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Tax Strategies for Family and Estate Planning

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Speaker

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Recent Updates

Secure 2.0: Key Provisions

- Increase in age to start taking RMDs
- Change to catch-up contributions
- Reduced penalty for missed RMD
- Statute of limitations on assessment of excise tax
- 529 Plan rollover to Roth IRA

Secure 2.0: Required Beginning Date

- Currently, RBD is April 1 following the year in which the plan owner attains age 72
- **Change:** RMDs start at age 73 (rather than age 72) for individuals who attain age 72 after 2022 and at age 75 for individuals who attain age 74 after 2032
- Below is a summary of the timeline:

Birth Year	Age at Which RMDs Begin
1950 or earlier	**72 (70½ for those who turned 70½ prior to 2020)**
1951 – 1959	**73**
1960 or later	**75**

- Effective for distributions made after December 31, 2022 for individuals who attain 72 after that date

Secure 2.0: Catch-up Contributions

- Currently, individuals aged 50 and older can make additional pre-tax contributions to workplace retirement plans (e.g., 401(k)) which are limited to $7,500 in 2023
- **Beginning in 2025,** the catch-up contribution limit for individuals ages 60-63 is increased to the greater of $10,000 (indexed for inflation) or 50% more than the regular catch-up amount
- **Starting in 2024**, anyone earning more than $145,000 (indexed for inflation) in the prior year must make catch-up contributions to a Roth account in after-tax dollars
- **Beware:** Beginning in 2024, retirement plan participants won’t be eligible to make catch-up contributions due to a drafting glitch

Secure 2.0: Reduced Penalty on Missed RMD

- Under the current law, if an individual fails to take his RMD, an excise tax equal to 50% of the RMD will be imposed
- **Beginning in 2023,** the excise tax is reduced from 50% to 25%
- Furthermore, if the failure to take the RMD is corrected in a timely manner, the penalty is reduced from 25% to 10%

Statute of Limitations on Assessment of Excise Tax on Excess IRA Contributions and Missed RMDs

- Under prior law, the statute of limitations on excess IRA contributions and missed RMDs started with the filing of Form 5329
- **Effective immediately,** the statute of limitations starts when the taxpayer files his return for the year in which the error occurred
- Statute is 3 years for missed RMDs and 6 years for excess IRA contributions

Tax-free Rollovers from 529 Accounts to Roth IRAs

- **Change:** Direct trustee-to-trustee rollovers from a 529 account to a Roth IRA is permitted without tax or penalty under certain circumstances
- 529 account must have been open for more than 15 years and the rollover cannot exceed the aggregate amount contributed to the account (and earnings thereon) more than 5 years before the rollover
- Aggregate rollovers can’t exceed $35,000
- Effective for distributions after 2023

Notice 2022-53: 10-Year Payout Period-Missed RMD Relief

- RMDs must begin the year after the participant's death if the participant died after his RBD
- Effective for participants who died after 12/31/2019: a retirement account must be fully distributed no later than the end of the tenth year after it is inherited
- Misinterpretation: No annual RMD during the first 9 years of the 10-year period
- Relief: Waiver of 50% excise tax on 2021 and 2022 missed RMDs
- Do the missed RMDs need to be taken?

Checks Unpaid at Death: Estate of DeMuth v. Commissioner, T.C. Memo 2022-72 (July 12, 2022)

- Decedent gave his son a durable power of attorney which included the power to make annual exclusion gifts on his behalf
- Son made annual exclusion gifts by writing checks to the donees
- In the year of decedent's death, son wrote checks to the recipients before the decedent's death; however, only one of those checks was paid before the decedent's death
- The decedent's estate did not include the check amounts in the decedent's estate presumably because they represented completed gifts
- IRS issued a notice of deficiency asserting that that the checks delivered to the donees but uncashed as of date of death should have been included in decedent's estate
- Mere delivery of check does not complete a gift because the donor can always stop payment so uncashed checks don't represent completed gifts
- Nevertheless, the IRS erroneously conceded that three of the checks were not includible in decedent's gross estate because they had been credited by drawee banks

Defined Value Based on Appraisal: Nelson v. Commr, 128 AFTR2d 2021-6532

- Mrs. Nelson created a trust for her husband and their children, and transferred partnership interests to the trust
- The memorandum of gift provided that she was making a gift to the trust of a limited partnership interest having a fair market value of $2,096,000 on the date of the gift, *as determined by a qualified appraiser within 90 days*
- Two days later, Mrs. Nelson sold a limited partnership interest in the same entity; the memorandum of sale provided that she was selling a limited partnership interest with a fair market value of $20 million on the date of the sale, *as determined by a qualified appraiser within 180 days*
- The appraiser subsequently determined the value of a 1% LP interest and based on that appraisal, Mrs. Nelson was deemed to gift a 6.14% LP interest and to sell a 58.65% LP interest to the trust
- The IRS subsequently determined that the gift was undervalued and that there was a gift tax deficiency associated with the sale because of the undervaluation
- The taxpayer argued that the initial valuation was correct and even if it wasn't, Mrs. Nelson had transferred a specific dollar amount, not a fixed percentage, of the LP but the Tax Court disagreed noting that the interests transferred were expressed as an interest having a fair market value of a specific dollar amount as determined by a qualified appraiser
- Fifth Circuit Court of Appeals affirmed: The transfer documents lacked specific language describing what would happen to any additional shares that were transferred should the valuation be successfully changed
- **Not a rejection of Defined Value Clauses; Acceptance of Time-Limited Defined Value Clauses**

Wandry Clause: Sorensen v. Commr, Tax Ct. Dkt. Nos. 24797-18, 24798-18, 20284-19, 20285-19 (decision entered August 22, 2022)

- Two brothers created grantor trusts and gifted nonvoting stock in their company having a value of $5 million as finally determined for gift tax purposes
- Based on an appraisal, this equated to approximately 30% of each brother's nonvoting shares (or 9,385 shares) with a value of $5 million
- The brothers subsequently each decided to sell an additional 20% of their company stock with a value of almost $3 million to their trusts based on an appraisal
- Their gift tax returns reported the defined value transfers
- The IRS issued a notice of deficiency of almost $14 million per taxpayer plus penalties
- 7 years later, the company was sold for $1 billion, and each trust received about $153 million
- IRS did not respect *Wandry* clause: (1) Company stock ledger showed 9,385 shares transferred to each trust, (2) distributions were made based on ownership of 9,385 shares, (3) no agreement with trusts, (4) third-party buyer of 9,385 shares
- Distinguishable from *Wandry*: Specific shares were transferred, taxpayers failed to follow transfer clause (i e , donors rounded up number of shares gifted); shares could not be adjusted because there was a sale of all shares to a third party
- Stipulation: Defined value formula does not apply to each donor's gift. Each brother gifted 9,385 shares.
- WIN FOR BROTHERS because of significant appreciation

Indirect Gifts: Smaldino v. Commissioner, T.C. Memo 2021-127 (11/10/2021)

- In 2013, Donor transferred (1) an 8.05% interest in his LLC holding rental properties to a trust for his children/grandchildren and (2) a 40.95% in the LLC to his wife; the transfer to the trust used his remaining gift tax exclusion, and the transfer to his wife was virtually equivalent to her remaining gift tax exclusion
- The day after the Donor's transfers, Donor's wife transferred the 40.95% interest in the LLC to the trust for Donor's children/grandchildren
- The Service contended that the doctrine of substance over form applies and that the Donor's purported transfer of the LLC interest to his wife followed by her transfer of this interest to the trust should be disregarded because the actions were part of a prearranged plan to transfer ownership of the LLC
- The Tax Court held that Donor never effectively transferred an LLC interest to his wife and thus, the trust received its 49% interest in the LLC from the Donor

GRAT Valuation Issue: Baty v. Commr, Tax Court Docket No. 12216-21

- CCA 201939002 (12/30/2021): Publicly traded stock must be valued for gift tax purposes taking into consideration an anticipated merger that was expected to increase the value of the company stock
- Case ended up in Tax Court
- Donor was co-founder of one of the nation's largest assisted living and memory care providers that was traded on NYSE
- Prior to Donor transferring stock to a GRAT, the company was in acquisition discussions with multiple companies and just prior to the transfer, the company was in exclusive merger discussions with another company. The Donor was aware of these discussions
- On January 14, 2014, the Donor contributed company stock to a two-year zeroed-out GRAT and valued the stock based on the mean between high and low NYSE price on date of gift
- The value of the shares of stock increased significantly following the announcement of a merger, which was eventually completed on August 1, 2014. The IRS asserted that the stock valuation should have considered the merger discussions even though not publicly announced at time of gift; IRS issued notice of deficiency using the stock's trading price on date of merger (six months later) and refused to adjust annuity payments asserting an additional gift, and in the alternative that the GRAT failed to qualify whereby the entire amount contributed to the GRAT would be a taxable gift.
- In a settlement, the IRS conceded

Another GRAT Valuation Ruling: CCA 202152018 (12/30/2021)

- Donor funds a two-year GRAT with shares of his privately-held company stock
- The appraisal of the stock did not consider a pending merger
- IRS concluded that basing the annuity on an undervalued appraisal causes the retained interest to fail to function exclusively as a qualified interest from inception

Marital Deduction Planning

Goals of Marital Deduction Planning – Asking the Right Questions

- Goals of Marital Deduction Planning:
  - Effective use of both spouse's basic exclusion
  - Effective use of both spouse's GST exemptions (because there is no portability of GST exemption)
  - Deferral of estate tax until second spouse dies
- Requires flexibility – no one knows what the estate tax will be on second spouse's death
- It's all about…Asking the Right Questions
- Review family situations
- Discuss how much control client wants

Qualification for Marital Deduction – IRC §2056(a)

- In order to qualify for the marital deduction, the property must
  1. pass from the decedent (D)
  2. to the surviving spouse (S), and
  3. be included in D's gross estate

- Other requirements:
  - S must be U.S. citizen spouse
    - D need not be U.S. citizen or resident
  - Interest must not be nondeductible terminable interest
    - Terminable interest terminates or fails either on lapse of time or occurrence or nonoccurrence of event or contingency

Types of Marital Deduction Bequests

- Outright
  - Simple plan - Leave everything outright to spouse
  - Relies on portability and use of Deceased Spouse's Unused Exclusion (DSUE)
- Qualified Terminable Interest Property (QTIP)
- General Power of Appointment Trust
  - All trust income payable to S annually for life
    - S has all-events general power to appoint to S or S's estate
      - Payment to creditors is not enough
      - No other beneficiaries other than S
        - Trustee can have discretionary power to distribute to S or;
        - S can have inter vivos power to appoint to third parties (not allowed in QTIP)

Types of Marital Deduction Bequests (Cont.)

- Estate Trust
  - Does not require annual payments - Payments can be discretionary
  - Accumulated income and principal must be paid to spouse's estate
    - This is a deductible terminable interest
- Qualified Domestic Trust (QDOT)
  - Trust for non-citizen spouse

Marital Deduction Bequests – Portability

Pros of portability:

- Simplicity
- No balancing of assets needed
- Step up in basis at second death
- No trusts are needed
- Works for larger estates (even if exemption goes down)

Marital Deduction Bequests – Portability (Cont.)

Cons of portability:

1. DSUE can be lost if surviving spouse remarries and survives another spouse
   - Only applies to the surviving spouse's **last** post-2010 predeceased spouse
2. Estate tax return filing requirement
   - Rev. Proc. 2022-32 extends the time to file the return to five years but only if a return is not otherwise required
3. DSUE is not indexed for inflation. It is a fixed amount and does not grow as assets appreciate.
   - A credit shelter trust, on the other hand, can appreciate outside of the surviving spouse's estate
4. GST exemption is NOT portable
   - May be beneficial to allocate decedent's GST exemption to nonmarital trust
5. Portability of DSUE is federal tax concept – consider state estate taxes
   - If estate is subject to state estate taxes, any benefits of credit shelter planning are lost
   - In states like New York (where the estate tax exemption is $6,580,000 (2023)), it may be advisable to shelter state tax exclusion and elect portability for the rest

Types of Marital Deduction Bequests – QTIP Trust

Qualified Terminable Interest Property (QTIP)

A QTIP trust is an effective way to use the marital deduction and retain control of the assets from the grave. In order to qualify for the marital deduction as a QTIP Trust, there are four requirements under IRC section 2056(b)(7):

(1) the property must pass from the decedent;

(2) the spouse must have a qualifying income interest for life;

(3) no other beneficiary during the spouse's life; and

(4) election must be made

Types of Marital Deduction Bequests – Partial and Reverse QTIP Elections

Partial QTIP elections available

- Authorized by the Code and regulations
- By formula
- Allows for post-mortem planning
- Irrevocable
- Drafting tips:
  - Use savings clause
  - Include statement of intent
  - Consider effect of partial election on other portions of document (i.e., tax apportionment clause);
  - Allow for division of trusts
  - Beware of assets that do not qualify. Document should state cannot be funded with assets that do not qualify

Reverse QTIP election

- Must be made to avoid loss of GST exemption
- Allows D to remain as transferor for GST purposes
- No partial reverse QTIP election
  - Trust instrument should include severance power to allow for fully exempt and non-exempt shares

Types of Marital Deduction Bequests – QTIP Election Timing and Remedies

- Time for making QTIP election or Reverse QTIP election
  - The time for making the QTIP election is on the last estate tax return that is filed, including extensions
  - If a return has not been filed timely, then the deadline is the first estate tax return filed after the due date
- Remedies – Allows an extension of time to cure administrative defects
  - Automatic 6-month extension if corrective action taken within 6-month period
    - File a replacement original or amended return listing the property and claiming the deduction
  - 9100 relief
  - Late reverse QTIP election – Rev. Proc. 2004-47
    - Simplified alternate method under Section 2652 to be used in place of formal process for obtaining a letter ruling and without user fee

Types of Marital Deduction Bequests - Disclaimers

- Disclaimer planning is an alternative to an all-outright plan since it allows for post-mortem planning
  - D makes unlimited marital deduction bequest to S
  - S can disclaim appropriate amount
- Can be used by both spouses
- Disclaimer must be made within 9 months after D’s death
  - S may be unwilling to give up control
  - S may not have capacity to disclaim or may die before disclaimer is made
  - Disclaimer may affect timing and rights of beneficiaries
  - S cannot have already accepted property
  - Document must specify disposition of disclaimed interests (but not by S)

Planning for the Middle-Rich

Who are the “Middle Rich?”

Who are the Middle Rich?

Rich - $12M to $13M

Middle Rich – $24M to $26M

Planning for Middle-Rich – stick with tried-and-true basics. Advanced esoteric planning not necessary. Middle Rich must be comfortable giving away assets.

Step 0 – Who do you represent? Senior family members or younger generation? Gather information.

Step 1 – Nontax aspects: Powers of attorney, health care directive

Step 1 ½ - Middle Rich will make gifts if they are not giving up control or income

The “Test Trust”

<u>Do a “Test Trust”</u>

- Gift a small amount in trust for beneficiary over which beneficiary has influence
- Purpose is to educate client and family on use of the trust and get them comfortable with making gifts
- Use an existing trust or a new trust
- Choice of assets in important

Foundation for Planning for Middle Rich – Gifts to Grantor Trust

A funded grantor trust can facilitate:

- Swaps
- Sales
- Joint Purchases

Middle Rich Will Make Gifts if Not Giving up Control

- Investment control – Easy to do. Use voting and nonvoting shares.
- Distribution control – Harder to do. Grantor can "inspire" but not control fiduciaries.
- Beware of too much control under §2036(a)(2). If any interest is retained, assets can be pulled into estate under §2036(a)(2).
  - Need to pry control out of client's hands at least three years prior to death
  - Consider power of appointment
    - Does not require same fiduciary standard as trustee
    - 2036 problem if power holder or "trust protector" does whatever grantor says
  - Upstream planning for Basis Adjustment – give senior generation a general power of appointment over trust assets
  - "Circumscribed general power of appointment" for purposes of obtaining a step-up in basis for assets upon death for those with excess estate exclusion
    - (1) Testamentary power (2) in favor of creditors of estate (3) with consent of non-adverse party (4) only over assets with a fair market value in excess of basis, and (5) capped at such amount subject to the power when added to other assets produces a total that is $10,000 less than Basic Exclusion Amount

Middle Rich Will Make Gifts if Not Giving up Income

- Gift non-income producing property
  - Life insurance
  - Raw land
- When cash is needed, swap assets with trust and take cash out
- Sales to grantor trusts provide cash flow in form of interest and principal payments
- Include spouse as trust beneficiary

A Note on Spousal Lifetime Access Trusts “SLATs”

Spousal Lifetime Access Trust

- One spouse transfers property or remaining exemption amount in trust for the benefit of the other spouse, children and future generations
- While the grantor is alive, the other spouse has access
- Captures the current exemption amount while not compromising the spouse (and vicariously the grantor)
- Possible for both spouses to fund a SLAT, but reciprocal trusts must be avoided
- Grantor trust implications
- Uses grantor’s GST exemption

A Note on Spousal Lifetime Access Trusts “SLATs” (Cont.)

Issues with SLATs

- Who do you represent? Is there a conflict of interest?
- Advise of divorce risk
  - Is spouse removed as beneficiary in case of divorce?
- Wait until following year to set up second SLAT
- Make sure trusts are not reciprocal
  - Step transactions concerns
    - Smaldino v. Commissioner – Tax Court held Mr. Smaldino never effectively transferred his LLC interest to his wife and therefore it was a gift from him
- For lower Middle Rich clients, one SLAT may be used for purposes of “use it or lose it” exemption. Result may be that non-grantor spouse has more assets than grantor spouse.

Gifting Strategies

- Annual exclusion gifts (via Crummey Powers)
- Remaining exemption gifts (but don’t pay gift tax)
  - Middle Rich want certainty
  - Middle Rich don’t want to pay gift tax
  - Make a fractional gift “as finally determined for federal gift tax purposes” with excess to a donor advised fund. Gift should be over fractional amount (remaining exclusion) so something goes to DAF
    - Nelson v. Commissioner – Mrs. Nelson made a gift for a specific dollar amount “as determined by a qualified appraiser within ninety (90) days of the effective date of this assignment”
- Grantor Retained Annuity Trusts (GRATs) - Don’t require a gift

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A Note on Texas Franchise Tax

Choice of Texas Entity – LLC or LP?

- Partnerships (general, limited, and limited liability) can be passive for Texas Franchise Tax.
  - LLCs not eligible to be passive for Texas Franchise Tax. This can cause passive income at lower tier entities
- 90% of the entity's federal gross income from:
  - Dividends
  - Interest
  - Gains
  - Passthrough income
  - Royalties and non-operating working interests in minerals
- Rental income not eligible - but time the sale for passive treatment on large net gains.

Looking Forward

Sunsetting Provisions

- Set to expire at end of 2025:
  - Unified lifetime estate and gift tax exclusion reduced by about half.
    - No clawback per Regs. Sec. 20.2010-1(c), but;
    - Use it or lose it
    - Portability elections should not be affected.
  - Deduction for Qualified Business Income (QBI)
  - State and local tax deduction cap of $10,000 expires
  - And more

- Maximum personal income tax rates increase from 37% to 39.6%. Consider accelerating income, for example with Roth conversions.

Biden 2024 Tax Budget Proposals

Income Tax

- Restore the top 39.6% income tax rate for individuals.
- Remove preferential capital gain tax rate for income in excess of $1 million.
- Tax capital gains at death or date of transfer.
- 25% minimum tax on total income, including unrealized gains, of high-net-worth taxpayers (>$100 million).
- Increase minimum distribution requirements for tax-preferred retirement accounts in excess of $10 million.
- Remove capital gain treatment for carried interests for income in excess of $400,000.
- Subject more passthrough income to the net investment income tax. Also increase this tax rate by 1.2% for income in excess of $400,000
- Make the Sec. 461(l) excess business loss limitation permanent.
- Apply wash sale and mark-to-market rules to digital assets

Biden 2024 Tax Budget Proposals

Estate and Gift Tax

- Require defined value formula clauses to be based on a variable that does not require IRS involvement.
- Eliminate present interest requirement for gifts under the annual gift tax exclusion. Impose annual exclusion limit of $50,000 for certain transfers.
    - Transfers in trust
    - Transfers of interests in passthrough entities
    - Transfers of interests subject to a prohibition on sale
    - Transfers of partial interest in property
    - Other transfers the donee cannot immediately liquidate
- Replace IRC Sec. 2704(b) to limit application of discounts (i.e., lack or marketability, lack of control) to valuations of partial interests in property when the family owns >25% of the asset.

Biden 2024 Tax Budget Proposals

Estate and Gift Tax

- Minimum current value of a GRAT would be greater of 25% of assets or $500,000. Decrease of annuity prohibited. No tax-free exchange of assets held in trust. Minimum 10-year term.
- Limit duration of GST exemption to beneficiaries no more than two generations below the transferor and younger generation beneficiaries alive at creation of the trust.
- Require reporting of estimated total value of trust assets, information on the trustee and grantor, and other additional information.
- Expand the definition of executor to apply for all tax purposes.

Thank You

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