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# HECKERLING UPDATE FOR THE TWIN CITIES ESTATE PLANNING COUNCIL

**2020**

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**TOPIC LIST**

# SECURE ACT

## LIFE EXPECTANCY PAYOUTS ARE "GONE WITH THE WIND"

**Maximum payout period for most beneficiaries is 10 years, effective for persons dying AFTER December 31, 2019**

- The Stretch IRA is gone (almost) and we have more to say about that

- Stretch is allowed for "Eligible Designated Beneficiaries" (EDB) – Top Tier Beneficiary
    - Surviving Spouse of the participant
        - Life expectancy, but at death the 10-year rule applies
    - Minor Child of the participant (NOTE: grandchildren are limited to 10-year rule)
        - Life expectancy until age of majority, and then the 10-year rule applies
    - Disabled beneficiary (see 72(m)(7))
        - Life expectancy, but at death the 10-year rule applies
    - Chronically ill individual (see 7702B(c)(2))
        - Life expectancy, but at death the 10-year rule applies
    - < 10 years younger beneficiary with respect to the participant
        - Life expectancy, but at death the 10-year rule applies

- The 5-year payout still applies to non-designated beneficiaries (NDB), no change - Bottom Tier

# SECURE ACT (CONT.)

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## EFFECTS ON CONDUIT AND ACCUMULATIONS TRUSTS

**Conduit trusts – all retirement plan distributions must be passed out to the individual life beneficiary.**

- 10-year rule applies for the payout of the plan AND it must be paid to the lifetime beneficiary
    - Did the grantor of the trust want this amount of money to go out that quickly to the beneficiary?
    - If lifetime beneficiary is an EDB, then it can still go out over the life expectancy of the EDB

**Accumulations trusts – retirement benefits may be accumulated in the trust and the trust pays the tax on the income.**

- 10-year rule applies for the payout
    - Did the grantor of the trust understand the very high income tax cost associated with this accelerated payout where the top trust tax rate begins at $12,950?
    - It can't be an EDB because it is not for a sole beneficiary who qualifies as EDB
        - Exceptions: for disabled or chronically ill
    - A DB is still required to avoid the 5-year rule as well as to qualify as a see-thru trust

**Conduit trusts – all retirement plan distributions must be passed out to the individual life beneficiary.**

# SECURE ACT (CONT.)

## PLANNING FOR BENEFICIARIES

### No annual distributions are required, provided it is all distributed during the 10-year period

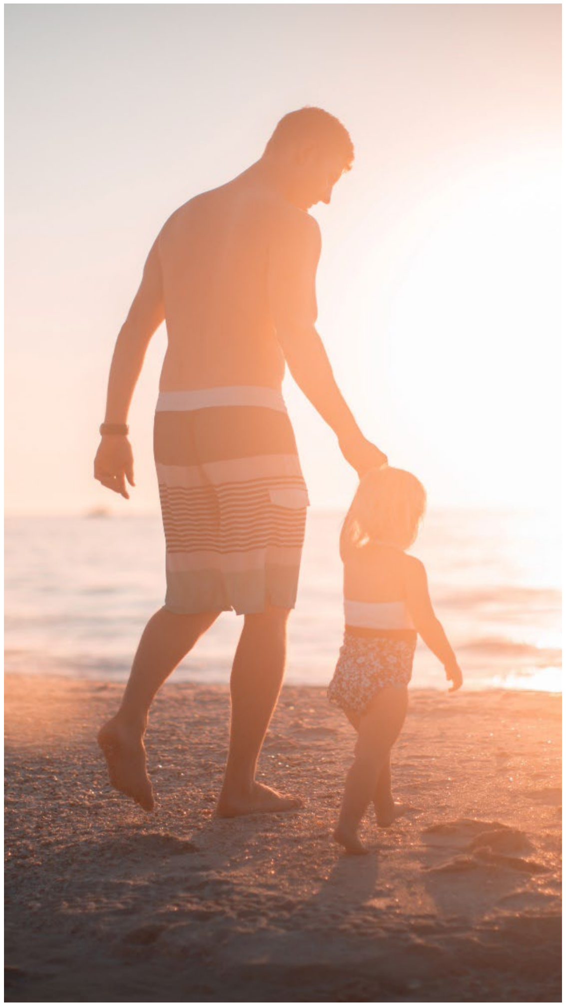
- Bunching the income in a final year may push the recipient into higher tax bracket which must be weighed against the tax-free deferral of income and appreciation
  - Maybe there is a loss from other income that could offset a large distribution

### Surviving spouse

- Rollover and take RMDs beginning at age 72
  - If a beneficiary was 70.5 prior to January 1, 2020, the required age for distribution is still 70.5
- Life expectancy calculated annually
- 10-year distribution rule does not apply
- QTIP trusts still work where the trust must distribute the greater of the RMD or the income generated from the IRA in addition to the other trust income
- Accumulation trusts for a spouse do not work (not a sole life beneficiary) and the 10-year payout rule applies

### Minor child

- Conduit trust for a sole beneficiary works until the age of majority (is it state law 18 or 21, or is it 26 if not completed a specified course of education?), then is subject to the 10-year rule
  - If a child is disabled, then life expectancy may continue and a "pot trust" may divide into a separate share for a disabled beneficiary and use a life expectancy for that child's share
  - If a minor child is disabled or chronically ill at the time of majority, then it can continue for the life of the child (NOTE: this does not work for a grandchild)



# SECURE ACT (CONT.)

**PLANNING FOR BENEFICIARIES (cont.)**

### Disabled/chronically ill (D/CI) individual and trusts

- A multi-beneficiary trust where all beneficiaries are DB which subdivides at the participants death will be allow to stretch out the payments over the life expectancy of the one D/CI beneficiary's separate sub-trust 401(a)(9)(H)(iv)(I)
    - This trust subdivision exception does not extend to any other EDB category
- Accumulations trust where the D/CI is the sole lifetime beneficiary and the rest of the beneficiaries are DB, may stretch out the distributions but there is uncertainty whether it is the D/CI or eldest DB list expectancy

### Less than 10 years younger than plan participant

- Still works as expected, and the beneficiary may name someone "their age" as a successor beneficiary and avoid the 10-year payout at their death

# THE END OF THE STRETCH IRA: WHAT DO WE DO?

## PLANNING CONSIDERATIONS

### Leave the retirement assets to a charitable remainder trust (CRT)

- The trust is tax exempt and the beneficiary(ies) only pay ordinary income tax to the extent of the required annual payment
    - The IRA distribution to the trust is all tier 1 income that will be distributed out first
- A 20-year term may be the largest stretch if the beneficiaries are young as the CRT must meet the 10% charitable remainder test
- Potential to defer distributions to individuals using a NIMCRUT if important to defer the timing of the distributions to the beneficiary

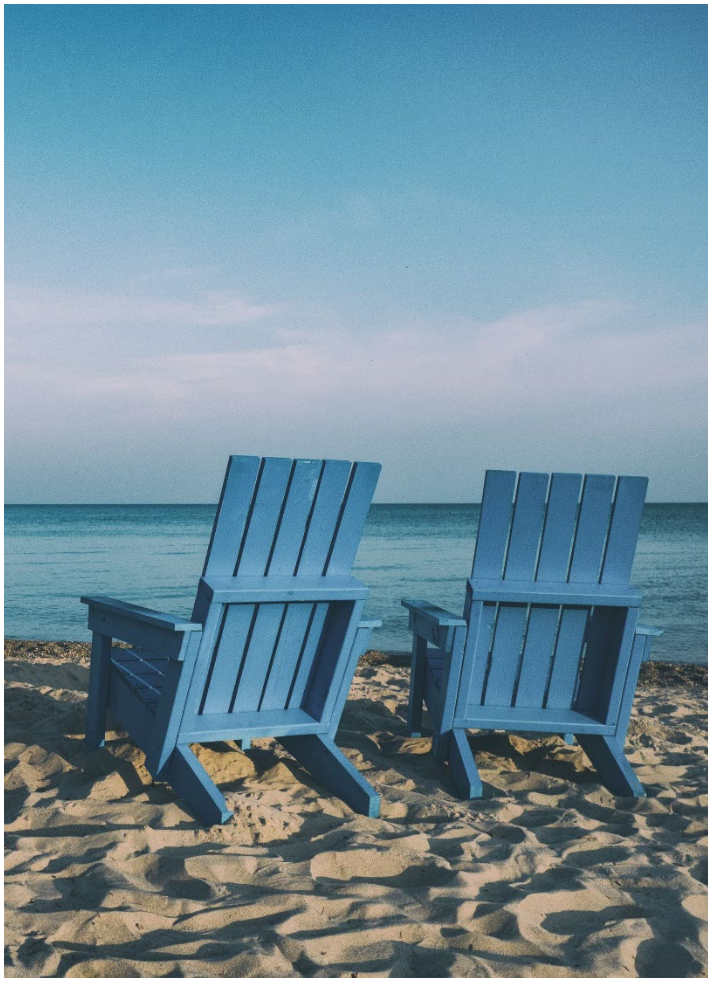
### Leave the retirement asset directly to a charity

- Consider leaving it to a donor advised fund(s) rather than separate charities due to the peculiarities of each financial institution

### Purchase life insurance to address the “asset shortfall” due to accelerated tax payments

### A Roth conversion may help if the participant is in a lower tax bracket

- Assets still come out in 10 years but there is no income tax, only the loss of additional appreciation
- Disadvantage is that the tax is paid earlier than required and no one knows where the tax laws and rates will be in the future



# OTHER SECURE ACT CHANGES

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## RETIREMENT PLANS

**Required minimum distributions begin at age 72**

- You may continue to make contributions to a tax-deductible IRA after age 70-1/2
    - Qualified Charitable Distributions must be reduced by any contributions made after age 70-1/2

**The kiddie tax (dependent children under age 19 or full-time students under age 24) has been modified from the 2017 Tax Act by reverting to the way that the kiddie tax worked before 2018 and not at the onerous estate/trust income tax rates for the child's unearned income (highest tax rate for a trust begins at $12,950 of taxable income)**

- Legislation allows for retroactively amending 2018 and/or 2019 tax returns to claim a refund.
- Addressed issues of children receiving government benefits and college scholarships and taxed at rates higher than their parents receiving the very same benefit

**Penalty free withdrawals from retirement plans for childbirth or adoption up to $5,000 for each parent**

# ANTI-CLAWBACK REGULATIONS

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## FINAL REGULATIONS CLEARLY STATE THAT LIFETIME GIFTS WILL NOT BE TAXED AGAIN

**Regs. 20.2010-1(e)(3) conforms to the Tax Cuts and Jobs Act increases of the applicable exclusion amount, including the cost of living adjustment increases**

**The sunset of the higher basic exclusion amount in 2025 may have denied the taxpayers who died after 2025 but made gifts prior to 2026 of large gifts, the full benefit of the higher applicable exclusion applied at the time of the gift.**

- When calculating the applicable exclusion after 2025 at the taxpayer's death, if the basic exclusion amount (BEA) credit is lower at death than the credit allowed in calculating post 1976 gifts, then the higher credit will be allowed. Regs. 20.2010-1(c)

**Window of opportunity**

- Give money/assets now up to the full amount of the increased applicable exclusion (or as much as one is comfortable transferring)
- Review non-exempt and partially exempt trusts currently in place and determine whether a late GST allocation would be appropriate
    - The regulation did not directly address GST anti-clawback, but the preamble may give you some comfort
- Consider drafting (maybe even executing) thoughtful documents now and take a wait and see approach for funding (e.g. Irrevocable trusts such as SLATs or other grantor trusts)
    - Think 2012, where some funded trusts are now regrets because they were done in haste without as much preplanning or discussion or understanding
    - The congress may change, maybe a tax law change, and the exemption reverts to old levels prior to 2025

**The DSUE is locked in and available**

# GRANTOR TRUSTS (IDGT, SPOUSAL)

## GRANTOR TRUSTS CONTINUE TO BE ONE OF THE MOST EFFICIENT WEALTH TRANSFER TOOLS

### Advantages of a Grantor trust in general

- Taxable transactions between the grantor and the trust are ignored or deferred, as the IRC confirms that the trust and the grantor are one and the same
- Payment of the annual income tax liability associated with the trust by the grantor is not considered a gift to the beneficiaries of the trust as it is the grantor's personal liability under the IRC
- Potential freezing of the value of a part of the grantor's estate if a sale to the trust is made reducing future estate taxes, and the post transfer appreciation inures to trust beneficiaries
- May hold S-corporation stock
- May substitute assets of equal value to adjust basis or to lock down asset value in the grantor trust
- Discretionary reimbursement for income taxes is allowed and does not trigger inclusion in the grantor's estate (Rev. Rul. 2004-64)

### Disadvantages

- If the grantor trust is irrevocable, there may be loss of control over the asset

### Sale to an Intentionally Defective Grantor Trust (IDGT)

- An alternative to an installment sale
    - No current capital gain is recognized where the appreciated asset is sold to an IDGT
        - Payments, representing principal income or interest will not be a taxable event in an IDGT
- Both Sales (Installment sale and sale to an IDGT) may increase the liquidity of the grantor's holdings
- Control may be maintained if the buyer is inexperienced by selling only non-voting share of a closely held entity or continuing as a manager of the business

# GRANTOR TRUSTS (IDGT, SPOUSAL) (CONT.)

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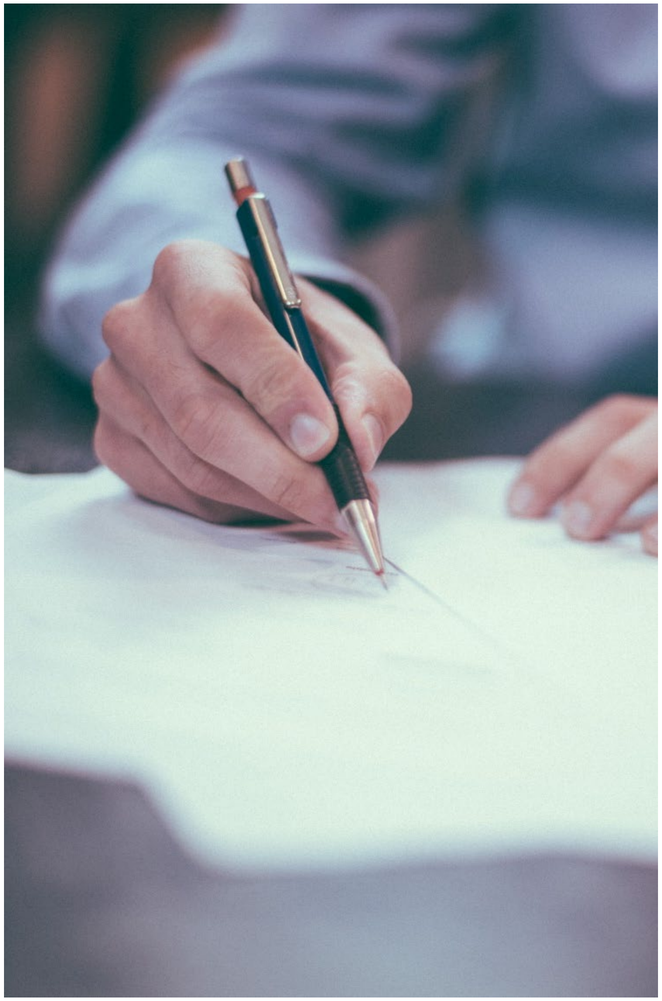
## SPOUSAL GRANTOR TRUSTS (SGT) ADD A TWIST ON A GOOD TRANSFER IDEA

### One spouse sells an asset to the other spouse's irrevocable grantor trust, the SGT

- The sale is not recognized for federal income tax purposed as a taxpayer couple is treated as only one taxpayer
- Advantages
    - Selling spouse may be a beneficiary of the SGT, serve as a trustee, and hold a testamentary limited power of appointment over the trust assets
        - The impact is that the selling spouse may retain an interest in the assets, a limited amount of control, without the risk of inclusion in the selling spouse's estate
- Risks include
    - Taxation of the interest income on the promissory note
    - Potential recognition of gain on the sale after the death of either spouse
    - Inclusion of the trust property in the selling spouse's estate



## LOW INTEREST LOANS TO GRANTOR TRUST

### Simple wealth transfer technique is to make a loan to an irrevocable grantor trust (IGRT)

- Loan from the grantor to the IGRT at the AFR rate, and the IGRT purchases an appreciating asset
- The arbitrage between the rate of return on the asset and the interest owing on the note is a gift tax free transfer to the trust

# NON-GRANTOR TRUSTS (BDOT, ING)

## BENEFICIARY DEEMED OWNER TRUST (BDOT)

**Under IRC 678(a), a person, other than the grantor is treated as the owner of any portion of the trust, with respect to which one has the power exercisable solely by oneself to vest the corpus or the income therefrom in oneself**

- Design the BDOT as to the "taxable income only" of the trust
- Simply having the power to withdraw the income, will make the trust a BDOT and the income tax burden shifts to the power holder, not the person who may receive a distribution

### Advantages

- Tax benefits include simpler reporting, potentially lower income and capital gains taxes and net investment income surtax, use of capital losses that may be held in the trust and S-corporation status
- Creditor protection
- Basis adjustments

### Disadvantages

- The beneficiary may exercise the power the when the grantor's desire is to accumulate assets, earnings and appreciation for others

# NON-GRANTOR TRUSTS (BDOT, ING) (CONT.)

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## INCOMPLETE NON-GRANTOR TRUST (ING)

**Not a grantor trust so that with careful planning it may be used to avoid or minimize state income tax**

**Potential to be another taxpayer and use an additional $10,000 state income or property tax deduction (e.g. family vacation home) provided there exists sufficient trust rental income to offset the deduction**

- Caution should be exercised if there is a plan to exclude gain under IRC §121
- A rental agreement for fair market value should also be used to avoid unintended gifts

**A CRUT can be a beneficiary of ING trust if provided in the document or a permissible appointee**

# ENTITY VALUATION AND AUDIT CHALLENGES

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## S-CORPORATION TAX-AFFECTED VALUATION WAS ALLOWED

**James F. Kress and Julie Ann Kress v. United States of America, 2019 case accepted the tax-affecting of earnings for the valuation of a minority interest in an S-corporation**

- All the experts in the case, plaintiff and government, tax-affected the earnings in the valuation

**Current IRS position is based on the 1999 tax court case of Gross v. Commissioner held that valuations should not tax-affect earnings of the pass-through entities when estimating the value of the business**

- IRS released a job aid in 2014 for its internal valuation analysts that suggested it was inappropriate to tax-affect the cash flows of pass-through entities

**A BIG WIN for the taxpayers, as closely held business entities valued for estate and gift tax purposes should not be overvalued in comparison with C-corporations**

## RESPECTING THE FAMILY LIMITED PARTNERSHIP/LIMITED LIABILITY ENTITIES

**To make sure that the entity ownership unit is valued, the owners should specifically address the business purpose for the creation of the entity that include non-tax reasons so that the IRS will respect the valuations**

- Recommend the adult members/trusts involved in the organization's meetings are represented by their own counsel in any governing document negotiations on the structure to accomplish the non-tax purposes
- The regular meetings and related minutes should clearly reflect the non-tax purpose of the family entity (e.g. educate family members, participation by spouses of members, pooling of assets for unique investments, etc.)
- All formation documents should clearly address the non-tax purpose for the entity so that the  entity is respected

# FINAL QUALIFIED OPPORTUNITY ZONE REGULATIONS

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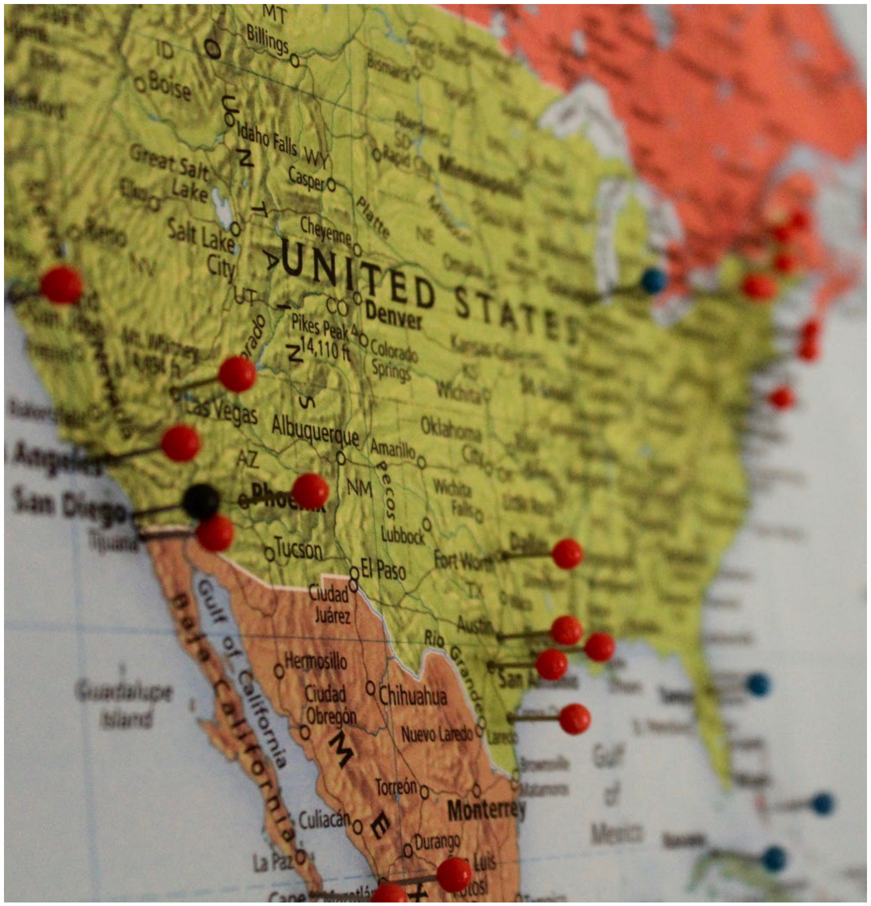



## FINAL REGULATIONS TO PROVIDE ADDITIONAL CLARITY

**Expansion of the list of transactions that accelerate the inclusion of income deferred by investing in a Qualified opportunity fund (QOF)**

- Gifts are generally inclusion events
  - Exception is a gift to a grantor trust where the taxpayer is the deemed owner of the trust
    - Exercise caution as a change in grantor trust status holding QOZ investments is an inclusion event
  - Exercise care when titling the qualifying investments to avoid the unintentional loss of the tax benefits

**It is good to clarify that death is not an inclusion event!**

# TRUST RESIDENCY

## SUPREME COURT CASE ADDRESSES RESIDENCY OF A TRUST

### Advantages of a Grantor trust in general

- Kaestner Case, a victorious taxpayer case, where the US Supreme Court unanimously held that the single criteria for taxing an out-of-state trust, due to the residency of a beneficiary, in and of itself, is not constitutional under the commerce and due process clauses
  - No ability for the beneficiary to demand distributions
  - No actual distributions made at the discretion of the trustee
    - This trust has been previously decanted to remove required distribution/withdrawals
  - The court did not go any farther with this case as the state hadn't established a "minimum connection" and the court stated "[we] did not decide what degree of possession, control, or enjoyment would be sufficient to support taxation"

### What about the Fielding case (Minnesota Supreme Court) which was not granted certiorari after the Court ruled on Kaestner?

- Neither the Minnesota legislature nor the department of revenue has addressed this to date
- Many states are probably looking at what might be minimum contacts

### Perhaps it is time to go state shopping

- Review the trust document to see whether the situs and governing law may be changed
- Chose a tax friendly state
  - There may need to be a change of trustee(s)
- Additional attractive benefits under the new state's law may include
  - Creditor protection
  - Quiet trusts
  - Favorable bankruptcy provisions

# 199A – MAXIMIZING THE DEDUCTION

## USE THE 199A DEDUCTION, WHILE IT LASTS, TO THE GREATEST DEGREE

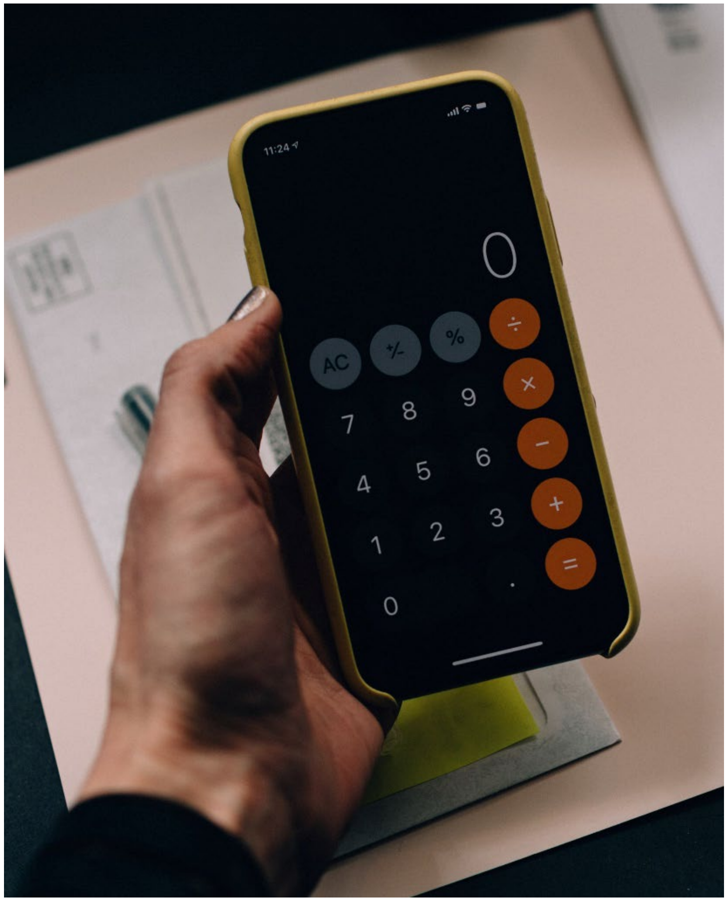
**The goal, until the sunset of this section of the law in 2025, will be to maximize the deduction for qualified business income (QBI)**

**S-corporation stock (or other closely held entity) may be given to multiple recipients, including trusts**

- Anti-abuse rules will apply where trusts are created in order to take advantage of this deduction
    - Consider whether there are other trusts, created prior to 199A, that could be the recipient of these gifts business asset gifts
- A trust that holds S-corporation stock will be taxed either to the grantor, the trust beneficiaries, if a Qualified subchapter S trust (QSST), or the trust itself, if an electing small business trust (EBST) so try to use them all where available

**A 20% deduction is fully allowed if the trust's taxable income, after the distribution deduction, does not exceed the "threshold" for the calendar year ($163,300 in 2020)**

- There is also a wage and capital limitation calculation to further limit the deduction where the taxable income threshold is exceeded
- The final regulations allow for a trust to use the 65-day distribution rule to manage "taxable income" of the trust in order to qualify for the 199A deduction
    - Note that distributing QBI to a beneficiary who files a joint tax return with a spouse receives a higher threshold amount of $326,600



# SPECIAL NEEDS TRUSTS FOCUS ON THE BASICS

## THREE MAJOR CONCEPTS

1

**Understand public assistance programs are means-tested and those that are not**

- Determine the requirement imposed on a person attempting to qualify for the assistance means-tested program

2

**Know the difference between a third-party trust and a self-settled trust**

- Means-tested assistance treat these trusts very different

3

**Distribution clauses in the trust document will impact the trust beneficiary's eligibility**

- Mandatory distributions, general support distributions and withdrawal rights are considered available to the beneficiary and can cause the beneficiary to not qualify
- Discretionary distributions to enhance a beneficiary's life in excess of what they may qualify for from other governmental resources are likely to maintain access to the programs

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## SOPHISTICATED FINANCIAL EXPLOITATION IS HAPPENING MORE FREQUENTLY

### Understand the concept between incapacitated and vulnerable

- Incapacitated means that they do not have the mental faculties to know what is happening to their assets or how to manage them
- Vulnerable means that they know but have somehow been taken in by someone or a situation and didn't intend to be used that way or deplete their assets for that purpose
- Relatives may still want to gamble all their assets away, enjoy every bit of the time doing so and understand the consequences of that decision because it is "their money"
    - Rational but not necessarily reasonable in other's mind

### The increased sophistication of the approach for financial abuse includes:

- Manipulating Caller ID so that it looks like it is coming from a familiar person or number so the phone gets answered
- "Free trial offers" for products that are costly
- Hard to cancel and long term
- "Free" computer security scanning that results allowing internet access/control to a computer to steal private information or put the individual in compromising situations

### Where older individuals are experiencing difficulty in managing their financial affairs:

- Professional bill paying services
- Ride-sharing services
- Putting in place limitations on banking/credit facilities (e.g. maximum ATM withdrawals, particular types of transfers, prepaid credit cards)

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