

(2) to any portion of a trust established before the date of the enactment of this Act which is attributable to a contribution made on or after such date.

Experts who read this sentence when the bill was released assumed that this meant that disregarded trusts created before the enactment of this Act would continue to be disregarded so that assets could be sold or exchanged with the trust so long as there was no "contribution" (aka a gift) made to the trust on or after the enactment of the Act, but this was apparently not the case.[1]

The House Report clarified that the effective date was intended to cover transactions between a grantor and any grantor trust after the date of enactment, even if the trust was created before the date of enactment, specifically stating:

> The provision is generally effective for (1) trusts created on or after the date of enactment and (2) any portion of a trust established before the date of enactment that is attributable to a contribution made on or after such date. The portion of the provision relating to sales and exchanges between a deemed owner and a grantor trust is intended to be effective for sales and other dispositions after the date of enactment.

The House Report noted in a footnote that “A technical correction may be necessary to reflect this intent.”

COMMENT:

The immediate thought with respect to this provision is that after the date of enactment assets having a fair market value exceeding their tax basis will not be good candidates for being sold to a defective grantor trust in exchange for a note or other assets. The other thing that becomes apparent is that the opposite may apply – If a grantor trust transfers an asset that it owns that is worth more than the tax basis of the asset, then income tax may be triggered as if the asset was sold to a third party.

In many situations this will not be a problem. For example, if a taxpayer has an active business corporation and the stock has a basis of $1 million and is worth $1,500,000, then a 99% non-voting member interest in the company may be worth $1 million, after discounts, and discounts will be permitted after enactment for “all business” assets.

Therefore, a sale of the 99% non-voting member interest for $1 million will trigger no income tax in the above example, and there is nothing in the legislation that appears to cause the basis of the stock to be reduced. But issues may arise with respect to other kinds of trusts that are disregarded for income tax purposes.

WHAT ABOUT GRATs AND CLATs?

For example, under present law Grantor Retained Annuity Trusts (“GRATs”) can receive appreciated assets on an income tax-free basis and will be required to make payments in cash, or in kind, back to the grantor based upon a formula which usually provides that what the grantor will receive will have a value that is approximately equal to what has been placed into the GRAT, plus a rate of return equal to the Section 7520 rate, which is presently 1%, in a series of annual payments that range from being equal to increasing by up to 20% per year.

As the result of this many existing GRATs do not have sufficient cash to meet the payment requirements, and therefore make payments in kind of investment or other assets that are valued as of the date of distribution.

Will the transfer of an appreciated asset from a GRAT to its grantor be considered to be a sale of the asset for income tax purposes, thus triggering capital gains or ordinary income due to depreciation recapture based upon its character? This appears to be what Congress is intending and what the IRS would enforce if the Act is passed as proposed.

And what about Charitable Lead Trusts which receive gifts and make annual payments to charity which may be in cash or in kind? Many Charitable Lead Annuity Trusts are “Grantor CLATs” considered to be owned by the contributor, so the same issues can apply – the distribution of an appreciated asset to charity may be considered to be a taxable event if the IRS considers the payment to charity to be in discharge of a financial obligation of the grantor. This issue is discussed in a number of articles, including *Charitable Giving With a Charitable Lead Annuity Trust* by Dino Giannobile from Plante Moran.[2]

And then what about capital losses that might occur if a defective grantor trust transfers an asset that has gone down in value to a grantor in exchange for a note or cash? The legislation specifically provides that IRC Section 267(b), which disallows losses on sales between related parties, will be amended to now include transactions between a grantor trust and its deemed owner.

PLANNING POINT:

As a result of the above, taxpayers who have irrevocable trusts that are disregarded for income tax purposes, including Section 678 trusts that are considered as owned by a person or persons other than the grantor should review what assets are presently in the trusts and what assets are outside of the trusts to decide whether there should be “swapping” or sales in the immediate future, before the date of enactment, to optimize tax planning and minimize potential taxable income.

For example, if a taxpayer has appreciated stock that he or she would like to have held under the trust and would like to receive back a low-interest promissory note or cash in exchange for the stock, or if the trust has appreciated stock that planners would like to have in the taxpayer's name in order to ensure a new fair market value date-of-death income tax basis if the taxpayer dies and the stepped-up basis rules remain the same, then the swapping of assets should occur before the date of enactment. Likewise, if the taxpayer is owed payments by a GRAT which has appreciated assets, he or she can receive the appreciated assets now in exchange for cash or non-appreciated assets that can be paid to the grantor to avoid the possible income tax described above.

Some taxpayers will have their grantor trusts borrow monies at arm's length from third parties or related parties to repay promissory notes owed to the grantor and be able to retain appreciated assets so as not to trigger gain.

A tax advisor's work is never done!

CONCLUSION:

The one thing that we can probably be sure of is that tax legislation resulting from a compromise between the House and Senate and refinement between now and passage will probably not be the same as what now have on the table. Nevertheless, a new law can be substantially similar to what is being formally proposed, and Congressmen should be reluctant to make things worse than what is being proposed, or to move timetables forward as opposed to backwards from an effective date

standpoint. Stay tuned, keep your seatbelts on, and remember to exit the ride to the left when it is over, keeping all hands, arms, hats, and sunglasses inside the ride until coming to a complete stop.[3]

HOPE THIS HELPS YOU HELP OTHERS MAKE A *POSITIVE* DIFFERENCE!

Alan Gassman

Brandon Ketron

CITE AS:

CITATIONS:

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[1] While the word case commonly refers to a court decision, it may also refer to four six-packs of beer, which many of us need after reading this kind of legislation.

[2] https://www.plantemoran.com/explore-our-thinking/insight/2020/10/charitable-giving-with-a-charitable-lead-annuity-trust

[3] Until the 1980s, those purchasing admission to Disney World received tickets that admitted the Disney visitor onto rides. The very best rides required tickets, which could be purchased for additional monies if an attendee wanted to go on an any ticket ride more than once. Great

experiences in the 1970s were therefore described as “any ticket”. This is not relevant to the article but possibly of interest to Mouseketeer enthusiasts who consider tax law to be more fun than Disney World.

Steve Leimberg's Estate Planning Email Newsletter - Archive Message #2914

Date: 14-Oct-21

From: Steve Leimberg's Estate Planning Newsletter

Subject: **Alan Gassman, Jonathan Blattmachr & Brock Exline: Using the Florida Irrevocable Community Property Trust to Protect an Elderly Couple from Abuse**

"Effective July 1st, married couples can establish trusts having one or more Florida trustees that can qualify to be considered to be 'community property' for purposes of receiving a full new step-up in income tax basis to fair market value on the death of either spouse. This will be the primary reason that many married couples living in Florida and elsewhere will establish Florida Community Property Trusts, but there is another good reason for elderly couples who wish to protect their assets from potential predators, including their own children."

Alan Gassman, Jonathan Blattmachr and **Brock Exline** provide members with commentary that reviews how Florida's Community Property Trust Act can be used to protect an elderly couple from abuse. Members who wish to learn more about this topic should consider watching Jonathan and Alan in their exclusive **LISI** Webinar titled: Florida Snowbird Planning: When and How to Use Florida, New York and APT Jurisdiction Trusts.

Alan S. Gassman, J.D., LL.M., is a partner in the law firm of **Gassman, Crotty & Denicolo, P.A.**, and practices in Clearwater, Florida. He is a frequent contributor to LISI, and has published numerous articles and books in publications such as BNA Tax & Accounting, Estate Planning, Trusts and Estates, and Interactive Legal and is coauthor of Gassman and Markham on Florida and Federal Creditor Protection and several other books. His email address is agassman@gassmanpa.com. Alan is presenting with a panel at the 46th Annual Notre Dame Tax & Estate Planning Institute on the subject of termination of charitable trusts. More information on the 46th Annual Notre Dame & Estate Planning Institute, which will be held as a virtual conference on Thursday, October 29, and Friday, October 30, can be viewed by clicking here. Please join us! Alan is also the Executive Producer of the free newsletter known as the Thursday Report, which is sometimes published on Thursdays. To obtain your free subscription, email info@gassmanpa.com and make sure the subject of the email is "Secret Decoder Ring."

Jonathan G. Blattmachr is Director of Estate Planning for **Peak Trust Company** (formerly Alaska Trust Company), co-developer of **Wealth Transfer Planning**, a computer system for lawyers, published by Interactive Legal Systems and its Editor-in-Chief, director of Pioneer Wealth Partners, LLC, author or co-author of nine books and over 500 articles, and a retired member of Milbank, LLP, and of the Alaska, California, and New York Bars.

Brock Exline is a second year law student at Stetson University College of Law. He graduated from Stetson University with a Bachelors of Arts in Political Science. Brock is also the Florida Bar Liaison for the Stetson Business Law Society.

Here is their commentary:

EXECUTIVE SUMMARY:

Effective July 1st, married couples can establish trusts having one or more Florida trustees that can qualify to be considered to be "community property" for purposes of receiving a full step-up in income tax basis to fair market value on the death of either spouse. This will be the primary reason that many married couples living in Florida and elsewhere will establish Florida Community Property Trusts, but there is another good reason for elderly couples who wish to protect their assets from potential predators, including their own children.

The authors also explain the possible concerns voiced by Jonathan Blattmachr with respect to whether the Florida Community Property Trust Act will deliver the full step-up in basis on the death of one spouse.

COMMENT:

Lawyers are challenged when representing elderly individuals who may have one or more aggressive or imbalanced children. A big challenge occurs when one or both parents get sick and the aggressive or imbalanced child shows up and moves in with them. When that happens, estate planning documents and intentions can change and the unruly, aggressive, or imbalanced child can end up inheriting all of the assets or spending them contrary to the parent's wishes, which may leave the parents penniless and/or take assets away from other desired beneficiaries.

Florida’s new Community Property Trust Act allows married couples to set up irrevocable community property trusts that must be for their sole benefit, without the requirement to provide notice of the trust, trust accountings, or other information to secondary beneficiaries, which may include their children or other relatives.

Florida Statute Section 736.1504 provides that the settlor spouses of a Florida community property trust may agree upon whether the trust is revocable or irrevocable. Section 736.1504 further provides that “the settlor spouses shall be deemed to be the only qualified beneficiaries of a community property trust until the death of one of the settlor spouses, regardless of whether the trust is revocable or irrevocable.” This part of the statute gives the settlor spouses wide latitude to administer the trust without having to inform and give notice to descendants who would otherwise be considered qualified beneficiaries under a non-community property trust instrument.

As used in the Florida Trust Code, the term “beneficiary” under the Florida Law refers to the universe of individuals who have a beneficial interest in a trust, as well as to any person who has a power of appointment over trust property in a capacity other than as trustee. For purposes of determining the beneficiaries of a trust, it is immaterial whether the interest is present or future, vested or contingent, or whether the beneficiary is ascertainable or even living.

By contrast, Section 736.0103(19) defines the term “qualified beneficiary” to refer to only a limited subset of all trust beneficiaries. Essentially, the class is narrowed to the living persons who are current beneficiaries, intermediate beneficiaries, and first-line remainder beneficiaries, whether the interest is vested or contingent.

The statutory language applicable under Florida Statute Section 736.0103(19) is as follows:

> ‘Qualified Beneficiary’ means a living beneficiary who, on the date, the beneficiary’s qualification is determined:
>
> > (a) is a distributee or permissible distributee of trust income or principal;

(b) Would be a distributee or permissible distributee of trust income or principal if the interests of the distributees described in paragraph (a) terminated on that date without causing the trust to terminate; or

(c) Would be a distributee or permissible distributee of trust income or principal if the trust terminated in accordance with its terms on that date.

Florida Statute Section 736.0103 further defines the term "Distributee" as a beneficiary who is currently entitled to receive a distribution (emphasis added), and the term "permissible distributee" as a beneficiary who is currently eligible to receive a distribution (emphasis added).

The concept of a "Qualified Beneficiary" is important with respect to trust administration because the Florida Trust Code requires that a trustee has a duty to "inform and account" to a trust's qualified beneficiaries. Beneficiaries who are not qualified beneficiaries are not entitled to the same privileges.

Because Florida Statute Section 736.1504 dictates that only the settlor spouses will be considered qualified beneficiaries of the community property trust until the death of one of the settlor spouses, the trustee of a Florida community property trust owes no duty to the settlor spouses' descendants or other qualified beneficiaries (while both settlor spouses are alive) to keep them reasonably informed of the trust and its administration.

For example, assume that Ma and Pa Kettle establish an irrevocable trust to benefit them for their lifetime and to provide future benefits for their children and grandchildren after the death of the survivor of Ma and Pa Kettle. In such a case, Ma and Pa are the current beneficiaries, their children are the intermediate beneficiaries, and their grandchildren are the first-line remainder beneficiaries. As qualified beneficiaries, both Ma and Pa's living children and living grandchildren are entitled to be reasonably informed of the trust and its administration. Reasonably informing the qualified beneficiaries entails providing accountings, complete copies of the trust instrument, relevant information about the assets and liabilities of the trust, and providing due notice in the event of a trust modification, all of which can be expensive and cumbersome.

If the irrevocable trust is not a community property trust under the Florida

Community Property Trust Act, then the qualified beneficiaries of the trust (including the successor beneficiaries after the death of Ma and Pa Kettle) will be entitled to receive trust accountings and other information regarding the trust. However, if the irrevocable trust is established as a community property trust under the Florida Community Property Trust Act, then such remainder beneficiaries are not entitled to trust accountings or other information, regardless of their status as beneficiaries. Trust accountings typically must be completed based upon a prescribed form and format which can cause additional costs of administration. This makes the Florida community property trust an attractive planning tool for an elderly couple that once had an irrevocable trust established but does not want to have any administrative inconvenience associated with providing trust accounting and other information to other beneficiaries of the trust.

An alternative to providing qualified beneficiaries directly with notice is to appoint a “Designated Representative” in the trust document under Florida Statute Section 736.0306. The Designated Representative can be any individual named in the trust document, other than the trustee. The Designated Representative can be authorized to waive the right to receive accountings, copies of the trust, and other information on behalf of one or more beneficiaries and can represent and bind one or more of the beneficiaries with respect thereto. The Designated Representative has to be willing to assume these responsibilities and understanding that beneficiaries may be upset and may sue the Designated Representative. Nevertheless, the Designated Representative is shielded from liability under Florida Statute Section 736.0306(4) from the beneficiary whose interests are represented by the Designated Representative, or to anyone claiming through that beneficiary, for any actions or omissions to act that are made in good faith by the Designated Representative.

The new Florida Community Property Trust Act, which is intended to allow assets to get a step-up in basis on the death of the first dying spouse provides a new opportunity for planners to help elderly or infirm couples protect their assets without being required to give notice to descendants or other qualified beneficiaries. Even though such a trust can be irrevocable the trust language can allow amendments to the trust when approval is received from one or both of the spouses if they are confident in one or more trusted individuals to verify that there is no undue influence or circumstances that would cause an amendment to be problematic.

For example, assume Ma and Pa Kettle establish an irrevocable Florida community property trust to benefit them for their lifetime, and to benefit their children and grandchildren after the death of the survivor. Although Ma and Pa's children and grandchildren would normally be considered qualified beneficiaries, because under a Florida community property trust, Florida Statute Section 736.1504 dictates that only the settlor spouses are considered qualified beneficiaries, the trustee of Ma and Pa Kettle's irrevocable community property trust owes no duty to reasonably inform the children and grandchildren of the trust administration. As a result, Ma and Pa's aggressive, unruly, or imbalanced child is left "out of the loop" and may be unable to manipulate his or her way into a larger inheritance.

Florida trust experts are aware of another way to have someone eliminated from being a "Qualified Beneficiary" during the lifetime of an individual trust beneficiary. If a beneficiary holds a power of appointment over an individual who would otherwise be a "qualified beneficiary," then notice and waiver provided to the holder of the power will be sufficient to satisfy the notice and the accounting requirements. This is provided by Florida Statute Section 736.0302, which specifically states that the holder of a power of appointment may represent and bind persons whose interests, as permissible appointees, takers in default, or otherwise, are subject to the power.

Nevertheless, giving Ma or Pa Kettle the right to divest one or more of their descendants from an irrevocable trust can cause a significant danger because one or more unruly descendants may influence one or both spouses to exercise the power of appointment to exclude siblings and other descendants that are not favored by the person exercising the undue influence.

Critics of this type of irrevocable trust planning will point out that Ma and Pa Kettle should have the right to change their trust, and their dispositive intentions for as long as they live.

This may be accomplished by having the trust agreement name Trust Protectors who may be trusted advisors or close and trustworthy friends of the family who would be able to make changes upon the request of Ma and Pa Kettle, subject to such ground rules as the trust may provide. Another variation of this concept involves giving Ma and Pa Kettle powers of appointment with respect to the trust, but these may be excludable only with the consent of one or more Trust Protectors, who must approve any such exercise of the power of appointment.

While the Florida Legislature passed the new Community Property Trust Act to enable married couples to get a step-up in basis on the first death, Jonathan Blattmachr has pointed out legitimate concerns as to whether an elective community property arrangement like the Florida Community Property Trust Act will be recognized by the IRS as a legitimate community property arrangement to qualify all trust assets for a fair market value date of death basis step-up on the death of the first dying spouse. There is a question as to whether it is possible to have community property trust assets treated as community property for federal income tax purposes when the assets held are not 100% accessible to the creditors of one spouse or where the property does not remain community property if distributed out of the trust while the spouses are both alive or whether the property will satisfy the requirement under Section 1014(b)(6) of the Code that it must be community property under the law of a state (or territory) since Florida does not really have a community property system. . Alaska community property trust law more closely follows traditional community property law by allowing creditors of one spouse to access 100% of the assets held in a community property trust. Plus Alaska has a full panoply of community property laws for married couples who elect into the Alaska community property system. Therefore, the Alaska community property trust may be a safer vehicle to receive a step-up in basis on the death of one spouse.

While the step-up in basis on the first death may be the primary reason that most married couples will use Community Property Trusts, the incidental benefit of not having to inform children or other descendants, not having to account to them, and not even being able to make distributions to or for their benefit from the Trust are other advantages that may be very attractive to planners who are worried about difficult situations that often face elderly clients that have forceful or abusive descendants.

HOPE THIS HELPS YOU HELP OTHERS MAKE A *POSITIVE* DIFFERENCE!

Alan Gassman

Jonathan Blattmachr

Brock Exline

CITE AS:

Steve Leimberg's Estate Planning Email Newsletter - Archive Message #2897

Date:	**02-Aug-21**
From:	**Steve Leimberg's Estate Planning Newsletter**
Subject:	**Mary Vandenack's Notes from the NYU Advanced Trusts and Estates Conference**

The **NYU Advanced Trusts & Estates Conference** was held virtually July 28, 2021. **Mary E. Vandenack** attended the NYU Advanced Trusts & Estates Conference, virtually, and agreed to share her notes.

Mary E. Vandenack, J.D., ACTEC, CAP®, COLPM®, is founding and managing member of **Vandenack Weaver LLC** in Omaha, Nebraska. Mary is a highly regarded practitioner in the areas of tax, trusts and estates, private wealth planning, asset protection planning, executive compensation, business and business succession planning, tax dispute resolution, and tax-exempt entities. Mary's practice serves businesses and business owners, executives, real estate developers and investors, health care providers, companies in the financial industry, and tax-exempt organizations. Mary is a member of the American Bar Association Real Property Trust and Estate Section where she serves as on the Planning Committee, Nominations, and Council. Mary is a member of the American Bar Association Law Practice Division where she currently serves as Secretary. Mary has been named to ABA LTRC Distinguished Women of Legal Tech, received the James Keane Award for e-lawyering, and serves on ABA Standing Committee on Information and Technology Systems. Mary is a frequent writer and speaker on tax, benefits, asset protection planning, and estate planning topics as well as on practice management topics including improving the delivery of legal services, technology in the practice of law and process automation. Mary hosts a podcast called Legal Visionaries.

NOTES:

CHAIR:

Brad J. Richter

OUT WITH THE OLD, IN WITH THE NEW, USING TRUST DECANTING TO ADAPT TO CHANGED CIRCUMSTANCES

Presenter: Wendy Wolff Herbert, Esq., Fox Rothschild, LLP, Princeton, NJ

Decanting is an ability to provide flexibility to our clients to make changes to our documents.

Why Decant?

An irrevocable trust is supposed to be irrevocable so why do we want to make changes? The fact is that it is impossible to anticipate all the legal and life changes that will occur ahead of time. There may be a need to change the trustee, trustee powers, consider tax impacts due to tax law changes, address drafting errors, and family changes that were unanticipated.

There are three methods to change an irrevocable trust. The first is judicial modification, which is likely the safest but least favorable in terms of accomplishing the process. Non-judicial modifications are another way to make changes to irrevocable trusts. There are challenges such as capacity of beneficiaries. What statutes allow concerning non-judicial modification may be limited.

What is Decanting?

Decanting allows the trustee to make changes to an irrevocable trust without beneficiary consent or judicial approval. Decanting is the trustee's exercise of a discretionary power to distribute the trust assets to another trust. Authority can come from the trust instrument. Authority can also come from common law and likely exists in all states. A state may have passed an explicit statute authorizing decanting.

The first recognition of decanting was Phipps v. Palm Beach Trust Company, 142 Fla. 782. The Florida Supreme Court held that a trustee who has a discretionary power to distribute property to a beneficiary outright may also distribute the property to the beneficiary in further trust. The goal was to allow the primary beneficiary to have a testamentary power of appointment in favor of his spouse.

All states that have considered the issue of the power to decant have determined that the trustee has such power.

In Weidenmayer v. Johnson, 106 N.J. Super. 161 (App. Div. 1969). John Seward Johnson created a trust for his son, John Seward Johnson, Jr. The trustees exercised their discretion to distribute Seward's interest to him and he contributed the distribution to another trust. Such trust provided for Johnson for life and for some of his children. Two children from a prior marriage were excluded. There was some doubt as to whether those children were his. The children that were cut out as a result of the distribution to a second trust sued. The court held the trustees had not abused their discretion. The court noted that the two children who were cut out were not damaged because distribution or exercise of power of appointment could have prevented them from inheriting anyway. The court noted that the settlor's peace of mind was a reasonable basis for the exercise of the trustee's discretion.

<u>Hodges v. Johnson</u>, 170 N.H. 470 (2017). New Hampshire has a decanting statute allowing a trustee to decant from one irrevocable trust to another. A trust had been created by Settlor. Over the years, family rifts evolved related to the involvement of some family members in the family business. The Settlor requested the trustees to decant the trusts in a manner that would result in a change of the beneficiaries. The trustees did so and the result was to eliminate four of six beneficiaries and various contingent beneficiaries. The New Hampshire Supreme Court upheld a lower court ruling that the decanting was improper and void because the trustee violated his fiduciary duty. The Court stated that the trustee had failed to treat the beneficiaries equitably given the intent and purposes of the trust. There is a difference between a power to distribute and a power of appointment in this context.

In the <u>Wiedemeyer</u> case, the court said that X was clearly the primary beneficiary and he had a testamentary of appointment. In the <u>Hodges</u> case, the trust was for the spouse and children and there was no direction to favor one beneficiary.

- Where trustee has broad discretion to distribute property, trustee can likely decant.
- Exercise of power must be in good faith.
- Trustee must act consistently with terms of the trust.
- Know who the primary beneficiary is.
- What were the intentions of the settlor in setting up the trust?
- Equitably consider the interests of beneficiaries.

In at least thirty states, there is statutory authority to decant. New York was the first state to enact a decanting statute. Statutes vary in significant aspects.

A trustee with an unlimited power to invade principal has the right to decant to a trust that cuts out beneficiaries that were named in the first trust. A modification of unlimited discretion with health, education, maintenance and support does not result in limiting the discretion to distribute for decanting purposes.

Statutes often require that notice of decanting must be given. To the extent that notice is required, the person being notified does not necessarily have any ability to do anything about it.

<u>Tax Issues Related to Decanting</u>.

Decanting does not generally result in a recognition event if the trustee has the power to distribute the assets; however a decanting of assets from one trust to another may result in a taxable recognition event if beneficiaries possess interests in the new trust that are materially different and the transfer requires beneficiary approval.

Carrying out of DNI from one trust to the other may result in income tax issues and should be considered prior to decanting. A shift of income from one trust to another could be a positive.

Generally, there is no gift arising from decanting even when the decanting favors one beneficiary over another. There is a different result if the trustee is also a beneficiary. There can be a gift if there is a transfer of an interest from the trustee/beneficiary to another beneficiary.

Decanting may be favored over judicial modification to avoid gift tax issues that may arise from a requirement of beneficiary consent.

Decanting may have tax issues where the trust from which assets are being distributed has an ascertainable distribution standard. When trustee is beneficiary, the best approach may be to use a special trustee to effectuate decanting.

When decanting from a grandfathered GST trust, there are some safe harbors. See Reg. 1.26-2601-1.

Decanting deals with trusts that are already in place and how we can take advantage of decanting statutes to support flexibility when needed. Consider building flexibility into the trust documents.

ESTATE PLANNING UNDER THE NEW BIDEN ADMINISTRATION

Presenters: George D. Karibjanian, Esq., Franklin Karibjanian & Law, Boca Raton, FL & Washington D.C.

Reconciliation simply requires a majority vote but tax changes have to sunset. Otherwise, a vote of 60 is required.

What Happens if Estate Exemption Falls?

Even if there is no change now, TCJA expires 12/31/2025 and exemption returns to 2011 levels. Treasury regulations provide that there will be no clawback for the drop in exemption amount after 2025. 20.2010-1(c). These regulations do not contemplate an exemption prior to the sunsetting of the TCJA.

Retroactivity is constitutional and can occur. Whether it can occur is different from whether it is fair. A way to combat retroactivity is to use a defined value clause. The IRS could raise Procter as a challenge to validity. It is more difficult to use a formula for hard assets than for closely held business interests.

Gifting in 2021

Outright gifting is the easiest thing to do. Disadvantage is that recipient has full use of gifted funds and donor loses complete control. Outright gifting does not necessarily maximize the use of all the donor's available exemptions, such as GST.

Gifts in trust allow donor to retain some control over gifted funds. Donor may benefit multiple generation. Settlor can use both gift tax exemption and GST exemption. Trust has some asset protection. Primary disadvantage is that donor has still lost use of 11.7m of assets.

Asset protection should be considered in all trusts.

Settlor might create an inter vivos QTIP trust. This is trust settlor creates for spouse, providing spouse mandatory income and discretionary principal. Trust is intended to qualify for gift tax marital deduction. If exemption amount is reduced, the QTIP election does not have to be made and exemption is used. If exemption amount is not reduced, then QTIP election can be made and no exemption will have been used.

Inter-vivos QTIP trust can result in a "back end" trust interest for donor spouse. Treas. Reg. 25-2523(f)-1(f) – A back end interest does not create gross estate inclusion under 2036 and 2038. Issue could still be under 2041. Several states have enacted statutes that negate potential 2041 argument by stating that creator of trust with Back End interest is the spouse and not the settlor. Be aware that if the settlor resides in a jurisdiction that has adopted the Uniform Voidable Transactions Act, creating a trust in another jurisdiction could be deemed to be voidable per se.

Consider a completed gift DAPT. A DAPT is often created as an incomplete transfer so there is no transfer tax assessed upon creation. Remainder interest is not a completed gift because settlor retains a special testamentary power of appointment. The income interest is not a completed gift because the settlor either retains a veto power over distributions or a special lifetime power of appointment. The only time transfer taxes are due prior to death is if distributions are made to anyone other than settlor. As a completed gift, the DAPT can provide the settlor with the use of exclusion amount while retaining the ability to receive distributions. The IRS determined in PLR 200944002 that an Alaska DAPT where there was no retention by the settlor of any special powers or the veto power, which meant that the settlor departed with dominion and control upon the transfer, resulted in a completed gift. UVTA affects DAPT planning.

An alternate is the Hybrid DAPT. In a hybrid DAPT, the trust is created as a standard third party irrevocable gifting trust where the settlor is not a potential beneficiary; however, a Trust Protector has the power to add the settlor as a permissible beneficiary. The presumption is that the settlor would only be added if the settlor needs the funds. Because the Trust Protector is an independent party, the settlor's addition as a beneficiary is completely out of the settlor's control. Thus, the trust is a completed gift trust.

When drafting a SLAT, absolutely consider the reciprocal trust doctrine. Reciprocal trusts are those created at the same time with substantially identical terms. If trusts are reciprocal, IRS may disregard the gift and negate the use of exemption amount.

Although GRATs are typically zeroed out, they should be considered as hedge strategies. Consider laddered GRATs. GRATS may be eliminated or require longer terms under future legislation.

Beware of divorce. As a result of 2017 Tax Act §682 was repealed, which results in a grantor trust remaining a grantor trust upon divorce. This result can be prevented in a SLAT with a death on divorce clause but cannot be resolved in an inter vivos QTIP.

A beneficiary defective inheritor's trust ("BDIT") is a trust that is deemed to be owned by a beneficiary for income tax purposes because it grants the beneficiary powers over the entire corpus, yet is not considered to be owned by them for estate/gift/asset protection purposes after lapse. BDIT's are primarily used as a substitute for sales to IDGTs. Some commentators state that BDITS are mostly useless unless leveraged.

A beneficiary deemed owner trust ("BDOT") refers to a trust that is deemed to be owned by a beneficiary for income tax purposes because it grants a beneficiary powers over income, but is not considered to be owned by them for estate/gift/asset protection purposes, because it does not grant a power over corpus. As a result, a BDOT has many uses besides being a substitute for an installment sale to an IGT.

HIGHLIGHTS OF SECURE ACT – Developments in Retirement Planning

Presenter: Brad J. Richter, Esq**.**, Fried, Frank, Harris, Shriver & Jacobson LLP

A significant amount of assets exist in the form of retirement assets. Such assets exist in many different forms of investments. IRAs hold the most retirement assets. That is followed by defined contribution plans. There are also assets in private sector defined benefit plans, government defined benefits and annuity reserves.

There are multiple sources of controlling laws: Internal Revenue Code, ERISA, DOL, PBGC, creditors rights issues. The multiple sources of these laws makes it difficult to simplify the rules in this area.

SECURE ACT was passed as part of budget bill December 20, 2019. Act is known as "Setting Every Community Up for Retirement Enhancement". A companion act was passed in the Senate called the Retirement Enhancement and Savings Act. Changes were in two areas: plan level and individual level.

Changes at plan level include escalated automatic enrollment cap and credit for the same; increased flexibility for safe harbor plans and to the employer offering annuity/life income options including portability; credit increase to small employers establishing SEP, SIMPLE-IRA, or other plan; 529 expansion to Registered Apprenticeship Programs and Educational

Loan Repayments, Pooled Employer Plan; and allowing long term part time workers to participate in 401k.

Changes at individual level included repeal of age limit for contributions. There must still be earned income to make IRA, ROTH IRA or spousal IRA contributions. Back-Door ROTH IRA conversions are permitted. The age at which required minimum distributions increased to age 72. There are penalty free withdrawals for birth/adoption. Graduate non-tuition fellowship and stipends are treated as compensation for IRA purposes. Such amounts were previously not treated as compensation. Kiddie tax was re-established beginning in 2020 but election could be made to apply to 2018 and 2019.

The ability to use a stretch IRA was eliminated by repeal of the life expectancy for a majority of beneficiaries. Life expectancy has been replaced with a ten year distribution period. There are limited exceptions for "Eligible Designated Beneficiaries". Eligible Designated Beneficiaries (for whom life expectancy can be used) include spouse, minor child of participant/owner, disabled/chronically ill beneficiaries and beneficiaries not more than ten years younger. SECURE Act impacts see-through trusts.

IRAs are income in respect of decedent. The amounts are includible in decedent estate and taxable for income tax purposes to recipient upon withdrawal. In estate plan drafting, give attention to estate tax apportionment clause.

There are basically two types of qualified plans: defined contribution plan and defined benefit plan. Defined contribution plans have become most common. Defined benefit plans may be seen with educational, governmental, or old large corporate plans.

Types of IRAs include basic (traditional), SEP (simplified employee pension), SIMPLE (savings incentive match plan for employees), spousal IRA, rollover IRA, inherited IRA, Roth IRA.

The general rule of income taxation is one of ordinary income upon receipt. If there is no constructive receipt, there is no current taxation without actual receipt. Taxation results upon assignment in satisfaction of pecuniary amount. Exceptions to income taxation include rollovers, return of basis, life insurance, Roth IRA distributions. Assignment of a retirement account in satisfaction of a pecuniary amount results in taxation. Plan failure of qualification can result taxation of income and disallowance of deductions. Prohibited transactions may result in taxation.

There are exceptions regarding taxation related to rollover, return of basis, special averaging, life insurance, employer securities, and Roth IRA distributions. There is a 60-day limit on rollovers.

Retirement assets are also included in estate of decedent. Close attention should be paid to estate tax apportionment. Retirement assets are income in respect of a decedent. There is no step up in basis. There is a 691(c) deduction.

A lump distribution is a distribution of the entire amount of a qualified account. There used to be 5 and 10 year averaging that is now gone; however, there is some relief for clients 85 and older.

When employer offers a plan and employer securities are held in plan, there are some additional deferral that can result from net unrealized depreciation. This must be considered when contemplating a rollover.

Historically, a key driver was deferral. In some cases, tax considerations should not be the driver. For example, if there is a concern about the ability of a beneficiary to manage finances, beneficiary protection may prevail over tax consequences. Trusts can still be used to separate control from a beneficiary even though tax benefits are not as significant.

Deferral remains important. Consider when and how much.

Required beginning date for required minimum distributions was changed to April 1 following the year participant turns 72. That is the date that distributions must commence.

Distribution must be made by December 31 of each distribution calendar year. If first distribution is delayed to required beginning date, a second distribution must be made that year prior to December 31. More than the required distribution can always be distributed.

After the SECURE Act, three sets of rules govern. The most favored status is the spouse. The next most favored beneficiary is an eligible designated beneficiary (non-spouse). The next most favored status is designated beneficiary. The least favored status is no designated beneficiary (estate, charity, non-see through trust).

Lifetime distribution rules are unchanged. If an account owner dies after required beginning date, the life expectancy distribution scheme for beneficiaries other than eligible designated beneficiaries applies. Modified life expectancy rules apply to eligible designated beneficiaries.

If an account owner dies before required beginning date, the distribution rules depend on whether there is a designated beneficiary. If spouse is sole designated beneficiary, spouse can use spouse's single life expectancy or rollover; however the ten year rule applies to the successor beneficiary.

If beneficiary is not spouse but is an eligible designated beneficiary, the life expectancy of eligible designated beneficiary can be used but ten year rule applies to successor beneficiary. If designated beneficiary is not an eligible designated beneficiary, ten-year rule applies. If there is not a designated beneficiary, five-year rule applies.

If an account owner dies after required beginning date, the rules depend on whether there is a designated beneficiary. If spouse is sole designated beneficiary, spouse can use the longer of spouse's single life expectancy or participant's life expectancy (rollover is still usually the best approach). If beneficiary is not spouse but is an eligible designated beneficiary, the life expectancy of beneficiary can be used but ten-year rule applies to successor beneficiary. If beneficiary is not an eligible designated beneficiary, then ten-year rule applies. If there is not a designated beneficiary, distributions continue over life expectancy of account owner.

IRS Publication 590-B has clarified that ten year rule means that beneficiary has ten years to fully distribute account. Distributions may, but are not required, to be taken during that period. There is still some confusion on when 10 year period ends.

Check plans to determine whether designated beneficiary is specified. Plan beneficiary designation will control over will.

Trusts can be designated beneficiaries if rules are followed. Look-through status can be obtained with a trust that is valid under state law, is irrevocable or will become so on account owner's death, beneficiary information is filed with custodian and all beneficiaries are identifiable. All beneficiaries count, including successive and contingent beneficiaries.

The first trust option is the conduit trust. Such a trust is merely a conduit for plan distributions. All benefits are payable immediately to the beneficiary. Trustee is directed to withdraw RMD annually and distribute to beneficiary. Remainder beneficiaries are disregarded for purposes of determining conduit beneficiary.

Accumulation trusts do not distribute all of RMD each year to beneficiary. Trust will have a remainder after income passing to primary beneficiary.

This trust is easiest to use for multiple/difficult contingencies. SECURE Act language seems to authorize accumulation trusts. Post-SECURE, pot trusts for DB's are okay but age differential is no longer a concern.

To get EDB status post SECURE, use conduit trust. Accumulation trusts should generally be used in those situations where non-tax concerns control.

Post SECURE planning is highly fact specific. Planning ideas include using a CRT, life insurance, Roth conversions, and family bracket management.

INCOME TAX DEFERRAL FOR TAXPAYERS WHO ANTICIPATE SELLING APPRECIATED ASSETS WHILE LIVING

Presenter: Jerome M. Hesch, Director Notre Dame Virtual Tax & Estate Planning Institute

Ideas are intended to cover income tax deferral techniques that will become more important if carryover basis at death is enacted.

Installment Sale to a Non-Grantor Trust

Individuals in their late 80s and 90s, and individuals in poor health should consider taxable gifts that exceed their exemption and pay the gift taxes. If the donor survives the three years after making the gift, the gift tax paid reduces the amount exposed at death.

Consider creation of a complex trust that is a non-grantor trust. Use an installment sale of an asset to complex trust for both estate planning and income tax deferral for the gain realized upon eventual sale of an appreciated asset for cash.

Example: Senior owns a family business with value of $30,000,000. Senior's basis in asset is $4,000,000. Senior's exit strategy is to sell business for cash at retirement. Spouse and children are not involved in family business.

Consider using a non-grantor trust created by someone other than Senior, such as Senior's mom. If someone else creates trust for Senior, Senior can have a special power of appointment and can be a beneficiary without estate tax exposure. After a valuation discount, the business is worth $20,000,000. Senior gifts half the business to his spouse. Senior and his spouse each sell $5,000,000 interests to the complex trust for installment notes that are interest only with principal due in 23 years. 453A is avoided as long as there is a two year period before further sale. In the next calendar year, Senior and his spouse each sell another $5,000,000 interest for installment notes. The complex trust's cost for business is $20,000,000 as it acquired the business by purchase. If trust later sells the business for $42,000,000, the complex trust realizes a capital gain of $22,000,000. Because Senior and spouse have not had any installment gain, they are not paying income taxes (although the notes will be IRD at time of death).

This structure allows Senior, Senior's spouse, and children to be beneficiaries of the trust. Income can be distributed based on tax brackets to reduce overall income tax cost of asset in trust.

<u>Encumbered Real Estate Owned by a Partnership</u>

Senior owns real estate with an adjusted basis of $25,000, a value of $100,000 and is subject to a $60,000 mortgage. At the time of the sale for $100,000, Senior received only a $40,000 installment note, annual interest on the outstanding principal, with four $10,000 principal payments and interest to be made every 12 months. The buyer assumes the existing mortgage. The $35,000 excess of the $60,000 mortgage over the $25,000 basis is deemed to be a payment of cash at the time of the sale ("phantom gain").

Selling price is $100,000, consisting of the $40,000 note and the $60,000 mortgage taken over by the buyer. With a $25,000 basis, the realized gain is $75,000. The installment method allows the seller to defer the reporting of the gain in the installment note. In arriving at the contract price, the selling price is reduced by the amount of the mortgage, but only up to the seller's $25,000 basis in the property. Therefore, the gross profit ratio is 100%. The $35,000 amount by which the mortgage exceeds the basis is treated as a fictional cash payment at the time of the sale. Accordingly, S is treated as having received $35,000 at the date of the sale. With a $60,000 liability and only a $25,000 basis, only $25,000 of the mortgage can be treated as a tax-free return of basis.

Defer reporting phantom gain using an installment sale to a related party.

Senior tax capital account is a negative $5,000,000 ($4,000,000 – $9,000,000). Senior's outside basis is $4,000,000. If the partnership sells the real estate subject to the mortgage, it receives only $6,000,000 of cash, but reports an $11,000,000 gain. Phantom gain is $5,000,000 (mortgage in excess of basis).

Senior contributes a capital asset with a basis and value of $5,000,000 to the partnership. Senior's outside basis in now $9,000,000. Senior's book and tax capital accounts are increased by the contribution of an asset with a value and basis of $5,000,000 . Tax capital account is now zero $9,000,000 tax basis -$9,000,000 liability).

Consider 453(g), section 1239 and section 453(k)(2) with respect to this transaction.

Senior then sells entire partnership interest to a non-grantor trust for $11m note realizing an $11m gain. Trust's cost basis for partnership interest $20m. The $9m of liabilities do not exceed the $9m basis for Senior's partnership interest. The $9m of liabilities is treated as a non taxable return of basis. This results in a shift of the real gain and phantom gain.

If the partnership sells real estate two years later for $15m, subject to the $9m liability. If basis for real estate is still $4m, the partnership's gain is $11m. The partnership nets $6m of cash. Trust's outside basis is increased by $11m share of gain. Trust's outside basis is reduced by $9m. Upon termination of partnership, $6m cash is distributed and the capital asset with basis and value of $5m is distributed as liquidating distribution. Trust's outside basis of $22m is reduced by $6m of cash. Then trust receives capital asset with inside basis of $5m but as a liquidating distribution, the trust's remaining outside basis as substituted as its basis for capital asset. Trust must sell capital asset in same year as liquidating distribution received.

An alternative is to terminate the partnership before the real estate is sold.

It is possible to borrow basis from another asset to increase the basis of the encumbered real estate.

Senior has two assets, marketable securities, both valued at $30,000,000. Stock A has a basis of zero and recently purchased Stock B has a basis of $30,000,000. Senior desires to sell Stock A in the future and hold on to Stock B as a long-term investment. Can Senior shift the $30,000,000 basis in Stock B to Stock A so that a sale of Stock A for $30,000,000 cash will not result in any realized gain? The basis shifted from Stock B to Stock A creates potential gain for Stock B.

Review the basis rules under § 732 for property distributed by a partnership to a partner. When a partnership distributes an asset to a partner, the partner's basis in the distributed asset is that same as the partnership's basis. The partnership's basis carries over to the partner for both appreciated assets and assets that have declined in value. The built-in gain or built-in loss stays with the distributed asset.

A, a 20% partner, has a $14,000 basis in her partnership interest ("outside basis"). A's 20% interest is valued at $20,000. -Partnership distributes to A, an asset with **a basis to the partnership of $6,000** ("inside basis") and a value of $10,000 (the *value reduces A's book capital account)*.

-No gain is realized by A or by the partnership.
-A's basis in the distributed asset is $6,000.
-A's basis in his partnership interest is reduced by $6,000 to $8,000 and A's capital account is reduced by $10,000.
-With a carryover basis, all other income tax attributes for the distributed asset are carried over to A.

Exception: Basis in distributed asset cannot exceed a partner's outside basis:
• B's outside basis is $4,000. B's partnership interest is worth $20,000 (***the built-in gain is $16,000***). B receives a *liquidating* distribution of an asset with an inside basis of $7,000 and a value of $20,000 (**the built-in gain is $13,000**).
• If B were permitted a $7,000 carryover basis, B would have only $13,000 of built-in gain in the distributed asset and $3,000 of potential gain will disappear.
• To preserve **the $16,000 of built-in gain**, B's basis in the distributed asset is limited to $4,000.

If a partner's interest is terminated, the partner's outside basis is substituted as the basis for the distributed asset.
• The extra $3,000 of inside basis cannot used by B.
• Does the $3,000 of basis disappear?
• **Apply the Section 754 election**
• The partnership can increase the inside basis for its remaining appreciated assets by the $3,000 of basis that B could not use. See Section 734(b).

HOPE THIS HELPS YOU HELP OTHERS MAKE A *POSITIVE* DIFFERENCE!

Mary Vandenack

CITE AS: