This Year's Top Tax and Financial-Planning Ideas

IEF4/24/V1

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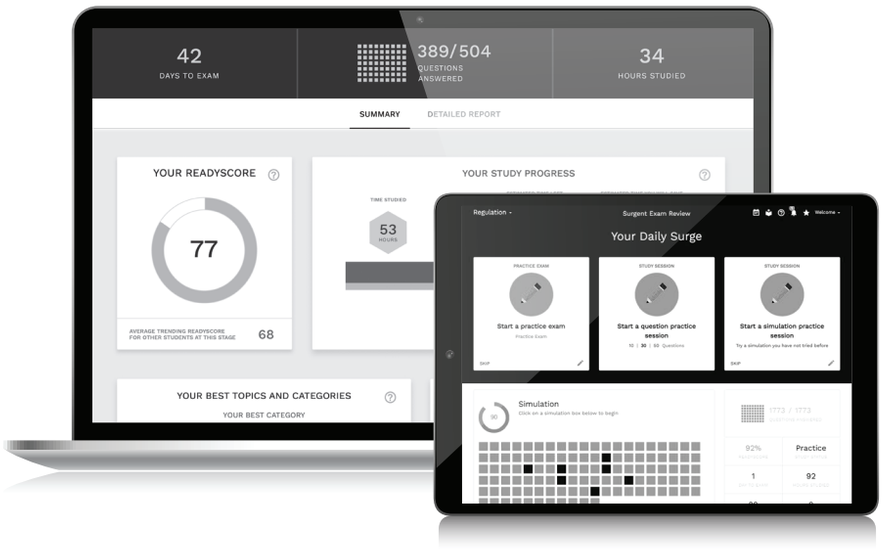

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Learning objectives

Upon reviewing this material, the reader will be able to:

- Explain the major provisions of the SECURE Act and proposed regulations;
- Explain how the decrease in tax rates on ordinary income affects planning strategies;
- Discuss the taxes on unearned income and compensation and what taxpayers must consider now;
- Discuss exclusion opportunities with qualified small-business stock;
- Explain the tax rates applicable to capital gains and the impact this has on dividends and redemptions;
- Define a Roth contribution program and distinguish it from a Roth IRA and a §401(k) plan;
- Explain the rollover provisions as they apply to a Roth contribution program;
- Describe how contributions are made to a Roth contribution program and how an existing §401(k) plan can be converted into a Roth contribution program;
- Identify what the state of estate planning is in 2024;
- Describe the nature of portability in the transfer-tax system; and
- Discuss general estate-planning strategies under recent legislation.

I. The SECURE 2.0 Act of 2022

On December 29, 2022, President Biden signed the SECURE Act 2.0 of 2022 ("SECURE 2.0") into law as part of the Consolidated Appropriations Act, 2023. SECURE 2.0 expands on many retirement provisions included in the original Setting Every Community Up for Retirement Enhancement Act (SECURE 1.0), signed into law in 2019. SECURE 1.0 was the most significant retirement legislation passed in over a decade and included 30 provisions primarily aimed at expanding access to retirement savings programs. SECURE 2.0 includes over 100 retirement-related provisions, with highlighted provisions outlined as follows.

A. Planning considerations

1. Increase in age for Required Beginning Date for mandatory distributions

SECURE 1.0 raised the age requirement for required minimum distributions ("RMDs") from age 70 ½ to 72. This provision allowed individuals to let their retirement savings accumulate for a longer time period if they did not need to rely on retirement savings to cover living expenses. Under SECURE 1.0, the Required Beginning Date ("RBD") was April 1 following the calendar year in which the IRA owner attained age 72.

SECURE 2.0 further increases the age requirement for RMDs to age 73 starting on January 1, 2023, and to age 75 starting on January 1, 2033. It is important to note that individuals can postpone taking their first RMD as long as they continue to work full or part time for the employer offering the plan.

The new SECURE 2.0 provision applies to distributions required to be made after December 31, 2022 for individuals who attain age 72 after such date.

Tax Year	Birth Date	RMD Age
Through 2019	Before July 1, 1949	70 ½
2020 through 2022	July 1 1949 through 1950	72
2023 through 2032	1951 – 1959	73
2033 and beyond	1960 and beyond	75

On March 7, 2023, the IRS provided guidance regarding the new SECURE 2.0 changes to RMDs. IRA owners who attain age 72 in 2023 will not have an RMD for 2023. IRA owners who attain age 72 in 2023 will have a required beginning date of April 1, 2025, instead of April 1, 2024. SECURE 2.0 did not change the required beginning date for IRA owners who attained age 72 prior to January 1, 2023. IRA owners who attained age 72 in 2022 were required to take 2022 RMDs by April 1, 2023. [1]

Since financial institutions have not had a sufficient time to incorporate SECURE 2.0 updates to their internal systems, Notice 2023-23 stated that the IRS would not consider RMD statements provided to an IRA owner who attained age 72 in 2023 to have been provided incorrectly, provided the owner was notified by April 28, 2023 that no RMD was actually required for 2023.

Financial institutions also expressed concern that certain plan participants and IRA owners who would have been required to begin receiving RMDs for calendar year 2023, but for the new required beginning date provision under SECURE 2.0 (i.e., those who will attain age 72 in 2023) and who received distributions in 2023, could have had those distributions mischaracterized as RMDs (and therefore ineligible for rollover).

Notice 2023-54, released on July 14, 2023, granted relief relating to certain distributions made during 2023 to individuals that were characterized as RMDs but are not actually RMDs as a result of the new SECURE 2.0 provision. This relief applied with respect to any distribution made from a plan between January 1, 2023, and July 31, 2023, to a participant born in 1951 (or that participant's surviving spouse) that would have been an RMD but for the new required beginning date provision under SECURE 2.0. Additionally, Notice 2023-54 extended the 60-day rollover period for such distributions so that the deadline for rolling over such a distribution was September 30, 2023.

> ***Example***: Todd was born in 1951 and received a single-sum distribution in January 2023, part of which was treated as ineligible for rollover because it was mischaracterized as an RMD; Todd had until September 30, 2023, to roll over that mischaracterized part of the distribution.

Similarly, Notice 2023-54 extended the 60-day rollover period for certain IRA distributions made to an IRA owner (or the IRA owner's surviving spouse), so that the deadline for rolling over that portion of the distribution was September 30, 2023. The distributions that were subject to this extension were distributions made from an IRA between January 1, 2023, and July 31, 2023, to an IRA owner born in 1951 (or that individual's surviving spouse) that would have been RMDs but for the new required beginning date provision under SECURE 2.0. This rollover was permitted even if the IRA owner or surviving spouse rolled over a distribution within the last 12 months. It is important to note that making such a rollover of the portion of an IRA distribution mischaracterized as an RMD will preclude the IRA owner or surviving spouse from rolling over a distribution in the next 12 months. However, under this scenario, the individual could still make a direct trustee-to-trustee transfer.

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[1] Notice 2023-23.

2. Indexing IRA catch-up limit

Under pre-SECURE 2.0 law, the limit on IRA contributions is increased by $1,000 (not indexed for inflation) for individuals who have attained age 50. SECURE 2.0 indexes such limit and is effective for taxable years beginning after December 31, 2023.

3. Higher catch-up limit to apply at age 60, 61, 62, and 63

Under current law, employees who have attained age 50 are permitted to make catch-up contributions under a defined contribution retirement plan. The limit on catch-up contributions for 2024 is $7,500, except in the case of SIMPLE plans for which the limit is $3,500.

SECURE 2.0 increases these limits to the greater of $10,000 or 50 percent more than the regular catch-up amount in 2024 (2025 for SIMPLE plans) for individuals who have attained ages 60, 61, 62 and 63. The increased amounts are indexed for inflation after 2025. Additionally, SECURE 2.0 requires the catch-up contributions to be made as Roth contributions. However, an exception applies to workers with earnings of $145,000 or less – they can continue to make traditional contributions.

The Roth catch-up provision applies only to qualified plans, including 401(k), 403(b), and 457(b) plans. Simple IRAs are not subject to this provision. Requiring all catch-up contributions to be Roth contributions for workers with wages in excess of $145,000 ensures such taxpayers will pay tax on their catch-up contributions during high-earning years. Per SECURE 2.0, if an individual earned more than $145,000 (as indexed) in wages in the previous tax year with the same employer sponsoring the plan, they must make all catch-up contributions as Roth contributions. Under current wording, taxpayers that do not receive W-2 wages, such as partners or sole proprietors, may be exempt from this provision.

This new SECURE 2.0 provision was intended to be effective for taxable years beginning after December 31, 2024. On August 25, 2023, the IRS issued Notice 2023-62, providing additional guidance regarding implementation of the new SECURE 2.0 provisions and announcing a two-year administrative transition period with respect to the requirement that catch-up contributions made on behalf of certain eligible participants be designated as Roth contributions. As a result of Notice 2023-62, the new requirement that any catch-up contributions made by higher income participants in 401(k) and similar retirement plans must be designated as after-tax Roth contributions is delayed until 2026. As such, for 2026, the compensation determination year will be 2025 (the preceding calendar year). Lastly, Notice 2023-62 clarifies that taxpayers with self-employment income do not have Social Security tax wages and thus are not subject to the requirement that catch-up contributions be made as Roth contributions, regardless of the amount earned.

It is important to note that some employer 401(k) plans do not allow for Roth contributions. As a result, if employees eligible for catch-up contributions earn over $145,000 in the prior year, they cannot make catch-up contributions if the employer plan does not allow for Roth contributions.

> ***Example:*** Jody is 60 years old and had $200,000 in W-2 wages from her employer, ABC Corporation, in 2025. If Jody wants to make a catch-up contribution to her retirement account in 2026, she must make those catch-up contributions as Roth contributions since her wages were over the $145,000 threshold in 2025.

4. Contribution limit for SIMPLE plans

Under pre-SECURE 2.0 law, the annual contribution limit for employee elective deferral contributions to a SIMPLE IRA plan is $16,000 (as indexed for inflation in 2024) and the catch-up contribution limit

beginning at age 50 is $3,500 (as indexed for inflation in 2024). Additionally, under pre-SECURE 2.0 law, the small employer (under 100 employees) of a SIMPLE IRA is required to either make matching contributions on the first three percent of compensation deferred or an employer contribution of two percent of compensation (regardless of whether the employee elects to make contributions).

Under SECURE 2.0, the annual deferral limit and the catch-up contribution at age 50 is increased by 10 percent for employers with no more than 25 employees. Under SECURE 2.0, an employer with 26 to 100 employees is permitted to provide higher deferral limits, but only if the employer either provides a four percent matching contribution or a three percent employer contribution. These changes are effective for taxable years beginning after December 31, 2023.

5. Modification of age requirement for qualified ABLE programs

ABLE programs are tax-advantaged savings programs for certain individuals with disabilities. SECURE 2.0 increases the age by which blindness or disability must occur for an individual to be an eligible individual by reason of such blindness or disability for an ABLE program. Prior to SECURE 2.0, the individual's disability or blindness had to occur before age 26, but SECURE 2.0 increases the age requirement to age 46. This new SECURE 2.0 provision is effective for taxable years beginning after December 31, 2025.

6. Special rules for certain distributions from long-term qualified tuition programs to Roth IRAs

SECURE 2.0 permits beneficiaries of 529 college savings accounts to rollover up to $35,000 over the course of their lifetime from any 529 account in their name to their Roth IRA. Such rollovers are subject to Roth IRA annual contribution limits, and the 529 account must have been open for more than 15 years. Additionally, the rollover cannot exceed the total amount contributed to the account more than five years before the rollover. Roth income limit restrictions are not applicable to the 529 plan Roth conversion.

As a result of this new provision, individuals will have the option to avoid the penalty on a non-qualified withdrawal of leftover 529 plan funds. This new SECURE 2.0 provision applies to distributions after December 31, 2023.

7. One-time election for qualified charitable distribution to split-interest entity; increase in qualified charitable distribution limitation

SECURE 2.0 allows for a one-time, $50,000 distribution to charities through charitable gift annuities, charitable remainder unitrusts, and charitable remainder annuity trusts, effective for distributions made in taxable years beginning after the date of enactment of this Act. Additionally, SECURE 2.0 indexes for inflation the annual IRA charitable distribution limit of $100,000, effective for distributions made in taxable years ending after the date of enactment.

8. Roth plan distribution rules

Under pre-SECURE 2.0 law, owners of Roth-designated employer retirement plan accounts, such as 401(k) plans, were required to take pre-death distributions. SECURE 2.0 eliminates this requirement, effective for taxable years beginning after December 31, 2023. Prior to SECURE 2.0, individuals with Roth-designated employer retirement plan accounts would have to transfer such accounts to a Roth IRA in order to avoid taking RMDs. In other words, individuals with Roth-designated employer retirement plan accounts are required to take RMDs, just as individuals are not required to take RMDs from Roth IRAs.

II. The SECURE Act

A. Planning considerations

In addition to recently enacted SECURE 2.0, it is important to discuss the ongoing provisions outlined in the original SECURE Act signed into law on December 20, 2019.

Under pre-SECURE Act rules, a non-spousal beneficiary of an IRA could "stretch" the receipt of RMDs over his or her remaining actuarial life expectancy with payouts starting in the year immediately after the decedent's death. This estate planning strategy allowed one to extend IRA distributions over future generations while the IRA continued to grow tax-free. In this scenario, the younger the beneficiary, the better, as the RMD would be smaller and the account could grow tax-free for a longer period of time. Younger beneficiaries have longer actuarial life expectancies, resulting in smaller RMDs taken in the beginning, growing larger over time. The "stretch IRA" strategy minimized the amount that must be withdrawn from the IRA each year and avoided a large, taxable, lump-sum distribution to the beneficiary.

One of the most controversial provisions of the SECURE Act is that it stipulates that upon death of a retirement plan account holder, all distributions must be made within 10 years of death to an eligible designated beneficiary, provided the account holder dies after December 31, 2019. Individuals inheriting an IRA after December 31, 2019 are required to withdraw all IRA plan assets within 10 years of the original account holder's death. Section 401 of the SECURE Act essentially eliminates "stretch" IRAs that could be stretched over the life of the beneficiary and grow tax-free for an extended period of time. Section 401 of the SECURE Act does not apply to account holders who die prior to December 31, 2019, and in this scenario, a beneficiary may still "stretch" distributions over his or her own lifetime. It is important to review client estate plans as the 10-year payout rule will come as a surprise to many and could undermine the original intent of the estate plan.

The IRS issued proposed regulations on February 24, 2022, to reflect these changes made by the SECURE Act. The effective date of these proposed regulations is for tax years beginning on or after January 1, 2022. [2] It is possible that changes could be made to the SECURE Act proposed regulations if finalized.

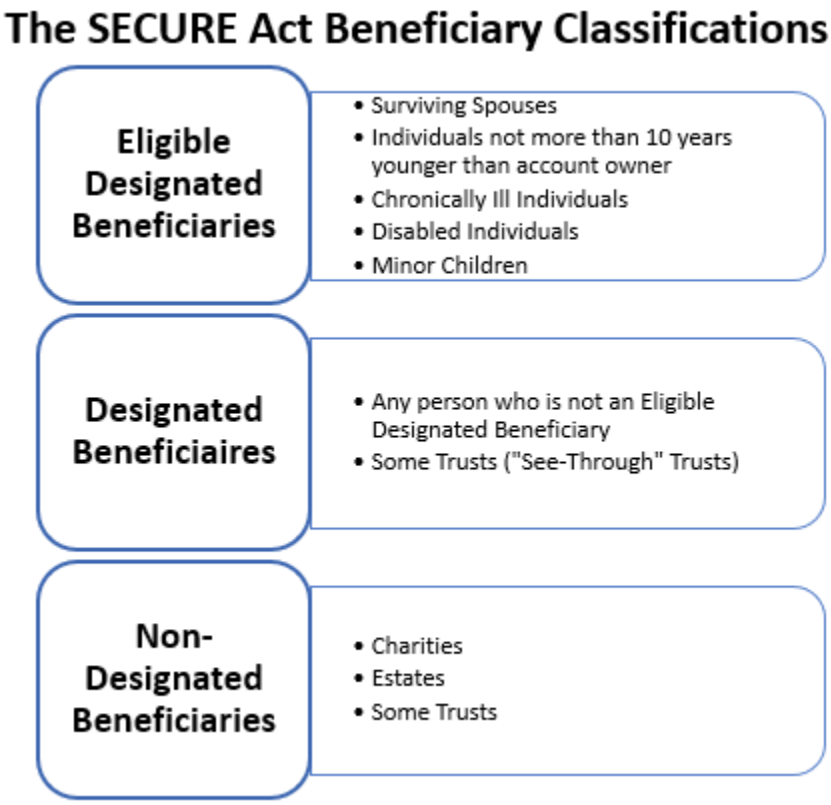
The proposed regulations address situations in which the original account holder dies before or after the required beginning date:

- **Original Account Holder Dies Before Required Beginning Date:** If a beneficiary inherits an IRA in which the account holder did not reach his or her required beginning date before death, the non-eligible beneficiary must withdraw the entire IRA balance within 10 years of the original account holder's date of death.
- **Both Original Account Holder and Designated Beneficiary Die Before Required Beginning Date:** The proposed regulations state that if both the original account holder and designated beneficiary die before the required beginning date, the beneficiary of the original designated beneficiary is subject to the 10-year rule.
- **Original Account Holder Dies After Required Beginning Date:** The proposed regulations clarify that if the original account holder dies after the required beginning date, distributions to the account holder's beneficiary for calendar years after the

[2] REG-105954-20.

calendar year in which the account holder died must satisfy §401(a)(9)(B)(i) as well as §401(a)(9)(B)(ii).

- In order to satisfy both requirements, these proposed regulations provide for the same calculation of the annual required minimum distribution that was adopted in the existing regulations but with an additional requirement that a full distribution of the entire IRA balance be made on the 10th year.
- In other words, RMDs are required for the first nine years, as calculated under existing regulations, with a required distribution of the remaining balance on the tenth year.
- Note: Individuals who inherited Roth IRAs are not required to take annual distributions, as RMDs are not required for Roth IRAs, but such individuals must withdraw all funds by 12/31 of the year of the 10th anniversary of the original account holder's death.



1. Eligible designated beneficiaries

Per SECURE Act §401(a)(2), there are few exceptions to the 10-year payout rule. Spouses, account holder's children who have not reached the age of majority, beneficiaries less than 10 years younger than the account holder, and chronically ill or disabled beneficiaries are **NOT** subject to the 10-year distribution rule and are considered "eligible designated beneficiaries." These individuals are eligible to withdraw inherited IRAs over their life expectancy, bypassing the 10-year rule. Designated beneficiaries include any person (i.e., not an entity or institution) subject to the 10-year rule.

a. **Surviving spouses** -- For purposes of the SECURE Act, surviving spouses are eligible designated beneficiaries, and as such, they are entitled to spousal rollover of IRAs. The surviving spouse has the option to roll the deceased spouse's IRA to his or her own IRA, and the surviving spouse will be able to defer the required beginning date for required

minimum distributions until April 1 of the following year that the surviving spouse reaches the required beginning date.

Example: Todd dies in May 2024 at age 80, and he leaves his $1 million Roth IRA to Margot, his 25-year-old spouse. Since Margot is an eligible designated beneficiary, the 10-year rule does not apply to her.

As a surviving spouse, she can retitle the inherited Roth account in her own name and will not have to take any RMDs for as long as she lives – the "stretch IRA" still works in this scenario.

b. **Individuals not more than 10 years younger than account owner** -- For purposes of the SECURE Act, individuals who are not more than 10 years younger than the IRA account owner qualify as eligible designated beneficiaries. As such, these individuals are eligible to "stretch" the inherited IRA balance and RMDs over their lifetime.

The proposed regulations clarify that whether a designated beneficiary is not more than 10 years younger than the employee is determined based on the dates of birth of the employee and the beneficiary rather than just the year of birth.

Example 1: Nancy died in 2024 and left her IRA to her sister, Anne, who was born 5 years after Nancy. The SECURE Act 10-year rule does not apply to Anne, because she is not more than 10 years younger than Nancy.

Anne is an eligible designated beneficiary and the balance of the IRA at Nancy's death may be paid over Anne's actuarial life expectancy.

In the event that Anne dies before all distributions are made from the IRA, the remaining balance must be paid out within 10 years of Anne's death.

Example 2: Elizabeth dies in 2024 and left her IRA to her sister, Ashley, who was born 11 years after Elizabeth. Ashley **is not** a designated beneficiary, since she is more than 10 years younger than Elizabeth.

The balance of Elizabeth's IRA must be paid out to Ashley within 10 years of Elizabeth's death.

Example 3: Silvia dies in August 2024 and leaves her IRA to Eva, her sibling who is 7 years younger. Since Eva is an eligible designated beneficiary, the balance in her inherited IRA could be paid out over her remaining life expectancy.

If Eva dies before the IRA is exhausted, any remaining balance going to a non-spousal beneficiary or other kind of eligible designated beneficiary would have to be paid out within 10 years of Eva's death.

c. **Chronically ill** -- For purposes of the SECURE Act, a chronically ill individual is considered an eligible designated beneficiary and can stretch RMDs from an inherited IRA over his or her lifetime. Under IRC §7702B(c)(2), a "chronically ill individual" is defined as an individual that: (i) "is unable to perform at least two activities of daily living for a period of at least 90 days, without substantial assistance from another individual, due to a loss of functional capacity; or (ii) requires substantial supervision to protect such individual from threats to health and safety due to severe cognitive impairment. Such term shall not include any individual otherwise meeting the requirements of the preceding sentence unless within the preceding 12-month period a licensed health care practitioner

has certified that such individual meets such requirements. Each of the following is an activity of daily living: (i) Eating. (ii) Toileting. (iii) Transferring. (iv) Bathing. (v) Dressing. (vi) Continence." [3]

The proposed regulations require, with respect to a beneficiary who is disabled or chronically ill as of the date of the original account holder's death, that documentation of the disability or chronic illness is provided to the plan administrator no later than October 31 of the calendar year following the calendar year of the original account holder's death. The proposed regulations state that the documentation also must include a certification from a licensed health care practitioner that, as of the date of the certification, the individual is unable to perform (without substantial assistance from another individual) at least 2 activities of daily living for an indefinite period that is reasonably expected to be lengthy in nature. The proposed regulations clarify that the period must be "lengthy in nature" and not merely 90 days as outlined under §7702B(c)(2).

d. **Disabled** -- For purposes of the SECURE Act, a disabled individual is considered an eligible designated beneficiary and can stretch RMDs from an inherited IRA over his or her lifetime. The proposed regulations provide two definitions of a disabled individual, depending on if the child is age 18 or older or less than age 18.

- **Less than age 18**: If on the date of the employee's death, the beneficiary is younger than age 18, the proposed regulations apply a comparable standard that requires the beneficiary to have a medically determinable physical or mental impairment that results in marked and severe functional limitations, and that can be expected to result in death or to be of long-continued and indefinite duration.
- **Age 18 or older**: If on the date of the employee's death, the beneficiary is age 18 or older, the proposed regulations state an individual is disabled if he or she is unable to engage in substantial gainful activity by reason of any medically determinable physical or mental impairment which can be expected to result in death or to be of long-continued and indefinite duration.

The proposed regulations require, with respect to a beneficiary who is disabled or chronically ill as of the date of the original account holder's death, that documentation of the disability or chronic illness is provided to the plan administrator no later than October 31 of the calendar year following the calendar year of the original account holder's death.

Per the proposed regulations, the determination of whether a beneficiary is disabled is made as of the date of the original account holder's death.

Example 1: Jon died on February 15, 2024. Aiden, his 10-year-old son, is his designated beneficiary. Aiden is not disabled as of February 15, 2024, but 5 years later, he is in a bad car accident and becomes disabled. Aiden's disability is not taken into account, as he was not disabled on the date of Jon's death, and he will cease to be an eligible designated beneficiary on his 21st birthday.

e. **Minor children** -- For purposes of the SECURE Act, minor children of the account owner are eligible designated beneficiaries. They can utilize the "stretch" IRA strategy until reaching the age of majority. Prior to the release of the proposed regulations, there was

[3] IRC §7702B(c)(2).

ambiguity as to what age constituted the age of majority. The proposed regulations clarify that the age of majority takes place on the child's 21st birthday.

Upon reaching the age of majority, the child becomes subject to the 10-year rule. If the beneficiary has no need for the funds, the IRA balance may be left to compound until December 31 of the tenth year.

It is important to note that the minor child exception **only** applies to the account holder's children. In other words, minor grandchildren **are not** considered eligible designated beneficiaries of a grandparent's IRA account and are subject to the SECURE Act 10-year payout rule.

Example 1: Greg is a single father to his 8-year old son, Elias. In an unfortunate turn of events, Greg passed away, leaving his entire IRA balance to Elias. Since Elias is Greg's minor child, he qualifies for an exception to the SECURE Act 10-year payout rule under §401(a)(2).

Elias must begin receiving RMDs the year after Greg's death. Elias does not pursue college after high school. Upon reaching age 28, Elias must withdraw any remaining IRA balance.

Example 2: Assuming similar facts as **Example 1**, assume Elias's grandparent, Boris, died when Elias was 8 years old. Boris left his entire IRA balance to Elias.

Despite being a minor child, Elias is **not** an eligible designated beneficiary as he is not Boris's child. Elias is required to withdraw the entire inherited IRA balance within 10 years.

Note:

It is important to realize that while eligible designated beneficiaries are exempt from the SECURE Act 10-year payout rule, subsequent beneficiaries are subject to the SECURE Act 10-year payout rule.

Example 3: Harry and Greta were happily married for many years and have one adult daughter (age 40), Agnes. Unfortunately, Harry passed away and left his $500k IRA to his spouse, Greta. Since Greta is a surviving spouse, she is considered an eligible designated beneficiary under the SECURE Act rules and is exempt from the 10-year payout rule.

Five years after Harry died, Greta passes away and leaves the remaining IRA to Agnes. Agnes is **not** an eligible designated beneficiary, and under the SECURE Act 10-year rule, she is required to fully distribute the balance of the IRA within 10 years of her mother Greta's death.

Example 4: Bob dies on 11/8/2019, leaving his IRA to his designated beneficiary, Mike, his nephew, who is 20 years younger than he is.

Under the SECURE Act rules, since Bob died before 2020, Mike is treated as an eligible designated beneficiary, and the balance of the IRA at Bob's death may be paid out over Mike's actuarial life expectancy.

2. Designated beneficiaries

Designated beneficiaries include any person (i.e., not an entity or institution) subject to the 10-year rule.

3. Non-designated beneficiaries

While the SECURE Act made major changes to the distribution rules for designated beneficiaries, it did ***not*** address distribution rules for non-designated beneficiaries. Non-designated beneficiaries include legal entities, estates, trusts that do not qualify as "see-through", charities, institutions, and any human who for whatever reason is not considered a designated beneficiary.

The SECURE Act does not change pre-SECURE Act law, in that non-designated beneficiaries have up to 5 years to distribute the entire account balance of an inherited IRA if the original account holder died prior to making required minimum distributions. There are no required minimum distributions; the beneficiary can wait until the end of the 5-year period to take the entire distribution.

If required minimum distributions began before the non-designated beneficiary inherited the IRA, the non-designated eligible beneficiary can use the deceased original account holder's life expectancy as the distribution period if that period is longer than 5 years. This is often referred to as the owner's "ghost life expectancy."

4. Charitable Remainder Trusts

Charitable Remainder Trusts (CRTs) are a potential workaround to the SECURE Act 10-year distribution rule. A CRT is an irrevocable trust. A named beneficiary receives income (fixed percentage or dollar amount) for a specified period of time (beneficiary life or up to 20 years), and the trust's remaining assets go to a predetermined charity. The CRT bypasses the 10-year payout rule, as the IRA funds can be spread out over a defined period of time or a beneficiary's lifetime.

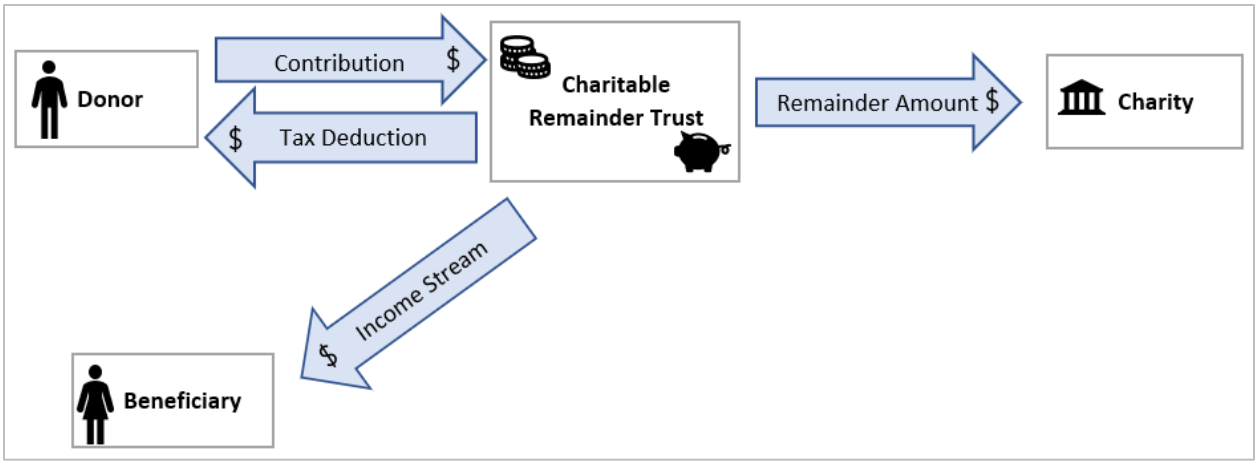
At the time the irrevocable CRT is established, the retirement account owner's estate receives a charitable tax deduction for the projected value of the portion of the trust that will go to charity. The retirement account owner also pays the estate tax, if any, on the projected value of the portion of the trust that will go to the beneficiary. Upon death of the retirement account holder, the beneficiary receives the specified payout. The designated charity receives the balance of the trust/IRA upon the death of the beneficiary or the end of the trust term.

To qualify for tax-exempt status, CRTs must meet the following criteria:

- The predetermined charity must receive at least 10% of the initial value of the trust;
- The payout percentage to the named beneficiary must be at least 5% but not more than 50%; and
- The payments may be fixed based on the initial value of the trust, or variable based on the value of the trust each year.

The funds distributed to the CRT from the IRA are tax-exempt. The payments from the trust to the beneficiary are considered taxable income. The CRT does not report income or pay tax.

While CRTs offer an alternative to the SECURE Act 10-year payout rule, there are disadvantages to consider. CRTs have a large administrative burden. The trustee of a CRT is responsible for a number of administrative duties, such as tax return preparation, payment of income to the beneficiary, and investment of the trust assets. A tax return (Form 5227) must be filed annually with the IRS and the 1041 K-1 (detailing annual payments) must be provided to the beneficiary.



5. Roth conversions

If an individual does not want to leave his or her IRA to a trust, he or she could consider converting taxable IRA funds to a Roth IRA. The retirement account holder would incur income tax on the converted funds, but the beneficiary of the inherited Roth IRA would receive the funds tax-free. Non-eligible designated beneficiaries will still be subject to the SECURE Act 10-year distribution rule, but the distributions will not be taxable to the beneficiary.

Wealthy individuals eligible to take advantage of Roth conversions should consider doing so, as tax rates are at some of the lowest historical levels. Roth conversions can be taken over a period of several years to avoid the highest income tax rates on the conversion. To maximize the benefit of converting a traditional IRA to a Roth IRA, consider the following:

a. The individual must have enough non-retirement funds to pay the income tax on the converted funds;
b. The individual should ideally not depend on the Roth IRA assets during his or her lifetime; and
c. The amount converted should end up being taxed at a lower marginal tax rate compared to the marginal tax rate that would have been used had no conversion taken place. As mentioned above, tax rates are at some of the lowest historical levels. Future legislation has the potential to greatly influence future tax rates.

6. Review beneficiaries

It cannot be stressed enough that one should review estate plans and plan beneficiaries. As discussed, the SECURE Act defines a narrow category of eligible designated beneficiaries who are not subject to the 10-year distribution rule. All other beneficiaries will be required to distribute the inherited plan's assets according to the 10-year rule.

If an individual has multiple beneficiaries to choose from, he or she should consider choosing an eligible designated beneficiary to avoid the 10-year distribution rule.

Example: An account holder may have previously designated a young grandchild as a beneficiary of their IRA account, with hopes the grandchild could take advantage of long-term tax-deferred growth. A grandchild is not an eligible designated beneficiary, and thus would be subject to the SECURE Act 10-year rule. The account holder should consider choosing an eligible designated beneficiary, such as a spouse, instead of the grandchild, in order to bypass the 10-year rule.

In addition, an individual passing on a traditional IRA may want to consider the marginal tax rates of the named beneficiary(ies). If the individual has multiple potential beneficiaries to choose from, he or she may want to choose the beneficiary with the lowest marginal tax rate to minimize the amount of income taxes associated with the distribution.

7. Life insurance policies

With the elimination of the "stretch IRA" strategy due to the enactment of the SECURE Act, life insurance policies will be sure to increase in popularity. If set up correctly, the life insurance payout will be tax-free to beneficiaries, representing a great alternative to wealthy retirement account holders who do not need to use distributions to provide for living expenses.

An individual can take one of two approaches in setting up a life insurance policy as an estate planning strategy:

a. **Relocating Funds:** The individual can distribute funds from his or her retirement account to fund a life insurance policy. This strategy could be utilized if the individual does not need his or her retirement account assets to support his or her lifestyle. Ideally, an irrevocable trust would be established, and upon death of the original account holder would be paid out to beneficiaries. Note that an irrevocable trust must be set up, as all incidents of ownership are forfeited if the owner of the life insurance policy is a trust. If the deceased was named as the life insurance policy holder, they would have incidents of ownership, and the full amount would be included in their estate.

   Effectively, the individual will convert income that would be highly taxed after his or her death (RMDs) into tax-free life insurance proceeds.

b. **Funding Strategy:** Alternately, an individual can set up a life insurance policy to assist beneficiaries in paying the income tax cost on retirement plan assets. If the individual account holder has a traditional IRA that will be paid to a non-eligible designated beneficiary, that beneficiary will have to distribute all of the traditional IRA funds within 10 years of the original account holder's death. If the account holder can estimate the amount of income taxes that the beneficiary will incur through RMDs, he or she could set up a life insurance policy to cover this amount.

This is a pivotal time to review plans and check plan beneficiaries, as the "stretch" IRA no longer represents a viable tax planning vehicle.

III. Recent updates and considerations

A. Individual changes

1. Recent individual changes

The new individual tax rates for 2024 appear below:

Unmarried Individuals (other than Surviving Spouses and Heads of Households)

If taxable income is:	The tax is:
Not over $11,600	10% of taxable income.
Over $11,600 but not over $47,150	$1,600 plus 12% of the excess over $11,600.
Over $47,150 but not over $100,525	$5,426 plus 22% of the excess over $47,150
Over $100,525 but not over $191,950	$17,186.50 plus 24% of the excess over $100,525.
Over $191,950 but not over $243,725	$39,110.50 plus 32% of the excess over $191,150.
Over $243,725 but not over $609,350	$55,678.50 plus 35% of the excess over $243,725.
Over $609,350	$183,647.50 plus 37% of the excess over $609,350.

Heads of Households

If taxable income is:	The tax is:
Not over $16,550	10% of taxable income.
Over $16,550 but not over $63,100	$1,655 plus 12% of the excess over $16,500.
Over $63,100 but not over $100,500	$7,241 plus 22% of the excess over $63,100.
Over $100,500 but not over $191,950	$15,469 plus 24% of the excess over $100,500.
Over $191,950 but not over $243,700	$37,417 plus 32% of the excess over $191,150.
Over $243,700 but not over $609,350	$53,977 plus 35% of the excess over $243,700.
Over $609,350	$181,954.50 plus 37% of the excess over $609,350.

Married individuals filing joint returns and surviving spouses

If taxable income is:	The tax is:
Not over $23,200	10% of taxable income.
Over $23,200 but not over $94,300	$2,320 plus 12% of the excess over $23,200.
Over $94,300 but not over $201,050	$10,852 plus 22% of the excess over $94,300.
Over $201,050 but not over $383,900	$34,337 plus 24% of the excess over $201,050.
Over $383,900 but not over $487,450	$78,221 plus 32% of the excess over $383,900.
Over $487,450 but not over $731,200	$111,357 plus 35% of the excess over $487,450.
Over $731,200	$196,669.50 plus 37% of the excess over $731,200.

Married individuals filing separate returns

If taxable income is:	The tax is:
Not over $11,600	10% of taxable income.
Over $11,600 but not over $47,150	$1,160 plus 12% of the excess over $11,600.
Over $47,150 but not over $100,525	$5,426 plus 22% of the excess over $47,150.
Over $100,525 but not over $191,950	$17,168.50 plus 24% of the excess over $100,525.
Over $191,950 but not over $243,725	$39,110.50 plus 32% of the excess over $191,150.
Over $243,725 but not over $365,600	$55,678.50 plus 35% of the excess over $243,725.
Over $365,600	$98,334.75 plus 37% of the excess over $365,600.

Estates and trusts

If taxable income is:	The tax is:
Not over $3,100	10% of taxable income.
Over $3,100 but not over $11,150	$310 plus 24% of the excess over $3,100.
Over $11,150 but not over $15,200	$2,242 plus 35% of the excess over $11,150.
Over $15,200	$3,659.50 plus 37% of the excess over $15,200.

For 2024, the tax rate on capital gain and/or qualifying dividend income is available to individuals only with ordinary taxable income of the following:

Filing Status	0%	15%	20%
Single	$0-$47,025	$47,026-$518,900	$518,901 or more
Married Filing Jointly and Surviving Spouses	$0-$94,050	$94,051-$583,750	$583,751 or more
Married Filing Separately	$0-$47,025	$47,026-$291,850	$291,851 or more
Head of Household	$0-$63,000	$63,001-$551,350	$551,351 or more
Estates, Trusts & Kiddie Tax	$0-$3,150	$3,150-$15,450	Over $15,450
Unrecaptured Section 1250 gain			25%
Collectibles Eligible gain on qualified small business stock less the 1202 exclusion			28%

a. For 2024, the standard deduction is increased to $29,200 for married couples filing jointly, $21,900 for heads of household, and $14,600 for all others.

b. As a counterpoint, the personal exemptions have been suspended for 2018-2025.

c. The TCJA imposed a "Kiddie Tax" on children's unearned income in excess of $2,500 at the highest trust and estate tax rates. The SECURE Act restores pre-TCJA Kiddie Tax rules, in which the child's unearned income over the $2,500 income threshold is taxed at the parent's marginal tax rate ($2,600 in 2024). This change is effective for tax years beginning after December 31, 2019.

d. Capital gains rates are conformed, meaning basically that the breakpoints have been indexed for inflation.

e. For taxable years beginning after December 31, 2017 and before January 1, 2026, the TCJA provided that "excess business losses" of a taxpayer other than a corporation were not allowed for the taxable year. [4] ARPA extended this provision for one year, to include tax years beginning before January 1, 2027. The Inflation Reduction Act further extended the excess business loss limitation provision under §461(l) for two additional years.

   An "excess business loss" is defined as the excess of aggregate deductions of the taxpayer attributable to trades or businesses over the sum of aggregate gross income or gain of the taxpayer plus a threshold amount ($250,000 for individuals or $500,000 for joint filers, not indexed for inflation). For 2024, the excess business loss thresholds are as follows:

Filing Status	2024 Threshold Amount
Joint filers	$610,000
Other returns	$305,000

[4] IRC §461(i)(1).

Since the §461(l) limitation applied solely to taxpayers other than C-corporations, it caused a disproportionate impact on small business owners. The CARES Act temporarily modified the loss limitation for noncorporate taxpayers set forth in the TCJA and allowed them to deduct excess business losses arising in a tax year beginning after December 31, 2017 and before January 1, 2021.[5] It also turned off active farming loss rules for tax years beginning after December 31, 2017 and before December 31, 2020.

f. The state and local tax deduction (SALT) is limited from 2018–2025 to $10,000 (for both married filing joint and single filers). **This provision does not apply to businesses**.

The TCJA provides that in the case of an individual, state, local, and foreign property taxes and state and local sales taxes are allowed as a deduction only when paid or accrued in carrying on a trade or business, or an activity described in §212 (relating to expenses for the production of income). Thus, the TCJA allows only those deductions for state, local, and foreign property taxes, and sales taxes that were deductible in computing income on an individual's Schedule C, Schedule E, or Schedule F on such individual's tax return. Thus, for instance, in the case of property taxes, an individual may deduct such items only if these taxes were imposed on business assets (such as residential rental property).

In the case of an individual, state and local income, war profits, and excess profits taxes are not allowable as a deduction. The provision contains an exception to the above-stated rule. A taxpayer may claim an itemized deduction of up to $10,000 for the aggregate of:

1. State and local property taxes not paid or accrued in carrying on a trade or business, or an activity described in §212; and
2. State and local income, war profits, and excess profits taxes (or sales taxes in lieu of income, etc. taxes) paid or accrued in the taxable year.

Foreign real property taxes may not be deducted under this exception.

Per Notice 2019-12 (6/11/19), a safe harbor was created to treat state tax credit disallowed charitable contributions as SALT payments in the year of payment or preceding year. So, there's a planning opportunity to amend the prior year's return. The IRS issued final regs on August 7, 2020, largely adopting the proposed regs and the safe harbor in Notice 2019-12 and addressing SALT cap workarounds. A taxpayer's payment to a §170(c) entity is considered an allowable deduction as a trade or business expense under §162, rather than a charitable contribution under §170. A taxpayer will be treated as receiving goods and services in consideration for a payment to a §170(c) entity, if at the time the taxpayer makes the transfer, the taxpayer either receives or expects to receive goods or services in return. This is often referred to as the "quid pro quo" principle, and it applies regardless of whether the party providing the quid pro quo is the donee or a third party. The fair market value of goods and services includes the value of goods and services provided by parties other than the donee.

[5] CARES Act §2304(a).

On November 9, 2020, the IRS issued Notice 2020-75, stating that the Treasury Department and IRS intend to issue proposed regulations clarifying SALT deduction limitations. "**Specified Income Tax Payments**" are deductible by partnerships and S corporations in computing their non-separately stated income or loss for the tax year of the payment. Specified income tax payments are any amount imposed on and paid by a partnership or S corporation to a state to satisfy its income tax liability. These payments are not subject to the SALT deduction limitation for partners and shareholders who itemize their deductions. These payments are fully deductible. It is anticipated that as a result of this notice and the impending proposed regulations, more states will enact mandatory entity-level taxes and provide a corresponding owner-level deduction or credit. Currently, Connecticut is the only mandatory PTE tax state.

Historically, very few states have imposed PTE-level taxes, but more states are proposing taxes or have enacted taxes.

- Taxes would be assessed at the entity level and would not subject PTE owners to tax.
- This resembles corporate income tax on PTEs.
- Most regimes are currently elective and are not mandatory on PTEs.

A resident state credit may exist for taxes paid to other states, where states allow credits for resident individuals paying taxes to other states. PTE-level taxes ultimately result in an individual claiming a federal deduction for taxes paid rather than claiming state credits. This is beneficial for partners in low-tax states; however, analysis is required when partners reside in higher tax jurisdictions. The election could yield mixed results depending on the residency and demographics of partner group.

While the IRS seemingly gave the "green light" on the PTE workaround through Notice 2020-75, further questions remain that require additional IRS guidance:

- How is the PTE workaround considered for §199 purposes? Would this amount reduce QBI?
- Uncertainty exists regarding resident tax credits and nonresident partners/shareholders, especially for pass-through entities with operations in multiple states.
- How will state-level PTE taxes change if the SALT cap is eliminated?

In the distributive share/composite regime, many states allow credits and exclusions to mitigate double taxation. Some states provide percentage limitation on available credits, while other states provide subtraction modifications for income subject to tax at the PTE level. PTE-level taxes need to be modeled to determine what is the best answer before electing to PTE-level tax regimes.

g. For 2018–2025, the miscellaneous itemized deductions (subject to a 2% floor) have been suspended.

h. The TCJA provides that alimony and separate maintenance payments are not deductible by the payor spouse and repealed the rule that a recipient of alimony and separate maintenance payments must include such amounts in income. The intention of this change in the TCJA was to follow the ruling of the United States Supreme Court in *Gould v. Gould*, where the Supreme Court held that such payments were not income to the recipient. When this new rule comes into effect in 2019, income used for alimony payments will be taxed at the rates applicable to the payor spouse rather than the recipient spouse.

   The TCJA is effective for any divorce or separation instrument executed after December 31, 2018 or for any divorce or separation instrument executed on or before December 31, 2018, and modified after that date, if the modification expressly provides that the amendments made by this change apply to such modification

i. For 2018-2025, the exclusion for moving expense reimbursements has been suspended.

j. The Affordable Care Act individual mandate has been repealed for years after 2018.

k. The AMT has been retained with higher exemptions: $133,300 (2024) for a married couple filing jointly or surviving spouses, $66,650 (2024) for MFS, and $85,700 (2024) for others aside from trusts and estates ($29,900) (2024). The exemption phaseout is increased to $1,218,700 (2024) for married filing joint or surviving spouses and $609,350 (2024) for all others except estates and trusts ($99,700) (2024).

l. ABLE accounts from 2018-2025 allow for an increase in contributions.

m. For distributions beginning in 2018, qualified higher education expenses include tuition at elementary or secondary schools up to a limit of $10,000 per year. For distributions made after December 31, 2018, the SECURE Act expands the coverage of qualified expenses to include apprenticeships and trade schools. In addition, the SECURE Act allows for up to $10,000 (lifetime maximum) to be withdrawn from a §529 plan to pay student loan principal amounts and related interest expenses for the beneficiary or the beneficiary's siblings. As discussed, SECURE 2.0 also permits beneficiaries of 529 college savings accounts to rollover up to $35,000 over the course of their lifetime from any 529 account in their name to their Roth IRA.

n. Estate and gift exclusions are retained but the estate exemption is increased to $13,610,000 for 2024, double that for a married couple (2018-2025).

o. The TCJA provides that, in the case of taxable years beginning after December 31, 2017, and beginning before January 1, 2026, a taxpayer may treat no more than $750,000 as acquisition indebtedness ($375,000 in the case of married taxpayers filing separately). In the case of acquisition indebtedness incurred before December 15, 2017, this limitation is $1 million ($500,000 in the case of married taxpayers filing separately). The itemized deduction for mortgage insurance premiums has expired.

Practitioner note:

As of April 1, 2022, upfront fees on certain high balance loans sold to Fannie Mae and Freddie Mac increased between 0.25% and 0.75%.

Additionally, as of April 1, 2022, the upfront fees for mortgage loans on second homes will increase between 1.125% and 3.875% depending on the loan-to-value ratio.

Taxpayers can utilize the interest tracing rules of Temp Regs 1.163-8T to avoid the lower limitation. Debt is allocated by tracing disbursements of the debt proceeds to specific expenditures (i.e., trade or business, investment, passive, etc.). The related interest expense assumes the character of that expenditure and is treated under the appropriate set of rules. An election to treat mortgage debt as not secured by residence is binding on all future years unless IRS consents to revoke the election.

Home equity debt and lines of credit are subject to the overall $750,000 limitation but may no longer be used for simply any purpose and still be deductible. They must be used to **buy, build, or substantially improve the home that secures the loan**.

The SECURE Act temporarily extended the exclusion from gross income up to $2M (Married Filing Joint, $1M maximum for Single) of discharge of qualified principal residence indebtedness and extends this credit for discharges of indebtedness after December 31, 2017 and prior to January 1, 2021. Qualified principal residence indebtedness includes any debt incurred in acquiring, constructing or substantially improving a principal residence that is secured by the principal residence. The CAA 2021 extends the exclusion from gross income of discharge of qualified principal residence indebtedness through 2025. It also reduces the maximum exclusion amount from $2,000,000 to $750,000 (for married filing jointly filers).

B. Energy provisions introduced by the Inflation Reduction Act

The Inflation Reduction Act (IRA) signed into law by President Biden on August 16, 2022, implemented and expanded a variety of tax provisions for individuals related to clean energy and energy security.

1. Energy Efficient Home Improvement Credit (formerly known as the Nonbusiness Energy Property Credit)

Prior to the IRA, a credit was available to individual taxpayers for nonbusiness energy property placed in service prior to January 1, 2022. The property that qualified for the credit included Qualified Energy Efficiency Improvements and Residential Energy Property Expenditures. The credit was equal to 10 percent of the amount paid or incurred by the taxpayer for qualified energy efficiency improvements installed during the taxable year and the amount of the residential energy property expenditures paid or incurred by the taxpayer during such taxable year. Additionally, there was a lifetime limitation on the amount of the credit ($500 nonrefundable credit during the taxpayer's lifetime). Pre-IRA rules regarding the energy-efficient home improvement credit applied for 2022.

Per §25C(c), "qualified energy efficiency improvements" are any energy efficient building envelope component, if:

- The component is installed in or on a dwelling unit located in the United States and owned and used by the taxpayer as his or her personal residence;
- The original use of the component commenced with the taxpayer; and
- The component could reasonably be expected to remain in use for at least five years.

Per §25C(d), “residential energy property expenditures” are expenditures made by the taxpayer for qualified energy property which is:

- Installed on or in connection with a dwelling unit located in the United States and owned and used by the taxpayer as the taxpayer’s principal residence; and
- Originally placed in service by the taxpayer.

The IRA renamed the nonbusiness energy property credit to the “Energy Efficient Home Improvement Credit” and made the following changes:

- It expanded the credit for energy-efficient components placed in service before January 1, 2033.
- It increased the nonbusiness energy property credit from 10% to 30% of the amount paid or incurred by the taxpayer for qualified energy efficiency improvements installed during the taxable year and the amount of the residential energy property expenditures paid or incurred by the taxpayer during such taxable year.
- It repealed the requirement that residential energy property expenditures must be made with respect to the taxpayer’s principal residence.
- It repealed the $500 lifetime credit limitation and replaced it with an annual credit limitation of $1,200 per taxpayer per year, including annual sub-limits of:
  - $600 for credits related to qualified residential energy property expenditures (including central air conditioners, electric panels, natural gas, propane, or oil water heaters, oil furnaces, and water boilers);
  - $600 for windows, and skylights that meet Energy Star most efficient certification requirements; and
  - $250 for any exterior door ($500 aggregate limit for all exterior doors) that meet applicable Energy Star requirements.
- It increases the $1,200 annual limit to $2,000 for amounts paid for specified heat pumps, heat pump water heaters, and biomass stoves and boilers.
  - The maximum total yearly energy efficient home improvement credit amount may be up to $3,200.
- It increased the credit to $150 for amounts spent for a home energy audit, defined as an inspection and written report with respect to a dwelling unit located in the United States and owned or used by the taxpayer as the taxpayer’s principal residence that:
  - Identifies the most significant and cost-effective energy efficiency improvements with respect to such dwelling unit, including an estimate of the energy and cost savings with respect to each such improvement; and
  - Is conducted and prepared by a home energy auditor that meets the certification or other requirements specified by the Secretary in regulations or other guidance.

The credit percentage rate phases down to 26% for property placed in service in 2033 and 22% for property placed in service in 2034. For qualified property placed in service after December 31, 2024, no credit shall be allowed unless:

- Such item is produced by a qualified manufacturer; and
- The taxpayer includes the qualified product identification number of such item on his or her tax return.

Additionally, the credit may not be claimed until the year it is installed. The IRA did not make changes to refundability (i.e., the credit remains nonrefundable), and the taxpayer may not carry the credit forward to future tax years.

The Energy Efficient Home Improvement Credit is only available for primary homes and certain improvements made to second homes. The credit cannot be taken for improvements made to homes not used as a residence by the taxpayer (i.e., landlords can never take the Energy Efficient Home Improvement Credit for a home they rent out but do not use as a residence for themselves). Renters may be eligible for the credit, provided the home they are renting is their principal residence and additional requirements are met.

If a taxpayer has a residence in which they also conduct business, they may be eligible for the Energy Efficient Home Improvement Credit as follows:

Percentage Business Use of Residence	Credit Eligibility
Not more than 20%	Full credit can be claimed.
More than 20% but under 100%	The credit is reduced to include only the portion of expenditures for the property that is allocable to use for nonbusiness purposes.
100%	The credit cannot be claimed.

A taxpayer can claim the Energy Efficient Home Improvement Credit only for qualifying expenditures incurred for an existing home or for an addition to or renovation of an existing home, not for a newly constructed home. Certain labor costs related to the installation of eligible types of property may qualify for the credit. However, used property is not eligible for the Energy Efficient Home Improvement Credit.

The credit may be adjusted if the taxpayer receives any of the following incentives:

- **Subsidies**: If a public utility provides a subsidy to the taxpayer for the purchase or installation of an energy conservation measure, the taxpayer cannot claim a credit for the amount of the subsidy used to purchase or install the qualifying property.
- **Rebates**: The taxpayer must reduce the amount of the expenditure on which credit is calculated by the amount of the rebate.
- **State Energy-Efficiency Incentives**: Generally, a taxpayer is not required to reduce the purchase price or cost of property acquired with a governmental energy-efficiency incentive unless that incentive qualifies as a rebate under federal income tax law.

2. Residential Clean Energy Credit (formerly known as the Residential Energy Efficient Property (REEP) Credit)

The residential energy efficient property credit (REEP) allows taxpayers to take an individual tax credit for solar electric, solar hot water, small wind energy, full cell, biomass fuel property, and geothermal heat pumps installed in homes before January 1, 2024. Labor costs related to the installation of these types of property are eligible for the credit. The IRA renames the Residential Energy Efficient Property Credit to the Residential Clean Energy Credit. For property placed in service after December 31, 2019, and before January 1, 2023, the credit applicable percentage was equal to 26% of the taxpayer's qualified expenditures. For property placed in service after December 31, 2022, and before January 1, 2024, the applicable percentage was planned to equal 22% of the taxpayer's qualified expenditures. There is no annual limit on eligible costs.

The IRA extends the Residential Clean Energy Credit through 2035 and increases the applicable percentage to:

- 26% for property placed in service before January 1, 2022;
- 30% for property placed in service after December 31, 2021, and before January 1, 2033;
- 26% for property placed in service after December 31, 2032, and before January 1, 2034;
- 22% for property placed in service after December 31, 2033, and before January 1, 2035.

Lastly, the IRA expands the Residential Clean Energy Credit for qualified battery storage technology expenditures.

Specifically, the Residential Clean Energy Credit allows taxpayers to take an individual tax credit of a percentage of the cost of:

- Solar electric property expenditures (solar panels);
  - (IRS FAQs clarify that solar roofing tiles and solar roofing shingles serving as solar electric collectors while also performing the function of traditional roofing qualify for the credit).[6]
- Solar water heating property expenditures (solar water heaters);
- Fuel cell property expenditures;
- Small wind energy property expenditures (wind turbines);
- Geothermal heat pump property expenditures; and
- Battery storage technology expenditures.

The credit may not be claimed until the year it is installed. Certain labor costs related to the installation of eligible types of property may qualify for the credit. There is no overall dollar limit for the Residential Clean Energy Property Credit; however, the credit allowed for fuel cell property expenditures is 30% of the expenditures up to a maximum credit of $500 for each half kilowatt of capacity of the qualified fuel cell property.

In the case of a residence or dwelling unit that is jointly occupied by two or more individuals, the maximum amount of such fuel cell property expenditures used to calculate the total Residential Clean Energy Property Credit amount for all individuals living in that dwelling unit during a calendar year is limited to $1,667 for each half kilowatt of capacity of qualified fuel cell property.

The Residential Clean Energy Credit is nonrefundable, but a taxpayer may carry forward the unused amount of the credit to reduce tax liability in future tax years. The Residential Clean Energy Credit is only available for primary homes and certain improvements made to second homes.

- The credit cannot be taken for improvements made to homes not used as a residence by the taxpayer (i.e., landlords can never take the Residential Clean Energy Credit for a home they rent out but do not use as a residence for themselves).
- Renters may be eligible for the credit, provided the home they are renting is their principal residence and additional requirements are met.

If a taxpayer has a residence in which they also conduct business, they may be eligible for the Residential Clean Energy Credit as follows:

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[6] Fact Sheet 2022-40.

Percentage Business Use of Residence	Credit Eligibility
Not more than 20%	Full credit can be claimed.
More than 20% but under 100%	The credit is reduced to include only the portion of expenditures for the property that is allocable to use for nonbusiness purposes.
100%	The credit cannot be claimed.

A taxpayer can claim the Residential Clean Energy Credit for qualifying expenditures incurred for either an existing home or a newly constructed home. However, used property is not eligible for the Residential Clean Energy Credit.

The credit may be adjusted if the taxpayer receives any of the following incentives:

- **Subsidies**: If a public utility provides a subsidy to the taxpayer for the purchase or installation of an energy conservation measure, the taxpayer cannot claim a credit for the amount of the subsidy used to purchase or install the qualifying property.
- **Rebates**: The taxpayer must reduce the amount of the expenditure on which credit is calculated by the amount of the rebate.
- **State Energy-Efficiency Incentives**: Generally, a taxpayer is not required to reduce the purchase price or cost of property acquired with a governmental energy-efficiency incentive unless that incentive qualifies as a rebate under federal income tax law.

3. Clean Vehicle Credit

Prior to the IRA, taxpayers could claim a credit for a new qualified plug-in electric drive motor vehicle placed in service by the taxpayer during the taxable year. The base amount of the credit was $2,500. In the case of a vehicle which draws propulsion energy from a battery with not less than 5 kilowatt hours of capacity, the amount of the credit is $2,500, plus $417 for each kilowatt hour of capacity in excess of 5 kilowatt hours (not to exceed $5,000), for a total maximum credit amount of $7,500. Heavier fuel cell vehicles qualified for up to a $40,000 credit. The credit phased out after the manufacturer sold its 200,000th electric drive motor vehicle, and for certain vehicles manufactured by Tesla and GM.

The IRA removed the limitation on the number of vehicles eligible for the credit, applicable for all vehicles sold after December 31, 2022. The IRA also changed the dollar amount of the credit, allowing taxpayers to receive a $3,750 credit for meeting a “critical minerals requirement” and $3,750 for meeting a “battery component requirement”. The maximum credit per vehicle is $7,500.

The credit may only be claimed to the extent of the taxpayer’s tax due and is not refundable. The credit cannot be carried forward to the extent it is claimed for personal use; however, the credit may be carried forward to the extent it is claimed for business use. Only one taxpayer may claim the Clean Vehicle Credit per vehicle placed in service (i.e., the credit cannot be allocated or prorated between multiple taxpayers). In the case of married filing jointly taxpayers, either spouse may be identified as the owner claiming the new vehicle credit. The Clean Vehicle Credit is claimed on Form 8936, *Qualified Plug-in Electric Drive Motor Vehicle Credit*, in the year that the vehicle is placed in service, and the VIN of the new vehicle must be reported on this form.

Per IRS FAQs, a new clean vehicle for purposes of the Clean Vehicle Credit is a vehicle that:[7]

- Is placed in service on or after January 1, 2023 and acquired by a taxpayer for original use;
  - Note that original use is defined as "the first use to which the vehicle is put after it is sold, registered, or titled."
- Is not acquired for resale;
- Is manufactured by a qualified manufacturer;
- Is manufactured primarily for use on public streets, roads, and highways, with at least four wheels;
- Has a gross vehicle weight of less than 14,000 pounds;
- Is powered to a significant extent by an electric motor with a battery capacity of 7 kilowatt hours or more and must be capable of being recharged from an external source of electricity; and
- Has final assembly in North America.

Fuel Cell Vehicles are also considered new clean vehicles for purposes of the Clean Vehicle Credit if:

- Original use begins with the taxpayer;
- Final Assembly occurs in North America; and
- The seller of the vehicle provides a report to the IRS.

Under the IRA, the $7,500 clean vehicle credit consists of a $3,750 credit for meeting a "critical minerals requirement" and $3,750 for meeting a "battery component requirement" as follows:

- Vehicles meeting neither requirement will not be eligible for the Clean Vehicle Credit.
- Vehicles meeting only one requirement may be eligible for a $3,750 credit.
- Vehicles meeting both requirements may be eligible for the full $7,500 credit.

The critical mineral and battery components requirements of the Clean Vehicle Credit apply to vehicles placed in service on or after April 18, 2023, including vehicles ordered or purchased prior to but placed in service on or after April 18, 2023.

The amount of the Clean Vehicle Credit depends on when the taxpayer placed the vehicle in service, regardless of purchase date. For vehicles placed in service January 1, 2023, through April 17, 2023, the credit is calculated as follows:

- $2,500 base amount.
- Plus $417 for a vehicle with at least 7 kilowatt hours of battery capacity.
- Plus $417 for each kilowatt hour of battery capacity beyond 5 kilowatt hours.
- Up to $7,500 total.

For vehicles placed in service January 1, 2023, through April 17, 2023, the minimum credit will generally be $3,751 ($2,500 + (3 x $417)), the credit amount for a vehicle with the minimum 7 kilowatt hours of battery capacity.

For vehicles placed in service April 18, 2023, and after, the credit is calculated as follows:

- $3,750 if the vehicle meets the critical minerals requirement only;
- $3,750 if the vehicle meets the battery components requirement only; and

[7] FS-2023-08.

- $7,500 if the vehicle meets both requirements.

A vehicle that does not meet either requirement will not be eligible for the Clean Vehicle Credit.

The critical minerals requirement essentially states that critical minerals contained in the battery must be:

- Extracted or processed in the United States, in any country with which the United States has a free trade agreement in effect, or recycled in North America; and
- Equal to or greater than the applicable percentage:
  - 40% for a vehicle placed in service after December 31, 2022 (and after April 18, 2023), and before January 1, 2024;
  - 50% for a vehicle placed in service during calendar year 2024;
  - 60% for a vehicle placed in service during calendar year 2025;
  - 70% for a vehicle placed in service during calendar year 2026; and
  - 80% for a vehicle placed in service after December 31, 2026.

The battery components requirement essentially states that the battery's components must be:

- Manufactured or assembled in North America; and
- Equal to or greater than the applicable percentage:
  - 50% for a vehicle placed in service after December 31, 2022 (and after April 18, 2023), and before January 1, 2024;
  - 60% for a vehicle placed in service during calendar year 2024;
  - 60% for a vehicle placed in service during calendar year 2025;
  - 70% for a vehicle placed in service during calendar year 2026;
  - 80% for a vehicle placed in service during calendar year 2027;
  - 90% for a vehicle placed in service during calendar year 2028; and
  - 100% for a vehicle placed in service during calendar year 2029 and thereafter.

A list of eligible clean vehicles that qualified manufacturers have indicated meet the IRS requirements is located at www.fueleconomy.gov/newtaxcredit. This list will be updated as manufacturers continue to provide information about eligible clean vehicles. Individuals can typically find the vehicle's weight, battery capacity, final assembly location, and VIN on the vehicle's window sticker. If the VIN is known, it can confirm final assembly information. Final confirmation of whether a vehicle qualifies for the credit should be done at the time of purchase, and the seller must provide the buyer with a report about a vehicle's eligibility at the time of sale. Buyers are advised to obtain a copy of the IRS's confirmation that a "time-of-sale" report was submitted successfully by the dealer.
To qualify for the credit, the final assembly of the vehicle must occur in North America. The clean vehicle credit is not allowed if the manufacturer's suggested retail price (MSRP) is in excess of:

- $80,000 for vans, SUVs, and pickups; and
- $55,000 for all other vehicles.

A vehicle's MSRP is the vehicle's base retail price as suggested by the manufacturer, plus the retail price suggested by the manufacturer for each accessory item or optional equipment attached to the vehicle at the time of delivery to the dealer. MSRP does not include destination charges, optional items added by the dealer, or taxes and fees. The Clean Vehicle Credit limitations are based on MSRP, not the actual price paid for the vehicle (i.e., if the purchase price drops below the MSRP due to manufacturer/dealer incentives).

Final Assembly is defined as “the process by which a manufacturer produces a new clean vehicle at, or through the use of, a plant, factory, or other place from which the vehicle is delivered to a dealer or importer with all component parts necessary for the mechanical operation of the vehicle included with the vehicle, whether or not the component parts are permanently installed in or on the vehicle.”

The clean vehicle credit is disallowed if the lesser of the MAGI of the taxpayer for the current or preceding tax year exceeds the following threshold amounts:

- $300,000 for taxpayers filing joint returns or surviving spouses;
- $225,000 for head of household taxpayers; and
- $150,000 for all other taxpayers.

Per IRS FAQs, if a partnership or an S corporation places a new clean vehicle in service and the new clean vehicle credit is claimed by individuals who are direct or indirect partners of that partnership or shareholders of that S corporation, the modified AGI thresholds apply to those partners or shareholders.[8]

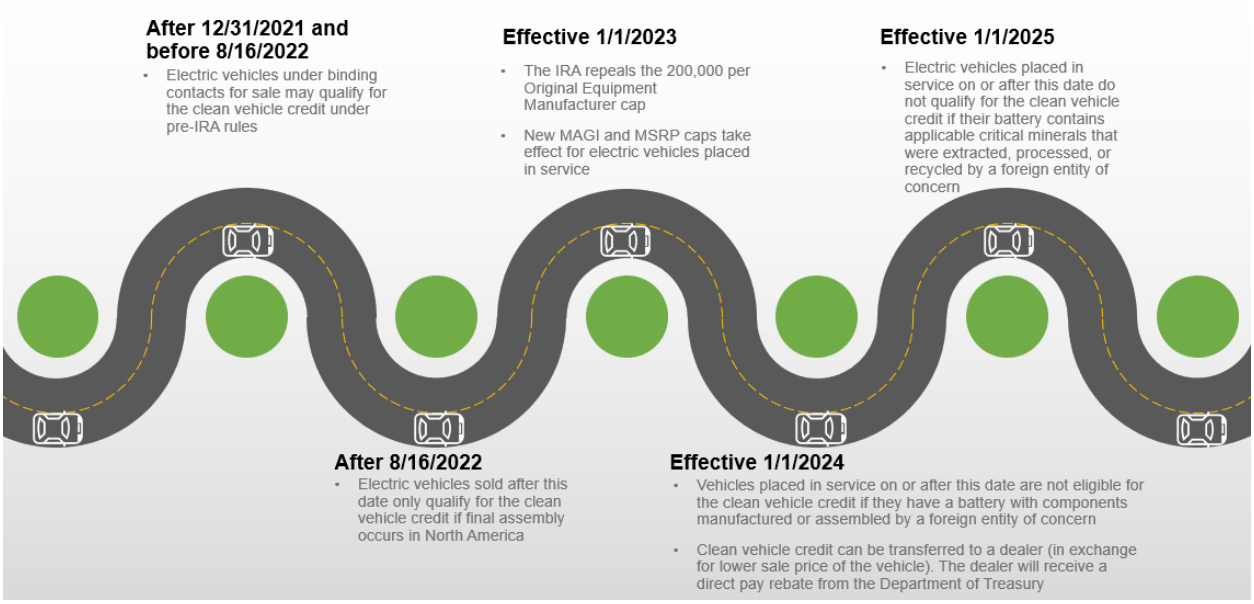
For purposes of the Clean Vehicle Credit, the seller must provide the following information to the taxpayer and IRS:

- Name and taxpayer identification number of the seller;
- Name and taxpayer identification number of the taxpayer (only one taxpayer may be listed on the seller report – in the event of multiple owners, only the taxpayer that intends to claim the credit should be listed);
- Vehicle identification number (VIN) of the new clean vehicle;
- Battery capacity of the new clean vehicle;
- Verification that the taxpayer is the original user of the new clean vehicle;
- The date of the sale and the sale price of the vehicle;
- Maximum credit allowable for the new clean vehicle being sold;
- For sales after December 31, 2023, the amount of any transfer credit applied to the purchase; and
- A declaration under penalties of perjury from the seller.

The seller must provide such report to the taxpayer no later than the date of purchase. Taxpayers that did not receive a report from the seller because their vehicle was previously ineligible, but their vehicle is now eligible (i.e., due to a change in the vehicle’s classification and MSRP limitation) may request and receive a report from the seller after the vehicle’s purchase date.

The clean vehicle credit will cease to apply to vehicles placed in service after December 31, 2032. For vehicles placed in service after 2023, qualifying vehicles will not include any vehicle with battery components that were manufactured or assembled by a foreign entity of concern (Iran, China, Russia, North Korea, and Iran). Taxpayers are required to include the vehicle identification number (VIN) on their tax return to claim a clean vehicle tax credit.

[8] FS-2023-08.



4. Credit for Previously Owned Clean Vehicles

The IRA created a clean vehicle credit for used vehicles, effective for sales occurring after the date of enactment (August 16, 2022) through December 31, 2032. This credit is only available to individual taxpayers; business entities such as corporations or partnerships are not eligible for the credit.

New IRC §25E provides that a qualified buyer who places in service a previously owned clean vehicle during the taxable year may take a credit equal to the lesser of:

- $4,000; or
- The amount equal to 30% of the sale price with respect to such vehicle.

The credit is not refundable and cannot be carried forward.

Per IRS FAQs, a previously owned clean vehicle is a motor vehicle that meets the following requirements:

- The model year of the vehicle is at least two years earlier than the calendar year in which a taxpayer acquires the vehicle;
- The purchasing taxpayer is not the original user of the vehicle;
- The vehicle was acquired for a sales price of $25,000 or less from a dealer and the purchasing taxpayer is the first qualified buyer to claim the credit since August 16, 2022, other than its original user; and
- Such motor vehicle is a:
  - Qualified fuel cell motor vehicle with a gross vehicle weight rating of less than 14,000 pounds, or
  - A vehicle made by a qualified manufacturer that meets the definition of a motor vehicle under Title II of the Clean Air Act, has a gross vehicle weight rating of less than 14,000 pounds, is powered to a significant extent by an electric motor with a battery capacity of seven kilowatt hours or more, and is capable of being recharged from an external source of electricity.
- Note that the dealer selling the previously owned clean vehicle must provide a report containing purchaser and vehicle information to the purchaser and to the IRS.

This credit is disallowed if the taxpayer's MAGI for the year of purchase or preceding year exceeds:

- $150,000 for married filing jointly taxpayers;
- $112,500 for head of household taxpayers; and
- $75,000 for all other taxpayers.

The taxpayer's MAGI would be the lesser of MAGI in the taxable year or the prior tax year.

The IRA defines a previously owned clean vehicle as a motor vehicle:

- In which the model year is a least two years earlier than the calendar year in which the taxpayer acquires such vehicle;
- In which the original use commenced with a person other than the taxpayer; and
- That is acquired by the taxpayer in a qualified sale, defined as the sale of a motor vehicle by a dealer for a price of $25,000 or less.

The §25E credit for previously owned clean vehicles only applies to the first resale for a used vehicle, and the buyer must purchase the used vehicle from a dealership. Buyers can only claim the §25E credit for previously owned clean vehicles once every three years. Similar to the new clean vehicle credit, the credit may be transferred to the dealer that is selling the previously owned clean vehicle, provided the credit amount is deducted from the sales price at the time of sale. Certain restrictions apply to sales between related parties, and buyers cannot claim the credit if they can be claimed as a dependent on another taxpayer's return. The credit for previously owned clean vehicles applies to vehicles acquired after December 31, 2022, and before January 1, 2033

C. Recent business updates

a. Corporate tax rate for C corporations is reduced to a flat rate of 21%.

b. Under the pre-Act law, corporations that received dividends from other corporations were entitled to a deduction called the "dividends received deduction." If a corporation owned at least 80% of another corporation, the dividends received deduction was 80% of the dividends received. If less than 80% ownership, the deduction was 70% of dividends received. Under the Act, as a counterpoint to the 21% flat tax for C corporations, the 80% deduction has been reduced to 65% and the 70% deduction has been reduced to 50%.

c. In 2024, the maximum §179 expensing has increased to $1,220,000 with a phaseout threshold of $3,050,000.

d. 100% Bonus depreciation existed for qualifying business assets placed in service after September 27, 2017 and before January 1, 2023. The 100% AFYD deduction is stepped down as of January 1, 2023.

   - In the 4-year period from 2023 through 2026, the 100% deduction is stepped down 20% per year, until the rule sunsets in 2027. The bonus depreciation percentage is as follows:
     (i) Property placed in service in 2023**:** 80% deduction;
     (ii) Property placed in service in 2024**:** 60% deduction;
     (iii) Property placed in service in 2025**:** 40% deduction; and
     (iv) Property placed in service in 2026**:** 20% deduction.

e. Luxury automobile depreciation limits have been increased.

f. New farming equipment and machinery is 5-year property for property placed in service after December 31, 2017.

g. Limits for deduction of business interest (§163(j)). The CARES Act temporarily amended the TCJA §163(j) limitation by retroactively increasing the limitation on the deductibility of interest expense from 30% to 50% for tax years beginning after December 31, 2018 and before January 1, 2021. The limitation has since reverted to 30%.

h. Modification of NOL: two-year carryback repealed after 2017 except for certain farming losses with a limitation of 80% of taxable income. The CARES Act amended the TCJA and provided that NOLs arising in a tax year beginning after December 31, 2017 and before January 1, 2021 could be carried back to each of the five tax years preceding the tax year of such loss. It also temporarily suspended the taxable income limitation in the TCJA to allow an NOL to fully offset income.

NOL Generated in Tax Years	Eligible for Carryback	Eligible for Carryforward	Eligible to Offset % of Taxable Income
Beginning on or before 12/31/17	2 tax years	20 tax years	100% of taxable income
2018–2020	5 tax years	Indefinite	100% of taxable income prior to 2021. 80% of taxable income after 2020.
2021 and beyond	Generally, no carryback	Indefinite	80% of taxable income

i. Domestic production activities repealed for tax years after 2017 (Code §199).

j. Like-kind exchange limited to **real property**.

k. Five-year write off of specified R&E expenses.

l. Employer deduction for fringe benefits limited.

m. Rehabilitation credit limited.

n. For years after 2017, a taxpayer is required to recognize income no later than the tax year in which such income is taken into account as income on an applicable financial statement (AFS) or another financial statement under rule specified by the IRS.

o. For years after December 31, 2017, there are new rules for taxpayers that meet the $25,000,000 gross receipts test. As indexed for inflation, this is $30,000,000 in 2024.

p. For years beginning after December 31, 2017, any producer or reseller that meets the $25,000,000 gross receipts test is exempted from the application of the UNICAP rules of Code §263A. As indexed for inflation, this is $30,000,000 in 2024.

1. S corporation, partnership, and other changes

a. The TCJA created the 20% §199A deduction for certain pass-throughs (sole proprietorships, partnerships, limited liability companies, and S corporations). This provision is a counterpoint to the 21% flat tax rate for C corporations.

b. The partnership technical termination has been repealed (50% or more sale or exchange of capital and profits in one 12-month period).

c. Partnership “substantial built-in loss” provision modified.

2. Corporate Transparency Act (CTA)

Due to regulations under the Corporate Transparency Act of 2020 (CTA), most small corporations, LLCs, and partnerships will be required to report beneficial ownership information to FinCEN. Beneficial ownership information is identifying information about the individuals who directly or indirectly own or control a company.

On March 1, 2024, in the case of *National Small Business United v. Yellen*, the U.S. District Court for the Northern District of Alabama rendered a summary judgment declaring the Corporate Transparency Act unconstitutional. This ruling has prompted the potential for similar legal challenges from other business groups. In response to the court's decision, the Justice Department, representing the Department of the Treasury, filed a Notice of Appeal on March 11, 2024. In response to the court ruling, as of March 1, 2024, FinCEN has ceased enforcement of the CTA for the plaintiffs involved in the lawsuit, which includes approximately 65,000 members of the National Small Business Association. All other entities are required to continue complying with the law.

Currently, there is no centralized database that contains complete information about owners and operators of legal entities within the United States. Most jurisdictions do not require the identification of an entity's individual beneficial owners at or after the time of formation. Many states require little to no disclosure of contact information or other information about an entity's officers or others who control the entity. The beneficial ownership information reporting requirement was created to "enhance U.S. national security by making it more difficult for criminals to exploit opaque legal structures to launder money, traffic humans and drugs, and commit serious tax fraud and other crimes that harm the American taxpayer."[9]

Reporting companies are required to report beneficial ownership information to FinCEN. The two types of reporting companies are:

- **Domestic Reporting Companies**, defined as:
  - Corporations;
  - LLCs; or
  - Any other entity created by the filing of a document with a secretary of state or any similar office under the law of a state or Indian tribe.
    - Common structures include limited liability partnerships, limited liability limited partnerships, business trusts, and most limited partnerships.
- **Foreign Reporting Companies**, defined as:
  - Corporations, LLCs, or other entities formed under the law of a foreign country; and
  - Registered to do business in any U.S. state or in any tribal jurisdiction by the filing of a document with a secretary of state or any similar office under the law of a U.S. state or Indian tribe.

Limited exemptions from the reporting requirement apply, and most exempt entities are already subject to federal and state information reporting.

A beneficial owner is any individual who:

- Directly or indirectly exercises substantial control over the reporting company; or
- Directly or indirectly owns or controls 25 percent or more of the "ownership interests" of the reporting company.

Limited exemptions to the beneficial owner requirement apply.

If a reporting company is created or registered on or after January 1, 2024, the reporting company will also need to report information about itself, its beneficial owners, and its company applicants. If a

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[9] 87 FR 59498 (September 30, 2022).

reporting company was created or registered before January 1, 2024, the reporting company only needs to provide information about itself and its beneficial owners. The reporting company **does not** need to provide information about its company applicants.

The information that a reporting company must report about itself includes:

- The company's legal name;
- Any company trade names, "doing business as" (d/b/a) names, or "trading as" (t/a) names;
- The current street address of its principal place of business if that address is in the United States, or, for reporting companies whose principal place of business is outside the United States, the current address from which the company conducts business in the United States;
- The company's jurisdiction of formation or registration; and
- The company's TIN.

A **company applicant** is:

- The individual who directly files the document that creates or first registers the reporting company; and
- The individual who is primarily responsible for directing or controlling the filing of the relevant document.

Note that no reporting company will have more than two applicants.

The information that a reporting company must report about a beneficial owner or company applicant includes:

- The individual's name, date of birth, and current personal address; and
    - A unique identifying number for the individual from an acceptable identification document (examples include driver's licenses, passports, or identification documents issued by a U.S. state or local government or Indian tribe).
    - Note that the reporting company must submit an image of such identification document to FinCEN.

A reporting company created or registered to do business before January 1, 2024, will have until January 1, 2025, to file its initial beneficial ownership information report. Under the initial BOI reporting requirements, a reporting company created or registered on or after January 1, 2024, would have 30 days to file its initial beneficial ownership information report. On November 29, 2023, FinCEN issued a final rule, extending the filing deadline from 30 days to 90 days for entities created or registered on or after January 1, 2024, and before January 1, 2025. This 90-calendar day deadline runs from the time the company receives actual notice that its creation or registration is effective, or after a secretary of state or similar office first provides public notice of its creation or registration, whichever is earlier. Under the final rule, entities created or registered on or after January 1, 2025, will have 30 days to file their initial BOI reports with FinCEN. FinCEN began accepting beneficial ownership information reports on January 1, 2024, and there is no fee for submitting the report. Updated reports must be filed if any previously reported information changes.

Many taxpayers may be unaware of the existence of these reporting requirements. FinCEN estimates approximately 32.6 million reports will be filed initially, with an additional five million filings annually for the

next nine years. Significant penalties can result from failure to comply with these new reporting requirements. Any person who willfully provides false or fraudulent information to a reporting company or willfully fails to file a complete initial or updated report with FinCEN is subject to a $500-per-day fine up to $10,000 and imprisonment for up to two years.

Senior officers of an entity that fails to file a required BOI report may be held accountable for that failure. An individual may also be subject to civil and/or criminal penalties for willfully causing a company not to file a required BOI report or to report incomplete or false beneficial ownership information to FinCEN.

For more detailed information regarding the CTA, consider enrolling in Surgent CPE's *Guide to the Corporate Transparency Act for Accounting and Finance Professionals (CTA2)*.

3. Like-kind exchanges

With the real estate market continuing to have increased activity, many taxpayers are seeking the assistance from tax professionals on how to manage tax liabilities amidst the buying and selling. As a result, like-kind exchanges under §1031 have increasingly become topics of conversation and are being seen with greater frequency among taxpayers newer to real estate investing.

Like-kind exchanges represent the most common type of nontaxable exchange, the exchange of property for the same kind of property. These exchanges allow taxpayers to effectively defer taxes on gain realized with the sale of a property under the right conditions. To be qualified as a like-kind exchange, the property traded and the property received must be both qualifying property and like-kind property.

Like-kind exchange treatment applies only to exchanges of real property held for use in a trade or business or for investment, rather than real property held primarily for sale. Under the TCJA, beginning after December 31, 2017, §1031 now applies only to exchanges of tangible real property and no longer to exchanges of personal or intangible property. The following types of owners of investment and business property are eligible for the IRC §1031 deferral:

- Individuals;
- General Partnerships;
- Limited Partnerships;
- Limited Liability Companies;
- C Corporations;
- S Corporations;
- Trusts; and
- Any other taxpayer entity.

In a like-kind exchange, both the property received, and the property traded must be only real property held for investment or productive use in a trade or business. Exceptions apply if property is disposed of prior to January 1, 2018, or to property received in an exchange before January 1, 2018. Examples of qualifying property include buildings, land, and rental property. For exchanges of the following property, the like-kind exchange rules do not apply:

- Real property used for personal purposes, such as a person's home;
- Real property held primarily for sale to customers; and
- Any personal or intangible property.

However, a taxpayer may have a nontaxable exchange under other rules. An exchange of a business's assets for a similar business's assets cannot be treated as an exchange of one property for another property. An analysis of each asset involved in the exchange is necessary.

Practice note:

As previously noted, a personal residence is not eligible for like-kind treatment. However, if a portion of the house was used in a trade or business or for investment, that portion would be eligible for like-kind exchange treatment under IRC §1031.

Like-kind properties have the same character or nature, even if they differ in grade or quality, and include the exchange of real estate for real estate. For instance, the exchange of land improved with a store building for land improved with an apartment house, improved real property for unimproved real property, or rural real property for city real property all are considered a like-kind exchange. Conversely, an exchange of real property for personal property does not qualify as a like-kind exchange. For example, an exchange of a store building for a piece of machinery does not qualify. An exchange of farm property for city property, or unimproved property for improved property, is a like-kind exchange.

The exchange of real estate that is owned for a real estate lease on property that runs 30 years or longer is a like-kind exchange. However, not all exchanges of interests in real property qualify for like-kind exchange. The exchange of a life estate (this gives the holder the power to retain ownership until death) expected to last less than 30 years for a remainder interest, which gives the holder the right to take ownership when the life estate has ended, is not a like-kind exchange. Even so, if the nature or character of the two property interests is the same, an exchange of a remainder interest in real estate for a remainder interest in other real estate is a like-kind exchange.

On December 2, 2020, the IRS issued final regulations, providing guidance on like-kind exchanges. [10] The final regulations make significant changes to prior proposed regulations, most notably by limiting the application of the like-kind exchange rules under §1031 to exchanges of real property and adding a definition of real property. The TCJA failed to clarify what is considered real property for purposes of §1031. Per the final regulations, real property is any property that is:

a. Considered real property under state or local law (the "State and Local Law Test", such test applies to both tangible and intangible property and states may have differing definitions of real property);
b. Considered real property based on all of the facts and circumstances; or
c. Considered real property due to being specifically identified as such in the final regulations.

Prior to the TCJA amendment of §1031, assets expressly excluded from like-kind exchange treatment were listed in §1031(a)(2), including:

- Stock in trade or other property held primarily for sale;
- Stocks, bonds, or notes;
- Other securities or evidences of indebtedness or interest;
- Interests in a partnership (other than an interest in a partnership that has in effect a valid election under §761(a) to be excluded from the application of all of subchapter K);
- Certificates of trust or beneficial interests; and
- Choses in action.

[10] T.D. 9935.

The TCJA eliminated this list, but the final regulations state that in order to be consistent with legislative history, property that was ineligible for like-kind exchange treatment prior to the TCJA would continue to be ineligible. This holds true even if the property is considered real property under state or local law, since such property was never considered real property eligible for like-kind exchange treatment prior to the enactment of the TCJA.

The final regulations explicitly name certain property that is considered real property for purposes of §1031, including:

- Land;
- Improvements to land, including inherently permanent structures, such as buildings, and the structural components of inherently permanent structures, such as central air conditioning and heating systems;
- Unsevered natural products of land, such as timber, plants, or crops;
- Water and air space superjacent to land; and
- Certain intangible interests in real property, such as leaseholds.

Generally, if a taxpayer actually or constructively receives money or non-like-kind incidental personal property before receiving like-kind replacement real property, the transaction is a sale or taxable exchange and not a like-kind exchange, even though the taxpayer may ultimately receive like-kind replacement real property. The final regulations clarify the treatment of incidental personal property to a like-kind exchange. Property is incidental to a larger property if, in a standard transaction, the property is typically transferred with the larger item of property, and the aggregate fair market value of all of the incidental property does not exceed 15% of the aggregate FMV of the larger item of property. This 15% limitation is determined by comparing the value of all incidental property to the value of all real property acquired in the exchange. The final regulations clarify that taxpayer must still recognize any gain on the personal property received, but the remainder of the transaction will still be afforded §1031 treatment. In other words, receiving non-incidental personal property will not disqualify a §1031 exchange.

The final regulations further clarify that the rules outlining the definition of real property only apply for purposes of §1031. In other words, a taxpayer's asset can be considered real property for §1031 purposes but personal property for depreciation purposes.

Example: A structure or a portion of a structure may be §1245 property for depreciation purposes and for determining gain under §1245, while being classified as real property under §1031.

D. Sale of a principal residence

The COVID-19 pandemic led to an unprecedented number of individuals contemplating their living situation. Lured by the promise of remote work, many individuals considered selling their house and moving to their "dream home." This increased demand, coupled with historically low interest rates, led to soaring home prices since 2020. As a result of soaring housing prices, more individuals may consider selling their primary or secondary home. Even individuals who purchased their home only a year or two ago may have significant equity in their home.

A Congressional Research Service report notes that 29% of home sale prices in 2021 were at $500,000 or more and 43% were at prices of $250,000 to $500,000, with approximately 1/3 of sales involving single

individuals. [11] Of these sales, 43% could be exposed to capital gain taxes depending on the seller's basis. Individuals who sold a home that they lived in for a significant period of time are more likely to have a lower basis, and therefore, a higher likelihood of exposure to capital gain taxes.

1. Background and overview

Generally, under §121(a), a taxpayer may **exclude up to $250,000** ($500,000 for joint returns) of **gain realized on the sale** or exchange of the taxpayer's **principal residence** if the taxpayer **owned and used** the property as the taxpayer's principal residence for **at least two years during the five-year period** ending on the date of the sale or exchange. This is often referred to as the **ownership test** and the **use test.**

- The use test does not have to occur over a single block of time, rather, the two years of residence may occur anytime within the five-year period. If the taxpayer becomes physically or mentally unable to care for themselves and used the residence as their principal residence for 12 months in the 5 years preceding the sale or exchange, any time they spent living in a care facility counts toward their two-year use/residence requirement.
- If the taxpayers are married and filing a joint return, only one spouse must meet the ownership test. However, each spouse must meet the use test to qualify for the full exclusion.
- The taxpayer's principal residence need not be a single-family home in order to qualify for the exclusion. It may be a townhome, condominium, a cooperative apartment, a mobile home, or even a houseboat. Generally, the residence must have sleeping, cooking, and toilet facilities.
- Taxpayers may only take advantage of the home sale exclusion of gain (maximum or partial) on their principal residence. A taxpayer's principal residence is their main home. Taxpayers may have more than one home, but they may only have one main home at a time. Such taxpayers must apply a "facts and circumstances" test to determine which of their properties is considered their main home. This "facts and circumstances" test utilizes many of the factors previously discussed regarding residency and domicile, including:
    - The taxpayer's address listed on their U.S. Postal Service address;
    - The taxpayer's address on their voter registration card;
    - The taxpayer's address on their federal and state tax returns; and
    - The taxpayer's address on their driver's or car registration.

Section 121(c) provides that a taxpayer who fails to meet any of these conditions by reason of a change in place of employment, health, or, to the extent provided in regulations, unforeseen circumstances, may be entitled to an exclusion in a reduced exclusion amount (i.e., partial exclusion). Examples of these unforeseen circumstances include the following:

- The taxpayer's home was condemned or destroyed.
- The taxpayer's home suffered a casualty loss due to a natural or man-made disaster.
- The taxpayer, his or her spouse, a co-owner of the home, or anyone else for whom the home was his or her residence:
    - Died;
    - Became divorced or legally separated;
    - Gave birth to two or more children from the same pregnancy;

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[11] Congressional Research Service, "The Exclusion of Capital Gains for Owner-Occupied Housing" February 2, 2022.

- Became eligible for unemployment compensation;
- Became unable, due to a change in employment status, to pay basic living expenses for the household (including food, clothing, housing, medication, transportation, taxes, court-ordered payments, and expenses reasonably necessary for making an income); and
- Any other event determined to be an unforeseeable event per IRS published guidance.

For purposes of determining whether a situation is an unforeseen circumstance, the following factors are often considered:

- The taxpayer sold the home not long after the situation arose.
- The taxpayer began to experience significant financial difficulty maintaining the home as a result of the situation.
- The situation that caused the sale of the home arose during the time the taxpayer owned and used the property as their residence.
- The taxpayer was unable to reasonably anticipate the situation.
- The situation caused the taxpayer's home to become significantly less suitable as a main home for the taxpayer and/or their family.

A health-related move must meet the following requirements in order to be eligible for a partial exclusion of gain:

- The taxpayer moved to obtain, provide, or facilitate diagnosis, cure, mitigation, or treatment of a disease or illness of themselves or a family member.
- The taxpayer moved to obtain or provide medical or personal care for a family member suffering from a disease, illness, or injury.
- The taxpayer's doctor recommended a change in residence because they were experiencing a health problem.
- Any of the above statements are true for the taxpayer's spouse, co-owner of the home, or anyone else from whom the home was his or her residence.

A change in place of employment must meet the following requirements in order to be eligible for a partial exclusion of gain:

- The taxpayer accepted a new position in a work location at least 50 miles farther from their home than the previous work location. For example, the taxpayer's previous work location was 10 miles from their home, and their new work location is 60 miles from their home.
- The taxpayer had no previous work location and began a new job at least 50 miles away from their home.
- Either of the above bullet points is true of the taxpayer's spouse, co-owner of the home, or anyone else for whom the home was his or her residence.

If a taxpayer is eligible for a partial exclusion, the exclusion limit is calculated as follows:

Step 1	Determine the shortest of the following 3 periods: 1. Your time of residence in the home during the 5-year period leading up to the sale ..... 2. Your time of ownership of the home leading up to the sale ..... 3. The time that has elapsed between the sale and the date you last sold a home for which you took the exclusion, if applicable	_____ _____ _____
Step 2	Take the smallest period from Step 1 (you may use days or months) and divide that number by 730 (if using days) or 24 (if using months)	_____
Step 3	Multiply the result from Step 2 by $250,000. Stop here if not married filing jointly	_____
Step 4	Repeat Steps 1–3 for your spouse and add the two results	_____
C) Your exclusion limit is $_____. Unless you have taxable gain from business or rental use (see *Business or Rental Use of Home*), only gain in excess of this amount is taxable.		

[12]

Any gain from the sale of a principal residence that is not eligible for the §121 exclusion is subject to capital gain tax and/or NIIT depending on the taxpayer's AGI.

2. Spousal considerations

A sale or exchange of property by an unmarried individual whose spouse is deceased on the date of such sale, shall be entitled to the entire **$500,000 exclusion** (rather than $250,000 for single filers) if the date of sale occurs **not later than two years after** the date of death of such spouse, and the requirements were met immediately before such date of death.

A taxpayer that was separated or divorced prior to the sale of the home may treat the home as his or her residence if:

- The taxpayer was the sole or joint owner; and
- The taxpayer's spouse or former spouse was allowed to live in the home under a divorce or separation agreement and used the home as his or her main home.

If the residence was transferred to the taxpayer by a spouse or ex-spouse, the taxpayer can count any time when the spouse owned the house as time when the taxpayer owned it (ownership test). However, the taxpayer must still meet the "use" test on his or her own.

E. Planning strategies

1. Converting rental property to owner-occupied property

Taxpayers who own rental property may consider converting it to owner-occupied property to take advantage of the capital gain exclusion. This strategy is especially useful for taxpayers who own both a primary property and a rental property that substantially increased in value. However, for purposes of determining the exclusion of gain, periods of nonqualifying use must be considered. **Nonqualifying use** is defined as any period (other than the portion of any period preceding January 1, 2009) during which the property is not used as the principal residence of the taxpayer or the taxpayer's spouse or former spouse. Examples of nonqualifying use include periods that the property was used as a rental property, investment property, or vacation home. The following formula is used to determine the amount of gain ineligible for exclusion due to periods of nonqualified use:

[12] Publication 523.

$$Gain\ Ineligible\ for\ Exclusion = Total\ Gain \times \frac{Sum\ of\ all\ periods\ of\ nonqualified\ use\ during\ ownership\ period}{Entire\ ownership\ period}$$

Example: In January 2022, Aiden and Audrey purchased a "fixer-upper" primary residence for $400,000 as well as a rental property for $220,000. Aiden and Audrey lived in the primary residence property full-time from January 1, 2022, through January 1, 2024. They made $150,000 of capital improvements during their ownership, bringing their total basis to $550,000 ($400,000 initial basis + $150,000 capital improvements). Aiden and Audrey sold the primary residence property for $1,050,000 on January 1, 2024, resulting in $500,000 of gain ($1,050,000 sale price less $550,000 adjusted basis). Aiden and Audrey can exclude the entire $500,000 gain on their residence since they met the use and ownership tests.

Aiden and Audrey move into the former rental property on January 1, 2024. They live in that property full-time until January 1, 2026, at which time they sold the property for $700,000. They made no improvements during their ownership, but the area in which the property was purchased became very popular, and home prices skyrocketed in value. Aiden and Audrey took $20,000 of depreciation deductions when the property was a rental property. Of the $500,000 gain on the sale of the former rental property ($700,000 purchase price less $200,000 adjusted basis), only 50%, or $250,000, is eligible for the gain. See calculation as follows:

$$Gain\ Ineligible\ for\ Exclusion = Total\ Gain \times \frac{Sum\ of\ all\ periods\ of\ nonqualified\ use\ during\ ownership\ period}{Entire\ ownership\ period}$$

$$\$250{,}000 = \$500{,}000 \times \frac{2\ years}{4\ years}$$

The first $20,000 of the gain is subject to depreciation recapture (unrecaptured §1250 gain up to 25% tax rate).

The remaining $480,000 of gain is allocated between qualifying and non-qualifying use:

- $240,000 is eligible for the §121 exclusion and the remaining $240,000 is subject to capital gains taxes.

IV. Net investment income tax

A. In general

1. Calculation of undistributed net investment income

Generally, an estate's or trust's net investment income is calculated in the same manner as that of an individual.[13] An estate's or trust's undistributed net investment income is the estate's or trust's net investment income reduced by distributions of net investment income to beneficiaries and by deductions under §642(c) in the manner described below:[14]

a. In computing the estate's or trust's undistributed net investment income, net investment income is reduced by distributions of net investment income made to beneficiaries. The deduction allowed under this provision is limited to the lesser of the amount deductible to the estate or trust for distributions of distributable net income or the net investment

[13] Treas. Regs. §1.1411-3(e)(1).
[14] Treas. Regs. §1.1411-3(e)(2).

income of the estate or trust. In the case of a distribution deduction that consists of both net investment income and excluded income, the distribution must be allocated between net investment income and excluded income in a manner similar to §1.661(b)-1 as if net investment income constituted gross income and excluded income constituted amounts not includable in gross income.[15]

b. If one or more items of net investment income comprise all or part of a distribution for which a deduction is allowed under the preceding paragraph a., such items retain their character as net investment income for purposes of computing net investment income of the recipient of the distribution who is subject to NII tax. This also applies to distributions to United States beneficiaries of current year income from foreign estates and foreign non-grantor trusts.[16]

The NII tax applies to 3.8% of the lesser of:

- Undistributed net investment income; or
- The excess of adjusted gross income over $14,450.

Note:

In computing the estate's or trust's undistributed net investment income, the estate or trust is allowed a deduction for amounts of net investment income that are allocated to amounts allowable under §642(c). In the case of an estate or trust that has items of income consisting of both net investment income and excluded income, the allowable deduction must be allocated between net investment income and excluded income as if net investment income constituted gross income and excluded income constituted amounts not includable in gross income.[17]

In each example, Year 1 is a year in which the NII tax is in effect and the taxpayer is not a foreign estate or trust:

Example 1: (i) In Year 1, Trust has dividend income of $15,000, interest income of $10,000, capital gain of $5,000, and $75,000 of taxable income relating to a distribution from an individual retirement account. Trust has no expenses. Trust distributes $10,000 of its current year trust accounting income to A, a beneficiary of Trust.

(ii) Trust's distributable net income is $100,000 ($15,000 in dividends plus $10,000 in interest plus $75,000 of taxable income from an individual retirement account), from which the $10,000 distribution to A is paid. Trust's distribution deduction is $10,000. The deduction reduces each class of income comprising distributable net income on a proportional basis. The $10,000 distribution equals 10 percent of distributable net income ($10,000 divided by $100,000). Therefore, the distribution consists of dividend income of $1,500, interest income of $1,000, and ordinary income attributable to the individual retirement account of $7,500. Because the $5,000 of capital gain allocated to principal for trust accounting purposes did not enter into distributable net income, no portion of that amount is included in the $10,000 distribution nor does it qualify for the distribution deduction.

(iii) Trust's net investment income is $30,000 ($15,000 in dividends plus $10,000 in interest plus $5,000 in capital gain). Trust's $75,000 of taxable income attributable to the individual retirement account is excluded income. Trust's undistributed net investment income is $27,500, which is Trust's net investment income ($30,000) less the amount of dividend income ($1,500) and interest

15 Treas. Regs. §1.1411-3(e)(3)(i).
16 Treas. Regs. §1.1411-3(e)(3)(ii).
17 Treas. Regs. §1.1411-3(e)(4).

income ($1,000) distributed to A. The $27,500 of undistributed net investment income is comprised of the capital gain allocated to principal ($5,000), the remaining undistributed dividend income ($13,500), and the remaining undistributed interest income ($9,000).

(iv) A's net investment income includes dividend income of $1,500 and interest income of $1,000 but does not include the $7,500 of ordinary income attributable to the individual retirement account because it is excluded from net investment income.

Example 2: (i) Same facts as **Example 1**, except Trust is required to distribute $30,000 to A. In addition, Trust has a $10,000 deduction under §642(c) (deduction for amounts paid for a charitable purpose). Trust also makes an additional discretionary distribution of $20,000 to B, a beneficiary of Trust. As in **Example 1**, Trust's net investment income is $30,000 ($15,000 in dividends plus $10,000 in interest plus $5,000 in capital gain). The items of income must be allocated between the mandatory distribution to A, the discretionary distribution to B, and the $10,000 distribution to a charity.

(ii) For purposes of the mandatory distribution to A, Trust's distributable net income is $100,000. Trust's distribution deduction for the distribution to A is $30,000. The deduction reduces each class of income comprising distributable net income on a proportional basis. The $30,000 distribution equals 30 percent of distributable net income ($30,000 divided by $100,000). Therefore, the distribution consists of dividend income of $4,500, interest income of $3,000, and ordinary income attributable to the individual retirement account of $22,500. A's mandatory distribution thus consists of $7,500 of net investment income and $22,500 of excluded income.

(iii) Trust's remaining distributable net income is $70,000. Trust's remaining undistributed net investment income is $22,500. The $10,000 deduction under §642(c) is allocated in the same manner as the distribution to A, where the $10,000 distribution equals 10 percent of distributable net income ($10,000 divided by $100,000). For purposes of determining undistributed net investment income, Trust's net investment income is reduced by $2,500 (dividend income of $1,500, interest income of $1,000 but with no reduction for amounts attributable to the individual retirement account of $7,500).

(iv) With respect to the discretionary distribution to B, Trust's remaining distributable net income is $60,000. Trust's remaining undistributed net investment income is $20,000. Trust's deduction under §661 for the distribution to B is $20,000. The $20,000 distribution equals 20 percent of distributable net income ($20,000 divided by $100,000). Therefore, the distribution consists of dividend income of $3,000, interest income of $2,000, and ordinary income attributable to the individual retirement account of $15,000. B's distribution consists of $5,000 of net investment income and $15,000 of excluded income.

(v) Trust's undistributed net investment income is $15,000 after taking into account distribution deductions and §642(c). To calculate Trust's undistributed net investment income of $15,000, Trust's net investment income of $30,000 is reduced by $7,500 of the mandatory distribution to A, $2,500 of the §642(c) deduction, and $5,000 of the discretionary distribution to B. The undistributed net investment income consists of the remaining dividend income of $6,000 ($15,000 less $4,500 less $1,500 less $3,000), interest income of $4,000 ($10,000 less $1,000 less $3,000 less $2,000), and the $5,000 of undistributed capital gain.

Example 3: (i) D died in 2023. D's estate (Estate) filed its first return that established its fiscal year ending October 31, 2023. During Estate's fiscal year ending October 31, 2023, it earned $10,000 of interest, $1,000 of dividends, and $15,000 of short-term gains. The Estate distributed its interest and dividends to S, D's spouse and sole beneficiary, on a quarterly basis; the last quarter's payment for that taxable year was made to S on December 5, 2023. S is deemed to have received the first three payments for that taxable year, regardless of the actual payment dates, on October 31, 2023, the last day of Estate's taxable year. Estate makes a **timely §663(b) election** to treat the fourth quarter distribution to S as having been made on October 31, 2023, the last day of Estate's preceding taxable year. Accordingly, S is deemed to have received $10,000 of interest and $1,000 of dividends on October 31, 2023.

(ii) Because Estate's fiscal year ending October 31, 2024, began on November 1, 2024, the Estate is not subject to NII tax on income received during that taxable year. Therefore, none of the income received by Estate during its fiscal year ending October 31, 2024, is net investment income. Because none of the distributed interest or dividend income constituted net investment income to Estate, the $10,000 of interest and $1,000 of dividends that Estate distributed to S does not constitute net investment income to S.

Note:

Estates and trusts face a major hurdle: capital gains are ordinarily not included in distributable net income and therefore cannot be distributed out to the beneficiaries. Given the disparity as to when the NII tax kicks in for individuals (beneficiaries) and fiduciaries, the strategy of spreading investment income among multiple taxpayers -- many or all of whom have a significant threshold -- and away from the highly vulnerable estate or trust that has a low threshold, is thwarted in most cases.

c. Fiduciaries are stymied not only on the low threshold but on the difficulty a fiduciary has with establishing income that is not included in NII.

(i) The Service does not believe that a fiduciary can establish the material participation in an activity that could rise to a trade or business level; as noted, this can eliminate the important income or gain in the course of a trade or business exception to NII. For example, it is possible that a decedent's real estate operation rises to the level of a §162 trade or business, which would exempt the rents and the gain on the sale of the real estate from NII inclusion, BUT FOR the fiduciary being passive with respect to the activity. So, at best the fiduciary may have a fight on its hands by treating such income as not subject to the NII tax. There is some somewhat favorable judicial opinion, but largely the passive issue is largely uncertain and bids to haunt fiduciaries particularly now with additional NII tax.

(ii) Interest is almost per se not a trade or business item and so will be included in NII. Thus, an important consideration for a fiduciary may be generating most or all of its income from tax-exempt bonds, because interest on such bonds is not included in gross income and thus cannot be included in NII.

(iii) A critical distinction arises when a qualified plan or IRA wrapper holds the investment assets because the character of distributions from such trusts -- while sourced generally in dividends, interest, and gains -- does not have the character of its constituent elements; instead, it has its own character, one which is specifically exempt from inclusion in NII. However, to the extent that they are included in gross income, such distributions increase the taxpayer's gross

income and adjusted gross income, which can have the effect of exposing more (undistributed) investment income to the tax.

(iv) Investments with deferral features, such as life insurance and certain annuity contracts, postpone the inclusion of the kind of income that may or will be included in NII.

d. If capital gains are distributed to a beneficiary, the beneficiary may not only be subject to the NII tax but may also be taxed on such gains at a 0- or 15-percent tax rate, while the trust or estate does not need much undistributed gains to be taxed at the highest rate. Because the surtax also applies to short-term capital gains, a trust or estate could in theory have an item taxed at a 37-percent rate.

e. An estate could defer its capital gains recognition, relatively small generally because of the step up in basis until its year of termination, when in any case capital gains are distributed to the beneficiaries. This is much more of a problem for longstanding trusts that neither benefit from a basis adjustment during its term nor have a reasonably ascertainable year of termination.

(i) Like-kind exchanges.

(ii) Installment sales. See discussion of charitable remainder trusts.

f. Fully charitable and charitable remainder trusts are not subject to the NII tax. See discussion of charitable remainder trusts.

g. Trusts that are grantor trusts -- which could arise if the beneficiary has a general power of appointment -- automatically allocate such gains to the individual because they are not taxable to the trust as such. This may expose the trust assets to the claims of the beneficiary's creditors.

h. Some states have conversion statutes that permit an "income" trust to a unitrust (with a 3 percent to 5 percent rate). This may, however, force out more or less than what is needed to avoid the surtax problem.

i. The regulations permit capital gains to be included in distributable net income in three instances, pursuant to the terms of the governing instrument and applicable local law or pursuant to a reasonable and impartial exercise of discretion by the fiduciary (in accordance with a power granted by applicable local law or by the governing instrument and not prohibited by local law):

(i) Allocation to income. Usually, this has been difficult, if not impossible.

- Gains may be allocated to income under a unitrust structure but only to the limited extent of the excess of the unitrust amount over the amounts included in DNI without regard to capital gains.

Example: Trust has a fair market value of $1,000,000 and a unitrust provision that is keyed to 4 percent. During that year, the trust has $30,000 of dividends and a $30,000 long-term capital gain. Because the unitrust amount is $40,000 and all $30,000 of dividends are automatically included in DNI, only $10,000 of the capital gains may be allocated to DNI.

- One interesting case involved the determination that gains from a partnership, where the trust was a limited partner, were properly classified as a net profit, which under the Principal and Income Acts was in turn properly classified as income. Note that the court had to determine that the trust did not have the primary intent of accumulating

property for the eventual distribution to the remaindermen. Local law will be determinative here.[18]

(ii) Allocation to corpus but consistent treatment by the fiduciary on the trust's books, records, and tax returns as part of a distribution to a beneficiary. For a new trust or estate, this can be done, but the consistency requirement means a possible inefficient allocation of capital gains between the trust and its beneficiaries; it also can result in fiduciary liability issues, as the remainder interests may challenge the practice as detrimental to their interests. It is also difficult for an existing trust to suddenly claim a consistent practice.

(iii) Actual distribution of capital gains would also accomplish this goal, but this is considerably more difficult than it sounds. The trustee must race the proceeds of a sale to a beneficiary; any not-insignificant time lapse between sale and distribution probably taints the claim of actual distribution.

Planning point:

What is the upshot? Going forward, instrument drafters must include greater discretionary powers to the fiduciary that may enable capital gains to be distributed but **without** undermining the interest of the remainder interests.

2. Electing small business trusts (ESBTs)

The S portion and non-S portion of a trust that has made an ESBT election are treated as separate trusts for purposes of the computation of undistributed net investment income in the manner described below but are treated as a single trust for purposes of determining the amount subject to NII tax. If a grantor or another person is treated as the owner of a portion of the ESBT, the items of income and deduction attributable to the grantor portion are included in the grantor's calculation of net investment income and are not included in the ESBT's computation of NII tax.[19]

a. The method for an ESBT to compute the NII tax is as follows:

(i) **Step one.** The S portion and non-S portion computes each portion's undistributed net investment income as separate trusts in the manner described below and then combine these amounts to calculate the ESBT's undistributed net investment income.[20]

(ii) **Step two.** The ESBT calculates its adjusted gross income. The ESBT's adjusted gross income is the adjusted gross income of the non-S portion, increased or decreased by the net income or net loss of the S portion, after taking into account all deductions, carryovers, and loss limitations applicable to the S portion, as a single item of ordinary income (or ordinary loss).[21]

(iii) **Step three.** The ESBT pays tax on the lesser of: (a) the ESBT's total undistributed net investment income; or (b) the excess of the ESBT's adjusted gross income over the dollar amount at which the highest income tax bracket begins for the taxable year.[22]

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18 *Crisp v. United States*, 34 Fed. Claims (1995), 76 AFTR 2d ¶95-6261.
19 Treas. Regs. §1.1411-3(c)(1).
20 Treas. Regs. §1.1411-3(c)(2)(i).
21 Treas. Regs. §1.1411-3(c)(2)(ii).
22 Treas. Regs. §1.1411-3(c)(2)(iii).

Example: (i) In Year 1 (a year that §1411 is in effect), the non-S portion of Trust, an ESBT, has dividend income of $15,000, interest income of $10,000, and capital loss of $5,000. Trust's S portion has net rental income of $21,000 and a capital gain of $7,000. The Trustee's annual fee of $1,000 is allocated 60 percent to the non-S portion and 40 percent to the S portion. Trust makes a distribution from income to a single beneficiary of $9,000.

(ii) **Step one.** (A) Trust must compute the undistributed net investment income for the S portion and non-S portion.

The undistributed net investment income for the S portion is $20,600 and is determined as follows:

Net Rental Income	$21,000
Capital Gain	$7,000
Trustee Annual Fee	($400)
Total S portion undistributed net investment income	$27,600

(B) The undistributed net investment income for the non-S portion is $12,400 and is determined as follows:

Dividend Income	$15,000
Interest Income	$10,000
Deductible Capital Loss	($3,000)
Trustee Annual Fee	($600)
Distributable net income distribution	($9,000)
Total non-S portion undistributed net investment income	$12,400

(C) Trust combines the undistributed net investment income of the S portion and non-S portion to arrive at Trust's combined undistributed net investment income.

S portion's undistributed net investment income	$27,600
Non-S portion's undistributed net investment income	$12,400
Combined undistributed net investment income	$40,000

(iii) **Step two.** (A) The ESBT calculates its adjusted gross income. The ESBT's adjusted gross income is the non-S portion's adjusted gross income increased or decreased by the net income or net loss of the S portion.

(B) The adjusted gross income for the ESBT is $38,000 and is determined as follows:

Dividend Income	$15,000
Interest Income	$10,000
Deductible Capital Loss	($3,000)
Trustee Annual Fee	($600)
Distributable net income distribution	($9,000)
S Portion Income	$27,600
Adjusted gross income	$40,000

(C) The S portion's single item of ordinary income used in the ESBT's adjusted gross income calculation is $27,600. This item of income is determined by starting with net rental income of $21,000 and capital gain of $7,000 and reducing it by the S portion's $400 share of the annual trustee fee.

(iv) **Step three.** Trust pays tax on the lesser of:
(A) The combined undistributed net investment income ($40,000); or
(B) The excess of adjusted gross income ($40,000) over the dollar amount at which the highest tax bracket in §1(e) applicable to a trust begins for the taxable year ($15,200 in 2024).

3. Application to charitable remainder trusts (CRTs)

Treatment of annuity or unitrust distributions: If one or more items of net investment income comprise all or part of an annuity or unitrust distribution from a CRT, such items retain their character as net investment income in the hands of the recipient of that annuity or unitrust distribution.[23] In the case of a CRT with more than one annuity or unitrust beneficiary, the net investment income is apportioned among such beneficiaries based on their respective shares of the total annuity or unitrust amount paid by the CRT for that taxable year.[24] The accumulated net investment income of a CRT is the total amount of net investment income received by a CRT for all taxable years that begin after December 31, 2012, less the total amount of net investment income distributed for all prior taxable years of the trust that begin after December 31, 2012.[25]

The federal income tax rate of the item of net investment income to be used to determine the proper classification of that item within the appropriate income category of the classes and tiers is the sum of the income tax rate applicable to that item under the regular income tax and the NII tax rate. Thus, the accumulated net investment income and excluded income of a CRT in the same income category constitute separate classes of income within that category.[26]

Example 1: (i) In 2009, A formed CRT as a charitable remainder annuity trust. The trust document requires an annual annuity payment of $50,000 to A for 15 years. For purposes of this example, assume that CRT is a valid charitable remainder trust under §664 and has not received any unrelated business taxable income during any taxable year.

(ii) As of January 1, 2024, CRT has the following items of undistributed income within its categories and classes:

Category	Class	Tax Rate	Amount
Ordinary Income	Interest	37%	$4,000
	Net Rental Income	37%	$8,000
	Non-Qualified Dividend Income	37%	$2,000
	Qualified Dividend Income	20.0%	$10,000
Capital Gain	Short-Term	37%	$39,000
	Unrecaptured §1250 Gain	25.0%	$1,000
	Long-Term	20.0%	$560,000
Other Income	None		None
Total undistributed income as of January 1, 2024			$624,000

None of the $624,000 of undistributed income is accumulated net investment income (ANII) because none of it was received by CRT after December 31, 2012. Thus, the entire $624,000 of undistributed income is excluded income.

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23 Treas. Regs. §1.1411-3(d)(1)(i).
24 Treas. Regs. §1.1411-3(d)(1)(ii).
25 Treas. Regs. §1.1411-3(d)(1)(iii).
26 Treas. Regs. §1.1411-3(d)(2)(i).

(iii) During 2024, CRT receives $7,000 of interest income, $9,000 of qualified dividend income, $4,000 of short-term capital gain, and $11,000 of long-term capital gain. Prior to the 2024 distribution of $50,000 to A, CRT has the following items of undistributed income within its categories and classes:

Category	Class	Excluded/ANII	Tax Rate	Amount
Ordinary Income	Interest	NII	40.8%	$7,000
	Interest	Excluded	37%	$4,000
	Net Rental Income	Excluded	37%	$8,000
	Non-Qualified Dividend Income	Excluded	37%	$2,000
	Qualified Dividend Income	NII	23.8%	$9,000
	Qualified Dividend Income	Excluded	20.0%	$10,000
Capital Gain	Short-Term	NII	40.8%	$4,000
	Short-Term	Excluded	37%	$39,000
	Unrecaptured §1250 Gain	Excluded	25.0%	$1,000
	Long-Term	NII	23.8%	$11,000
	Long-Term	Excluded	20.0%	$560,000
Other Income	None			None

(iv) The $50,000 distribution to A for 2024 will include the following amounts:

Category	Class	Excluded/ANII	Tax Rate	Amount
Ordinary Income	Interest	NII	40.8%	$7,000
	Interest	Excluded	37%	$4,000
	Net Rental Income	Excluded	37%	$8,000
	Non-Qualified Dividend Income	Excluded	37%	$2,000
	Qualified Dividend Income	NII	23.8%	$9,000
	Qualified Dividend Income	Excluded	20.0%	$10,000
Capital Gain	Short-Term	NII	40.8%	$4,000
	Short-Term	Excluded	37%	$6,000
	Unrecaptured §1250 Gain	Excluded	25.0%	None
	Long-Term	NII	23.8%	None
	Long-Term	Excluded	20.0%	None

The amount included in A's 2024 net investment income is $20,000. This amount is comprised of $7,000 of interest income, $9,000 of qualified dividend income, and $4,000 of short-term capital gain.

(v) As a result, as of January 1, 2024, CRT has the following items of undistributed income within its categories and classes:

Category	Class	Excluded/ANII	Tax Rate	Amount
Ordinary Income	Interest			None
	Net Rental Income			None
	Non-Qualified Dividend Income			None
	Qualified Dividend Income			None
Capital Gain	Short-Term	Excluded	37%	$33,000
	Unrecaptured §1250 Gain	Excluded	25.0%	$1,000
	Long-Term	ANII	23.8%	$11,000
	Long-Term	Excluded	20.0%	$560,000
Other Income	None			None

4. Material participation of a trust

a. The National Office expressed the Service's view on material participation in the context for a fiduciary entity in a Technical Advice Memorandum.[27] At issue was what types of involvement and by whom constitute "material participation" by a trust for purposes of the passive loss rules. Two trusts, Trust A and Trust B, each owned an interest in an S corporation, which wholly owned a qualified Subchapter S subsidiary. The remaining interest in the S corporation was owned by an individual A, who is also the Special Trustee of both Trust A and Trust B. The beneficiaries of the Trusts included A and several of A's family members. B was the sole trustee of both trusts. Both trusts reported positive taxable income from their interests in the S corporation. The trusts had research and experimentation expenses for regular tax purposes but desired not to capitalize and amortize them over a 10-year period generally required by the AMT unless the taxpayer is materially participating in the activity. The issue turned on whether the activities of the special trustee counted for purposes of determining whether either Trust materially participated in the activities of the corporation. Taxpayers argued that all of the personal services performed by A in the relevant activities of the corporation should count towards meeting the material participation requirements because A's roles of Special Trustee, individual shareholder, and President of Company were all interrelated and A was essentially fulfilling A's obligations for these various roles simultaneously.

   (i) The trust agreements specifically delineated the power of the Special Trustee (A) to control certain activities relating to the corporations' common stock owned by the trusts. These activities included all decisions regarding the sale or retention of such stock and all voting of such stock. The Special Trustee did not have any further fiduciary powers over the Trusts' assets or with respect to the operations or management of the Trusts. In addition to serving as the Special Trustee, A also served as president of the corporation and, as such, was directly involved in the day-to-day operations of the corporation's trade or business activities. B (the trustee of both trusts) was not involved in the operations of the relevant activities of either Company X or Company Y on a regular, continuous, and substantial basis.

   (ii) The Service upheld Examination's position that the Trusts did not materially participate in the relevant activities of the corporation because the only relevant participation was A's participation in A's fiduciary capacity as Special Trustee, not A's time spent serving as president of the corporation. Examination's position was based on the trust agreements, which limited A's powers to certain enumerated acts and, therefore, did not give A broad or unlimited discretionary authority to bind the Trusts without B's consent.

b. Yet, in the one case litigated prior to the end of March of 2014, the Service lost. In that case, a ranch ("Ranch") was held in a testamentary trust ("Trust") that employed a full-time ranch manager and full-time and part-time employees who performed essentially all of the activities for Ranch. The manager managed all of Ranch's day-to-day operations subject to the trustee's approval. The trustee directed a substantial amount of time and attention to ranch activities, having been chosen for his extensive business, managerial, and financial experience. His duties included reviewing and approving all financial and operating proposals for the Ranch and the Trust, budget and budgeting for the Ranch, all

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[27] TAM 201317010.

investment decisions for the Trust, asset acquisition, and sales; supervising all employees and agents of the Trust and the Trust's service providers; reviewing all financial information; and maintaining all banking relationships of the Trust. These duties and responsibilities as trustee routinely required a significant percentage of his time and attention, and he maintained regular office hours during which he was consulted regarding any Trust matter that arose. He delegated certain aspects of the operation and management of the Ranch. It was necessary for Ranch to employ someone with extensive experience in the management and operation of a large, active cattle ranch, who was responsible for the day-to-day operations of Ranch, subject to his approval. With respect to how to determine whether Trust materially participated in Ranch operations, the Service took the position that the material participation of a trust in a business should be made by reference only to the trustee's activities. Trust claimed that, as a legal entity, it could participate in an activity only through the actions of its fiduciaries, employees, and agents and that through such collective efforts, its cattle ranching operations were regular, continuous, and substantial.

(i) Common sense dictated that the participation of the trust in the ranch operations should be scrutinized by reference to the trust itself, which necessarily entailed an assessment of the activities of those who labored on the ranch, or otherwise in furtherance of the ranch business, on behalf of the trust.

(ii) The court concluded that the material participation of the trust in the ranch operations should be determined by reference to the person who conducted the business of the ranch on the trust's behalf, including the trustee. The collective activities of those persons with relation to the ranch operations during relevant times were regular, continuous, and substantial so as to constitute material participation. Alternatively, the court found that the trustee's activities with regard to the ranch operations, standing alone, were regular, continuous, and substantial so as to constitute material participation by him, as trustee.

(iii) In the view of the National Office, the Service found the holding in the *Carter* case to be inconsistent with the legislative history of the material participation standard that it claimed the proper focus is on the activities of the executors and trustees.[28] Thus, in the situation, the Trusts are materially participating in the relevant activities of the corporations only if the fiduciaries, in their capacities as fiduciaries, are involved in these activities on a regular, continuous, and substantial basis. A was not vested with any degree of discretionary power to commit the Trusts to any course of action or control trust property beyond selling or voting the stock of Company X or Company Y. The work that A performed in the day-to-day operations and management decisions of those companies was work performed as an employee and not as a fiduciary. Therefore, that work did not count toward material participation. A's time spent serving as Special Trustee voting the stock of Company X or Company Y or considering sales of stock in either company did count but did not rise to the level of being "regular, continuous, and substantial." In addition, B (the trustee) did not participate in the day-to-day operations of the relevant activities of Company X or Company Y.

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[28] *Mattie K. Carter Trust v. United States*, 256 F. Supp. 2d 536 (N.D. Tex. 2003).

(iv) A second problem the Service had with the *Carter* decision was the court's holding that the activities of the trust's fiduciaries, employees, and agents should be considered to determine whether the trust's participation in an activity was regular, continuous, and substantial. The court rejected the argument that material participation by a trust should be established solely by reference to the trustee's activities. The Service infers that the purpose of material participation is to determine whether an owner of a trade or business participates sufficiently to justify the deduction of losses. If the activities of the owner's employees and agents were attributed to the owner for purposes of these rules, the owner would invariably be treated as materially participating. For this reason, the legislative history provides that "the activities of [employees] are not attributed to the taxpayer." According to the National Office, a trust should be similarly treated. A trustee performs its duties on behalf of the beneficial owners. Therefore, in the context of a trust, it is appropriate to look only to the activities of the trustee to determine whether the trust materially participated in the activity. Therefore, the National Office concluded that the Trusts did not materially participate in the relevant activities of the corporations. The Trusts were, therefore, not able to currently deduct research or experimental expenditures for purposes of the computation of AMTI.

c. The Tax Court held that a residuary trust qualified for the real estate professional exception to the passive activity loss per se rules in respect of rental activities, finding that the **trust was capable of performing personal services through its individual trustees, that it materially participated in a real property trade or business, and that its rental activities were not passive**.[29] The trust was a complex (not required to distribute all income currently) residuary trust that owned rental real estate and engaged in other real estate activities, including holding and developing real estate. The trustees of the trust were five siblings and one unrelated individual who all received fees as trustees. Three of the siblings were also employed by a wholly owned company of the trust that managed the trust's rental properties. The trust conducted its real estate holding and development activities through entities in which it held interests along with two of the trustees. The Service determined that all rental activities were passive activities under the per se rule for rental activities.

(i) The taxpayers successfully argued that the trust was a real estate professional, a status that required the trust to show that it performed more than one-half of all its personal services in trades or businesses in real property trades or businesses in which the trust **materially participated**, as well as performing more than 750 hours of services during the taxable year in real property trades or businesses in which the trust **materially participated**. The court found the trust had materially participated.

(ii) The court found that a trust as such can meet the real estate professional requirements just as a closely held C corporation can, even though it performs personal services through individual agents, including employees.

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[29] *Aragona Trust v. Commissioner*; 142 T.C. No. 9 (2014).

d. The court took a dim view of the Service's contention that the activities of the trust's non-trustee employees should be ignored, but without deciding whether the activities of non-trusteed employees should be disregarded in determining whether the trust materially participated, the court concluded that the activities of the trustees should be considered in determining whether the trust materially participated in its real-estate operations.

(i) The trustees were required by state law to administer the trust solely in the interests of the trust beneficiaries, because trustees have a duty to act as a prudent person would in dealing with the property of another; i.e., a beneficiary. Trustees were not relieved of their duties of loyalty to beneficiaries by conducting activities through a corporation wholly owned by the trust. The court further rejected the claim that that the activities of these three trustees should be considered the activities of employees and not fiduciaries because: (1) the trustees performed their activities as employees of the LLC; and (2) it is impossible to disaggregate the activities they performed as employees of the LLC, and the activities they performed as trustees. Their activities, as employees of the LLC, should be considered in determining whether the trust materially participated in its real-estate operations. Based on that premise, the court determined that the six trustees materially participated in the rental real estate activities.

(ii) Three of the trustees participated in the trust's real-estate operations full time. The trust's real-estate operations were substantial. The trust had practically no other types of operations. The trustees handled practically no other businesses on behalf of the trust.

(iii) The court further rejected the Service's argument that the activities of two trustees should not be counted because those trustees owned minority interests in the LLC and other operating entities of the real-estate holding and real-estate development projects, and because they had minority interests in some of the entities through which the trust operated its rental real-estate business, and therefore some of these two trustees' efforts in managing the jointly held entities were attributable to their personal portions of the businesses, not the trust's portion. Their combined ownership interest in each entity was never greater than the trust's ownership interest, and their interests as owners were generally compatible with the trust's goals -- they and the trust wanted the jointly held enterprises to succeed. These trustees were involved in managing the day-to-day operations of the trust's various real-estate businesses.

Note:

The holding will present planning opportunities for estates and trusts with respect to the NII tax. Even items of income that otherwise might be excepted from category 1 by the "derived in the ordinary course of business" or category 3 "property held in a trade or business" may yet be included in category 2 passive income. To escape such categorization, a trust or estate must establish that it materially participated in the (§162) trade or business activity, and this has been an unresolved issue for trusts and estates. The Service has consistently challenged a taxpayer's claim in its private letter rulings and technical advice memoranda.

The Tax Court essentially agreed with the Texas district court as to the activities of the trustees being counted without some showing that they were performed solely in a fiduciary capacity, and while it did not count the activities of employees as attributable to the trust -- because it was not necessary for the decision -- the language the court used in examining the issue suggests strongly that it would count employee activities in determining the material participation of a trust in a later case.

5. What should individuals consider in 2024 in light of the tax on investment income?

a. Consider electing out of installment-sale treatment (when available) and recognizing the entire amount of gain in the year of sale (instead of deferring it over the payment period). Thus, the taxpayer can, in essence, elect to recognize the entire gain when the pressure of net investment income will be higher in the future due to low AGI in the current year (other than potential recognized gains) and projected gains. There is no reason why gain sales followed by repurchases over a series of years cannot be effective to control both AGI and net investment income by resetting basis (to reduce future recognized gain).

b. Taxpayers that have high-yield stocks should consider, in connection with the disposition of those stocks, the opportunity to reset the portfolio in more tax-effective investments. This can shift control of the recognition of investment income (at rates as high as 20 percent) from the dividend-paying company to the investor who can time the gain. In addition to non-dividend paying stocks, investments in qualified small-business stocks can provide the additional benefit of gain that is excluded not only from taxable income but also AGI and net investment income. Tax-exempt bonds may work well tax-wise, but are subject to principal risks as interest rates change.

c. Although some taxpayers may benefit from making the election to treat long-term capital gain and qualified dividend income as ordinary so as to deduct otherwise not currently deductible interest expense, such expense disallowed by the limitation is carried over to the extent it exceeds the investment income as though incurred in the following year, when it may be more usefully applied against other net investment income. Such carryover may also be an offset in calculating net investment income for purposes of the 3.8-percent tax.

d. Because passive income -- which is not included in net investment income, as that term is used in connection with the limitation on investment interest expense -- is always included in the net investment income tax base for purposes of the NII tax, taxpayers with multiple passive activities ought to be examining current grouping elections for each activity that may enable a reclassification of such activity from passive to active or vice versa. Passive activity losses (PALs) can be deducted only against passive activity income; regroupings may release the otherwise suspended losses, which may be even more beneficial in the post-2013 higher tax rate environment than they are today. In the same manner, re-characterizing an activity from active to passive status may suspend otherwise allowable losses, which likewise might be more valuable when projected to be

released in future higher tax rate years. The status of future years must take into account the projected extent to which the NII tax might apply.

e. Be careful with respect to the disposition of §1231 assets. On the one hand, gain is treated as capital and can be offset by capital losses; most losses on such assets are fully deductible against ordinary income so for regular income tax purposes, they are deductible currently and not carried over to a future year, but if there are inadequate capital gains, they serve less than full application against net investment income tax. Therefore, it may be advisable in such year as a §1231 loss is recognized to sell a capital gain asset to generate enough gain to offset the loss and repurchase the asset at the selling price in order to reduce the category 3 gain that will be recognized in the future on the disposition of the property.

f. Taxpayers should consider doing as much of their investing inside a qualified vehicle as possible. Investment activity inside a tax-exempt entity is not taxed as such and when it is distributed (even from a taxable, non-Roth trust) its character as investment income is lost. While distributions from such vehicles can increase AGI, they do not add to the investment income even though all of the distributions arise out of investment income. Of particular note are defined-benefit plans, which are ideal for an older sole proprietor where the actuarial calculation blending mortality and low rates of investment return enable very significant contributions to the plan that: (i) are deductions that reduce AGI and taxable income; and (ii) are not subject to Social Security taxes either when contributed (thereby helping against the 0.9-percent tax on excess wages) or when distributed. Another popular choice is a §401(k) plan, although it is limited to deferring only $69,000 (2024) and does not escape Social Security taxes when contributed; a simple profit-sharing plan for a sole proprietor without employees is more effective because the contributions would not be subject to Social Security taxes.

g. Consider establishing an appropriate retirement savings vehicle, such as a Keogh or a SEP IRA, which would allow for maximum contribution to a qualified plan based on self-employment income. The conversion of IRAs to Roth IRAs will eliminate the inclusion in AGI of future distributions, thereby lowering the exposure to the tax on net investment income.

h. Consider the use of a charitable remainder trust in appropriate circumstances and taxpayers to control the timing of NII.

V. Qualified small-business stock

A. An exclusion

Individuals have a significant opportunity under §1202 to reduce their tax liability. Code §1202 defines certain stock as “qualified small-business stock” (QSBS). Taxpayers who have held QSBS for five years or more can exclude 100% on their gain up to $10,000,000 provided the shares were issued after September 27, 2010. The alternative minimum tax does not apply. Even taxpayers who miss the magic five-year period can roll the QSBS gain into a new qualified small business provided that they reinvest within 60 days.

One must be aware, however, that **not** all stock or all dispositions qualify for this treatment, and excess levels of gain do not qualify for the exclusion even if a portion of the gain does, but such levels of gain are not likely to be realized. In addition, the exclusion only applies to a disposition if the stock was held by the taxpayer for more than five years (as said). In order to understand if a corporate business could qualify for

the exclusion and if the gain recognized exceeds the amount eligible for the exclusion, two terms must be kept in mind.

a. The first is qualified small business stock. Qualified small business stock refers to stock in a **C corporation**, which was originally issued after August 10, 1993, which, as of the date of its issuance, was a **qualified small business**;[30] such stock was acquired by the taxpayer at its **original issue** (directly or through an underwriter) either in exchange for money or other property (not including stock),[31] or as compensation for services provided to such corporation (other than services performed as an underwriter of such stock);[32] and during substantially all of the taxpayer's holding period for such stock, such corporation meets the **active business requirements** and such corporation is a C corporation.[33]

(i) A **qualified small business** means any domestic corporation that is a C corporation if:

- The aggregate gross assets of such corporation (or any predecessor thereof) at all times on or after 1993, and before the issuance did not exceed $50,000,000;[34] and
- The aggregate gross assets of such corporation immediately after the issuance (determined by taking into account amounts received in the issuance) does not exceed $50,000,000.[35]

Note:

In general, all corporations that are members of the same **parent-subsidiary controlled group** shall be treated as one corporation for these purposes.[36] For these purposes, the term "parent-subsidiary controlled group" means any controlled group of corporations as defined in §1563(a)(1), except that "more than 50 percent" shall be substituted for "at least 80 percent" each place it appears in §1563(a)(1),[37] and §1563(a)(4) shall not apply.[38]

(ii) The active business requirements are met by a corporation for any period if during such period at least 80 percent (by value) of the assets of such corporation are used by such corporation in the active conduct of one or more **qualified trades or businesses**,[39] and such corporation is an **eligible corporation**.[40]

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30 I.R.C. §1202(c)(1)(A).
31 I.R.C. §1202(c)(1)(B)(i).
32 I.R.C. §1202(c)(1)(B)(ii).
33 I.R.C. §1202(c)(2)(A). A corporation shall be treated as meeting the active business requirements for any period during which such corporation qualifies as a **specialized small business investment company**. I.R.C. §1202(c)(2)(B)(i). A "specialized small business investment company" means any eligible corporation which is licensed to operate under §301(d) of the Small Business Investment Act of 1958 (as in effect on May 13, 1993). I.R.C. §1202(c)(2)(B)(ii).
34 I.R.C. §1202(d)(1)(A).
35 I.R.C. §1202(d)(1)(B).
36 I.R.C. §1202(d)(3)(A).
37 I.R.C. §1202(d)(3)(B)(i).
38 I.R.C. §1202(d)(3)(B)(ii).
39 I.R.C. §1202(e)(1)(A).
40 I.R.C. §1202(e)(1)(B). An "eligible corporation" means any domestic corporation; except that such term does not include a DISC or former DISC, a corporation with respect to which an election under §936 is in effect or which has a direct or indirect subsidiary with respect to which such an election is in effect, a regulated investment company, real estate investment trust, or REMIC, and a cooperative. I.R.C. §1202(e)(4).

- If, in connection with any **future qualified trade or business**, a corporation is engaged in **start-up activities**,[41] activities resulting in the payment or incurring of expenditures that may be treated as **research and experimental expenditures**,[42] or activities with respect to **in-house research expenses**,[43] assets used in such activities are **treated as used in the active conduct of a qualified trade or business**. Any determination is made without regard to whether a corporation has any gross income from such activities at the time of the determination.
- A **qualified trade or business** means any trade or business **other than**—
  - Any trade or business involving the **performance of services** in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any other trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees;[44]
  - Any **banking, insurance, financing, leasing, investing**, or similar business;[45]
  - Any farming business (including the business of raising or harvesting trees);[46]
  - Any business involving the production or extraction of products of a character with respect to which a deduction is allowable under §613 or §613A;[47] or
  - Any business of **operating a hotel, motel, restaurant, or similar business**.[48]
- For these purposes, stock and debt in any subsidiary corporation shall be disregarded and the parent corporation shall be deemed to own its ratable share of the subsidiary's assets, and to conduct its ratable share of the subsidiary's activities.[49] A corporation shall be treated as failing to meet the active business requirements for any period during which more than 10 percent of the value of its assets (in excess of liabilities) consists of stock or securities in other corporations, which are not **subsidiaries** of such corporation (other than working capital assets).[50] For these purposes, a corporation shall be considered a subsidiary if the parent owns more than 50 percent of the combined voting power of all classes of stock entitled to vote, or more than 50 percent in value of all outstanding stock, of such corporation.[51]

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41 I.R.C. §1202(e)(2)(A).
42 I.R.C. §1202(e)(2)(B).
43 I.R.C. §1202(e)(2)(C).
44 I.R.C. §1202(e)(3)(A).
45 I.R.C. §1202(e)(3)(B).
46 I.R.C. §1202(e)(3)(C).
47 I.R.C. §1202(e)(3)(D).
48 I.R.C. §1202(e)(3)(E).
49 I.R.C. §1202(e)(5)(A).
50 I.R.C. §1202(e)(5)(B).
51 I.R.C. §1202(e)(5)(C).

Note:

A corporation is not treated as meeting the active business requirements for any period during which more than 10 percent of the total value of its assets consists of real property that is not used in the active conduct of a qualified trade or business. The ownership of, dealing in, or renting of real property is not treated as the active conduct of a qualified trade or business.[52]

b. Although for general holding period purposes, stock acquired in exchange for property tacks the holding period of the contributed property (other than money or stock), for purposes of the exclusion holding period, such stock shall be treated as having been acquired by the taxpayer on the date of such exchange.[53] In addition, while for general gain purposes, the basis of the stock is generally the basis of the property contributed, the basis of such stock in the hands of the taxpayer shall in no event be less than the fair market value of the property exchanged.[54] If the adjusted basis of any qualified small business stock is adjusted by reason of any contribution to capital after the date on which such stock was originally issued, in determining the amount of the adjustment by reason of such contribution, the basis of the contributed property shall in no event be treated as less than its fair market value on the date of the contribution.[55]

c. If the taxpayer has **eligible gain** for the taxable year from one or more dispositions of stock issued by any corporation, the aggregate amount of such gain from dispositions of stock issued by such corporation, which may be taken into account for the taxable year shall not exceed the **greater of** $10,000,000 reduced by the aggregate amount of eligible gain taken into account for prior taxable years and attributable to dispositions of stock issued by such corporation,[56] or 10 times the aggregate adjusted bases (determined without regard to any addition to basis after the date on which such stock was originally issued) of qualified small business stock issued by such corporation and disposed of by the taxpayer during the taxable year.[57] In the case of any joint return, the amount of gain taken into account is allocated equally between the spouses to subsequent taxable years.[58] For these purposes, eligible gain means any gain from the sale or exchange of qualified small business stock held for more than five years.[59]

d. Rule in other years: The Internal Revenue Code has provided a partial exclusion on certain capital gains from certain stock. In general, in the case of a **taxpayer other than a corporation**, gross income shall not include 50 percent of any gain from the sale or exchange of **qualified small business stock** held for more than five years.[60] Special rules apply to certain empowerment-zone businesses.[61] The portion of the gain includable in taxable income is taxed at a maximum rate of 28 percent under the regular tax.[62] A percentage of the excluded gain is an alternative-minimum tax preference;[63] the portion of

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52 I.R.C. §1202(e)(7).
53 I.R.C. §1202(i)(1)(A).
54 I.R.C. §1202(i)(1)(B).
55 I.R.C. §1202(i)(2).
56 I.R.C. §1202(b)(1)(A). In the case of a separate return by a married individual, this is applied by substituting "$5,000,000" for "$10,000,000." I.R.C. §1202(b)(3)(A).
57 I.R.C. §1202(b)(1)(B).
58 I.R.C. §1202(b)(3).
59 I.R.C. §1202(b)(2).
60 I.R.C. §1202(a)(1).
61 I.R.C. §1202(a)(2).
62 I.R.C. §1(h).
63 I.R.C. §57(a)(7). In the case of qualified small business stock, the percentage of gain excluded from gross income which is an alternative minimum tax preference is (i) seven percent in the case of stock disposed of in a taxable year beginning before 2011; (ii) 42 percent in the case of stock acquired before January 1, 2001, and disposed of in a taxable year beginning after 2010; and (iii) 28 percent in the case of stock acquired after December 31, 2000, and disposed of in a taxable year beginning after 2010. Section 102 of the bill extended the 2010 and 2011 dates by two years.

the gain includable in alternative-minimum taxable income is taxed at a maximum rate of 28 percent under the alternative-minimum tax. Gain from the sale of qualified small business stock generally is taxed at effective rates of 14 percent under the regular tax;[64] and:

(i) 14.98 percent under the alternative-minimum tax for dispositions before January 1, 2014;

(ii) 19.88 percent under the alternative-minimum tax for dispositions after December 31, 2010, in the case of stock acquired before January 1, 2001; and

(iii) 17.92 percent under the alternative-minimum tax for dispositions after December 31, 2010, in the case of stock acquired after December 31, 2000.[65]

The percentage exclusion for qualified small business stock acquired after February 17, 2009, and on or before September 27, 2010, was increased to 75 percent. As a result of the increased exclusion, gain from the sale of this qualified small business stock held at least five years is taxed at effective rates of seven percent under the regular tax[66] and 12.88 percent under the alternative-minimum tax.[67]

1. Planning implications

For taxpayers planning to start up a new business, the C corporation can produce a huge tax advantage, but of course the small business stock needs to increase in value over the next five years or longer in order to take advantage of the 100-percent capital gains exclusion.

Planning point:

One can be certain that the IRS will press taxpayers in audit or in court to present detailed evidence of qualification of the sale for this treatment. Those participating in the management of the corporation should generate adequate documentation and record keeping to track the value of the corporate assets. In theory, the Code requires that one show that at each instance up to the disposition the value of the assets did not exceed the upper threshold level; but in practice, unless the assets are wildly fluctuating and anywhere close to the $50,000,000 level, an annual written valuation of assets should suffice.

Planning point:

Creation of a business in this form will also prove effective in controlling AGI and reducing net investment income in the post-2012 period (when the Medicare tax nominally applies). Such an investment can fit well in an effort to avoid the Medicare taxes. Because the gain is excluded, it does not impact the taxpayer's AGI, thus perhaps avoiding or reducing the tax on unearned income in that year. The sale of qualified small business stock after the requisite five-year holding period will generally result in a gain that is neither included in gross income (and consequently, MAGI) nor in net investment income.

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64 The 50 percent of gain included in taxable income is taxed at a maximum rate of 28 percent.

65 The amount of gain included in alternative minimum tax is taxed at a maximum rate of 28 percent. The amount so included is the sum of (i) 50 percent (the percentage included in taxable income) of the total gain and (ii) the applicable preference percentage of the one-half gain that is excluded from taxable income.

66 The 25 percent of gain included in taxable income is taxed at a maximum rate of 28 percent.

67 The 46 percent of gain included in alternative minimum tax is taxed at a maximum rate of 28 percent. Forty-six percent is the sum of 25 percent (the percentage of total gain included in taxable income) plus 21 percent (the percentage of total gain which is an alternative minimum tax preference).

VI. Retirement planning

A. Maximizing a profit-sharing plan

1. Maximums

a. The maximum single-life annuity for a defined-benefit plan in 2024 is $275,000.
b. The maximum annual addition to a defined-contribution plan in 2024 is $69,000.
c. The maximum amount of compensation that can be taken into account under any qualified plan allocation or benefit formula in 2024 is $345,000.

Note:

Generalizations with respect to a defined-benefit plan are more difficult, as the contributions not only depend on compensation level but also the age of the participant and the number of years before the normal retirement age under the plan when the benefits must be fully funded. If the benefit formula is a fixed amount ($3,000 per month), the change in the limit has no effect. If the formula is a unit benefit type, where the benefit that is earned each year is based solely on the compensation for that year, the change in the maximum will require marginally more funding in all succeeding years for the highly compensated employee. The most interesting and potentially most expensive case is when the benefit formula is based on some percentage of a career-high average. As the higher compensation is taken into account, it not only increases the funding requirement for the current year, but generates in effect liabilities in respect of past years. Quantifying the effect for budgeting purposes requires the services of an actuary. Again, while the effect may be to require a higher funding level for the highly compensated to the extent there is an increased benefit, now is the time to have the additional costs determined so as to choose whether to continue the plan as is, or reduce, in respect of future years, the benefit formula.

Note:

Qualified retirement-planning services provided to an employee and his or her spouse by an employer maintaining a qualified plan after December 31, 2001 are excludable from income and wages without regard to the requirements of an education-assistance program or fringe benefit. “Qualified retirement-planning services” are retirement-planning advice and information. The exclusion is not limited to information regarding the qualified plan, and thus, for example, applies to advice and information regarding retirement-income planning for an individual and his or her spouse and how the employer’s plan fits into the individual’s overall retirement-income plan.

Caution:

On the other hand, the exclusion does not apply to services that may be related to retirement planning, such as tax-preparation, accounting, legal, or brokerage services.

The exclusion does not apply with respect to highly compensated employees unless the services are available on substantially the same terms to each member of the group of employees that is normally provided education and information regarding the employer’s qualified plan. It is intended that the treatment of retirement advice will be provided in a nondiscriminatory manner. It is intended that, in determining the application of the exclusion to highly compensated employees, the Service may permit employers to take into consideration employee circumstances other than compensation and position in providing advice to classifications of employees. Thus, for example, the Secretary may permit employers to limit certain advice to **individuals nearing retirement age** under the plan.

d. The maximum amount of deferral in a SIMPLE plan in 2024 is $16,000.

(i) The amount is adjusted at the same time and in the same manner as the annual additions or benefits dollar limit, except that the base period is the calendar quarter beginning July 1, 2004, and the amount resulting from any increase is rounded to the next lower multiple of $500.

(ii) A SIMPLE plan may now **allow** additional elective deferrals to be made to the plan by a participant who attains or has attained the age of 50 before the end of the plan year (the **catch-up**) up to $3,500.

(iii) Under a SIMPLE plan, an employer is generally required to make a contribution on behalf of each eligible employee in an amount equal to the employee's salary-reduction contributions, up to a limit of three percent of the employee's compensation for the entire calendar year.[68]

e. The threshold level of compensation at which an employer must cover an employee in a SEP in 2024 is $750.

(i) If an employer establishes and maintains an individual retirement account or annuity that qualifies as a SEP, the maximum amount that the employer may contribute is the lesser of $69,000 (in 2024) or 25 percent of the employee's compensation.[69] An employee for whom an employer contributes under a SEP is allowed a deduction for the employee's contributions to an IRA subject to the phase out rule for active participants.

(ii) Generally, any employee is protected from current tax only if the employer's contribution does not exceed the lesser of 25 percent of the employee's compensation from that employer or $69,000 in 2024.

Example: Corporation Q has established a SEP arrangement for the benefit of its eligible employees. Employee A earns $100,000 in compensation from Q in 2024. For 2024, the most Q can contribute to the SEP of A (without causing tax to A) is $25,000 (25 percent of $100,000). Twenty-five percent of A's compensation is less than $69,000, so this is the applicable prong of the two-part limitation.

Note that for purposes of calculating 25 percent of the employee's compensation, the employer's contribution to the employee's SEP is ignored. Thus, the limitation for Q is 25 percent of $100,000, not 25 percent of $125,000.

(iii) If an employer contributes more than the lesser of 25 percent of compensation or $69,000 in 2024 to the SEP of an employee, the amount in excess of that limitation is treated as an excess contribution by the employee to an IRA. On or before the due date for filing the employee's tax return (including extensions), the employee should withdraw the amount of the excess and any income on that amount. The employee thus would avoid a six-percent excise tax on the excess contribution but must pay tax on the amount of the contribution that exceeds the limitation.

f. The maximum amount of deferral in a §401(k) plan or §403(b) plan in 2024 is $23,000.

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[68] I.R.C. §§408(p)(2)(A)(iii) and (C)(ii)(I). See Notice 98-4, 1998-2 I.R.B. 25, Q&A, D-4.

[69] For the self-employed person, compensation means earned income as reduced for other contributions. I.R.C. §408(k)(7)(B). This is further reduced by the deduction for self-employment taxes.

g. A qualified plan may now **allow** additional elective deferrals to be made to the plan by a participant who attains or has attained the age of 50 before the end of the plan year (the **catch-up**) up to $8,000 in 2024. The additional elective deferrals are generally not taken into account under the actual deferral percentage (ADP) or other limitations on such contributions.[70] The applicable dollar amount increases in the cost of living at the same time and in the same manner as adjustments for annual benefits and additions, except that the base period taken into account is the calendar quarter beginning July 1, 2005, and any increase that is not a multiple of $500 is rounded to the next lower multiple of $500.

Note:

Since elective deferrals generally represent amounts the employer would have deducted under §162 for reasonable compensation but for the preemptive effect of §404 with respect to amounts contributed to a qualified plan, the elective-deferral component of the contribution is deducted as compensation rather than as a contribution.

Planning point:

Elective deferrals remain an annual addition, but the amount subject to the 25-percent-of-compensation limitation does not include them, but only the matching and any other nonelective employer contributions. Subject to any other limitations (such as the annual-additions limitation), an employee may defer 100 percent of current salary **and** the employer may deduct not only the amount so deferred by the employee but also up to 25 percent of the total participant compensation for the year for other contributions.

Planning point:

One of the major motivations for the use of a money-purchase pension plan rather than a profit-sharing plan lay in the enhanced deductibility of contributions up to 25 percent of total compensation to “fully fund” the annual additions. The disadvantage of a money-purchase pension plan is that as a pension plan, the formula for contributions is fixed and creates an annual liability much as a defined-benefit plan does. The change in the deductibility of contributions to a profit-sharing plan puts the future of the money-purchase plan in some doubt, as the enhanced deductibility and the annual-additions limitation can now be met by a profit-sharing plan that does not commit the employer to any specific level of contributions annually.

h. The minimum compensation of an employee owning less than five percent of the stock of the employer to be treated as a highly compensated employee in 2024 is $155,000.

B. Self-employed

Self-employed (unincorporated) individuals with no common-law employees provide a specific challenge. This group typically is looking to shelter some income, but needs the flexibility to make varying contributions each year.

1. SEP

The SEP works quite well for most self-employed persons. The individual can contribute 20 percent of self-employment income (after reducing income by the deduction for 1/2 of the Social Security taxes

paid). Contributions are flexible, the plan can be established with a simple document, and no annual reporting is required.

2. Profit-sharing

The profit-sharing plan is another alternative that provides the same contribution opportunity. The profit-sharing plan for the sole proprietor is generally not very complicated, since the plan's service provider may supply a prototype document at no or little cost. The profit-sharing plan does allow investments in life insurance, and if the sole proprietor expects to have employees in the near future, the sole proprietor may prefer the qualified plan eligibility and vesting provisions.

3. Money-purchase pension plan

For the sole proprietor, the money-purchase plan had been used as a supplement; because today's annual additions and deduction limitations are the same, its major use is not a tax one; the required contributions to the money-purchase plan may provide greater certainty to employees than a profit-sharing plan.

4. SIMPLE

For self-employed persons with relatively small income, the SIMPLE can result in a larger contribution than a SEP. Remember, an individual can defer up to $16,000 (2024) to the SIMPLE, and the employer is then required to make the additional contribution.

5. Defined-benefit plan

There is no rule prohibiting a self-employed person from establishing a defined-benefit plan. In some ways, the self-employed person is a good candidate because there will be no benefit costs for other employees. However, due to the additional administrative expense, few self-employed will be interested in a defined-benefit plan. The reasons to consider a defined-benefit plan is if the self-employed person is either looking for a deductible contribution in excess of $69,000 or a contribution in excess of 25 percent of compensation. A consultation with an actuary is needed to determine if it is possible to meet one of these objectives. It is more likely that this goal can be met for an individual over age 45.

6. Solo 401(k) plans

Because §401(k) plans are generally profit-sharing plans the same objections raised against the profit-sharing plan in favor of a SEP generally apply. However, in the case of a true sole proprietor (or one whose only employee is a spouse), the low-cost, flexible SEP may have to give way in favor of a **solo §401(k) plan** at certain levels of Schedule C income.

a. One advantage of the SEP was generally the low installation costs and nondiscrimination rules that are minimal in cases where there are several employees. But in a solo operation, nondiscrimination is not an issue, as there are no other employees against which to measure disparities of treatment.

b. The proprietor with other employees in a §401(k) plan must bridle any instinct to make the maximum elective deferral of $23,000, since ADP testing might preclude this and limit the amount of the elective deferral in accordance with the rules discussed. Again, this is not a concern in a case where there is a single participant in the plan.

c. Yet, for one major reason solo §401(k) plans have gained traction in the last couple of years, the availability of elective deferrals in such plans, a feature not now generally available in a SEP,[71] and only available in a SIMPLE to a much lesser extent. This presents an opportunity for the proprietor who wants to max out his contributions advantageously for some Schedule C proprietors.

(i) In either case the maximum annual addition to the participant's account in the plan is $69,000. But how the owner gets there is very different.

(ii) The SEP is a straight profit-sharing plan that limits employer contributions to 25 percent of the proprietor's earned income.

(iii) By contrast, the proprietor in a §401(k) plan may first make an "employee" contribution by an elective deferral of up to $23,000. At low levels of self-employment income this could generate a high ADP. But because there are no other employees, this will not be a problem. Thus, the proprietor now only has to fund $46,000 (2024) by an employer contribution, and it is only the employer contribution that is limited by the 25 percent of earned income rule applicable to defined contribution plans.

d. The solo §401(k) also works well when the proprietor has the spouse as the sole common-law employee. The spouse is treated as a highly compensated employee regardless of the level of compensation actually paid by reason of the relationship to the proprietor as a highly compensated employee.

(i) The spouse can electively defer the entire compensation up to $23,000 (2024) in the plan. In a SEP the maximum employer contribution is only $5,750 (2024).

(ii) If the spouse's compensation level is $53,000, the spouse can contribute a total of $36,750 ($23,500 elective deferral + $13,250 employer contribution) (25 percent maximum rate). Only $13,250 is available in a SEP having the same employer rate of contribution.

Note:

The economics tilt toward the solo §401(k) because of the availability of an up-front contribution that is largely independent of self-employment income or compensation paid.[72] This gives the plan a head start on contributions compared to the simpler and less expensive SEP.

[71] Certainly not in a new SEP. There are existing, grandfathered SARSEPs that permitted elective deferrals and participants in such plans are permitted to continue to do so. But new SARSEPs have not been permitted for more than 10 years.

[72] The elective deferral cannot exceed the self-employment income or compensation.

C. Roth contribution programs

Planning point:

Distributions from a Roth account – IRA or contribution program – provide a number of tax benefits taxpayers will need to consider in light of currently scheduled and likely tax rate changes. First, and most obvious is that qualified distributions are not subject to income tax; secondly, and perhaps as important, is the consequence that such amounts are not included in adjusted gross income; third, the amounts received are not subject to the special additional 3.8 percent Medicare tax on unearned income.

As noted earlier in these materials, the surtaxation of unearned income only kicks in at certain levels of adjusted gross income. The Roth vehicle allows investment return without being itself unearned income or pushing other unearned income into the surtaxation territory.

The Roth IRA is well known by most practitioners, but the Roth contribution account, an employer-sponsored qualified plan, is not only less well-known but has advantages over its IRA counterpart that taxpayers and their advisors must weigh.

1. In general

A §401(k) plan, §403(b) plan, or §457 government plan may permit an employee who makes elective contributions under a qualified cash or deferred arrangement to designate some or all of those contributions as **designated Roth contributions**. Although designated Roth contributions are elective contributions under a qualified cash or deferred arrangement, unlike pre-tax elective contributions, they are currently includable in gross income. However, a **qualified distribution of designated Roth contributions is excludable from gross income**.

a. Under the final regulations, the term "designated Roth contribution"[73] means an **elective contribution** under a qualified cash or deferred arrangement that, to the extent permitted under the plan, is:

   (i) **Designated irrevocably** by the employee at the time of the cash or deferred election as a designated Roth contribution that is being made in lieu of all or a portion of the pre-tax elective contributions the employee is otherwise eligible to make under the plan;[74]

   (ii) Treated by the employer as **includable in the employee's gross income at the time the employee would have received the amount in cash** if the employee had not made the cash or deferred election (e.g., by treating the contributions as wages subject to applicable withholding requirements); [75] and

   (iii) Maintained by the plan in a **separate account**. [76]

Note:

Unlike a §401(k) plan, the amounts contributed to a Roth program are not excluded from gross income of the employee. The employee thus must pay additional income taxes currently. As with the choice between a traditional IRA and a Roth IRA, such designation as a Roth contribution is generally made only because the taxpayer's future tax rate is higher than the current tax rate.

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73 Treas. Regs. §1.401(k)-6 defines a designated Roth account as a separate account maintained by a plan to which only designated Roth contributions (including income, expenses, gains, and losses attributable thereto) are made.

74 Treas. Regs. §1.401(k)-1(f)(1)(i).

75 Treas. Regs. §1.401(k)-1(f)(1)(ii).

76 Treas. Regs. §1.401(k)-1(f)(1)(iii). Treas. Regs. §1.401(k)-6 defines pre-tax elective contributions as elective contributions under a qualified cash or deferred arrangement that are not designated Roth contributions.

b. A designated Roth contribution must satisfy the **requirements applicable to elective contributions made** under a qualified cash or deferred arrangement.[77] Thus, see directly below for an example.

c. A **direct rollover** from a designated Roth account under a qualified cash or deferred arrangement may only be made to **another designated Roth account** under an applicable retirement plan maintaining a Roth contribution account **or to a Roth IRA,** and only to the extent the rollover is permitted under the rules of §402(c). Moreover, a plan is **permitted to treat the balance of the participant's designated Roth account and the participant's other accounts under the plan as accounts held under two separate plans** for purposes of applying the special rule under which a plan will satisfy §401(a)(31) even though the plan administrator does not permit any distributee to elect a direct rollover with respect to eligible rollover distributions during a year that are reasonably expected to total less than $200.[78]

d. As a qualified plan, however, the same contribution limitations that apply to a §401(k) plan apply. Thus, an employee may contribute up to $23,000 (2024) to a Roth contribution program and, if the employee has or will attain age 50 by the end of the year, an additional $8,000 catch-up contribution (2024). In addition, as a qualified plan, the employee's contribution limitations are not affected by the employee's adjusted gross income level.

2. How is a distribution from a designated Roth account taxed?

The taxation of a distribution from a designated Roth account resembles a distribution from a Roth IRA, and depends on whether or not the distribution is a **qualified distribution**.

a. A qualified distribution from a designated Roth account is **not includable in the distributee's gross income**.[79] In general, a qualified distribution is a distribution that is both:

- Made after the five-taxable-year **period of participation** has been completed; and
- Made on or after the date the employee attains age 59-1/2, made to a beneficiary or the estate of the employee on or after the employee's death, or attributable to the employee's being disabled.[80]

Note:

However, a distribution from a designated Roth account is not a qualified distribution to the extent it consists of a distribution of excess deferrals and attributable income described in §1.402(g)-1(e). Other amounts that are not treated as qualified distributions include excess contributions, or excess aggregate contributions, and income on any of these excess amounts.[81]

b. In general, a distribution from a designated Roth account that is not a qualified distribution is taxable to the distributee under the general rules applicable to a qualified plan. For this purpose, a designated Roth account is treated as a separate contract under §72. Thus, except as otherwise provided for a rollover, if a distribution occurs before the annuity starting date, the portion of any distribution that is includable in gross income as

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77 Treas. Regs. §1.401(k)-1(f)(3)(i).
78 Treas. Regs. §1.401(k)-1(f)(3)(ii).
79 Prop. Regs. §1.402A-1, A-2(a).
80 Prop. Regs. §1.402A-1, A-2(b).
81 Prop. Regs. §1.402A-1, A-2(c).

an amount allocable to income on the contract and the portion not includable in gross income as an amount allocable to investment in the contract is determined under §72(e)(8), treating the designated Roth account as a separate contract. Similarly, if a distribution occurs on or after the annuity starting date, the portion of any annuity payment that is includable in gross income as an amount allocable to income on the contract and the portion not includable in gross income as an amount allocable to investment in the contract is determined under §72(b), treating the designated Roth account as a separate contract. For purposes of §72, designated Roth contributions are employer contributions described in §72(f)(1) (contributions that are includable in gross income).[82]

c. The five-taxable-year period of participation for a plan is the period of five consecutive taxable years that begins with the first day of the first taxable year in which the employee makes a designated Roth contribution to any designated Roth account established for the employee under the same plan and ends when five consecutive taxable years have been completed. For this purpose, the first taxable year in which an employee makes a designated Roth contribution is the year in which the amount is includable in the employee's gross income.[83]

(i) Generally, an employee's five-taxable-year period of participation is determined separately for each plan in which the employee participates. Thus, if an employee has elective deferrals made to designated Roth accounts under two or more plans, the employee may have two or more different five-taxable-year periods of participation, depending on when the employee first had contributions made to a designated Roth account under each plan. However, if a direct rollover contribution of a distribution from a designated Roth account under another plan is made by the employee to the plan, the five-taxable-year period of participation begins on the first day of the employee's taxable year in which the employee first had designated Roth contributions made to such other designated Roth account, if earlier.[84]

(ii) The beginning of the five-taxable-year period of participation is not redetermined for any portion of an employee's designated Roth account. This is true even if the employee dies or the account is divided pursuant to a qualified domestic-relations order (QDRO), and thus, a portion of the account is not payable to the employee but is payable to the employee's beneficiary or an alternate payee. The same rule applies if the entire designated Roth account is distributed during the five-taxable-year period of participation and the employee subsequently makes additional designated Roth contributions under the plan.[85]

Planning point:

Under pre-SECURE 2.0 law, owners of Roth-designated employer retirement plan accounts, such as 401(k) plans, were required to take pre-death distributions. SECURE 2.0 eliminates this requirement, effective for taxable years beginning after December 31, 2023. Prior to SECURE 2.0, individuals with Roth-designated employer retirement plan accounts would have to transfer such accounts to a Roth IRA in order to avoid taking RMDs.

82 Prop. Regs. §1.402A-1, A-3.
83 Prop. Regs. §1.402A-1, A-4(a).
84 Prop. Regs. §1.402A-1, A-4(b).
85 Prop. Regs. §1.402A-1, A-4(c).

D. Rollover contributions to a Roth account/plan

1. In general

Taxpayers generally may convert a traditional IRA into a Roth IRA.[86] A conversion may be accomplished by means of a rollover, trustee-to-trustee transfer, or account redesignation. Regardless of the means used to convert, any amount converted from a traditional IRA to a Roth IRA is treated as distributed from the traditional IRA and rolled over to the Roth IRA. The amount converted is includable in income as if a withdrawal had been made, except that the 10-percent early withdrawal tax does not apply.

a. Amounts held in a Roth IRA that are withdrawn as a qualified distribution are not includable in income, or subject to the additional 10-percent tax on early withdrawals. A qualified distribution is a distribution that:

(i) Is made after the five-taxable-year period beginning with the first taxable year for which the individual made a contribution to a Roth IRA;

(ii) Is made after attainment of age 59-1/2, on account of death or disability, or is made for first-time-homebuyer expenses of up to $10,000;

(iii) Is made in the event of a qualified birth of a child or adoption for distributions up to $5,000 per individual made after December 31, 2019; or

(iv) Was made for coronavirus-related purposes of up to $100,000 on or after January 1, 2020 and before December 31, 2020.

(v) Newly added by SECURE 2.0, certain distributions that were used for emergency expenses, defined as unforeseeable or immediate financial needs relating to personal or family emergency expenses. Only one distribution of up to $1,000 is permissible per year, and a taxpayer has the option to repay the distribution within three years. No further emergency distributions may be made during the three-year repayment period unless repayment occurs. The new SECURE 2.0 IRC §72(t) exception applies for distributions made after December 31, 2023.

(vi) Newly added by SECURE 2.0, an individual self-certifying that he or she experienced domestic abuse may withdraw the lesser of $10,000 (as indexed for inflation) or 50% of the participant's account. The individual may choose to repay such amount over a three-year period and will be refunded income taxes on any amount that is repaid. This provision is effective for distributions made after December 31, 2023.

(vii) Newly added by SECURE 2.0, distributions made to a terminally ill individual. SECURE 2.0 modifies the definition of a terminally ill individual under §101(g)(4)(A) to be "an individual who has been certified by a physician as having an illness or physical condition which can reasonably be expected to result in death in 84 months or less after the date of the certification." Such provision is effective for distributions made after the date of enactment.

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[86] For taxable years beginning before January 1, 2010, such a conversion is not permitted to be made by a taxpayer whose modified adjusted gross income for the year of the distribution exceeds $100,000 (or who, if married, does not file jointly). For taxable years beginning before January 1, 2010, a rollover from an eligible employer plan not made from a designated Roth account is available only to a taxpayer whose modified adjusted gross income for the year of the distribution does not exceed $100,000 (and who, if married, files jointly).

(viii) Newly added by SECURE 2.0, affected individuals may have up to $22,000 distributed from employer retirement plans or IRAs in the case of a federally declared disaster. Specifically, a "qualified disaster recovery distribution" means any distribution made on or after the first day of the incident period of a qualified disaster and before the date that is 180 days after the applicable date with respect to such disaster and to an individual whose principal place of abode at any time during the incident period of such qualified disaster is located in the qualified disaster area with respect to such qualified disaster and who has sustained an economic loss by reason of such qualified disaster. Distributions in connection with qualified federally declared disasters are not subject to the 10% penalty on early distributions and may be taken into account as gross income over a three-year period. Distributions may be repaid to the tax-preferred retirement account. This SECURE 2.0 provision is effective for disasters occurring on or after January 26, 2021.

b. Distributions from a Roth IRA that are not qualified distributions are includable in income to the extent attributable to earnings. Under special ordering rules, after-tax contributions are recovered before income.[87] The amount includable in income is also subject to the 10-percent early withdrawal tax unless an exception applies. The same exceptions to the early withdrawal tax that apply to traditional IRAs apply to Roth IRAs.

A qualified retirement plan[88] that is a profit-sharing plan may allow an employee to make an election between cash and an employer contribution to the plan pursuant to a qualified cash or deferred arrangement. A plan with this feature is generally referred to as a §401(k) plan. A §403(b) plan may allow a similar salary-reduction agreement under which an employee may make an election between cash and an employer contribution to the plan.[89] Amounts contributed pursuant to these qualified cash or deferred arrangements and salary-reduction agreements generally are referred to as elective contributions and generally are excludable from gross income. There is a dollar limit on the aggregate amount of elective contributions that an employee is permitted to contribute to either of these plans for a taxable year, which is $23,000 for 2024. There is an additional catch-up amount that employees over age 50 are allowed to contribute, which is $8,000 for 2024.

c. Elective contributions under a §401(k) plan are subject to distribution restrictions under the plan. Such contributions generally may only be distributed after attainment of age 59-1/2, death of the employee, termination of the plan, or severance from employment with the employer maintaining the plan. These contributions are also permitted to be distributed on account of hardship. These limitations also apply to certain other contributions to the plan except that such distributions cannot be distributed on account of hardship. Similar distribution restrictions apply to salary-reduction contributions under §403(b) plans.

d. Amounts under a profit-sharing plan that are not subject to these specific distribution restrictions are distributable only as permitted under the plan terms. In order to meet the definition of profit-sharing plan, the plan may allow distribution of an amount contributed to a profit-sharing plan after a fixed number of years (but not less than two).[90]

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87 I.R.C. §408A(d)(4).

88 Qualified retirement plans include plans qualified under §401(a) and §403(a) annuity plans.

89 Code §403(b) plans may be maintained only by: (i) tax-exempt charitable organizations; and (ii) educational institutions of state or local governments (including public schools). Many of the rules that apply to §403(b) plans are similar to the rules applicable to qualified retirement plans, including §401(k) plans.

90 Rev. Rul. 71-295, 1971, C.B. 184, and Treas. Regs. §1.401(b)(1)(ii).

A qualified retirement plan with a cash or deferred arrangement can include a **designated Roth program** under which an employee is permitted to designate any elective contribution as a designated Roth contribution in lieu of making a pre-tax elective contribution. Although such a plan is permitted to offer only the opportunity to make pre-tax elective contributions, a plan that allows designated Roth contributions must offer a choice of both pre-tax elective contributions and designated Roth contributions.[91] The designated contributions are generally treated the same under the plan as pre-tax elective contributions (e.g., the nondiscrimination requirements and contribution limits) except a designated Roth contribution is not excluded from gross income.

e. All designated Roth contributions made under the plan must be maintained in a separate account (a designated Roth account). Any distribution from a designated Roth account (other than a qualified distribution) is taxable under §402 by treating the designated Roth account as a separate contract for purpose of §72. The distribution is included in the distributee's gross income to the extent allocable to income under the contract and excluded from gross income to the extent allocable to investment in the contract (commonly referred to as basis), taking into account only the designated Roth contributions as basis. The special basis-first recovery rule for Roth IRAs does not apply to distributions from designated Roth accounts.

f. A qualified distribution from a designated Roth account is excludable from gross income. A qualified distribution is a distribution that is made after completion of a specified five-year period and the satisfaction of one of three other requirements. The three other requirements are the same as the other requirements for a qualified distribution from a Roth account except that the first-time-homebuyer provision does not apply.

g. Eligible rollover distributions from designated Roth accounts may only be rolled over tax-free to another designated Roth account or a Roth IRA.

An eligible rollover distribution from an eligible employer plan that is not from a designated Roth account may be rolled over to an eligible retirement plan that is not a Roth IRA or a designated Roth account. An eligible employer plan is a qualified retirement plan, a §403(b) plan, and a "governmental §457(b) plan."[92] In such a case, the distribution generally is not currently includable in the distributee's gross income. An eligible retirement plan means an individual retirement plan or an eligible employer plan. An eligible rollover distribution is any distribution from an eligible employer plan with certain exceptions. Distributions that are not eligible rollover distributions generally are certain periodic payments, any distribution to the extent the distribution is a minimum required distribution, and any distribution made on account of hardship of the employee.[93] Only an employee or a surviving spouse of an employee is allowed to rollover an eligible rollover distribution from an eligible employer plan to another eligible employer plan.[94]

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91 Treas. Regs. §1.401(k)-1(f)(1)(i).

92 A governmental §457(b) plan is an eligible §457(b) plan maintained by a governmental employer described in I.R.C. §457(e)(1)(A).

93 I.R.C. §402(c)(4).

94 I.R.C. §402(c)(10) allows nonspouse beneficiaries to make a direct rollover to an IRA but not another eligible employer plan.

h. Distributions from an eligible employer plan are also permitted to be rolled over into a Roth IRA, subject to the present law rules that apply to conversions from a traditional IRA into a Roth IRA.[95] Thus, a rollover from an eligible employer plan into a Roth IRA is includable in gross income (except to the extent it represents a return of after-tax contributions), and the 10-percent early distribution tax does not apply.[96] In the case of a distribution and rollover of property, the amount of the distribution for purposes of determining the amount includable in gross income is generally the fair market value of the property on the date of the distribution.[97] The special rules relating to net unrealized appreciation and certain optional methods for calculating tax available to participants born on or before January 1, 1936 are not applicable.[98] A special recapture rule relating to the 10-precent additional tax on early distributions applies for distributions made from a Roth IRA within a specified five-year period after a rollover.[99]

2. Internal rollover

If a §401(k) plan, §403(b) plan, or governmental §457(b) plan has a qualified designated Roth contribution program, a distribution to an employee (or a surviving spouse) from an account under the plan that is not a designated Roth account is permitted to be rolled over into a designated Roth account under the plan for the individual.

a. However, a plan that does not otherwise have a designated Roth program is not permitted to establish designated Roth accounts solely to accept these rollover contributions. Thus, for example, a qualified employer plan that does not include a qualified cash or deferred arrangement with a designated Roth program cannot allow rollover contributions from accounts that are not designated Roth accounts to designated Roth accounts established solely for purposes of accepting these rollover contributions.

b. Further, the distribution to be rolled over must be otherwise allowed under the plan. For example, an amount under a §401(k) plan subject to distribution restrictions cannot be rolled over to a designated Roth account under this provision. However, if an employer decides to expand its distribution options beyond those currently allowed under its plan, such as by adding in-service distributions or distributions prior to normal retirement age, in order to allow employees to make the rollover contributions permitted under this provision, the plan may condition eligibility for such a new distribution option on an employee's election to have the distribution directly rolled over to the designated Roth program within that plan.

c. In the case of a permitted rollover contribution to a designated Roth account under this provision, the individual must include the distribution in gross income (subject to basis recovery) in the same manner as if the distribution were rolled over into a Roth IRA. The special recapture rule for the 10-percent early distribution tax applies if distributions are made from the designated Roth account in the relevant five-year period.

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95 For taxable years beginning before January 1, 2010, a rollover from an eligible employer plan not made from a designated Roth account is available only to a taxpayer whose modified adjusted gross income for the year of the distribution does not exceed $100,000 (and who, if married, files jointly).

96 Prior to enactment of the Pension Protection Act of 2006, an eligible rollover distribution from an eligible employer plan not made from a designated Roth account could be rolled over to a non-Roth IRA and then converted to a Roth IRA, but could not be rolled over to a Roth IRA without an intervening rollover to a non-Roth IRA followed by a conversion to a Roth IRA. See Notice 2008-30, 2008-12 I.R.B. 638.

97 Treas. Regs. §1.402(a)-1(a)(iii).

98 Notice 2009-75, 2009-39 I.R.B. 436.

99 I.R.C. §408A(d)(3)(F), Treas. Regs. §1.408A-6 A-5, and Notice 2008-30, Q&A-3.

d. This rollover contribution may be accomplished at the election of the employee (or surviving spouse) through a direct rollover (operationally through a transfer of assets from the account that is not a designated Roth account to the designated Roth account). However, such a direct rollover is only permitted if the employee (or surviving spouse) is eligible for a distribution in that amount and in that form (if property is transferred) and the distribution is an eligible rollover distribution. If the direct rollover is accomplished by a transfer of property to the designated Roth account (rather than cash), the amount of the distribution is the fair market value of the property on the date of the transfer.

e. A plan that includes a designated Roth program is permitted but not required to allow employees (and surviving spouses) to make the rollover contribution described in this provision to a designated Roth account. If a plan allows these rollover contributions to a designated Roth account, the plan must be amended to reflect this plan feature.

3. Tax-free qualified distributions from a Roth account

Perhaps most important to the taxpayer seeking to limit AGI in order to avoid higher individual income taxes and/or the Medicare tax on unearned income is the ability to receive qualified distributions free of tax. Because such distributions are not included in income, they are likewise not subject to the 10% penalty tax on premature distributions.[100]. By contrast, nonqualified distributions may be both taxable and subject to the premature distribution additional tax. A distribution must meet several requirements to be qualified.

a. To be a qualified distribution, the distribution must be made after a specified five-year period uniquely applicable to each participant. The five-year period begins with the first day of the first tax year the participant contributed to any Roth account in the same plan.[101]

Note:

To the extent the designated Roth account meets the planning objectives of the taxpayer, the sooner the designated Roth account is established, the sooner the taxpayer can start the clock toward qualification of later distributions by making a contribution.

However, if the distributing plan[102] receives a direct trustee-to-trustee rollover from a Roth account established under another plan, the starting date will be reset to the first day of the first tax year the retiree contributed to a Roth account in the other plan, if that date is earlier.

b. The distribution must be made on or after the date the retiree reaches age 59-1/2, dies, or becomes disabled.

Note:

However, certain distributions do not qualify. Qualified distributions do not include distributions of excess deferrals or contributions, or related earnings.[103] Furthermore, excess deferrals or contributions that are distributed do not start the five-year period required for qualified distributions. For this purpose, excess deferrals or contributions are amounts contributed that are in excess of the amounts allowable under statutory limitations.

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100 I.R.C. §402A(d)(1), §§72(t)(1), (2); Treas. Regs. §1.402A-1, Q&A 2(a).
101 I.R.C. §402A(d)(2)(B)(i); Treas. Regs. §1.402A-1, Q&A 2(b)(1), Q&A 4(a).
102 I.R.C. §402A(d)(2)(B)(ii); Treas. Regs. §1.402A-1, Q&A 4(b), Q&A 5(c).
103 I.R.C. §402A(d)(2)(C); Treas. Regs. §1.402A-1, Q&A 2(c).

Planning point:

Investors with higher adjusted gross incomes (AGIs) and taxpayers who are married filing separately have a less constrained opportunity to convert their traditional IRA to a Roth IRA. Many of these retirement accounts can be converted at perhaps discount rates. Furthermore, with increased tax rates seeming inevitable, the power of the Roth vehicle – whether IRA or designation program – is maximized when the tax is paid in a lower income-tax bracket environment with future distributions made in a higher income-tax bracket situation. In addition, the conversion serves to reduce taxable income in later years that could have the effect for pushing the taxpayer above the AGI threshold that can expose more of a taxpayer's unearned income to a higher Medicare tax rate.

Planning point: SECURE Act

Under pre-SECURE Act rules, a nonspousal beneficiary of an IRA could "stretch" the receipt of RMDs over his or her remaining actuarial life expectancy with payouts starting in the year immediately after the decedent's death. This estate planning strategy allowed one to extend IRA distributions over future generations while the IRA continued to grow tax-free. In this scenario, the younger the beneficiary, the better, as the RMD would be smaller and the account could grow tax-free for a longer period of time. Younger beneficiaries have longer actuarial life expectancies, resulting in smaller RMDs taken in the beginning, growing larger over time. The "stretch IRA" strategy minimized the amount that must be withdrawn from the IRA each year and avoided a large, taxable, lump-sum distribution to the beneficiary.

As discussed, the SECURE Act stipulates that upon death of a retirement plan account holder, all distributions must be made within 10 years of death to an eligible designated beneficiary (with limited exceptions), provided the account holder dies after December 31, 2019. Section 401 of the SECURE Act essentially eliminates "stretch" IRAs that could be stretched over the life of the beneficiary and grow tax-free for an extended period of time.

In light of the SECURE Act, a retirement account holder may consider converting taxable IRA funds to a Roth IRA. The retirement account holder would incur income tax on the converted funds, but the beneficiary of the inherited Roth IRA would receive the funds tax-free. Non-eligible designated beneficiaries will still be subject to the SECURE Act 10-year distribution rule, but the distributions will not be taxable to the beneficiary.

Wealthy individuals eligible to take advantage of Roth conversions should consider doing so, as tax rates are at some of the lowest historical levels. Roth conversions can be taken over a period of several years to avoid the highest income tax rates on the conversion. To maximize the benefit of converting a traditional IRA to a Roth IRA, consider the following:

1. The individual must have enough non-retirement funds to pay the income tax on the converted funds.
2. The individual should ideally not depend on the Roth IRA assets during his or her lifetime.
3. The amount converted should end up being taxed at a lower marginal tax rate compared to the marginal tax rate that would have been used had no conversion taken place. As mentioned above, tax rates are at some of the lowest historical levels. Future election results have the potential to greatly influence future tax rates.

c. The current and later years offer the opportunity to convert with respect to a §401(k) plan. As with the IRA counterpart, taxpayer will pay any income taxes due on pretax contributions and earnings in the plan, and invest the funds in a Roth, in order to make the future growth tax free. This may be an advantageous time to do so if the §401(k) investments have experienced steep declines in value.

Note:

A conversion makes more sense (or even sense at all) if the tax can be paid from nonretirement funds and the marginal tax rate is expected to be the same or higher in retirement and the funds are not needed.

d. The ADP rules limit the amount of elective deferrals the highly-compensated employees may make in any year; if the plan permits, such employees could have made (or recharacterized) the excess contribution as an after-tax contribution.

Planning point:

A taxpayer who has multiple IRAs and is converting less than all of the accounts is required to be treated as if the amount was sourced proportionately from the pretax and after-tax dollars in all the IRAs. Convert a §401(k) account directly into a Roth IRA, the other §401(k)s and IRAs are disregarded in determining the percentage of the conversion that's taxable.

Example: Taxpayer has $200,000 in pretax IRAs and $50,000 in an old §401(k), with half of that after-tax contributions. Taxpayer can roll the whole $50,000 §401(k) into a Roth, recognizing $25,000 as income. If the $50,000 were rolled into a traditional IRA, taxpayer would be treated as having one big $250,000 IRA, with $10,000 in after-tax contributions. This means that 80 percent, or $40,000, would be taxable.

Note:

It should be noted that not everyone can take advantage of the Roth in-service-rollover because this feature requires a §401(k) plan, existing elective deferrals in the plan, and, most importantly, a written amendment to the plan and trust that establishes this arrangement within the plan; in other words, the employee cannot merely request a rollover because they want to – the plan has to allow this specifically. Small companies will probably do this only if the owner or other highly-compensated employees find it in their interest to do so.

E. Converting to a Roth contribution program

1. Background

A qualified Roth contribution program within a §401(k) plan, §403(b), or §457 government plan permits a plan participant to elect to designate amounts, which otherwise would be pre-tax elective deferrals, as after-tax Roth contributions. These contributions are credited to the participant's "designated Roth account" that is separate from the pre-tax "traditional" elective deferral account or the employer contribution account. The Roth contributions are includable in gross income (by definition, pre-tax elective deferrals are not), and are subject to applicable wage withholding requirements. In all other respects, however, Roth contributions are treated in the same manner as pre-tax elective deferrals (e.g., they are subject to the Code's nondiscrimination requirements, contribution limits, and distribution restrictions).

2. Making contributions

There are three ways to contribute to the designated Roth account:

- **Designating** salary reductions as Roth contributions.
- Executing a **roll over** from a designated Roth account in another plan to the designated Roth account in the present plan.
- **Converting** retirement plan savings already held in the plan to Roth contributions.

3. Designation

The participant may designate all or a portion of his or her salary reductions as Roth contributions; of course, the plan could alternatively permit only after-tax contributions to the designated Roth account without permitting the allocation between these internal accounts. The plan could, but generally would not, distinguish the employee's contributions for purposes of determining its matching contributions.

a. But making contributions to a §401(k) or §403(b) plan, regardless of the designation, the participant is an active participant, which then triggers the limitations on the ability to make deductible contributions to a traditional IRA; it has no effect, however, on the ability to make contributions to a Roth IRA.

b. If the plan so permits, the participant may make "catch-up" Roth contributions (as well as catch-up pre-tax elective contributions) for that year.

4. Rollovers

An eligible rollover distribution from a Roth account under one plan may be rolled over tax free to a Roth account of another plan. Here, the rollover of the nontaxable portion of the distribution (see the discussion below) must be made by a direct rollover. For these purposes, an "eligible rollover distribution" is any distribution or withdrawal from a plan, other than certain periodic payments, a minimum required distribution, or a hardship withdrawal.

5. Conversion

New is the distribution or withdrawal from the eligible plan (other than from a Roth account), which qualifies as an eligible rollover distribution (as defined above), may be rolled over, by direct rollover only, to a Roth account under the same plan. This feature is not self-executing: it requires the employer to amend the §401(k)/§403(b)/§457 plan to permit the transferring funds from one or more other accounts under the plan to the Roth account.

Note:

The surviving spouse of a participant is eligible to make the conversion to a Roth account, as if the survivor were the participant.

Caution:

No distribution or withdrawal to be rolled over is permitted unless the plan allows it (and the Code permits the plan to allow it). The Code limits the ability of the plan to make distributions prior to the participant's termination of employment (or death) or the termination of the plan. There is no special exemption for these in-plan conversions. (1) Any amounts attributable to elective deferrals, safe harbor matching contributions, safe harbor nonelective contributions, qualified nonelective contributions (QNECs), and qualified matching contributions (QMACs) may **not be distributed** or withdrawn until the participant reaches age 59½, or becomes disabled.[104] This limits currently employed taxpayers who have not reached age 59½ from enjoying the benefits of a conversion. (2) A §401(k) plan, as a profit-sharing plan, may have other amounts not described in (1) that generally may not be distributed or withdrawn until either (x) the amounts have been held in the plan for at least two years, (y) the participant has participated in the plan for at least five years, or (z) a stated event (such as reaching a specified age, disability, layoff, or illness) has occurred.[105] (3) No restrictions apply to amounts attributable to after-tax contributions and rollover amounts held in the plan.

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104 I.R.C. §401(k)(2)(B)(i).

105 Treas. Regs. §1.401-1(b)(1)(ii) ; Rev. Rul. 68-24, 1968-1 C.B. 150, Rev. Rul. 71-295, 1971-2 C.B. 184.

One has to study the participant's account to determine if and to what extent amounts held in the participant's account are eligible for the conversion.

None of the foregoing statutory restrictions applies to a participant after termination of employment, but no amount may be distributed or withdrawn unless the plan expressly permits it.

a. In some cases, the employer must add to the plan's distribution options by add in in-service withdrawals at and after age 59-1/2 so that certain participants would then be able to roll over amounts to a Roth account. This should be carefully limited, however, lest some participants take a distribution outright rather than as a direct rollover.

Note:

The conversion is of little practical application to participants in government plans, because no amounts may be distributed until the earlier of the participant's termination of employment or reaching RMD age, and only if permitted by the plan. Further, a distribution or withdrawal may be made only as permitted by the plan. Current employees have no access.

(i) In the event of a permitted rollover to a Roth account, the amount distributed (other than any after-tax contributions contained in the distribution) is includable in gross income. While the taxable amount is not subject to the 10-percent early distribution tax under §72(t), a 10-percent tax will apply, to any amount distributed from the recipient Roth account within five years of the rollover.

(ii) Amounts rolled over to the Roth account are probably not subject to mandatory federal income-tax withholding, but the participant and plan administrator can agree to withhold certain amounts to pay any tax that might be due as a result of the conversion.[106] However, to the extent that any amounts (otherwise taxable on distribution) are withheld for tax purposes and are not rolled over to the Roth account, the amounts are immediately taxable to the participant, and also will be subject to the 10-percent early distribution tax unless an exception applies.

Note:

A plan that offers a qualified Roth contribution program is permitted, but not required, to allow a rollover to a Roth account. If a plan allows these rollover contributions, the plan must be amended to reflect this plan feature.

Example: Roger, age 60 (older than 59-1/2), is a fully vested participant in the company's §401(k) plan. His account balance is $50,000 (all vested) under the plan. This balance consists of $20,000 in profit sharing contributions and related earnings, $25,000 in elective deferrals and related earnings, and $5,000 in after-tax contributions and related earnings consisting of $4,000 in after-tax contributions and $1,000 in related earnings.

The §401(k) plan has a qualified Roth contribution program, but does not allow in-service distributions. In 2016, the employer amends the plan to permit an in-service withdrawal of any (vested) amounts by a participant who is at least age 59-1/2, conditioned on the participant's election to have the amounts withdrawn directly rolled over to a Roth account under the plan.

Roger elects to have the entire account balance withdrawn and directly rolled over to a Roth account. Roger will have total taxable income of $46,000 ($50,000

[106] Notice 2008-30, 2008-12 IRB 638, Q&A-6.

total minus $4,000 after-tax contributions). In general, no federal income tax is withheld from the amounts being withdrawn and rolled over.

b. The balance of a Roth account, as with any qualified plan, grows tax free. However, in order to obtain the Roth distribution tax treatment that such placement in a designated Roth account are aimed at, certain time frames must be met to make the distribution eligible for the not-included-in-gross-income treatment. A nonqualified distribution may trigger the AGI threshold or otherwise increase the tax rate on unearned income. A "qualified distribution" is a distribution or withdrawal that is:
   - Made after the **five-tax-year period** beginning with the first tax year for which the participant **made a Roth contribution to the plan**, **and**
   - Made **after the participant attains age 59-1/2**, **or** made on account of the participant's **death or disability**.

Note:

More liberal to taxpayers is the tacking of the time of making a Roth contribution in a rollover from another plan, where the time when the Roth contribution was first made to the transferor plan is used, while in a conversion, it will be at the time of the conversion.

c. A distribution or withdrawal from a Roth account that is not a qualified distribution is includable in gross income to the extent it is attributable to earnings. For these purposes, the Roth account is treated as a separate contract. The amount includable in income is also subject to the 10-percent early distribution tax unless an exception applies. An eligible rollover distribution from a Roth account may be rolled over tax free to another Roth account, as discussed above, or to a Roth IRA.

6. To elect to convert, rollover, or designate, or not?

Roth contributions are made with after-tax dollars, so there is no upfront deduction for the participant. The Roth account holding the contributions earns income and grows tax free, and the distributions (assumed, for convenience here and below, to be qualified distributions) are likewise tax free.

a. The choice between taking an upfront deduction, reducing current taxes, with a deferral of tax until distribution of amounts attributable to the pre-tax elective deferrals and taking the tax now on contributions in exchange for tax-free treatment when distributions of amounts attributable to the designated Roth contributions are made in the future is a complex one, requiring first an analysis of tax rates. If the participant expects to have lower tax rates now than when he or she retires and takes a distribution (if at all) from the retirement plan, then the participant is better off making Roth contributions.

b. The power of tax-free (not just deferred) compounding is enhanced the longer the accumulation phase (when the participant is continuing to make designations but not yet receiving distributions). The possibility of accruing large account balance that may be distributed without incurring income tax (or certain other tax consequences) may incentivize an employee to make Roth contributions.

c. As noted, Roth distributions will not add to AGI for purposes if the additional Medicare tax applies. For lower-income taxpayers, the Roth distribution will not increase the MAGI for purposes of determining whether and to what extent Social Security benefits are included in gross income. However, MAGI is increased for interest from tax-exempt bonds.

7. Rollovers from Roth accounts to other Roth IRAs

A retiree may have Roth accounts in two different plans, only one of which satisfies the five-year participation requirement for qualified distributions. If so, the retiree may qualify the balances of both accounts by rolling over the balance of one account directly to the other account. Of course, it is important that the retiree satisfy (or be close to satisfying) the other requirements for a qualified distribution (age, disability, etc.).

a. A rollover from a Roth account to a Roth IRA may provide a retiree or beneficiary with the following tax planning advantages:

   (i) A retiree or beneficiary generally has more control of the choice of trustee, the investment of the funds, and the timing of distributions following a rollover from a Roth account to a Roth IRA.

   (ii) A Roth account rollover may allow a recipient Roth IRA to use the rolled-over funds for tax-free qualified distributions even though they would not have qualified as tax-free if distributed by the Roth account. If the recipient Roth IRA has already satisfied the five-year period (and other conditions) required for tax-free qualified distributions, this treatment applies even if the Roth contribution program had not met its five-year rule at the time of the distributions; this could also accelerate the time when such distributions are tax-free if the Roth IRA will satisfy the five-year requirement before the Roth account would.

Caution:

Conversely, if the Roth program was nearer to meeting the five-year rule than the IRA, a rollover would defer the time before qualified distributions could be made. A retiree or surviving spouse who wishes to roll over funds from a Roth account to his or her own Roth IRA who has not previously established a Roth IRA will lose the years of participation in the Roth account already accumulated to satisfy the five-year requirement for qualified distributions with his or her rollover to a new Roth IRA.

b. If the Roth account has already satisfied all the qualified distribution requirements, the entire amount of the rollover is counted as investment in the new Roth IRA of the retiree or surviving spouse. The retiree or spouse may then withdraw that rolled-over investment tax-free, hopefully until the Roth IRA has itself satisfied all the requirements for qualified distributions. Distributions from a Roth IRA come first from the investment before earnings (potentially taxable in a nonqualified distribution) are deemed distributed.

   (i) In cases where the Roth account has yet to satisfy the qualified distribution requirements, the retiree or surviving spouse can (at most) roll over only a nonqualified distribution. In a rollover of a distribution to the retiree or spouse, the rollover is nonqualified and only the investment portion of the distribution becomes investment in the recipient Roth IRA available for tax-free withdrawal. In such a case, the retiree or spouse might be well advised to delay the rollover until he or she satisfies the requirements for a qualified distribution from the Roth account.

   (ii) A surviving spouse or other beneficiary may decide to roll over funds in the deceased retiree's Roth account to a Roth IRA in the **decedent's name**. Then the beneficiary may take advantage of any years of participation by the retiree in the retiree's own Roth IRAs.

c. A young surviving spouse who needs Roth account funds for living expenses generally should not roll over a retiree's Roth account to the **spouse's own Roth account or Roth IRA**. The spouse's own Roth account or Roth IRA cannot make qualified distributions to the spouse before he or she reaches age 59 1/2 or is disabled, even if the five-year rule is satisfied. Distributions from the spouse's own Roth account or Roth IRA will generally be taxable nonqualified distributions subject to the 10 percent penalty tax on premature distributions (unless a statutory exception applies).

Planning point:

The surviving spouse should simply take distributions from the retiree's Roth account. If the five-year requirement has been satisfied, the distributions will be tax-free qualified distributions. If the five-year rule has not been satisfied, the distributions will be taxable nonqualified distributions. However, the death exception (the retiree's death) will protect the distributions from the early distribution penalty.

Alternatively, the young surviving spouse might roll the funds over to a Roth IRA in the retiree's name with the spouse as beneficiary. Although subsequent distributions will be nonqualified if the Roth IRA has not satisfied the five-year requirement, the death exception will protect the distributions from the early distribution penalty.

Note:

A distribution from a Roth account may include stocks of a retiree's former employer or its affiliates. In a qualified distribution, employer securities included in the distribution are not taxable, and take on a tax basis equal to their then fair market value.[107] For a nonqualified distribution that is a lump-sum distribution, a retiree may choose to exclude from gross income the entire amount of the net unrealized appreciation in the employer securities.[108] Gain on sale of the securities is then long-term capital gain to the extent of the appreciation originally excluded from gross income, without regard to the holding period.[109]

Unfortunately, a retiree cannot exclude any net unrealized appreciation in a nonqualified distribution that is not a lump-sum distribution. One loses this advantage in a designated Roth account because the exclusion is limited to the amounts attributable to employee contributions, but any elective after-tax contributions are treated as employer contributions.[110]

8. Room in the bracket?

Individuals who are near the bottom of their bracket with a traditional should consider taking advantage of their bracket position by limiting the taxation on a sequence of conversions to a Roth IRA. Later when the taxpayer is in more constrained circumstances, she may not be able to take these steps without subjecting herself to increased MAGI that could trigger the Medicare tax. The taxpayer does not have to convert all of the IRA in one year, but can convert a portion of the IRA sufficient to produce a satisfactory tax result. This may allow the taxpayer over time to set the stage to avoid completely or substantially required minimum distributions that would otherwise apply at age 73.

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107 Treas. Regs. §1.402A-1, Q&A 2(a), Q&A 10(b).
108 Treas. Regs. §1.402A-1, Q&A 10(a).
109 Treas. Regs. §1.402(a)-1(b)(1)(i).
110 Treas. Regs. §1.401(k)-1(f)(4)(i).

Note:

Another planning reason for conversion of traditional to Roth or establishing Roth vehicles is independent of the Medicare tax. The medical deduction has a 7.5 percent of AGI haircut. As noted elsewhere, while distributions from a qualified plan or IRA are not investment income, they increase the taxpayer's AGI and at the same time disallow generally more medical expense deductions. Because the conversion increases AGI, to the extent possible, it should take place in a year in which the taxpayer has little or no deductible (determined after the haircut) medical expenditures; alternatively, discretionary surgery or medical procedures should be delayed until the year following the year of conversion.

Caution:

One should take care with a qualified plan that invests in employer stock. A distribution from a plan does not trigger tax on the net unrealized appreciation attributable to employee contributions. The employee is taxed only on the basis in the stock. But in a rollover, the advantage the stock may have is lost if the stock is placed in an IRA. While the taxpayer could sell the stock at its historical basis and recognize the gain at capital gains tax rates if held by the taxpayer individually, any distributions from an IRA is taxed in accordance with its rules – ordinary, in the case of a traditional, and nontaxable for a qualified distribution and possibly ordinary for a nonqualified distribution. Even if the IRA makes the distribution by recognizing the net unrealized appreciation, this character is irrelevant. One cannot short-circuit this by rolling over to a Roth IRA, since this is treated as a rollover to a traditional IRA followed by a rollover to a Roth; this means that the taxable conversion (from traditional to Roth IRA) will expose the net unrealized appreciation to ordinary income taxation.

F. Roth IRA conversions

Planning point:

The reason for having, or converting to, a Roth IRA is to eliminate future income taxation of distributions coming from the IRA whether to the owner or a subsequent beneficiary until the account is exhausted. This comes at an upfront cost either because the conversion triggers an income inclusion as discussed below, or because a contribution, whether a nondeductible contribution to a traditional IRA or a contribution to a Roth IRA,[111] is after-tax. In general, the upfront cost makes sense when a taxpayer anticipates being in a higher tax bracket when distributions are taken than when contributions or conversions take place; it makes no sense if the taxpayer will be in a lower bracket when distributions are made than when the contributions or conversions occur; and it is a matter of indifference from a tax perspective if the future rates are expected to be the same.[112] The increase in tax rates makes the first alternative more likely for many taxpayers.

The Roth supports avoidance or mitigation of the new tax on net investment income by producing cash flow that is neither investment income nor income included in adjusted gross income.

Converting to the Roth may also mitigate or eliminate the tax effects at the death of a married owner. Required minimum distributions in a traditional IRA do not significantly change in most cases where the spouse is the beneficiary. But since the spouse is, after the two years following the death of the owner, a single taxpayer, the tax imposed on the same amount of distribution will be considerably higher than it is for a married individual. A Roth conversion can serve to remove the additional income taxes that would be paid on the death of the owner by making the conversion at a time when the joint filing tax rates are available. In addition, the required minimum distribution rules do not apply to a Roth IRA.

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111 Unlike a nondeductible contribution to a traditional IRA, a contribution to a Roth IRA is subject to AGI limitations and phase outs, precluding many high-end taxpayers from making such contributions. Conversely, nothing precludes a taxpayer to make a nondeductible contribution to a traditional IRA, and then convert that traditional IRA to a Roth.

112 This is not exactly true; to some extent being in a slightly lower tax bracket in the future can still make the Roth conversion advantageous.

1. Converting to a Roth

Rolling over from a traditional IRA to a Roth IRA is sometimes described as "converting" a traditional IRA to a Roth IRA. This is a taxable rollover in contrast to the nontaxable rollover that occurs when a traditional IRA is rolled over to another traditional IRA. The rollover from a traditional IRA to a Roth IRA is treated as a taxable distribution from the traditional IRA. The 10-percent additional tax under §72(t) (applicable to certain distributions before age 59-1/2) does not apply to this "deemed" distribution. Thus a (otherwise eligible) young person may convert a traditional IRA to a Roth IRA without penalty.

Note:

The proceeds of a qualified plan cannot be rolled over to a Roth IRA directly. However, nothing precludes a participant from rolling a qualified plan to a traditional IRA and thereafter rolling ("converting") the traditional IRA into a Roth IRA.

Robert S. Keebler, CPA, has written a number of insightful articles related to the planning and tax issues of conversions[113] and with Stephen J. Bigge,[114] identified seven circumstances when someone should consider converting to a Roth IRA:

- To take advantage of favorable tax attributes such as charitable deductions carry-forwards, Net Operating Loss (NOL) carry-forwards, investment tax credits, etc.;
- Suspension of the required minimum distribution (RMD) rules during the lifetime of the converting taxpayer;
- Payment of income tax prior to the imposition of estate tax permits greater wealth to be transferred to future generations (due to the fact that no income-tax deduction is allowed for state death taxes levied on IRAs);
- Greater growth potential, to the extent that outside sources (i.e., taxable brokerage account) are used to pay for the taxes due on the Roth IRA conversion;
- To better utilize an IRA owner's applicable exclusions amount;
- To effectively reduce the taxable estate of the IRA owner; and
- To hedge against a projected increase in tax rates when a first spouse dies.

a. Roth IRAs have their greatest attraction to those who do not need to withdraw any funds from their IRAs during life, especially those who expect to live well beyond the average life expectancy due to their gender, genetic heritage, and/or health. A traditional IRA participant approaching age 73 is required to take distributions that will substantially diminish if not eliminate the account over a long life span.

b. Converting to a Roth IRA just before death should be considered when benefits would otherwise have to be paid out just after death since such conversion may permit the longer post-death deferral of distributions.

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113 "A CPA's Guide to Making the Most of the New IRAs" for the American Institute for Certified Public Accountants (1997). Other articles on conversions by Robert Keebler include:
- "Using Roth IRA Distributions to Mitigate Income Taxes and Enhance Overall Wealth," Part I (Feb 2010) and Part II (Apr 2010), Family Tax Planning Forum, *Taxes -- The Tax Magazine*;
- "Navigating the "Bermuda Triangle" of IRAs -- Nonqualified Roth IRA Distributions," Family Tax Planning Forum, *Taxes -- The Tax Magazine* (Feb 2008);
- "Deciphering the Roth IRA Conversion Enigma," Family Tax Planning Forum, *Taxes -- The Tax Magazine* (June 2004);
- "A Tax Alchemist's Paradise in a Post-"Pension Rescue" World -- A Mathematical Perspective," Family Tax Planning Forum, *Taxes -- The Tax Magazine* (April 2004);
- "Roth Segregation Conversion Strategy," Family Tax Planning Forum, *Taxes -- The Tax Magazine* (June 2003).

114 "To Convert or Not to Convert, That Is the Question," Family Tax Planning Forum, *Taxes -- The Tax Magazine* (Oct 2008). This is discussed in greater detail.

c. If an IRA must be used to fund the credit-shelter trust, part of the advantage of escaping estate taxes is mitigated by the necessity of the trust to pay income taxes out of its principal; in many cases, the tax rate on such taxable income will be higher for the trust than for any of the beneficiaries. Although this can be corrected by a withdrawal from the IRA of a sufficient amount (grossed-up by the income tax), this requires the loss of continued deferral inside the IRA. With the Roth IRA conversion, the income taxes are removed from the estate but the deferral of taxes continues and the credit shelter pays no income taxes on the receipt of distributions from the Roth IRA.

Note:

Although either a deductible or nondeductible IRA may also be converted into a Roth IRA, it makes no difference from which IRA the rollover distribution is made, because the amount included in income on conversion does not depend on the source. All IRAs (other than Roth IRAs) are aggregated for purposes of determining the exclusion ratio applicable to the distribution.

Planning point:

Another principle implicit in the IRA regime is that all IRAs are aggregated for distribution purposes. For example, if a taxpayer holds an IRA to which the taxpayer has made only deductible contributions and another to which only nondeductible contributions have been made, a distribution solely from the nondeductible IRA is treated as coming proportionately from the deductible and the nondeductible IRAs both for meeting any minimum-distribution requirements and for determining the tax consequences of the distribution. It is irrelevant from which account the contributions actually come. The taxpayer can neither reduce the amount of taxable income by taking distributions solely from the nondeductible IRA nor increase the amount of taxable income by taking the distribution solely from the deductible IRA. Consequently, the amount of income realized in a rollover into a conversion IRA does not depend on which or whatever combination of non-Roth IRAs are employed.

d. In general, there is no advantage to pay taxes now through a conversion rather than later when distributed if the tax rates are the same. However, once the owner reaches age 73, the Roth IRA begins to enjoy an ever-increasing advantage through continued deferral in comparison to the required minimum distributions. Note that an owner who withdraws more than the minimum from whatever IRA is owned obtains little benefit in that case.

Planning point:

Among the factors that must be taken into account are the size of the IRA, age of owner, tax rates, assumed growth rates, the availability of non-IRA assets to pay taxes, the age at death, and extent to which the beneficiary designation. The client's tax rate at withdrawal is one of the most important variables. Therefore, it would seem prudent to consider conversion of some part of the traditional IRA if for no other reason than to hedge potential income-tax changes. Clients nearing the required beginning date who do not need the income are the best candidates, especially if they have non-IRA assets with which to pay the tax.

Note:

The benefits depend on the rate at which the funds are drawn down in the absence of a conversion. An accelerated draw-down of funds increases the tax paid on distributions while simultaneously reducing the period of tax-deferred compounding. These effects make the non-conversion case less attractive and this, in turn, biases the analysis in favor of conversion.

Planning point:

One of the factors influencing the conversion decision is the availability of assets outside the IRA to pay the income-tax liability resulting from the conversion. The reason is obvious: if the taxes are paid from the IRA itself, the amount that remains qualified for tax-deferred compounding declines. To be sure, the individual is out the outside funds so applied together with the earnings on those funds, but the outside fund compounds only on an after-tax basis, while the additional amounts within the Roth IRA compound on a pretax basis.

Caution:

One kind of taxpayer who should be careful is someone whose tax bracket is higher now than the taxpayer's (or the taxpayer's heirs') tax bracket is likely to be whenever the IRA money will be spent. If the marginal tax rate when making a contribution is higher than the rate that will be applied to the distributions -- the typical scenario for most individuals -- then conventional IRAs and other deductible pensions offer a more tax-advantaged investment environment than does a Roth IRA. The tax loss would become a tax gain if the incremental tax on the conversion income were less than the tax on the pension without conversion. Nevertheless, some may wish to consider conversion of some part of the traditional IRA as a hedge against potential income-tax changes. On the other hand, small business owners who plan to sell upon retirement, investors with substantially appreciated portfolios, and someone with a multimillion-dollar pension plan or an inheritance could see their tax rate go up in retirement if their current income corresponds to a lower federal tax bracket.

e. **Starting with taxable years beginning in 2010** and thereafter, the income limitation on converting traditional IRAs to Roth IRAs is eliminated. Taxpayers may only convert until that time if the modified adjusted gross income without regard to the rollover amount included in income did not exceed $100,000. For taxpayers making the conversion in 2010, there was an election of including the rollover amount equally in 2011 and 2012 rather than wholly in 2010. Thus, taxpayers could then make such conversions without regard to their AGI.

Note:

Taxpayers who converted their IRAs in 2010 were entitled to a special deferral mechanism that generally place one-half of the inclusion in gross income in 2011 and 2012. As it turned out, because tax rates did not rise in 2011, a conversion in 2010 would have proved tax-efficient. For individuals whose IRAs have increased substantially in value, failure to convert in 2010 was a mistake, because a later conversion will increase the amount included in income. Nevertheless, the advantages of the Roth IRA in contrast to other qualified plans in relation to the Medicare tax and possible later medical expense deductions should not be overlooked.

f. Another problem related to this is what does the taxpayer have to convert in 2024? He may or may not have a traditional IRA in place, but subject to the income-tax issue noted above. Many taxpayers may not have a current IRA, and the road to getting one is complicated because the funding rules for IRAs are constrained by the phase out rules.

(i) An individual who is an active participant in one of certain types of retirement plans will be unable to make a deductible contribution to an IRA unless the individual's income is below an **applicable dollar amount**.[115] The deductibility of contributions to regular IRAs for active participants is phased out in a pro rata fashion over the applicable phase-out range of AGI.

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115 I.R.C. §219(g)(1).

Note:

If an individual is an active participant, the deduction for contributions to the individual's own IRA may be limited by the phase out rules. However, the contribution to the spousal IRA is deductible subject only to the phase out of AGI for individuals who are not active participants but whose spouses are active participants.

(ii) A spousal IRA deduction cannot be taken unless one spouse has no compensation or unless the spouse elects to be treated as having no compensation.[116] A spouse with less than $7,000 ($8,000 if age 50 or older) in compensation might wish to make an election to be treated as having no compensation in order that a spousal IRA contribution can be made on the spouse's behalf.[117] If the spouse were to establish the spouse's own IRA, the $7,000 ($8,000 if age 50 or older) or 100-percent-of-compensation limitation would limit the contribution to 100 percent of the spouse's compensation.

(iii) For Roth IRAs, the maximum amount is phased out between certain levels of modified AGI. For this purpose, a married individual who has lived apart from the individual's spouse for the entire taxable year and who files separately is treated as not married.[118]

(iv) An individual may make the maximum deductible contributions (if any) and then make nondeductible contributions until the total of both types of contributions equals the limit of $7,000 ($8,000 if age 50 or older), or 100 percent of taxable compensation, if less.[119] This is NOT subject to phase out.

g. What is not phased out is a **nondeductible IRA**. Either taxpayer or his spouse (or both) can fund a nondeductible IRA. A taxpayer can fund a nondeductible IRA to the extent of $16,000 in 2024, assuming he and his spouse reach age 50 in 2024: $8,000 (including the $1,000 catch-up in the year age 50 is reached). This can create a conversion candidate, and, if this is the taxpayer's only IRA, can (apart from any earnings) be completely tax-free and enable subsequent qualified distributions to be tax-free as well.

Example: Suppose taxpayer (T) has two IRAs, one a traditional deductible IRA having an account balance in 2024 of $80,000; the other is the $20,000 nondeductible IRA funded as above, which for these purposes has no earnings. Now T could convert the second IRA, but now the conversion will not be tax-free. The reason is that for these purposes one is required to aggregate all traditional IRAs. Even though the distribution is from an IRA that has a $20,000 basis, 80 percent ($80,000/$100,000) of the distribution is deemed to come from the taxable first IRA. The conversion will result in $16,000 of income that must be included in income in one or more years.

However, if instead taxpayer's spouse (S) funded her own nondeductible IRAs as above, she can convert that as a fully nontaxable conversion because she does not have to aggregate her IRA with T's. Thus, none of the $20,000 conversion is taxable in 2024.

116 I.R.C. §219(c)(1)(B)(i).
117 I.R.C. §219(c)(1)(B)(ii).
118 Treas. Regs. §1.408A-3, A-3(b).
119 I.R.C. §408(o)(2)(B).

Planning point:

While they are generally not nearly as valuable as a Roth contribution or a deductible contribution, nondeductible contributions are not without tax benefit. Nondeductible contributions can not only serve the limited-use purpose discussed above for a single year, but also provide in any event an additional base from which tax-deferred income can be generated, income that when distributed may be taxed at a lower rate than the same principal sum invested outside the IRA in some or all of the years between contribution and the date of distribution.

2. Recharacterization

The IRS has indicated a Roth conversion made in 2017 may be recharacterized as a contribution to a traditional IRA if the recharacterization is made by October 15, 2018. A Roth IRA conversion made on or after January 1, 2018 cannot be recharacterized.

3. Retirement funds under the Bankruptcy Act

Under ERISA, the non-alienation provisions have generally been thought to preclude attachment by a creditor of the participant/beneficiary. The 2005 Bankruptcy Act now specifically treats as exempt the funds in a qualified plan,[120] IRA,[121] deferred compensation arrangements of a state, local government, or tax-exempt organization,[122] and certain tax-exempt trusts.[123] This exemption is available even if the debtor's state has opted out of the federal scheme. It is not necessary to show that the funds are necessary for the support of the debtor and dependents.

Note:

In the case of an IRA or Roth IRA, but not a SEP-IRA or a SIMPLE-IRA, the exemption is limited to $1 million (plus inflation-adjusted amounts) unless the interests of justice require a higher amount. Because no limit attaches to other exempt retirement funds, there may be additional reason to favor qualified plans (such as the Roth contribution program) or the SEP/SIMPLE over other structures.

VII. When to take Social Security benefits

A. Social security distribution planning

1. In general

Social Security is a **lifetime annuity** (or joint and survivor annuity), that (i) has flexible beginning dates; and (ii) has differing amounts depending on the start dates. If we determine these at different start dates and add both a discount factor and annuity (life-expectancy) factors, we can determine the present values of each. While a present value is not as accurate as an actuarial valuation, it is still a relevant metric for making a decision. This methodology is applied in these materials. It is also noted that the numbers developed must be tempered by the fact that other considerations, such as need, may make the answers moot.

120 I.R.C. §§401 and 403.
121 I.R.C. §§408 (traditional) and 408A (Roth).
122 I.R.C. §457.
123 I.R.C. §501 (VEBAs, etc.).

a. The time to claim and receive benefits depends on:

- Age;
- Gender;
- Health;
- Tax-rate; and
- Rate of return.

Note:

A fully insured individual, as noted earlier, means any individual who had not less than forty quarters of coverage if:

- The individual has reached **age 62**; and
- The individual has **filed an application** for such benefits.

This means that someone cannot generally claim retirement benefits before reaching age 62, the **earliest date** when a claim for such benefits can be made. However, a fully insured individual does not claim benefits merely by reaching age 62. An individual must make an affirmative application for benefits.

b. For a single individual who was never married (and thus not entitled to a spousal benefit), deciding when to retire from a financial perspective is a question of whether the individual is better off taking approximately 75 percent of the primary insurance amount (PIA) at 62 or waiting to get 100 percent at the full retirement age (FRA), or receiving in excess of 100 percent by delaying a claim for retirement benefits past the FRA.

Note:

This is all that is involved in the case of a single individual, but matters are more complicated for a married individual who is subject to the same choices and consequences above and has additional considerations as well.

(i) By claiming benefits early, the worker will receive a greater number of payments than the FRA situation as the lifetime stream starts earlier than the FRA. However, the amount of the individual's monthly benefit is further reduced if the monthly earnings for a month between age 62 and FRA exceed a dollar limitation, currently $1,860.[124] To the extent the individual has earned income in excess of this amount, the monthly benefit otherwise receivable by the individual is reduced $1 for every two such dollars.

(ii) By taking benefits at FRA, the individual receives higher payments than the payments that are received by those claiming the benefits before FRA. Full benefits are computed for Full Retirement Age and then reduced for the number of months prior to FRA the benefits are claimed. For FRA of 66:

Age 62	25 percent
Age 63	20 percent
Age 64	13-1/3 percent
Age 65	6-2/3 percent

Example: For an individual whose PIA is $1,000, the effect of claiming benefits at 62, 63, 64, or 65 is, without regard to COLA, to reduce the initial year payments to $750, $800, $867, and $933, respectively.

[124] 2024 Cost of Living Fact Sheet, www.SSA.gov.

Note:

Generally, the present value of full retirement payments commencing at age 66 years will not equal the present value of reduced retirement benefits commencing at age 62 until many years in the future.

Full Retirement and Age 62 Benefit By Year of Birth

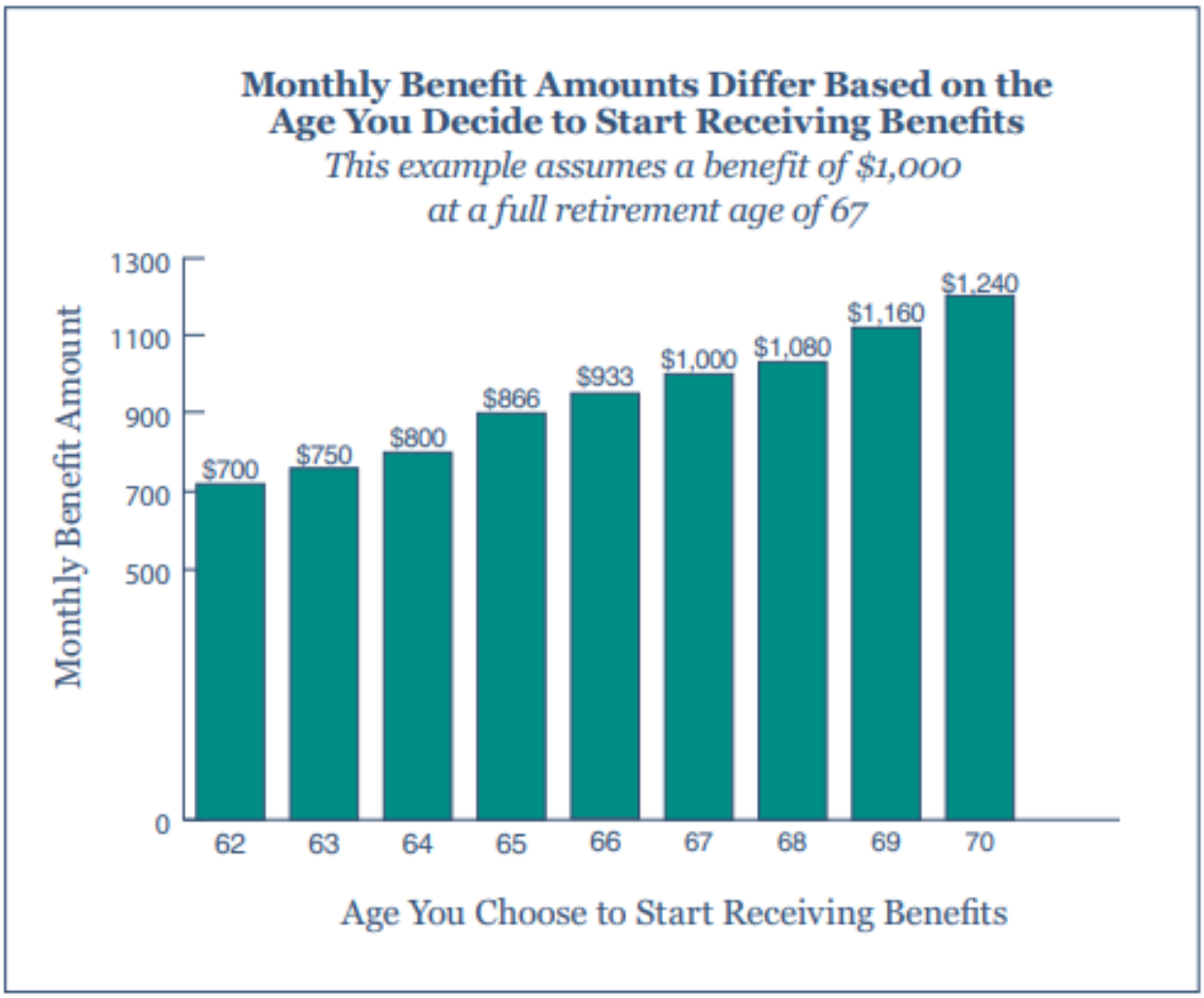
Year of Birth	Full (normal) Retirement Age	Age 62 Reduction Months	Total % Reduction	A $1000 retirement benefit would be reduced to	Total % Reduction (spouse)	Spouse's $500 benefit would be reduced to
1937 or earlier	65	36	20.00	$800	25.00	$375
1938	65 and 2 months	38	20.83	$791	25.83	$370
1939	65 and 4 months	40	21.67	$783	26.67	$366
1940	65 and 6 months	42	22.50	$775	27.50	$362
1941	65 and 8 months	44	23.33	$766	28.33	$358
1942	65 and 10 months	46	24.17	$758	29.17	$354
1943–1954	66	48	25.00	$750	30.00	$350
1955	66 and 2 months	50	25.83	$741	30.83	$345
1956	66 and 4 months	52	26.67	$733	31.67	$341
1957	66 and 6 months	54	27.50	$725	32.50	$337
1958	66 and 8 months	56	28.33	$716	33.33	$333
1959	66 and 10 months	58	29.17	$708	34.17	$329
1960 and later	67	60	30.00	$700	35.00	$325

c. A worker can earn a delayed retirement credit (DRC) for any month beginning with the month of attainment of FRA and ending with the month before attainment of age 70. Each credit is referred to as an increment month. An increment month is granted for any month in that period for which:

   (i) The worker was insured but benefits were not paid because an application was not filed; or

   (ii) Benefits were due but the worker elected to have the benefit voluntarily suspended in order to earn DRCs.

d. Conversely, by claiming benefits late, the worker will receive fewer payments than the FRA situation as the lifetime stream starts later than the FRA. Currently, if the worker delays collection past FRA, the full benefits are increased 2/3 percent for the number of months after FRA the benefits are claimed. This is 8 percent annually: in addition, the accrual of credits also is adjusted for inflation by the COLAs applied to FRA benefits.



Planning point:

While not important to a single individual, a deceased worker's DRCs will be used to increase survivor benefits (discussed later) to the widow(er), but not spousal benefits.

2. When to retire?

Should a prospective retiree retire at age 62 or 66 years? As noted above, the monthly retirement prior to normal retirement age is reduced by a percentage (see previous chart) for each month, so a 48-month early retirement (at age 62) reduces the monthly payment by 25 percent for someone with an FRA of 66 years. For people turning age 62 in 2024, their FRA is 67 years. If someone turning 62 in 2024 decides to retire immediately, they would be retiring 60 months early. Some people decide to continue working full-time beyond retirement age. In that case, people can increase their Social Security benefit in two ways:

- Each additional year a person works adds another year of earnings to his or her Social Security record, which can have the effect of increasing the individual's full retirement age benefit (except, for all intents and purposes, those who have already maxed out benefits by having maximum taxable wages for 35 years); and

- Higher lifetime earnings may result in higher benefits when one retires. As noted above, a person's benefit will be increased by a certain percentage (DRCs) if he/she delays claiming retirement benefits. These increases will be added in automatically from the time an individual reaches full retirement age until that individual starts taking benefits or reaches age 70.

Note:

As the preceding has indicated, a participant (and a spouse, as discussed below) may choose to take Social Security benefits along a continuum stretching from age 62 to age 70. Baby boomers are now approaching the middle bound of this range and are faced, in many cases, with an election that should be the result of an assessment of needs and a financial assessment.

3. Effect of claiming benefits

In the case of a single worker who was never married, the choice essentially boils down to determining which annuity starting date for a single-life annuity maximizes the present value given a projected term (life) of the benefits.

a. In the case of an unmarried individual, only the retirement benefits of the worker need be considered.

b. The value of an annuity is the net present value of its payments. The number of payments depends on how long one lives and when the payments begin.

c. The number of payments can be actuarially determined based on life expectancy factors at the time of each payment or, more simply but not as accurately, by assuming that:
   (i) The individual will live his or her life expectancy at the time the payments begin, i.e., 16.2 years; or
   (ii) The individual will live to a specified age, i.e., 77.

d. Time of claiming and receiving benefits depends on several factors:
   (i) Age and gender;
   (ii) Health; and
   (iii) After-tax rate of return on money received.

Note:

Like private retirement plans, Social Security calls on the participant to make fundamental choices concerning their benefits. Fortunately, there are actually fewer decisions (although a huge number of potential choices) in Social Security than in a qualified plan or in the post-retirement receptacle for most individuals in a rollover IRA. Social Security involves neither the investment choices nor the expenses associated with the maintenance of say a §401(k) plan that might erode the benefits actually received or enjoyed.

e. Social Security is a vestige of the defined benefit era. Up through ERISA, retirement plans, particularly those implemented by large corporations with large numbers of employees, were generally structured as a defined-benefit plan that eliminated investment risk from the employee in favor of a certain and guaranteed level of income that took the form of a lifetime annuity that also eliminated the actuarial risk of outliving a fixed sum amount. The entrepreneurial explosion of small companies with few employees was met in many, if not most cases, by the adoption of defined-contribution plans, whose investment rewards and risks largely mirrored what these companies themselves experienced. The emergence of the §401(k) plan that enabled employers to shift much or all of the funding to the employee accelerated the movement of even Fortune 500

companies to defined-contribution plans or surrogate defined-benefit plans, such as cash-balance plans, which largely shifted more and more of the responsibility to the employee for the ultimate benefit to be received. Inflation can erode the benefit: in a private retirement plan, equal minimum distributions actually reflect less and less purchasing power by reason of the inflationary devaluation of the dollar, while Social Security through the COLA seeks to provide a relatively fixed benefit in terms of purchasing power. While plans offered the possibility of meeting or exceeding inflationary loss through investment gains, many of the historical returns that could give an individual confidence in achieving this have been eroding by changes in the global markets that ratchet down realistic expectations of income.

Note:

In general, all benefits received from a qualified plan or traditional IRA are tax-deferred until they are received, but then are subject to income tax as ordinary income at the taxpayer's highest current tax bracket rate; in contrast, Social Security benefits are nominally not subject to income tax (unlike traditional defined-benefit plans), although may taxpayers will be required to include some (but not all) of their benefits into income under a complex taxation scheme. That less than all benefits are included is fully equivalent to having all those benefits taxed at a lower rate than the taxpayer's higher tax rate AND not increasing the taxpayer's AGI to the same extent as the private plan distribution of the same amount, a fact that further reduces the effective rate of tax with respect to the phase out of itemized deductions, personal exemptions, medical expenses, active participation losses, etc.

f. All that may be fine while working, and retirement seems a long way off, but when Social Security becomes a viable benefit, the time has arrived to examine the defined-contribution plan/IRA critically in comparison to Social Security. As noted above, Social Security provides a variety of timing options that also have an impact on setting the level of the benefits received. Similar timing options are generally available in a qualified plan and almost always in an IRA that gives the participant a menu of options determined by him or her rather than by his or her employer.

Comparison of Social Security and IRAs

Social Security	IRA
Tax-favored	Tax-deferred
No investment risk	Investment risk
Inflation protection	No inflation protection
Longevity protection	No longevity protection
Survivor protection	No survivor protection

Planning point:

Social Security in a society of single-worker families provided a basic option, from which most other options were then determined. A spouse was entitled to a spousal benefit. Another sociological change that has arisen over the past 35 years is the two-wage-earner family, a fact that now gives the spouse a choice between a benefit based on being a spouse, a spousal benefit, or a benefit based on his or her own worker record, a worker benefit.

The greater financial security that Social Security offers relative to an IRA suggests consideration, when retirement comes, of deferring such benefits and looking to IRA distributions, if needed before taking Social Security. In addition, a spouse may have choices to make concerning his or her own Social Security that may now be somewhat independent of the Social Security choice made by the other spouse.

g. Another factor to consider is that, except for Roth vehicles (IRA or §401(k)), usually the entire distribution from a qualified plan or IRA is fully included in adjusted gross income while Social Security payments are, at most, included only to the extent of 85 percent. In light of the additional tax on net investment income that depends in part on levels of adjusted gross income, Social Security may be more tax-efficient than distributions from qualified vehicles.

4. Comparing choices

One could create a spreadsheet that computes the present values of lifetime Social Security benefits and the monthly benefit amounts based on tested specified collection dates, and given the assumptions, the dates generating the highest lifetime benefits. Monthly benefits are adjusted annually for COLAs.

a. Because Social Security payments may in part be included in taxable income, the after-tax value of the payments must be determined by assuming an inclusion rate and a tax bracket rate of the recipient. For purposes of illustration, we have assumed the inclusion rate to be 85 percent.

Note:

The major problem is that the number of possibilities of choice involved in the analysis of Social Security is estimated at 100 million. Commercially available software and online material provides tools the financial planner can use to examine the possibilities. Examples of such resources include MaximizeMySocialSecurity.com and products in the ESPlanner line (esplanner.com).

b. The full retirement benefit is assumed to be $2,500. The calculations used 3 percent, 5 percent, and 7 percent before-tax rate of returns.

c. The COLA was assumed to be 2.8 percent, the level the Social Security trustees set as their long-range projection.

d. The income tax rate was assumed to be 35 percent. In most cases, retired taxpayers are likely to be in a lower bracket, and this variable can be programmed into a spreadsheet or be a variable parameter that a software program incorporates.

e. The analysis can produce different conclusions based on gender because of the gender-based differential in life expectancies. The individual is generally assumed to live to life expectancy (which is generally less than the median age). We have used the life expectancy tables the Social Security Administration published in 2007.

(i) The life expectancy of a male at age 62, age 66, and age 70 is 18.85 years (to age 80 years 10 months), 15.67 years (to age 81 years 8 months), and 13.27 years (to age 83 years 3 months), respectively.

(ii) The life expectancy of a female at age 62, age 66, and age 70 is 21.89 years (to age 83 years 10 months), 18.72 years (to age 84 years 9 months), and 15.72 years (to age 85 years 9 months), respectively.

Note:

Life expectancy is the average life measured by adding up the ages of all persons in the population, and dividing the sum by the number of individuals in the population. This is not the same as the median age – i.e., the age at which half of the population has died and half is still alive. There is thus more than a 50-percent probability that an individual will survive past the life expectancy.

Note:

It is important in this (as well as the early versus normal retirement decision) to take into account the investment profile of the client because the after-tax yield of the Social Security benefits received bears on the net present value of the benefits from the starting date for the rest of the client's life. In deciding when to start taking Social Security benefits, the anticipated investment returns on the after-tax Social Security benefits that will be invested and the nature of the taxation of the annual earnings from those investments must be considered. In general, because of the higher yield on capital gains and dividends the greater the value of the earlier years and thus the "break-even" lifetime for later starting Social Security. A computer model is necessary to take into account actuarial factors and different investment performance.

f. The value of an annuity is the net present value of its payments. The number of payments depends on how long one lives and when the payments begin.

g. Assuming a 3 percent/5 percent/7 percent return, viewed as a break-even issue where the only issue is the number of years actually lived by the recipient, the present value of the Social Security payments beginning at age 66 years breaks even with the present value of the payments that would have been made beginning at age 62 after some period of time. If one knew that the individual would not live so long, the annuity beginning at age 62 would be superior to that beginning at age 66 years. Similarly, the break-even for an annuity beginning at age 70 vis-à-vis the annuity beginning at 66 years is another period of time. If one knew that the individual would live beyond that age, the annuity deferred until age 70 would be superior to that starting at age 66 years.

5. Single males

The analysis looks solely at potential claiming of benefits at ages 62 (the earliest), 66 (FRA), and 70 (the latest age at which the amount of the benefit is affected).

a. For a male claiming at age 62, life expectancy is 18.85 years (age 80 years 10 months). In addition, the full retirement benefit is reduced by 25 percent to $1,875.

b. For a male claiming at age 66, the then life expectancy is 15.96 years (age 82 years 0 months). The full retirement benefit is increased by COLA $(1.028)^4$ x $2,500 to $2,716, the same amount of the payment in that year for the male who claimed benefits at age 62, but without the reduction for early payments.

c. For a male claiming at age 70, the then life expectancy is 13.27 years (age 83 years 3 months). The initial payment is $4,116 [$2,716 x $(1.028)^4$ x 1.32 (reflecting both the 32 percent premium and the COLAs for the intervening years)].

d. Summary of present values for **males at 3 percent** before-tax rate of return:

Live to	Claim at 62	Claim at 66	Claim at 70
Age 66 (FRA)	63,487	0	0
Age 70 (No more benefit premium)	129,069	86,863	0
Age 78, 8 months (where benefits at FRA exceed benefits at 62)	279,065	279,324	263,371
Age 79, 10 months (where benefits at 70 exceed benefits at 62)	300,063	306,575	300,231
Age 80, 7 months (where benefits at 70 exceed benefits at 66)	313,710	324,259	324,183
Age 80, 10 months (LE 62)	318,242	330,133	332,138
Age 82, 0 months (LE 66)	333,528	357,818	369,639
Age 83, 3 months (LE 70)	370,600	387,892	410,371

(i) The rate for males claiming at age 62 compares favorably for all such persons who do not live to age 78 years 8 months. For those who will live past that point, waiting to normal retirement age produces higher lifetime benefits, but at age 80 years 7 months the delayed retirement credits at age 70 are poised to become marginally better than claiming at age 66. Waiting until age 70 will be superior to claiming at age 66 if the male lives to age 80 years 7 months.

(ii) Assuming the male lives to his life expectancy (at age 62), the choice of claiming early is inferior financially to waiting until age 66 or age 70.

e. Summary of present values for **males at 5 percent** before-tax rate of return:

Live to	Claim at 62	Claim at 66	Claim at 70
Age 66	61,865	0	0
Age 70	122,596	80,360	0
Age 78, 8 months	251,675	244,395	224,542
Age 79, 10 months	267,275	266,163	254,029
Age 80, 0 months	269,642	269,132	258,184
Age 80, 10 months (LE 62)	281,617	284,747	279,197
Age 81, 8 months	293,534	300,188	300,122
Age 82, 0 months	298,236	306,281	308,236
Age 83, 3 months (LE 70)	316,009	329,310	339,555

(i) The higher rate of return/discount rate increases the relative value of the earliest payments and:

- Reduces the present values generally at every age;
- Pushes the age 62/age 66 break-even from 78 years 9 months to 80 years (still slightly under the life expectancy at age 62); and
- Pushes the break-even for age 66/age 70 from 80 years 10 months to 81 years 8 months (still slightly under the male life expectancy at age 66).

f. Summary of present values for **males at 7 percent** before-tax rate of return:

Live to	Claim at 62	Claim at 66	Claim at 70
Age 66	60,331	0	0
Age 70	116,565	74,367	0
Age 80, 10 months	250,482	246,382	235,111
Age 81, 8 months	259,772	258,421	251,418
Age 82, 0 months	264,339	264,338	259,432
Age 83, 1 month	275,125	278,431	278,520
Age 83, 3 months	277,026	280,777	281,698

(i) The higher rate of return/discount rate increases the relative value of the earliest payments and:

- Reduces the present values generally at every age;
- Pushes the age 62/age 66 break-even from 80 years to 82 years 1 month (now slightly over the life expectancy at age 62); and
- Pushes the break-even for age 66/age 70 from 81 years 8 months to 83 years 1 month (still slightly under the life expectancy at age 66).

Note:

Between 5 and 7 percent there is a rate of return at which the present values at the individual male's life expectancy at age 62 are the same whether claimed at age 62 or age 66.

Somewhat over 7 percent there is a rate of return at which the present values at the individual male's life expectancy at age 66 are the same whether claimed at age 66 or age 70.

6. Single females

A woman has a longer life expectancy than a man.

a. For a woman claiming at age 62, life expectancy is 21.89 years (age 83 years 10 months).

b. For a woman claiming at age 66, life expectancy is 18.72 years (age 84 years 9 months).

c. For a woman claiming at age 70, life expectancy is 15.72 years (age 85 years 9 months).

d. Summary of present values for **females at 3 percent** before-tax rate of return:

Live to	Claim at 62	Claim at 66	Claim at 70
Age 66	63,457	0	0
Age 70	129,069	86,863	0
Age 80, 10 months	318,242	330,133	332,138
Age 82, 1 month	341,162	359,835	372,370
Age 83, 10 months (LE at age 62)	373,696	401,985	429,460
Age 84, 9 months (LE at age 66)	390,934	424,310	459,703
Age 85, 9 months (LE at age 70)	409,874	448,843	495,689

e. Summary of present values for **females at 5 percent** before-tax rate of return:

Live to	Claim at 62	Claim at 66	Claim at 70
Age 66	61,865	0	0
Age 70	129,069	86,863	0
Age 80, 1 month	270,802	270,854	260,311
Age 81, 8 months	293,534	300,188	300,112
Age 83, 10 months	324,242	339,974	353,999
Age 84, 9 months	337,159	356,704	376,661
Age 85, 9 months	351,176	374,861	401,250

f. Summary of present values for **females at 7 percent** before-tax rate of return:

Live to	Claim at 62	Claim at 66	Claim at 70
Age 66	60,331	0	0
Age 70	116,565	74,367	0
Age 80, 10 months	250,482	246,382	235,111
Age 82, 1 month	264,339	264,338	259,432
Age 83, 10 months	283,257	288,848	292,632
Age 84, 9 months	290,940	301,389	309,620
Age 85, 9 months	303,318	314,832	327,825

Analysis:

Because the female has a longer life expectancy at each of the test points, the crossover point occurs sooner relative to life expectancy, again earlier than life expectancy.

At each rate of return, the present value of payments taken at age 70 are greater than those at age 66 or age 62, earlier than the life expectancy at either 62 or 66.

A high-earner female should consider delaying payments to age 70 wherever possible (unless she is in poor or below-average health).

7. And yet

And yet, in an era where 7-percent returns are difficult to come by, fully 72 percent of eligible workers claim before reaching FRA.

a. Most individuals are unaware of the consequences of claiming early and are not sophisticated enough to give this important financial decision the analysis it is due.

b. This cannot be explained merely by assuming that those claiming early are those who are likely not to survive to life expectancy (by reason of occupation and poorer-than-average health). Commentators suggest that this is a lifestyle choice, but one that is often made without consideration of its financial implications. The early claim makes even less financial sense in the case of a married couple.

8. Married workers

a. The above has assumed that the decision as to when to take retirement benefits was made by a single person. However, the decision to take an early retirement will have a consequence for the spousal benefit as well where the retiree is married. The single-life annuity analysis cannot be applied in the case of a married couple. Therefore, two adjustments have to be made where the spouse is not eligible to retirement benefits as a worker. First, any delay magnifies the total benefit received by the couple. Second, the life expectancy to be contemplated is a joint life rather than a single life. This brings the break-even points down by several years. This will generally have the effect of making the early claim for benefits even more questionable. Joint life expectancy is a better predictor of the projected term of the annuities.

   (i) **Worker's and spousal/survivor:** Worker will claim a benefit. The nonworking spouse will claim a spousal benefit and, if the spouse survives the worker, a survivor benefit following the worker's death.

   (ii) **Worker's and spousal worker/survivor:** Worker will claim benefits. Working spouse will claim his or her own retirement benefits and, following the death of the other spouse, a survivor benefit, if higher.

b. The joint life expectancy of a couple determines the term that at least one of them will survive. It depends on the ages of the spouses.

   (i) **Ages 66 and 66:** Median (50 percent) is 25.65 years (age 91 years 8 months). Twenty-five percent of such couples will have a survivor who lives 30.3 years (age 96 years 4 months).

   (ii) **Ages 62 and 60:** Median is 30.43 years. Twenty-five percent of such couples will have a survivor who lives 35.19 years from this date.

   (iii) **Ages 66 and 62:** Median is 27.70 years. Twenty-five percent of such couples will have a survivor who lives 32.51 years from this date.

Note:

Joint life expectancies are generally greater than the greater of the single life expectancy of either spouse individually. Focusing solely on the sets of two individuals who are alive at age 62, there is approximately a 50 percent probability that one will die before age 78 and a 50 percent probability that one or the other will survive to 89. So, if the wife, say, takes Social Security at 62, she may succeed to a larger payment 6 years before her life expectancy because 50 percent of the time her husband will die before reaching age 78. If the husband made it to 70 to begin payments then, in 50 percent of the cases that stream will be paid to the husband or the surviving spouse for 19 years or more (from age 70 to age 89). Of course, these numbers apply only in the case where the spouses, by hypothesis, are the same age. Different numbers will be applicable where there are age differentials.

c. In the case of a single individual who has never been married, the only Social Security benefit that bears on timing is the worker's own retirement benefit. When a spouse (or a minor child) is involved, there are secondary, derivative benefits that themselves may be impacted by the choice made by the primary worker. Of course, spouses can have their own retirement benefit as well. Among the benefits other than the worker's own benefit that need to be considered:
   (i) **Spousal benefit:** The spousal benefit is 50 percent of the worker's FRA benefit.
   (ii) **Survivor benefit:** The surviving spouse to claim the greater of the spouse's own (card) benefit or 100 percent of the deceased spouse's worker benefit.

d. For one-earner couples (both still alive), the spouse will choose the spousal benefit when it is available.
   (i) Spouse must be at least 62, OR have a minor child in his or her care.
   (ii) Worker must have claimed benefits. Generally, the worker may not claim benefits before age 62.
   (iii) Amount of spousal benefit depends on two factors:
      - The benefit the worker would receive at FRA (even if claiming earlier); and
      - The age of the spouse when claiming the spousal benefit.

Example: Fred, age 62, is married to Wilma, age 30. Regardless of when Fred claims, Wilma may not claim spousal benefits.

Take the same Example, except Wilma has an infant child of Fred's under her care. Wilma may be entitled to a spousal benefit equal to 50 percent of Fred's FRA benefit without reduction but only if Fred claims retirement benefits and the minor child is entitled to child benefits (i.e., is a dependent of Fred). Spousal benefits are not reduced even if Fred's are by reason of excess earnings or early claiming. The family maximum rules will apply to limit the total monthly benefit to 150 percent of Fred's monthly benefit at FRA.

Note:

When one spouse has zero or low benefit on his or her own card:

(i) The spousal benefit is only available if the worker has **claimed** benefits, and this can happen only if the worker is at least age 62.

(ii) Spouse must generally be at least age 62.

(iii) Spousal benefit reduced if spousal claim is made before spouse reaches FRA to the same extent a retirement benefit would have been reduced. **If the worker claims before FRA, he or she cannot claim and suspend**. This fixes the amount of the spousal benefit. The spousal claim, if made before the spouse's FRA, initiates a claim for the spouse's own benefit (dual eligibility). The size of the spouse's own benefit is not relevant in cases where the spouse's own benefit is less than one-half of the worker's FRA benefit.

Example: Jack has claimed benefits; his FRA benefits are $1,000. Jill, age 63, is entitled to a spousal monthly benefit of $500, but because she claimed three years before her FRA, she must reduce the monthly benefit 20 percent to $400.

Note:

There is no reduction regardless of the age when claimed by the spouse who has a minor child under her care. Thus, in May-December marriages where there is a child, the spousal benefit should always be claimed.

Planning point:

In virtually no situations should a non-working spouse defer her spousal claim to age 70. When a high-earner is wedded to a median-income wife, the choice between a claim by the median-income spouse at age 62 versus age 66 when the high-earner will claim at age 70 is a toss-up, but slightly better than the spouse waiting to age 70 to claim enhanced benefits. However, this toss-up may be broken in favor of the later age (66) because the spouse will not have claimed a spousal benefit and thus might be free to defer a claim for the higher survivor benefit (assuming sufficient funds between date of the high-earner's premature death and the spouse reaching FRA.

One must still approach this strategy not as a cookie-cutter solution. Nothing may be gained, and something actually lost if both spouses are long-lived. The spouse retiring early in this situation will receive less than he or she would have had he or she waited to full retirement or even to age 70. Conversely, workers in relatively poor health probably maximize benefits by taking old-age benefits as soon as possible.

(iv) If worker claims benefits before FRA, the spouse's claim for:

- Spousal benefits are not reduced if the worker claims retirement benefits before the worker's FRA, but only if the spouse is under the spouse's FRA when claiming those benefits.
- Survivor benefits when the worker dies are permanently reduced.

(v) The following chart illustrates the results of a spousal election at various ages by the spouse for a worker who has claimed benefits. It indicates the full spousal benefit at various ages of the spouse, the reduction in the benefit, if any, by claiming before the spouse's FRA, and the impact of the claim at that age on the spousal benefit at ages 66 and age 70.

Jack's age when claimed	Jill's age when claimed	Jack's benefit at FRA or later claim date by Jack	Full spousal benefit (.5 x Jack's FRA benefit)	Reduced spousal benefit (as a result of age when Jill claims)	Spousal benefit, Jill claiming at 66 (inflation-adjusted)	Spousal benefit, Jill at age 70
62	58	1,500	750	N/A		
66	62	1,650	825	619	694	780
70	66	1,850	925	925	925	1,040
74	70	2,080	1,040	1,040	N/A	1,040

When Jill claims early (age 62), her spousal benefit is permanently reduced.

Jill gains nothing in the spousal benefit by waiting past age 66. Instead, she has missed four years of spousal benefits. There are no DRCs applicable to a spousal claim.

e. The Senior Citizens Freedom to Work Act of 2000 established:

(i) An individual who has reached FRA may claim the FRA benefit, but suspend the collection of the FRA benefit.

Note:

The above strategy presumes that cash flow is not dependent on Social Security during the time the benefits are suspended, either because one continues working or because one has other resources (IRAs and qualified plans) one can access prior to making the claim for one's own benefits.

(ii) The spouse could claim a spousal benefit (assuming the minimum age requirement is met) even if the worker continues to work.

Note:

The Bipartisan Budget Act of 2015 revised this rule. If the older spouse is on suspension, the younger spouse may not claim a spousal benefit based on the older spouse's card. However, if the older spouse is taking benefits, the younger spouse may file a restricted application to claim a spousal benefit (but no earlier than his or her FRA) but not his or her own benefit and then claim benefits on his or her own card with accrued delayed retirement credits. Thus, if a working spouse has claimed, the other spouse may, **in certain circumstances**, suspend his or her own benefit at full retirement age but may not claim spousal benefits based on the earnings of the working spouse.

The general rule has been that an application for any benefit is a deemed application for other benefits to which the individual is entitled. Thus, when a working spouse claims spousal benefits (based on the other spouse's earnings record) it is also treated as an application for the working spouse's own benefits (based on her own earnings record). Since 2000, however, the law has permitted taxpayers to limit (restrict) the application when filing on or after full retirement age. This exception will no longer apply under the Act. A claim for one benefit will be deemed an application for all benefits even if the applicant has reached full retirement age. Stated somewhat differently, there will no longer be any option to apply, say, for a spousal benefit and to later switch to a delayed individual benefit. Instead, for better or worse, either all benefits start earlier, or all are delayed later. Under the Act, a claim for one benefit will be deemed an application for all benefits even if the applicant has reached full retirement age.

Important: The law does provide a grandfathering provision stating that the new rules on deemed application limiting restricted application will only apply to those individuals who turn age 62 beginning in 2016 or later. Therefore, individuals who were born on or before January 1, 1954 continue to be permitted to file a restricted application for one benefit and to later switch to another. Also, an individual who was age 66 before April 30, 2016, and filed and suspended prior to that date is grandfathered in. For these purposes and for the FRA, a person born on January 1 is considered to be born in the prior year. This constitutes the **certain circumstances** noted above.

(iii) The worker remains eligible to accrue delayed retirement credits for purposes of the worker's own benefits (8 percent for years after FRA).

(iv) The spouse may claim a higher monthly spousal benefit from COLA to the worker's claimed benefit, but not from delayed retirement credits.

Example: Jack claims and suspends at age 66 when his FRA benefit is $1,650 on April 1, 2016. With COLA at age 70, when he claims the retirement benefit it is $1,850. With DRCs, Jack's monthly benefit increases to $2,442. However, Jill's spousal benefit at that time is $925 (.5 x $1,850), not $1,221 (.5 x $2,442).

Note:

Wages or earned income of an individual above the FRA are not reduced. Jack's Social Security benefits are not reduced and may provide a source of cash flow even if Jack does not continue to work.

f. Married couples must also consider the benefit to a widow or widower (survivor benefit) based on the benefit of the deceased spouse. **Remember the joint life expectancies**. The greater the FRA (accrued DRCs), the greater the survivor benefit that can be paid to the lower-earning spouse if the higher-earner dies first. When one worker of a two-worker couple dies, the surviving spouse generally becomes entitled to a surviving spouse's benefit equal to 100 percent of the deceased spouse's benefit.

Planning point:

The longer joint life expectancies indicate that at least one spouse (the higher-earner) should claim and suspend and accrue DRCs to maximize not only his or her own benefits but also the survivor's.

(i) A surviving spouse age 60 or over is generally entitled to a survivor benefit if:
- The spouse is not entitled to a benefit in excess of the deceased's benefit. (In such cases where the surviving spouse has a higher benefit than the survivor benefit, the survivor will continue his or her own higher benefit.)
- The spouse **files** for the benefit.
- The spouse has not remarried.

(ii) Claiming the survivor benefit before FRA permanently reduces the amount, but may be necessary if the spouse has no other source of funds.
- The amount of the benefit is the deceased's FRA benefit (even if never claimed).
- Reduction is only if survivor claims before survivor's FRA. Maximum reduction of benefit is 28.5 percent, if survivor claims at age 60.

- Reduction is reduced pro rata over the age of claim between 60 and FRA (28.5/6 = 4.75 percent per year).

Example 1: If survivor claims benefit at age 63, one-half of the period between age 60 and FRA of 66, the reduction of the survivor benefit is 14.25 percent (3 years x .0475).

Example 2: Jack, age 66, has an FRA monthly benefit of $2,000; Jill is age 62 and has a $500 FRA monthly benefit. She elects a reduced spousal benefit ((1 - .25) x .5 x $2,000) = $750 (greater than her own claimed benefit of $375 (1 - .25) x $500). When Jack dies that month, Jill's spousal benefit is converted to a survivor benefit of $1,620 ($2,000 (Jack's FRA) x (1 - .19 [4 years before Jill's FRA] x .0475])) because she had claimed the spousal benefit.

Example 3: The facts are the same, except Jack suspends at 66, lives to age 68 (when his FRA is $2,120), and dies. Jack's FRA is increased by 16 percent in delayed retirement credits to $2,460. Jill's spousal benefit is converted into a survivor benefit of $2,226 ($2,460 x (1 - .095 [2 years before Jill's FRA])).

(iii) The mere claim of the spousal benefit exposed the couple to the risk of a reduced survivor benefit if death occurred before the spouse reached FRA.

Example: Suppose Jill made no claim at age 62. When Jack dies, she has no current claim for benefits. She may:

- Claim her own benefit (no spousal benefit tied to the claim) reduced because taken before FRA; and
- Defer a survivor claim for a reduced reduction.

Jill waits two years when her monthly benefit is $400 and claims the survivor benefit. With COLA adjustments this is $1,918 ($2,120 x (1 - .095 [2 years x .0475])) monthly benefit.

Suppose the same, except Jill waits until she reaches age 66 (when her monthly benefit is $425) to claim survivor benefits. With COLA adjustments this is $2,240 ($2,120 x 1.028 x 1.028 [assumed COLA]), and because Jill does not claim before FRA, it is unreduced.

Note:

To reiterate, when it comes to joint life expectancies of married couples (assumed both spouses are age 62 when benefits could first be claimed), there is an 80-percent probability that at least one will live to age 85, a 57-percent probability that at least one will live to age 90, and a 27-percent probability that at least one will live to age 95. Because taking early retirement means taking a permanent reduction in benefits, and because the most a non-working spouse can succeed to at the working spouse's death is that reduced benefit, it would appear obvious that the higher benefit will almost always prove successful over the (now) long(er) run. Yet, as noted above in the discussion of individual unmarried beneficiaries, Social Security has reported that some 72 percent of retirement income recipients receive the reduced benefits. Benefit timing appears to be more animated by lifestyle choices than on strict financial principles.

Planning point:

As was noted above, the chances of a spouse reaching age 90 or 95 are not insignificant. This exacerbates any permanent reduction over the extended survival period. It does not matter who dies first, as the spouse receives the higher of the spouse's worker's benefit or the spouse's widow's benefit. One consequence of this is that starting the spouse's benefits early is not a permanent problem, because the spouse will succeed to the higher widow's benefits.

Planning point:

In the event the spouse has taken early retirement on her own card, but the other spouse dies before able to accumulate additional credits for delayed retirement what can be done to make the decision to take early retirement viable? The spouse may be able to reassess the situation, determine that she would be better off repaying her early benefits, and defer to FRA or beyond to a deferred enhanced benefit on her own card.

g. Each working spouse has a choice between his or her own benefit and the spousal benefit based on the other spouse's record.

(i) At FRA a worker may **claim or suspend** the worker's own benefit but remain entitled to the spousal benefit if the other spouse has claimed retirement benefits.

Planning point:

A worker can, by claiming and suspending at FRA:

- Remain eligible for delayed retirement credits for purposes of claiming the worker's own benefits.

Example: Jack, age 66, and Jill, age 63, each have a 95 percent of maximum FRA monthly benefit (currently ~ $3,822). Both intend to work to age 70 and will continue to have taxable wages of at least the taxable wage base in later years. Jack can file and/or suspend. Jill can choose to take a spousal benefit (reduced by 20 percent by reason of claiming three years early) but only if Jack claimed. Because this claim takes place before her FRA, she has also made a claim for her own benefit. Her own benefit is permanently reduced by 20 percent.

(ii) It is not possible for **both spouses to elect a spousal benefit**.

B. Social Security solvency

Currently, Social Security benefits are provided to over 68 million beneficiaries. Social Security is comprised of two main components: Old-Age and Survivors Insurance (OASI) and Disability Insurance (DI). Together, these components are referred to as "OASDI," and both programs utilize a trust fund financing mechanism.

A Board of Trustees manages the OASDI trust funds and provides an annual report to Congress regarding the funding status and overall solvency projections. Solvency is defined as the fund's ability to pay full benefits scheduled under current law on a timely basis.

Until 2009, the OASDI program collected more in tax revenues (via Social Security payroll taxes) than what was required to pay benefits. In such years, the excess revenues were held in interest-bearing U.S. Treasury securities. However, since then, the OASDI trust funds have been facing solvency. One of the main factors causing the solvency issue is the demographic shift known as the "baby boomer" generation. A large number of individuals born between 1946 and 1964 are reaching retirement age and becoming eligible for Social Security benefits. This demographic trend has led to a strain on the trust funds as the number of beneficiaries increases while the number of workers paying into the system decreases.

Since 2021, the OASI Trust Fund has been drawing down asset reserves to finance benefits and will require increasing amounts of asset redemptions during the next decade. In the latest 2024 OASDI Trustees Report, the trust fund reserves are expected to be depleted by 2035 (one year later than the prior year report). The projected long-term finances of the combined OASDI fund improved this year

primarily due to an upward adjustment in labor productivity levels throughout the projection period and a reduced assumption regarding long-term disability incidence rates. However, these advancements were somewhat mitigated by a decline in the assumed long-term total fertility rate.

The number of beneficiaries (baby boomer generation) is increasing faster than the number of covered workers. This does not mean that Social Security benefits will disappear entirely once the trust funds are exhausted, but it would result in a shortfall in funding. The report projects that tax revenues will be able to pay approximately 83 percent of scheduled benefits in 2035, decreasing to 73 percent by 2098.

The report states that in order for the OASDI trust funds to remain solvent through 2098:

1. Revenue would have to increase by an amount equivalent to an immediate and permanent payroll tax rate increase of 3.33 percentage points to 15.73 percent beginning in January 2024;
2. Scheduled benefits would have to be reduced by an amount equivalent to an immediate and permanent reduction of 20.8 percent applied to all current and future beneficiaries effective in January 2024, or 24.8 percent if the reductions were applied only to those who become initially eligible for benefits in 2024 or later; or
3. Some combination of the above two approaches would have to be adopted.

Further, the report states that "significantly larger changes would be necessary if action is deferred until the combined trust fund reserves become depleted in 2035." [125]

Legislation has been introduced to address the OASDI trust fund solvency issues, but to date, no legislation has been passed by Congress. Finding a solution to the Social Security solvency issues is a complex task that requires balancing the need for financial sustainability with the goal of ensuring an adequate retirement income for future generations. Any changes to the program must be carefully considered to protect the interests of both current and future beneficiaries.

Taxpayers should consider the increased potential of reduced benefits when planning for retirement. A reduction in benefits would be a significant concern for future retirees who depend on Social Security as a major source of income.

VIII. Estate-planning

A. Exemption equivalent amounts and applicable tax rates

1. Overview

Changes to the federal gift, estate, and generation-skipping transfer taxes that will be effective in 2024 (because of indexing) may create significant new estate planning opportunities, and largely free many taxpayers from the federal transfer taxes that have dominated this area for over five decades. Greater emphasis will be placed on **nontax** considerations. These changes have resulted in a more legally stable environment that permits estates to plan with greater assurance there will be no change in significant areas of tax law. (But remember that the old number regime is back in 2026.)

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[125] The 2024 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Federal Disability Insurance Trust Funds.

2. The legislation – Rates and exclusions

The Tax Cuts and Jobs Act of 2017 (the Act) significantly changed the exclusion for years 2018-2025.

a. The gift tax applicable exclusion amount for gifts made in 2024, estate tax applicable exclusion amount for decedents dying in 2024, and generation-skipping transfers made in 2024 is indexed to $13,610,000.

Planning point:

Because of the high-indexed estate-tax exemption, many estates will have no federal estate tax concerns, but there may be much more of a concern about assuring that the assets will receive a step up in basis at the owner's death. And this favors inclusion of assets.

Planning point:

The most important advantage of the increased gift exemption for many individuals may prove to be the "cushion" effect – the ability to make gifts in excess of $1,000,000, but considerably less than $13,610,000, with a high degree of comfort that a gift-tax audit will not cause gift tax to be imposed (perhaps even if "aggressive" valuations are used).

Note:

The TCJA doubled the Basic Exclusion Amount (BEA) from $5 million to $10 million (adjusted annually for inflation) for decedents dying and gifts made after December 31, 2017, and before January 1, 2026. In 2024, the BEA is $13,610,000 ($27,220,000 for married taxpayers). On January 1, 2026, absent any legislation, the BEA will revert to $5 million.

On November 19, 2019, the IRS issued final regulations (IR 2019-189) that implemented a special rule applicable in cases where the credit against the estate tax that is attributable to the BEA is less at the date of death than the sum of the credits attributable to the BEA allowable in computing gift tax payable with regard to the decedent's lifetime gifts.

Under this special rule, the portion of the credit taken against the net tentative estate tax attributable to the BEA is based on the sum of credits attributable to the BEA allowable in computing gift tax payable regarding the decedent's lifetime gifts. In other words, this special rule ensures that donors are not taxed on completed gifts that were free of tax when made due to the increased BEA.

The special rule outlined in the 2019 final regulations was often referred to as the "anti-clawback" rule, as taxpayers would not have to worry about the IRS clawing back into the estate any gifts that were made when the higher BEA was in effect if the BEA later decreased. The final regulations also allowed taxpayers to claim the increased BEA without making a true gift by still having sufficient interest or income from the "gifted" property. Although the IRC distinguishes between taxable gifts not included in the donor's gross estate and includible gifts treated as testamentary transfers, the special rule in the final regulations did not distinguish between:

- Completed gifts that are treated as adjusted taxable gifts for estate tax purposes and that, by definition, are not included in the donor's gross estate; and
- Completed gifts that are treated as testamentary transfers for estate tax purposes and are included in the donor's gross estate (includible gift).

On April 26, 2022, the IRS issued proposed regulations regarding the increased estate and gift tax exclusion amount provided by the TCJA. The proposed regulations provide an exception to the special rule for includible transfers, or transfers treated as includible, in a grantor's gross estate. This exception would apply to transfers that allow a donor to retain sufficient interest or income from the gifted property. The proposed regulations state that "*the purpose of the special rule is to ensure that bona fide inter vivos transfers of property are consistently treated as a transfer of property by gift for both gift and estate tax purposes.*"

Without the proposed regulations, the application of the special rule to includible gifts results in securing the benefit of the increased BEA even when the donor continues to have title, possession, use, benefit, control, or enjoyment of the transferred property during life. In such circumstances, the proposed regulations provide an exception to the special rule that the amount includible or treated as includible as part of the gross estate is subject to estate tax with the benefit of only the BEA available at the date of death. The proposed regulations would also apply the exception to the transfer, elimination, or relinquishment within 18 months of the donor's date of death of the interest or power that would have caused inclusion in the gross estate, effectively allowing the donor to retain the enjoyment of the property for life. In other words, even if the donor gives up all rights or powers, if it is within 18 months of his or her death, the property is still subject to the exception to the special rule.

The proposed regulations outline the exception to the special rule in the following example: *"Assume that when the BEA was $11.4 million, a donor gratuitously transferred the donor's enforceable $9 million promissory note to the donor's child. The transfer constituted a completed gift of $9 million. On the donor's death, the assets that are to be used to satisfy the note are part of the donor's gross estate, with the result that the note is treated as includible in the gross estate for purposes of section 2001(b). Thus, the $9 million gift is excluded from adjusted taxable gifts in computing the tentative estate tax under section 2001(b)(1). Nonetheless, if the donor dies after a statutory reduction in the BEA to $6.8 million, the credit to be applied in computing the estate tax is the credit based upon the $6.8 million of the BEA allowable as of the date of death."*

The proposed regulations specify that the special rule will continue to apply to transfers includible in the gross estate when the taxable amount of the gift is not material. The taxable amount of the gift is not considered material when it is 5% or less of the total amount of the transfer, valued as of the date of the transfer. The proposed regulations are applicable to the estates of decedents dying on or after April 27, 2022. It is important to note that the special rule will not be needed until the BEA has been decreased by statute (currently January 1, 2026, but could potentially be sooner if legislation is enacted prior to this date).

b. The top rate has increased to 40 percent beginning at transfer levels in excess of $1,000,000 as noted earlier in these materials.
c. For 2011 and all later years, with respect to gifts made by and estates of decedents dying in those years, the spouses' unified credits may be shared through a portability structure that can enable a surviving spouse to use the unused portion of the deceased spouse's exclusion amount.

Note:

The Congressional strategy presents its own problems to an area that long had its emphasis on PLANNING, which requires certain assumptions and prognostication even in a stable tax environment but is debased when its longevity is only 2018-2025. Creation of trusts and other arrangements have historically been made to serve not just the immediate need but those lasting several generations. All this has been done with the understanding of legislative risk of occasional tax law changes, but the uncertain environment, coupled with seemingly large levels of exemptions are likely to cause many clients or potential clients to believe that planning is no longer required. Portability itself could be viewed as no longer requiring an analysis and action plan for redeployment of assets between a married couple, but this is in many cases misguided.

3. Why now?

While estate planners would love to have a crystal ball predicting the future, the reality is that nobody knows what the future holds. Although the increased estate tax exemption is set to sunset on December 31, 2025, tax law changes could accelerate a reduction in the estate tax exemption. President Biden has floated the idea of returning the estate tax to 2009 levels, meaning a base estate tax exemption amount of $3,500,000 per person (not indexed for inflation), and a top tax rate of 45%, with some predicting the

top rate could even exceed 55%. He also proposed eliminating step-up basis for inherited assets with capital gains, and instead heirs would take carryover basis in the decedent's asset.

Additionally, depressed asset values and historically low interest rates create an opportunity for estate tax planning. Certain assets have experienced a substantial decline in value due to the recent economic downturn. If such assets are expected to rebound in value, they are great candidates for gift and estate tax purposes, as gifts are valued on the date the gift is made. Any appreciation in value that the asset experiences after the date of the gift will not be subject to gift and estate tax. Additionally, interest rates continue to plummet. AFRs are used for a variety of estate planning purposes, such as establishing an IDGT or GRAT.

- **Intentionally Defective Grantor Trusts ("IDGTs"):** When interest rates are low and assets have declined in value, IDGTs present an opportunistic planning strategy. IDGTs are unique in that any income from the trust flows to the grantor for tax purposes, but any assets within the IDGT are excluded from the grantor's estate for estate tax purposes. Property is sold to an IDGT in exchange for an installment note calculated using the historically low AFR. In the long run, the grantor can recognize substantial estate tax savings, as any appreciation in the underlying asset above the installment note's interest rate is excluded from the grantor's estate. Depressed asset values coupled with low interest rates make IDGTs an attractive estate planning option in the current economic environment.
- **Grantor Retained Annuity Trusts ("GRATs"):** GRATs are irrevocable trusts that are usually funded with assets that are anticipated to appreciate over time. In return for contributing assets, the grantor receives an annuity payment from the trust each year. The annuity is computed by applying the historically low AFR to the value of the assets transferred to the GRAT. Any appreciation in the value of the assets over the AFR at the end of the trust term passes to the beneficiary free of estate tax. Assets that are expected to appreciate provide the greatest benefit. If the grantor survives the trust term, the assets remaining in the trust are not included in the grantor's gross estate for estate tax purposes.

Changes to the estate tax exemption will occur by 2026, or possibly even sooner depending on future legislative changes. Now is the time to be proactive and meet with clients as soon as possible to review their options and create an efficient estate planning strategy. Your clients will thank you later!

B. Planning with the applicable credit amount

1. No applicable credit amount planning

In the long term, the indexing feature of the exemption may have the most dramatic financial impact of the transfer tax provisions. Some clients are seemingly not candidates for applicable-credit-amount planning because their estates are less than $13,610,000, they are unmarried, or they are just not prepared to plan for the applicable credit amount. Estate planners must recognize that these clients still need estate planning. These clients should still have a will, a durable power of attorney, a health-care power of attorney, and a living will. One way to provide for future tax planning is to plan for the use of disclaimers, which is discussed in detail later in this material.

2. Applicable credit amount planning

a. In general – Planning for the use of the applicable credit amount has been at the heart of testamentary estate planning. If a married couple does not take steps to utilize the first spouse's applicable credit amount, it will be wasted. As a result, estate planners would tend to advise all of their clients with estates in excess of $13,610,000 to plan to use the applicable credit amount. However, this has become more complicated due to the permanence of portability election, which can double this basic exclusion amount.

b. Structure of the plan – At the first spouse's death, the first spouse's estate will be split into two shares: (i) the marital share; and (ii) the nonmarital share.

(i) The marital share will contain the amount qualifying for the marital deduction under §2056.

- The marital share can be determined by a specific number (e.g., $400,000), a specific portion of the estate (e.g., 50 percent), or a complex formula used to calculate the exact amount of the marital deduction to result in no tax (often referred to as a "formula marital clause"). This point is discussed further below.
- The marital share will either pass outright to the surviving spouse or in a qualified marital trust.
- The marital share is often referred to as the Marital Deduction Trust, QTIP Trust, or "A" Trust.

(ii) The nonmarital share is the amount of the first spouse's gross estate less the marital share.

Planning point:

The flexibility of the QTIP can be utilized by establishing a single trust as to which the QTIP election can be made. Because the QTIP election may be made with respect to less than the entire trust, the executor can determine what amount if any should be qualified by the election. The trustee must have the authority to delete from the non-QTIP portion of the trust those provisions required to qualify the trust as a QTIP. Such provisions include the provision that requires mandatory distribution of income to the spouse and the provision that prohibits the distribution of principal to the surviving spouse. Additionally, the trustee should also have the authority to add to the trust the surviving spouse's ability to have a lifetime power of appointment to persons other than to the surviving spouse. It could also provide that with respect to the non-QTIP portion, the surviving spouse would cease to be a beneficiary if he or she remarries. This, however, must be balanced against the loss of eligibility for basis step-up under the spousal provision.

- The nonmarital share does not qualify for the marital deduction under §2056.
- The nonmarital share will either pass: (i) outright or in trust to persons other than the surviving spouse; or (ii) in trust for the benefit of the surviving spouse (and maybe others). A U.S. citizen surviving spouse can never receive the nonmarital share as an outright transfer.
- The nonmarital share is often referred to as Family Trust, Credit Shelter Trust, nonmarital trust, or "B" Trust.

3. Type of funding mechanism

As discussed previously, the marital share can be determined through a variety of mechanisms.

a. Specific dollar amount – Many marital deduction gifts are expressed as a specific dollar amount or a bequest of specific property.
   (i) Specific dollar amount – I give to X, my wife, the sum of $250,000.
   (ii) Bequest of specific property – I give to Y, my husband, my 5,000 shares of IBM stock.

b. Specific percentage of estate – The first spouse may want to divide the estate between his surviving spouse and children.
   (i) Example: I give my wife, X, 40 percent of my entire estate and the remaining 60 percent shall pass in trust for the benefit of my children from a prior marriage.

c. Marital formula clause – There are two basic forms of marital formula clauses. Although both clauses arrive at the same marital share, they do so in a different manner.
   (i) Pecuniary marital clause – In a pecuniary marital clause, the surviving spouse receives a specific dollar amount of the estate determined by reference to a formula.
   (ii) Formula fractional share clause -- A fractional share of the decedent's residuary estate is bequeathed to the surviving spouse. The numerator of the fraction is the maximum allowable marital deduction (reduced by other qualifying nonprobate or probate transfers) and the denominator is the residuary estate. Thus, the surviving spouse receives a fraction of every asset in the residuary estate.

C. General approaches to estate planning

1. In general

Estate planning must be rethought in light of the: (i) transfer tax certainty; (ii) large indexed transfer tax exemptions; and (iii) portability provided by the 2012 tax law. Already, the number of estate tax returns filed is on a sharp downward slope: In 2001, 120,000 estate tax returns were filed, of which 60,000 were for taxable estates. In 2012, fewer than 4,000 taxable estate tax returns were filed. According to the Tax Policy Center, approximately 4,100 estate tax returns were filed for people who died in 2020, of which only 1,900 were taxable. This represents less than 0.1% of individuals who died during the year.

Number of Estate Tax Returns and Tax Liability
2001, 2007–2020

Calendar year	Number of Returns[a]	Number of Taxable Returns[a]	Estate tax liability ($ billions)[b]
2001	109,600	50,500	$23.7
2007	36,700	16,600	$24.6
2008	29,000	15,100	$18.9
2009	12,900	5,700	$13.6
2010	*	*	*
2011	9,400	4,400	$10.9
2012	9,600	4,100	$12.0
2013	11,300	4,700	$16.6
2014	11,000	5,400	$18.3
2015	11,000	5,300	$18.6
2016	11,200	5,300	$19.3
2017	11,300	5,500	$20.0
2018	4,000	1,900	$14.9
2019	4,100	1,900	$15.6
2020	4,100	1,900	$16.0

Sources: For 2001, 2007, 2009, 2011, and 2013: Internal Revenue Service. Statistics of Income. "Estate Tax Year of Death Tables." For 2008, 2012, and 2014–2020, Urban-Brookings Tax Policy Center Microsimulation Model (versions 0217-1 and 0718-1).
Note: Figures are for estate tax returns filed for decedents dying in each calendar year.
* The estate tax was repealed for 2010 decedents by the *Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA)*, but reinstated by the *Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010* with an option for executors to elect the EGTRRA rules; IRS SOI did not publish statistics for 2010 decedents.
(a) Number of returns is rounded to nearest multiple of one hundred.
(b) Estate tax paid is rounded to nearest multiple of $10 million.

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2. *Classifying estates for married couples*

a. Spouses having combined estates not in excess of the applicable basic exclusion amount ($13,610,000 for 2024) have little concern for the federal transfer tax system. Except for unusual cases (e.g., where a winning lottery ticket is purchased), there is no worry that a tax liability will be incurred. These couples will typically focus first on essential disposition planning without regard to "sophisticated" techniques. There is generally no federal estate-tax reason to maximize a marital bequest to the derogation of children or other beneficiaries. Nevertheless, decisions must be made concerning whether to use the marital deduction to assure a basis step-up in both estates, rather than use a credit shelter trust that will not afford the trust assets a further basis adjustment at the death of the surviving spouse. If a marital gift is contemplated, clients must still determine whether

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a trust can better provide asset protection, preservation, and investment return through a level of management expertise the spouse could not provide. Clients that have previously entered into estate planning transactions, such as creating entities or making gifts to trusts, may want to reverse the effects of some of those transactions. For example, dissolving the entity may avoid valuation discounts that would otherwise limit basis adjustments at the owner's death. A settlor may want to take steps to attempt to cause trust assets to be included in the settlor's gross estate for estate tax purposes so that a basis adjustment would apply at the settlor's death.

Example: J created a family limited partnership that contains $4,000,000 of assets. J owns a 25-percent general partnership interest that covers $1,000,000 of underlying assets, but J, as a limited partner, believes the interest will be valued at a 35-percent discount to $650,000. This has an income tax impact. If J dies, the basis of the interest will be adjusted to $650,000. If the partnership has a §754 election in place, it could adjust the basis of its assets but only up to the $650,000 level. A sale of the partnership assets would result in a gain because the fair market value of the assets would exceed the adjusted basis of the partnership assets. J would receive a distributive share of such gain (G) increasing its basis in the partnership. J's estate receives $1,000,000, resulting in a gain on distribution of $350,000 reduced by G. The net effect is that J's estate has taxable gain of $350,000 and a tax of approximately $70,000.

However, if J were instead distributed $1,000,000 of those assets, they would be included in J's estate and stepped up to a $1,000,000 basis. An immediate sale would result in no taxable gain.

b. Income tax issues will dominate the planning, and most critical is the step up in basis at the death of each spouse. The simplest way to obtain this is through a simple will or revocable trust leaving all of the assets outright to the surviving spouse, which will achieve a basis adjustment at the deaths of both spouses. If a trust is indicated for preservation, management, or asset-protection purposes, giving the surviving spouse a testamentary general power of appointment may be helpful to allow a basis adjustment at the surviving spouse's death.

Planning point:

Trusts have a built-in tax disadvantage: highest tax rates, significant capital gains taxed at the 20-percent level, and subject to the 3.8-percent tax on net investment income at very low levels of taxable income.

Note:

Reasons for selecting a trust over an outright disposition to a spouse include:

- The surviving spouse is not capable of managing assets;
- There is a second-marriage blended family, and each spouse wants to control where his or her assets will pass;
- The parties have a fear of the spouse's remarriage or a concern of undue influence; or
- There is a need for asset protection or divorce protection.

However, there will be additional administrative costs for trusts (filing trust income tax returns, additional income taxes, and similar items).

Planning point:

Additional expenses, such as making sure that an insurance trust has *Crummey* powers and that notices are mailed, may be reduced since the cost of noncompliance may not be felt at all or in any significant way; including the trust or picking up annual premiums in taxable gifts may not trigger any tax liability.

c. Considerably more attention will be directed to withdrawal strategies from qualified plans and IRAs.

d. Another area acquiring more of the estate planning market will be creditor "asset protection," which can be achieved in whole or in part through:
   (i) Titling property as tenancy by the Entireties;
   (ii) Homestead;
   (iii) Qualified retirement plans (but not IRAs);
   (iv) An inter vivos QTIP trust for spouse with spendthrift provisions (if the donee-spouse predeceases, and the assets pass back into a trust for the original donor-spouse [either directly or by the exercise of a power of appointment by the donee-spouse], then the assets may still be protected from the original donor-spouse's creditors, at least in some states); or
   (v) A lifetime credit shelter trust created by one spouse for the other spouse. If one spouse creates a lifetime credit shelter trust for the other spouse, neither spouse's creditors should be able to reach the assets in the trust. If both spouses create trusts that are not reciprocal of each other (different time, different amounts, different trustees, different beneficiaries, different powers of appointment, etc.), both trusts *may* be protected from claims of the spouses' creditors under state law. If a spouse dies and exercises a power of appointment to appoint the assets in the credit shelter trust back into a trust for the original donor-spouse, those assets *may* still be protected from creditors of the donor spouse.

e. For clients in the combined estate range of the exclusion to twice the exclusion, a primary estate-planning decision is whether to use a credit shelter trust or to rely on portability at the first spouse's death.

Note:

If a credit shelter trust is used, there is no potential inclusion in the estate of the surviving spouse, but the amount of the DSUEA is reduced by the extent that it is used in the deceased spouse's estate; however, there is no basis adjustment on the assets at the death of the surviving spouse. By contrast, a marital gift (including those in trust) will be included in the estate of the surviving spouse, whose estate will benefit by the higher DSUEA and will likewise enjoy a basis increase on the death of the surviving spouse.

Planning point:

Certain situations favor an approach of leaving all assets outright to the surviving spouse and relying on portability. These circumstances include:

- A competent spouse who can manage assets;
- A desire on the clients' part to avoid using trusts (taking into consideration the possible increased income tax and costs for administering trusts, as well as the general fact that many clients are unfamiliar and uncomfortable with trusts);
- A first marriage or no children existing by prior marriage of either spouse;
- Clients who are more interested in basis step up than getting future appreciation out of their estate;
- A situation in which it is undesirable to retitle assets (for example, in order to be able to utilize each spouse's exemption amount);
- The desirability of enabling the surviving spouse to create a trust following the first spouse's death that would be a grantor trust as to the surviving spouse;
- A residence or other assets that would be difficult to administer in a trust; or
- Qualified retirement plan assets that are the predominant assets in the estate.

Note:

For state estate tax planning purposes, creating a credit shelter trust to hold the state exemption amount will generally be indicated to avoid or mitigate the tax in the second estate.

f. Planning for couples with estates in excess of twice the basic exclusion follows familiar lines:

(i) Large gifts combined with sales or other leveraged transactions enable bringing the aggregate transfer tax values closer to twice the exclusion level;

(ii) One issue is whether gifts should be made in trust (asset protection, divorce protection, and management protection);

(iii) The question arises as to what assets should be transferred – for reasons of valuation discounting and leverage, entities will often be used;

(iv) Sales can leverage transfers to increase significantly the transfer of future appreciation;

(v) Grantor trusts can dramatically increase the amount transferred over time by permitting tax-free compounding for the trust; if a grantor is reluctant to utilize a grantor trust because of the ongoing income tax liability, consider reducing the amount being transferred to the trust but still leaving it as a grantor trust (with someone having the flexibility to cause the trust to lose its status as a grantor trust at some future point);

(vi) The gift exemption amount will increase each year with indexing, and it must be decided how to best use that increased gift exemption amount year by year; and

(vii) Gifts may be made requiring the payment of gift tax to take advantage of the tax-exclusive nature of the gift tax (assuming the donor lives at least three years after the gift).

Note:

ACTEC (American College of Trust and Estate Counsel) has already noted that there are many services that tax professionals provide to clients other than federal transfer tax planning. The following list, not meant to be exhaustive, identifies some of those items.[127]

- Planning for the disposition of the client's assets at his or her death;
- Asset protection planning;
- Planning for disability and incompetency;
- Business succession planning (without the estate tax to blame for failure of a business);
- Planning for marital and other dissolutions;
- Charitable giving (for its own sake, and because income tax considerations will still be relevant and techniques, such as lifetime charitable remainder trusts to facilitate diversification, will not be affected at all);
- Life insurance planning (other than to provide funds to pay taxes);
- Fiduciary litigation (enhanced because there is more to fight over);
- Retirement planning;
- Planning to pay state death taxes (in many states);
- Planning to avoid or minimize gift taxes (particularly if a client desires to gift more than the $13,610,000 (2024) indexed applicable exclusion amount for gift-tax purposes);
- Using business entities to accomplish nontax objectives;
- Planning for children with disabilities;
- Planning for spendthrift children;
- Planning for clients with real estate in more than one state, including ownership, asset protection, state income taxation, spousal rights, and probate issues (in addition to state estate tax);
- Planning for clients who are U.S. citizens or resident aliens who own property in other countries;
- Planning for nonresident aliens with assets in the U.S. or who plan to move to the U.S.;
- Planning for citizens who intend to change their citizenship;
- Planning for possible decrease in the estate, gift, and GST tax exemptions and/or increase in the transfer tax rates;
- Planning to pay education expenses, including contributing to I.R.C. §529 plans;
- Planning to deal with non-tax regulatory issues, such as the Patriot Act, HIPPA, and charitable governance reform; and
- Identifying guardians for minor children, if and when needed. This item is very important. A court does not have to agree that the identified guardians will raise the decedent's children, but it will give great weight to those identified.

3. Portability

Because the portability provisions, discussed below, have now been made permanent, married clients may be more inclined to proceed with fairly simple "all to spouse" will planning. That is, they may opt to rely on portability to take advantage of both spouses' estate exemptions, rather than use more complicated bypass trust planning.

a. The following are among the various reasons for using bypass (the surviving spouse's estate) trusts at the first spouse's death and not relying on the portability provision:

(i) The deceased spousal unused exclusion amount is not indexed;

(ii) The unused exclusion from a particular predeceased spouse will be lost if the surviving spouse remarries and survives his or her next spouse;

(iii) Growth in the assets is not excluded from the gross estate of the surviving spouse – unlike the growth in a bypass trust, which is excluded;

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127 Akers, citing Mezzullo (President of ACTEC); letter to ACTEC Fellows (January 2013).

(iv) There is no portability of the GST exemption;

(v) There is no statute of limitations on values for purposes of determining the unused exclusion amount that begins to run from the time the first deceased spouse's estate tax return is filed (whereas the statute of limitations does run on values if a bypass trust is funded at the first spouse's death);

(vi) On a closely related note, the bypass could be funded with discounted hard-to-value assets when there may be a low audit risk at the first spouse's death; and

(vii) There are other standard benefits of trusts, including asset protection, providing management, and restricting transfers of assets by the surviving spouse.

b. Leaving everything to the surviving spouse and relying on portability offers the advantages of simplicity and a stepped-up basis at the surviving spouse's death. However, the basis step up at the second death of a credit shelter trust may be achieved by the "Delaware tax trap," by which the surviving spouse has the ability to cause the trust assets to be includable in the spouse's gross estate. The decision of whether to trigger estate inclusion in the beneficiary's gross estate is then totally up to the spouse. If the surviving spouse wants to trigger estate inclusion, the spouse would exercise the original limited power to create a presently exercisable general power of appointment in someone else. That would cause estate inclusion in the surviving spouse's gross estate under §2041(a)(3). Thus, the assets would receive a step up in basis, and the first deceased spouse's estate would make the portability election.

Planning point:

For a couple with a blended family (i.e., one or both spouses has children who are not related to the other spouse), there are dangers if credit shelter trusts are not considered.

If the assets are left outright to the surviving spouse, the spouse may give or bequeath the assets to persons other than the first decedent-spouse's descendants (or may favor some of those descendants over others in ways that the decedent-spouse would not have wanted). While this could be eliminated by establishing a QTIP trust, the surviving spouse may nonetheless still take steps that would significantly disadvantage the decedent-spouse's descendants. For example, if the executor makes a QTIP election and elects portability, the surviving spouse will have the DSUEA from the decedent-spouse and could make gifts of the surviving spouse's assets to his or her own descendants utilizing all of the DSUEA and his or her gift exemption amount. The QTIP trust is required at the death of the surviving spouse to reimburse the surviving spouse's estate for taxes attributable to the QTIP trust assets.[128] In effect, the first decedent-spouse's descendants would not benefit at all from the first decedent-spouse's exemption amount. That could be addressed in a prenuptial (or other marital) agreement dictating that the portability election would be made in the decedent-spouse's estate only if the surviving spouse agreed to waive reimbursement rights from the QTIP trust. The decedent's will could direct the executor not to make the portability election unless the surviving spouse agrees to waive the right to be reimbursed for estate taxes from the QTIP trust at the surviving spouse's subsequent death.

Having the assets pass to a credit shelter trust to assure that the first decedent-spouse's descendants are treated fairly avoids those complexities.

[128] I.R.C. §2207A.

Note:

As stated previously, relying on portability may be better than creating credit shelter trusts in the first decedent-spouse's estate in certain circumstances, such as:

- A competent spouse who can manage assets;
- A first marriage or no children existing by prior marriage of either spouse,
- Clients who are more interested in basis step up than in getting future appreciation out of their estates; and
- A residence or other assets that would be difficult to administer in a trust.

c. For a client whose major assets are a residence and retirement or IRA benefits, full funding of a bypass trust without the use of the retirement or IRA benefits is problematic at best. In any event, however, the optimal income-tax deferral typically is achieved when the surviving spouse is the designated beneficiary. If the retirement and IRA benefits are left directly to the surviving spouse, portability could be elected to utilize the deceased spouse's unused estate tax exclusion amount at the surviving spouse's subsequent death.

Note:

Prior to the enactment of portability, if one spouse owned most of the marital assets, in order to utilize the estate exemption amount of the less-propertied spouse if he or she died first, the wealthier spouse would have to retitle assets into the name of the less wealthy spouse or fund a QTIP trust for that spouse, often unpopular with the moneyed spouse. The reluctance will be even larger with a $13,610,000 (2024) exemption – a very large amount might need to be transferred to the poorer spouse. That can be avoided if the spouses are willing to rely on portability to take advantage of the less wealthy spouse's exclusion amount if he or she should die first.

d. Leaving assets to the surviving spouse or QTIP and using portability allows the surviving spouse to make gifts using both spouses' exemption amounts; that full amount can pass to a trust that is a grantor trust as to the surviving spouse. For this purpose, portability may be desirable even for very large estates. If the QTIP approach is used to leave the surviving spouse the flexibility of making the portability decision, the QTIP trust should give some third party (trustee) wide discretion in making principal distributions to the surviving spouse (which the spouse could then use to make the gifts). (An obvious disadvantage of this strategy is that the spouse would not be able to be a discretionary beneficiary of the gifted assets.)

e. Making the decision depends on, among other factors, the following:

Factor	**Credit shelter**	**Portability**
Control by spouse	Little	Considerable
Administrative simplicity	Trust management	Individual or trust control
Basis step up at both deaths	No	Yes
Creditor protection	Significant	Little unless in QTIP
Sheltering appreciation between the two deaths	Yes	No

f. The surviving spouse could have some flexibility in deciding whether or not to rely on portability:

(i) To provide a drop-down credit shelter trust to which disclaimed interests pass; or

(ii) To leave assets to a QTIPable trust; so that the extent of portability that would be used would depend on the extent to which the election was made.

g. The portability election does not come without a price: It requires the filing of at least a pro forma Form 706, entailing costs that might otherwise not be incurred because the filing requirement now is only for estates with a combined gross estate/adjusted taxable gifts in excess of the basic exclusion ($13,610,000 for 2024). The will could designate whether the executor would be required -- or have the discretion -- to make or not make the portability election, or make the election only if the spouse agrees, or make the election unless the spouse directs the executor not to do so.

(i) Someone must bear the expense of preparing an estate tax return to make the portability election. Even with the simplifications allowed by the temporary and proposed regulations of not having to list the values of each asset passing to the surviving spouse or charity, that expense could still be not insignificant.

(ii) The will can address whether the estate or surviving spouse would pay the expenses of making the election. If the spouse is required to pay the preparation expense, this will likely reduce the marital deduction for assets passing to the spouse, which would reduce the DSUEA. (However, the spouse's estate would be reduced by a like amount, so that should not increase the aggregate estate tax payable at the surviving spouse's subsequent death.)

(iii) If the estate pays the preparation expense, the expense will be an estate transmission expense. So, if the expenses are claimed for purposes of income tax, the marital deduction would be reduced and there would be a concomitant reduction of the DSUEA.[129]

Planning points:

- The portability election is made by the executor's filing a timely and complete Form 706; however, in most cases there will be no need to list values of assets passing to a surviving spouse or charity if the estate was not otherwise required to file an estate tax return (but the return must contain an estimate of the total value of the gross estate within specified ranges, including assets passing to a spouse or charity).
- The surviving spouse's deceased spousal unused exclusion amount will not be reduced if Congress later reduces the basic exclusion amount.
- If the decedent made gifts requiring the payment of gift tax, the excess taxable gift over the gift exemption amount (on which gift tax was paid) is not considered in calculating the DSUEA.
- The surviving spouse can use the DSUEA any time after the decedent's death, assuming the portability election is eventually made by the executor.
- Any gifts made by the surviving spouse are first covered by the DSUEA, leaving the spouse's own exclusion amount to cover later transfers.
- DSUEAs from multiple spouses may be used to the extent that gifts are made to utilize the DSUEA from a particular spouse before the next spouse dies.
- If the estate leaves assets to a QDOT, the surviving spouse cannot use the DSUEA until the QDOT is fully distributed (or terminates at the surviving spouse's death).

4. More on making gifts

In addition to facilitating income shifting (particularly of unearned income), the $13,610,000 gift tax exclusion makes 2024 the time when certain estate planning transactions should be given considerable discussion.

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[129] Treas. Regs. §20.2056(b)-4(d)(1)(iii)(2).

a. One can help a child (or several children) obtain a home without significantly changing the taxpayer's transfer tax profile (or triggering immediate gift tax), as noted elsewhere.

b. Business owners should take the opportunity to facilitate succession planning. In doing so, the use of classic discounting techniques may enable the transfers of substantial value with little or no immediate tax liability. Typically, the business interest is the most difficult and most valuable asset in the estate, and one that is often the fastest appreciating (notwithstanding the economy of the past several years), so taxpayers interested in reducing exposure to estate taxes should consider making gifts of the business to the successor or other family members during life. These gifts can take many forms from outright transfers to transfers in trust, such as GRATs, GRUTs, CRUTs, CRATs, and CLATs. All of these techniques are explored further in *The Complete Trust Workshop* (TCTW); this book is published by Surgent McCoy CPE, LLC (website: www.surgentcpe.com).

Note:

Just because the exclusion amount has significantly increased does not mean that the taxpayer can drop his guard and not use it in combination with other longstanding techniques that can further reduce valuation.

(i) In general, when transferring a business in trust, control may be kept by the trustee, possibly the grantor or a family associate, for a period of years until the remainder interest vests in the younger-generation family member, but as an immediate transfer it establishes the valuation date for transfer tax purposes. Under ordinary principles the value of the remainder interest is a fraction of the entire amount transferred, and because one cannot make a gift to oneself, such a transfer can establish a **discount for the gift** by reason of its deferral. The Code, however, provides that for the purpose of determining: (i) whether a transfer in trust to or for the benefit of a **member of the family** of the transferor is a gift; and (ii) the value of such gift, the value of any interest in the trust retained by the transferor or any **applicable family member** is generally treated as zero. Thus, if a transfer is made to a trust benefiting a member of the transferor's family, the transferor is generally treated as making a gift of the entire amount transferred to the trust. The definition of a member of the transferor's family is the member's spouse, ancestors, or lineal descendants (including those of the spouse), siblings, and the spouses of ancestors, lineal descendants, and siblings. An applicable family member is the transferor's spouse, ancestor of either, or the spouse of any such ancestor.

(ii) Fortunately, the Code also provides that for some retained interests in trust, the subtraction method of valuation will be used to determine the gift-tax value of transfers in trust. This exception will apply to the valuation of retained interests that provide "qualified" payments to the holder of the retained interest. Retained interests that qualify are annuity or unitrust interests. This exception might be helpful for transferring closely held business interests, particularly S corporations, to the next generation. When the retained interest is the right to receive **fixed amounts** payable at least annually (a GRAT -- grantor-retained annuity trust interest), these amounts can either be stated as a fixed annual dollar amount or a fixed percentage of the amount initially contributed to the trust.

(iii) The irrevocable transfer of the remainder interest in the GRAT or GRUT is an immediate gift for gift-tax purposes. However, since the subtraction method of valuation is available, the gift is discounted from the full fair market value of the property transferred to the GRAT or GRUT by subtracting the value of the grantor's retained interest as determined under the normal actuarial valuation rules. Since the gift provides a future interest to the remainder beneficiaries, the gift does not qualify for the $18,000 gift-tax annual exclusion. The grantor's applicable credit amount must be used, to the extent of the grantor's remaining credit to shelter the transfer from tax.

(iv) Does the grantor of the trust lives until the termination of the retained interest? If the grantor survives the retained interest term in a qualified GRAT or GRUT, §2036 does not apply and the trust principal, including any appreciation that occurs prior to the initial transfer, is excluded from the grantor's gross estate. This is the freeze benefit of the GRAT or GRUT since an appreciating business interest can be transferred to family successors for a significantly discounted estate- or gift-tax cost. However, the estate-tax benefits are reduced or eliminated if the grantor fails to survive the term because some (or all) value of the retained rights returns to the gross estate. Thus, when planning a GRAT or GRUT, select a term that the grantor has a reasonable likelihood of surviving based on the grantor's health, family medical history, and actuarial life expectancy.

Planning point:

The use of a trust reduces the impact of this possibility as the leverage of the gift effectively removes all of the post-gift in trust appreciation from the transfer tax system and only includes the fractional portion of the transfer corresponding to the remainder interest only (rather than the entire property or business interest transferred).

5. Basis step-up

How can a couple in a non-community property state achieve a step-up in basis of assets[130] at the death of the first-to-die?

a. Assets owned by the first-to-die spouse that were not transferred by the other spouse within one year of death will be fully included in the gross estate and achieve a full basis step-up; alternatively, the disposition of such property must be to someone other than the surviving spouse. However, this presupposes that one knows well in advance which of the couple will be the first-to-die.

b. The estate planning documents to either provide that each of them will have a testamentary power of appointment over assets held in one another's separate revocable trusts or form one "joint exempt step-up trust" (JEST), which, by various rulings by the Service, appear to permit assets owned by a JEST to be considered to have passed through the "taxable estate" of the first dying spouse, although the one-year rule complicates this tactic.[131] The Service could challenge the step-up in basis.

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130 This does not include items of income in respect of a decedent such as pension plans and traditional IRAs. IRD is not stepped-up in any event.

131 PLRs 200101021, 200210051, and 200403094 and TAM 9308002.

c. A full basis step-up is available in a conventional Alaska community property trust with an Alaskan co-administrative trustee. The Alaskan community property law permits both Alaskan couples and non-Alaskan couples to form trusts that comply with the Code, which provides that the entire community property will receive a full basis step up on the death of one spouse.[132] The Alaska Trust Company provides the trust form to professionals, and an Alaskan lawyer is available to review and approve the trust document.

D. Undoing old estate plans

1. In general

From time to time, it is necessary to undo or modify estate planning transactions taxpayers previously put in place. (Practitioners would be well advised to remind their clients of this.) Among the reasons a client might no longer need or want a particular transaction he or she previously adopted are a significant change in net worth, a marriage or divorce, death of a spouse, birth or death of children, and estrangement between the client and his family. The American Taxpayer Relief Act of 2012 ("ATRA") provided yet another reason previous estate planning transactions to be reviewed and addressed. At the top of the list, the increases in the exclusion and exemption amounts have far outpaced the rate of inflation, creating a wide gap between wealth that once was subject to death taxes and those that now are. Between January 2000 and January 2014, the consumer price index increased by about 39 percent while the estate and gift tax exclusion increased by about 691 percent and the maximum federal wealth transfer tax rate dropped by 27 percent from 55 percent to 40 percent. Transactions entered into to combat federal transfer taxes now no longer provide as much (or any) of those tax savings when compared with what would be the case had they not been consummated. But while the federal transfer tax burden has decreased, the federal income tax burden has gone in the opposite direction. The maximum federal income tax rate has increased to 37 percent, and taxpayers in the highest tax bracket will pay tax on long-term capital gains and dividends at a rate of 20 percent rather than 15 percent (a 33-1/3 percent increase). Couple this with the 3.8 percent surtax on net investment income, and some taxpayers face marginal federal income tax rates as high as 41.7 percent on ordinary income and 23.8 percent on long-term capital gains and dividends. Because a trust or estate has a very low threshold for the highest bracket ($15,200 in 2024), one can grasp that the income tax burden on trusts, a common entity used to transfer wealth out of the gross estate of a taxpayer, is a particularly difficult issue going forward. Often, transactions or techniques designed to reduce transfer tax can result in increased income tax. Even before ATRA, a credit shelter trust had the effect of reducing transfer tax at the surviving spouse's death but at the cost of (i) forgoing a new income tax basis for appreciated assets, and (ii) potential increased capital gain tax.[133]

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132 I.R.C. §1014(b)(6).

133 This section is based upon a presentation, Bergner, Cantrell and Sloan, *Curing Obsolete Estate Plans in Light of ATRA 2012* at the 49th Heckerling Institute in early 2015.

Planning point:

Removing an asset from the transfer tax base can result in overall tax increases. Reducing income tax rather than reducing transfer tax must be considered: Does the income tax increase occasioned by the removal of an asset result in greater savings than the transfer tax savings? This will depend in large part on the size of the estate, the applicable state death tax, and the tax rats of potential beneficiaries.

Bottom line: Clients and professionals may determine that an earlier transaction that made sense in a transfer-tax dominated environment does not make sense or that there are better ways to handle it through modification. What are some of the ways clients can wrest themselves away from the no-longer-useful estate planning transaction or at least more efficiently administer those that they cannot escape from? What strategies best respond to a tax world in which avoidance of estate tax will most often be of less importance than income tax concerns?

Note:

Deciding whether to unwind a prior estate planning transaction may ultimately involve balancing its estate tax benefit against its income tax cost. The outcome of that balancing may depend upon where the client resides, where his or her property is located, the situs of a trust, and the residency of a trust's beneficiaries. It may yield one result for a Texas or Florida taxpayer, who faces no state transfer or income taxes, but another result for a New York City taxpayer, who faces both state and local transfer and income taxes, in addition to federal taxes.

2. Valuation discounts

Achieving a valuation discount was a popular strategy because it minimized the effect of the asset in the transfer tax calculations: included are family limited partnerships (where the owner has no rights of management and cannot readily sell), fractionalization of property, etc. Fundamental to the transfer tax is the proper valuation of the asset, its fair market value, the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts. For income tax purposes, the basis of property acquired from a decedent is its fair market value at the time of the decedent's death, and for this purpose the fair market value of property is generally its estate tax value. The ownership of assets structured in certain ways has been held to justify applying a discount in determining fair market value. Because these structures can reduce the fair market value of an asset and thereby reduce the estate tax due at the owner's death, it made sense for many clients to create such ownership structures. The reduction of the fair market value reduces its income tax basis, which in turn results in greater capital gains taxes upon sale or reduced depreciation deductions, but pre-ATRA, in many cases the estate tax benefits outweighed the income tax cost. After ATRA, valuation discounts will still produce an income tax cost but, because of reduced rates and increased exclusions and exemptions, may not yield as much, or even any, estate tax benefit. Valuation discounts should be avoided to obtain (in most instances) greater income tax savings.

a. A discounted property interest, such as a limited partnership interest can be converted into a nondiscountable asset by the entity redeeming the interest. Limited partner winds up with cash or other property which, because they are no longer held within the partnership wrapper, are not discounted.
   (i) Generally, a partner recognizes gain on a distribution in liquidation of his or her partnership interest only to the extent that any money received (or deemed to be received, in the case of relief from liabilities) exceeds his or her basis in his or her partnership interest.

(ii) Unlike nonliquidating distributions, a partner may recognize loss on a liquidating distribution, subject to potential disallowance if the partnership is owned by related parties.

(iii) A partner who receives a distribution of property in liquidation of his or her partnership interest generally takes such property with a basis equal to his or her basis in the partnership interest.

b. Discountable entity interests may be converted into non-discountable assets by liquidation of the entity and distribution of all its assets to its partners.

(i) A partner (or member, in the case of an LLC) generally recognizes gain on the liquidating distribution only to the extent that any money received exceeds his or her basis in his or her partnership interest and may recognize loss.

(ii) A partner who receives a distribution of property in liquidation of his or her partnership interest generally takes such property with a basis equal to his or her basis in the partnership interest.

Note:

Limited partnerships and limited liability companies often present complicated and complex dynamics and inter-relations that make continued administration expensive and annoying. Liquidation solves those problems and provides simplicity. However, it also forfeits the benefits of holding assets in the entity (e.g., creditor protection, and family asset management).

Caution:

As with any transaction, unwinding a limited partnership should be viewed in consideration of the impact on creditors. The creditors of a partner are generally limited to a charging order, which limits them to assets of the partnership only if, as, and when they are distributed to the partner; it does not give the creditor the right to force distributions from the entity. In contrast, the distribution of assets to the partner increases the exposure of the partner to those claims.

c. The purchase of interests in the entity held by others may eliminate the factors that caused the discount in the first place. However, unless the seller is the purchaser's own grantor trust, gain or loss (unless the parties are related) will be recognized.

Example: One of the limited partners could purchase the general partnership interest from another partner. If taxpayer is both a limited partner and the general partner, taxpayer's rights and powers as general partner may reduce discounts on the limited partnership interest.

Note:

The organizational documents of the entity may prevent an owner from selling his or her interest, grant options or rights of first refusal to other co-owners, or otherwise limit the ability of a co-owner to sell his or her interest; limited partnerships are by default not salable, but this can be overturned by agreement of the partners in the organizational document.

d. The owners could change the nature of the entity from one that has discountable features to one that does not.

Example: The owners of a limited partnership could convert the entity to a general partnership: each limited partner becoming a general partner. If either the partnership agreement or state law gives each general partner the right to manage the affairs of the partnership and to force a liquidation of the partnership, the discounts for lack of control in valuing a partnership interest may be substantially reduced or eliminated.

e. Another way of eliminating discounts to entity interests, like that of conversion to another form, is to leave the entity in place but amend its governing documents so as to eliminate those features that create discounts.

Example: A limited partnership agreement might be amended to permit a limited partner to compel redemption of his or her interest at any time based on its net asset value rather than its fair market value.

f. With respect to assets that a client owns only a fractional interest, the co-ownership limits his or her freedom to deal with the asset, such as a tenancy-in-common interest in real estate, mineral interests, and tangible personal property such as art work, a substantial discount may be available, even when entities are not involved. One can eliminate the fractional interest either by purchasing the interests held by other co-owners or selling his or her interest to them.

Example 1: During a period of several years, client made annual exclusion gifts of fractional interests in a painting to a grantor trust for the benefit of descendants. The painting, which has a $2 million fair market value and a nominal income tax basis, is currently owned 60 percent by client and 40 percent by the trust. Upon the client's death, his gross estate will include the 60 percent interest in the painting valued at a discount, and the basis in the trust's 40 percent interest in the painting will not be adjusted.

If client acquires the trust's 40 percent interest in the painting by purchase, the amount paid to the trust must reflect a fractional interest discount. The painting will pass to the client's children free of estate tax with a $2 million basis. If the client sells or gifts the interest in the painting to the trust [if the trust is a grantor trust with §675(4) powers of substitution], client can reacquire the low basis painting free of income tax and without discounts to permit a basis adjustment to undiscounted fair market value at death.

Example 2: Client and his three siblings inherited multiple parcels of farmland when their parent died 20 years ago. Upon client's death, the value of his ¼ interest in the parcels will reflect a fractional discount. If the discounted values are not needed to avoid estate tax, client and his siblings could enter into a Code §1031 tax-free exchange, with each sibling receiving a 100 percent interest in separate parcels. Upon the client's death, his gross estate will include the parcels allocated to him, valued without any discounts, enabling his beneficiaries to sell those parcels free of income tax. [And remember, §1031 is now restricted to real estate.]

(i) The transfer is income tax free if it is a transfer between spouses, a transfer between a grantor and one or more grantor trusts, or a §1031 like-kind exchange. Otherwise, there may be gain or loss depending upon the identity of the parties, the seller's basis, and the purchase price.

(ii) The client should try to acquire the fractional interests of others so he or she owns the full interest because if the client sells his or her interest to other co-owners and, to avoid making a gift to the client, the other co-owners pay only fair market value, he or she will receive consideration equal only to the discounted value of his or her fractional interest.

g. Co-owners of an asset could contribute their respective fractional interests to an entity (such as a general partnership) in exchange for an interest in the entity. An entity asset should no longer be discountable. Contributing an asset to an entity ordinarily is not a taxable transaction. If the entity's governing documents give each owner the right to force a sale of the asset at its undiscounted fair market value and to require distribution of the proceeds, discounts on the entity interests may be substantially reduced or eliminated.

3. Causing inclusion of trust assets in the settlor's estate

The creation of an irrevocable trust was another popular tactic to remove assets from the transferor's gross estate. This shifted future appreciation to children or more remote descendants, increasingly more in grantor retained annuity trust ("GRAT"); made use of annual exclusion gifts to *Crummey* trusts; or an installment sale to a grantor trust and taxable transfers (e.g., to an irrevocable trust to consume some or all of the client's basic exclusion amount). Often these transfers involved limited partnership interests or other interests that were subject to valuation discounts discussed above, thereby leveraging the amount of wealth shift the transaction achieved. Now low basis, appreciated (and/or appreciating) assets held in irrevocable trusts if they will produce little or no estate tax benefit (due to the greater basic exclusion amount and reduced marginal tax rate) expose the beneficiaries to an income tax cost through the loss of a basis step-up at the client's death. Clients should try to recover such low-basis assets from the irrevocable trust to the client and to achieve a new income tax basis equal to fair market value at the client's death, if the reacquisition would cause estate taxes in excess of the capital gains tax cost.

a. Many irrevocable trusts included a §675(4) "swap power" that permitted the grantor, acting in a nonfiduciary capacity, to reacquire the trust assets by substituting assets of equivalent value; such a power made the trust a grantor trust. Such a power enables the grantor to make additional, tax-free transfers of wealth to the trust by paying the income tax due on the trust's income (discharging his or her own, but not the trust's, obligation); and to engage in transactions (e.g., purchases, sales, interest payments, etc.) with the trust without income tax consequences, because they are deemed to be transactions between the grantor and himself or herself. If the trust contains a swap power, the client can freeze the amount of the wealth shift at the current level and regain ownership of low basis assets by substituting cash or other assets of equivalent value for an asset held in the trust (as determined at the time of the swap). If the asset to be reacquired is itself valued at a discount for purposes of the equivalent value substitution and the seller recovers it from the purchasing trust before it realizes its full value, the reacquired asset, assuming is an interest in an entity that would otherwise be subject to a valuation discount at the client's death, can then undo the valuation discount to make sure there is a full basis adjustment at the client's death. Because the trust is a grantor trust, the swap will not have income tax consequences. For income tax purposes, the grantor will simply have exchanged assets with himself or herself.

b. If the trust did not provide a swap power, the grantor can purchase the appreciating and/or low-basis asset from the trust at its current fair market value and thereby: (i) shift post-transfer appreciation away from the trust beneficiaries and to the grantor, and (ii) obtain a new income tax basis for the asset at the grantor's death. The grantor can purchase the asset at a discounted price, if the property is subject to valuation discounts and then eliminate the discount by one of the methods discussed above. This can only be done with the trustee's consent. But if the trust does not include a swap power, it may or may not be a grantor trust depending upon the other trust terms. No gain or loss is recognized if the trust is a grantor trust; but gain or loss is recognized if the trust is a non-grantor trust.

c. A client may have an existing grantor retained annuity trust ("GRAT") that, in light of the basic exclusion amount, is no longer needed to shift additional assets in order to avoid estate tax. In addition, a client may desire to eliminate the administrative duties associated with a GRAT and to ensure that any future appreciation generated by the GRAT assets is shifted to himself or herself. The grantor cannot be prepaid on his or her annuity interest but may purchase the remainder interest; this may not be possible in the case where the trust contains spendthrift provisions. If it does not, the grantor could purchase the remainder interest from the remainder beneficiary for its actuarial value and, as a result of then owning the annuity interest and the remainder interest terminates the GRAT. The grantor receives the assets and the appreciated assets may receive a basis adjustment at the grantor's death.

d. Many long-term qualified personal residence trusts ("QPRTs") were created when Code §7520 rates were significantly higher than the current rate and the estate tax exclusion was a small fraction of today's basic exclusion amount. To eliminate the restrictions associated with a QPRT and to ensure that the residence receives a basis adjustment upon the client's death, the remainder beneficiary who is not a grantor trust may sell the residence to the grantor after the retained term ends.

Caution:

The Service could infer a retained power to repurchase the residence, which could retroactively disqualify the grantor's retained interest from favorable QPRT treatment and result in a gift of the full value of the residence at the time of creation.

(i) If the trust instrument permits, the grantor could purchase the remainder interest in the QPRT from the remainder beneficiary in a taxable transaction (that is, so long as the remainder beneficiary is an individual or a non-grantor trust) for its actuarial value during the term of the QPRT. The grantor would then own the term interest and the remainder interest. This should cause a merger and a termination of the QPRT, putting the residence back into the hands of the grantor where it will be subject to a basis adjustment at the grantor's death. The remainder beneficiary will be left with cash or other high-basis assets equal to the value of the remainder interest at the time of the transaction.

(ii) When the QPRT has terminated, the settlor could purchase the residence in a taxable transaction from a remainder beneficiary that is not a grantor trust. This may be particularly important when the grantor wants to continue living in the residence after the QPRT term expires. If he or she paid rent, this would cause the remainder beneficiaries taxable income but the grantor would not receive an income tax deduction. The client recovers the residence, he or she can continue

to live in it rent-free, and the residence receives a new income tax basis equal to its fair market value at the client's death.

4. Causing inclusion of trust assets in a beneficiary's estate

Much estate planning revolved around designing irrevocable trusts to avoid inclusion of the trust assets in the beneficiary's gross estate, such as the credit shelter trust, created with estate tax savings at the beneficiary's death in mind, are potential candidates for this kind of planning. But bear in mind that a trust has several non-tax reasons, which are difficult to quantify unlike transfer tax savings that must be weighed. For example, a trust may provide an asset management vehicle to protect assets from the claims of beneficiary creditors, and avoiding inheritance and state death taxes.

a. The Trustee could distribute appreciated trust assets to the beneficiary pursuant to the standard of distribution included in the trust instrument. Determining whether such a distribution is consistent with the trustee's fiduciary duty to administer the trust in accordance with its terms requires a thorough analysis of all facts and circumstances, most notably the trust instrument itself and applicable state law. The trust instrument may provide that the trustee "may" (or "shall") make distributions to the beneficiary pursuant to a health, education, maintenance, or support standard. The trustee could also have broader discretion to distribute for comfort, happiness, or some other reason. The trust instrument may also provide some additional flexibility over distributions by expressly describing the factors that the trustee "may" (or "shall") consider. A common discretionary consideration "permits" (or "requires") the trustee to consider the beneficiary's other resources.

   (i) As a general matter, trust distributions carry out distributable net income, or "DNI," to the beneficiaries. This carry-out typically results in income to the beneficiaries and a corresponding deduction to the trust. After the distribution, income produced by the distributed asset will be taxed to the beneficiary rather than to the grantor of the trust (if a grantor trust) or to the trust (if not a grantor trust).

Caution:

Distribution of assets in satisfaction of a requirement to distribute income to beneficiary will trigger gain or loss to the trust.

   (ii) The purpose of distributing appreciated trust assets to a beneficiary in this context is to cause the assets to be included in the beneficiary's estate and receive a step-up in income tax basis at the beneficiary's death.

b. If the trustee's power to distribute to the beneficiary is not limited by an ascertainable standard relating to the health, education, maintenance, or support of the beneficiary; and the trust instrument does not prohibit the beneficiary from serving as trustee, if the beneficiary becomes the trustee, he or she will likely have a general power of appointment over the trust assets, causing inclusion of the trust assets in his or her gross estate at death. If the trust instrument or the law of the trust situs permits division of the trust into separate trusts, consider effecting such a division, funding one trust with appreciated assets but only in that amount necessary to fully use the client's applicable exclusion amount, and funding the other trust with high-basis or loss assets. The beneficiary could then become the trustee of the former but not of the latter, achieving a

step-up in basis on the appreciated assets but avoiding a step-down in basis on the depreciated assets.

c. Some trust instruments give an independent third party the power to grant the beneficiary a general power of appointment. In that case, the third party could simply grant that power and the trust assets should be includible in the beneficiary's gross estate. If the trust contains both appreciated and depreciated assets, the third party could grant the beneficiary a general power of appointment with respect to the former but not the latter, achieving a step-up in basis for appreciated assets but avoiding a step-down in basis for depreciated assets.

d. In a limited number of cases it may be possible for a beneficiary of an irrevocable trust to utilize the Delaware Tax Trap ("DTT") to cause appreciated trust assets to be included in the beneficiary's gross estate and thus obtain a basis adjustment at the beneficiary's death.

Note:

In general, if a person holds a non-general power of appointment, the exercise or lapse of the power will not cause the trust assets subject to the power to be included in the holder's gross estate. However, the Code provides a special provision (the "Delaware Tax Trap") with respect to a power holder that can cause the trust assets to be included in the non-general power holder's gross estate and thus achieve a basis adjustment upon the holder's death: Code §2041(a)(3) treats a non-general power of appointment that **is exercised** to create another power of appointment that can be exercised in a manner to postpone the vesting of an interest in the property for a period determined without regard to the time the first power was created as a general power of appointment.

Example: Wife created a credit shelter trust for the benefit of Husband. Husband is the primary beneficiary during his lifetime and is granted a testamentary non-general power of appointment. The trust assets have realized significant appreciation but will not receive a basis adjustment at Husband's death since the assets will not be included in Husband's gross estate. Husband does not have sufficient assets to fully take advantage of his applicable exclusion amount. If Husband exercises the power of appointment in a manner that triggers the DTT, the appointed assets will be included in Husband's gross estate and benefit from a stepped-up basis without generating an estate tax.

e. Section 678 of the Code provides that, under certain circumstances, a non-grantor beneficiary of a trust will be treated for income tax purposes as if he or she owned the trust assets. As a result, all items of income, deduction, and credit of the trust will be included in computing the beneficiary's taxable income and credits. If the client is a beneficiary of a §678 trust and the trust holds assets with appreciation potential, the client could purchase the appreciating assets from the trust, thereby freezing the value of the trust assets and shifting future appreciation to himself or herself.

f. Conventional estate planning for the affluent married client involved two principal gifts: (i) a gift of the deceased spouse's applicable exclusion amount to a "bypass" trust for the primary benefit of the surviving spouse; and (ii) a gift of the balance of the estate to or for the benefit of the surviving spouse in some form that qualified for the marital deduction. The client could achieve deferral of estate tax until the surviving spouse's death simply by making a marital deduction gift of his or her entire estate. However, such a plan would waste the client's unified credit and therefore pass up the opportunity to transfer assets in a way that not only deferred, but actually avoided, estate tax. The credit shelter trust solved the problem. It allowed the client to give the surviving spouse the use and

enjoyment of the property during his or her lifetime. However, because the surviving spouse's powers over and interests in the trust were sufficiently limited, the trust assets were not included in his or her gross estate at death. The credit shelter trust achieved the benefit of a marital deduction gift (giving the surviving spouse the benefit of the property) but without the tax detriment (inclusion of the property in the surviving spouse's gross estate). Now, if the client's and the spouse's combined estates are below their combined basic exclusion amounts, they can avoid estate tax with the marital deduction and portability; they do not need a credit shelter trust for this purpose, although the trust may still be worthwhile for non-tax purposes (e.g., creditor protection, management, control of distributions, control of ultimate disposition, etc.).

(i) The credit shelter trust results in several disadvantages: increased complexity, additional income tax returns, the need to plan to avoid income tax at the trust level, segregation of assets, additional fiduciary duties, and loss of basis adjustment at surviving spouse's death. If a client dies with an estate plan creating a credit shelter trust, consider ways in which to avoid funding the trust but instead distributing the trust assets to the surviving spouse free of trust. These options would generally be legal in nature, including judicial reformation or termination of the trust.

(ii) This technique substitutes the surviving spouse, as well as any other beneficiaries, for the trust as the owner(s) of assets and as the taxpayer(s) with respect to income attributable to those assets. This substitution may yield a positive or negative income tax result depending on the facts and circumstances of each trust. For instance, although trusts reach the top federal income tax bracket after earning just $15,200 of income (in 2024), because trust distributions carry out DNI to the beneficiaries, sophisticated trustees can manage overall income tax liability by making targeted distributions to specific trust beneficiaries (e.g., the trustee could make distributions to children, who are in lower income tax brackets, instead of to the surviving spouse, who may be in a higher income tax bracket). Without the continuing presence of a trust, the ability to spread income tax liability amongst beneficiaries would be lost.

g. A few states allow the "decanting" of trusts, where the assets of one trust are transferred to another trust (with different terms); if the trust has its situs in a state that permits decanting, consideration should be given to decanting to a second trust that grants the beneficiary a general power of appointment over its assets.

h. The trust assets may be included in a surviving spouse's estate and receive a new date-of-death value basis at the death of the surviving spouse if the trust is a QTIP trust. If the client's credit shelter trust designates the surviving spouse as the sole beneficiary, prevents the surviving spouse from appointing to anyone else during his or her lifetime, and requires the trustee to distribute all trust income to the surviving spouse currently, the trust may qualify for treatment as QTIP trust. If the decedent's estate did not file an estate tax return, it may be possible to file a late return and make the QTIP election even long after the decedent's death.

5. Causing inclusion of trust assets in a third party's estate

If a trust settlor or beneficiary already has assets greater than his or her applicable exclusion amount, one would not use a strategy that would subject the assets to actual estate tax liability when they otherwise would be free of estate tax. But third parties may have surplus exemption that can be used in certain

circumstances. The trust assets will be included in the gross estate of the third party, permitting an adjustment of basis to date of death value, even though the third party's estate might not have any claim on the assets.

a. If the trust instrument grants the beneficiary a non-general power of appointment that permits appointment of assets to a person (e.g., a spouse or other relative) who may have excess applicable exclusion amount and a shorter life expectancy than the beneficiary, the beneficiary could exercise the power in such a way that the assets will be included in the appointee's gross estate. The assets will then receive a new income tax basis at the appointee's death but at no estate tax cost due to the appointee's applicable exclusion amount.

Caution:

An appointment free of trust works, but this also puts the appointed assets in the hands of the appointee, who may dispose of them not in the way the beneficiary contemplated. If, instead, the beneficiary appoints the trust assets to a trust for the benefit of the appointee that gives the appointee a general power of appointment, but one that is "difficult" to exercise; and provides that, if the general power is not exercised, the trust assets will remain in trust for the benefit of the original beneficiary.

b. The beneficiary of a trust has a lifetime non-general power of appointment over the trust assets, which are not includible in the beneficiary's gross estate, that permitted appointment to a class of persons that includes the beneficiary's spouse; where the value of the beneficiary's and the spouse's assets outside the trust is substantially less than their combined applicable exclusion amounts should consider appointing appreciated assets to the beneficiary's spouse, thereby achieving a step-up in basis at the spouse's death. If the beneficiary survives the spouse, presumably the appointed assets will come back to the beneficiary. If not, they will go to the beneficiary's and the spouse's descendants.

c. Some trusts designate a "trust protector" in an irrevocable trust and give that person the power to add or change beneficiaries of the trust. If the trust designates such a person, he or she can exercise that power and add other persons as beneficiaries of the trust. If this results in granting the new beneficiary a general power of appointment or authorizing the trustee to make substantial distributions to the new beneficiary, then the trust assets can pass through the new beneficiary'' estate and receive a new income tax basis while still avoiding estate tax through use of the new beneficiary's applicable exclusion amount.

d. Suppose a client transferred assets to family members free of trust to avoid inclusion of those assets and their future appreciation in his or her gross estate. Inclusion of the previously gifted assets in the client's estate may secure the benefit of a new, higher income tax basis without the burden of incurring estate tax. Including the previously-transferred assets in the client's gross estate may work to the overall benefit of the family: it may result in bringing a transferred asset back into the transferor's gross estate, qualifying it for a basis adjustment at his or her death; it may result in eliminating features of the asset that would justify a valuation discount, enhancing the basis increase.

Example: Client made annual exclusion gifts of fractional interests in artwork to children during his lifetime with the objective of minimizing estate tax upon client's death. However, the artwork continued to be in client's possession. Client died with some of the artwork owned entirely by children while other artwork was owned fractionally by client and children. All of the artwork had a nominal income tax

basis. If the artwork interests gifted to children are not included in client's estate, they will retain a nominal income tax basis and the basis adjustment for client's fractional interests in artwork will reflect a discount. In contrast, if the value of client's assets plus the gifted artwork is less than client's applicable exclusion amount, inclusion of the artwork in client's gross estate will not generate an estate tax and will facilitate a full basis adjustment. The basis adjustment is especially important since collectibles can be subject to the higher capital gains rate of 28 percent.

6. Changing ownership of spousal assets to achieve a new income tax basis for appreciated assets and to preserve the income tax basis of loss assets

Changing the ownership of marital property can achieve income tax benefits without incurring estate tax costs. Spouses may be able to maximize the step-up in basis for their appreciated assets while avoiding a step-down in basis for their depreciated assets.

a. If both spouses own assets (including appreciated assets, depreciated assets, and assets whose basis is roughly equal to fair market value) and that one spouse has a shortened life expectancy, the spouses could exchange assets (tax-free under §1041) between them so that the spouse with the shortened life expectancy receives appreciated assets; and the other spouse receives depreciated assets and assets with no gain or loss. The lower-life-expectancy spouse's earlier death increases the income tax basis of the appreciated assets to fair market value, avoiding gain on the sale of those assets; and the income tax basis of the depreciated assets would not decrease to fair market value (because those assets are not included in the deceased spouse's gross estate), minimizing any potential taxable gain upon the future sale of the assets by the surviving spouse. Predicting which spouse will be the first to die cannot be done with certainty. This result should make no difference if the spouses file a joint return but it could be important if they file separate returns. The transfer is treated as a gift and the basis of transferred property in the hands of the transferee spouse is its adjusted basis in the hands of the transferor spouse. If the transferee spouse dies within one year after the transaction and the transferred property passes back to the transferor spouse, the transferor's basis will be the same as the transferee's basis immediately before his or her death. In some states, the agreement may be void as to preexisting creditors.

b. In a community property state, with respect to most assets, at the death of a spouse, both halves of the community property receive a new income tax basis equal to the then fair market value of the property. This basis adjustment applies notwithstanding the fact that only one-half of the community property is included in the estate of the spouse who died. Separate property, on the other hand, receives a new income tax basis only on the death of the spouse who owns such separate property. If the spouses own community property (including appreciated assets, depreciated assets, and assets whose basis is roughly equal to fair market value) and one spouse has a shortened life expectancy, partitioning the community property into appreciated and depreciated categories because this can avoid a step-down in basis for loss assets.

c. Spouses who live in a community property state each of whom owns appreciated separate property, the separate property of the spouse who dies first gets a basis adjustment but the separate property of the other spouse does not. In states that allow spouses to agree to convert separate property into community property, conversion will accord basis adjustment to all property then regardless of which spouse dies first.

d. Couples who live in a common law jurisdiction who want all or part of their property to become community property can create an Alaska Community Property Trust or a Tennessee Community Property Trust and contribute property to that trust, which is irrevocable unless the trust instrument provides otherwise.
   (i) Generally, Community Property Trusts will require a trustee who resides in Alaska or Tennessee, respectively, and administration of the trust to be located in such state. If properly established and administered, the property in the trust will be community property and will be owned one-half by each spouse.
   (ii) Converting a spouse's separate property into community property may subject it to claims of the other spouse's creditors when it would not have been subject to those claims had it remained separate property.

e. Assume that one spouse owns a significant amount of assets and that the other spouse owns a nominal amount of assets and has a shortened life expectancy. The wealthy spouse could gift appreciated assets to the poorer spouse so that the wealthier spouse's assets will be included in the poorer spouse's gross estate and eligible for a basis adjustment upon death. Upon the poorer spouse's death, the assets could return to the wealthy spouse with a new income tax basis, available for sale without capital gains tax. The same result could be achieved by transferring the assets to a trust for the poorer spouse's benefit and in which the poorer spouse has a general power of appointment. However, if the poorer spouse dies within one year of the transfer and the assets are returned to the donor spouse, the property is not eligible for basis increase; however, if the poorer spouse dies within one year of the transfer and directs the property to a bypass trust, the assets might -- the legal issue is still in dispute -- qualify for a basis adjustment.

7. Addressing life insurance policies and life insurance trusts that are no longer needed

Many clients procured life insurance to provide liquidity to pay estate tax. Due to the higher basic exclusion amount, along with the portability of a deceased spouse's unused exclusion amount and the expense and inconvenience of the attendant ILIT formalities, keeping a life insurance policy owned by the insured, by an irrevocable life insurance trust ("ILIT"), or directly by the insured's intended beneficiaries, in force may no longer make sense.

a. The owner may be able to surrender the policy to the issuing insurance company. Likewise, the trustee of an ILIT may consider surrendering a policy if the death benefit is no longer needed or the cash surrender value could be more prudently invested for the benefit of the beneficiaries. If an owner surrenders a policy, the owner will recognize ordinary income to the extent that the amount received from the insurance company exceeds the owner's basis in the policy.

b. In certain circumstances, selling a life insurance policy to a third party may generate a greater return than surrendering the policy to the insurance company. However, unless an exception applies, the purchaser is subject to the transfer-for-value rule, which limits the amount of proceeds that are tax-exempt to the amount paid for the policy. The seller recognizes gain to the extent the amount received exceeds the basis in the policy, i.e., premiums paid less cost of insurance. If the policy is sold for its cash surrender value, the gain is ordinary; if the amount exceeds the cash surrender value, the excess qualifies as capital gain.

Example: On January 1 of Year 1, A, an individual, entered into a life insurance contract with cash value. Under the contract, A was the insured, and the named beneficiary was a member of A's family. A had the right to change the beneficiary, take out a policy loan, or surrender the contract for its cash surrender value. The contract in A's hands was not property that is not a capital asset

On June 15 of Year 8, A sold the life insurance contract for $80,000 to B, a person unrelated to A and who would suffer no economic loss upon A's death.

A determines taxable income using the cash method of accounting and files income tax returns on a calendar year basis. As of June 15 of Year 8, A was not a terminally ill individual, nor a chronically ill individual.
A paid total premiums of $64,000 under the life insurance contract through the date of sale. Accordingly, A's adjusted basis in the contract as of the date of sale was $64,000.

Accordingly, A must recognize $16,000 on the sale of the life insurance contract to B, which is the excess of the amount realized on the sale ($80,000) over A's adjusted basis of the contract ($64,000).[134]

c. The grantor can acquire the policy from the ILIT, and simplify the ownership and maintenance of the policy, by purchasing the policy for fair market value or, if the ILIT contains a swap power, exercising the swap power by substituting assets of an equivalent value. Unless the ILIT is a grantor trust, the sale of the policy to the grantor-insured for fair market value is a recognized as a sale for federal income tax purposes. The "transfer-for-value" rule does not apply when a life insurance policy is transferred for valuable consideration to the insured, a partner of the insured, a partnership in which the insured is a partner, or a corporation in which the insured is a shareholder or officer. The purchase can simplify the maintenance of the policy.

8. Turning off grantor trust status to avoid unnecessary wealth shifts and to facilitate income tax planning

Many clients have grantor trusts into their estate plans. The most prominent tax advantages of a grantor trust are the nonrecognition of sales, interest payments, and the like, because the parties are the same; the transfer tax is not imposed on the grantor's payment of the trust's income tax liability but it will consume assets that might otherwise have received an estate tax-free step-up in basis at his or her death (that is, the grantor's own assets) rather than trust assets that will receive no basis adjustment. In many cases it will be possible to turn off grantor trust status and cause the trust to be treated as a separate taxpayer and taxed on its own income. The mechanism for doing so and the cost to the grantor depend on the particular trust provision that creates grantor trust status in the first place. Below we consider some of the most frequent bases for grantor trust status and the options for avoiding them.

a. Code §675(4)(C) provides that the grantor will be treated as the owner of any portion of a trust as to which any person, acting in a non-fiduciary capacity and without the consent of anyone in a fiduciary capacity, has the power to reacquire trust assets by substituting ("swap power") other property of an equivalent value. If grantor trust status results from a swap power, the holder of the power must release it in order to turn off grantor trust status.

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[134] Rev. Rul. 2009-13, 2009-21 I.R.B. 1029 as modified by Rev. Rul. 2020-9, IRB 454 (02/10/2020).

b. Each of the exceptions under §674 provides that it does not apply if anyone has the power to add to the class of beneficiaries except to provide for after-born or after-adopted children. If grantor trust status results from such a power, the holder of the power must release it in order to turn off grantor trust status.

c. Discretionary distribution powers can cause grantor trust status. However, there are important exceptions.

(i) Discretionary distribution powers held by independent trustees (i.e., none of whom is the grantor and no more than half of whom are related or subordinate parties who are beholden to the grantor's wishes) generally will not result in grantor trust status.

(ii) A discretionary power to distribute principal, limited by a reasonably definite standard, is not by itself a power that triggers grantor trust status so long as the power is held by a trustee or trustees, none of whom is the grantor or a spouse living with the grantor.

Planning point:

Depending upon the terms of a trust, avoiding or terminating grantor trust status may require a change in trustees so that only an appropriate person holds discretionary distribution powers over income and principal.

Example: Client transfers assets to an irrevocable trust for the benefit of Client's children, grandchildren, or more remote descendants. Client serves as trustee and is permitted to make discretionary distributions of income and principal to any one or more beneficiaries for their health, education, maintenance, and support. Client also has the right to remove and replace trustees. None of the beneficiaries possesses a power of appointment over the trust assets.

The trust is not a grantor trust with respect to principal because Client's ability to distribute principal is limited by a reasonably definite standard. The trust is a grantor trust with respect to income, however, because Client is trustee and neither of the exceptions in Code §674(b)(6) or §674(b)(7) applies. To convert the trust from a grantor trust to a non-grantor trust with respect to the trust's income, Client can resign as trustee and release any right to remove and replace trustees with related or subordinate parties.

d. According to the Service, the grantor who has an unfettered power to remove and replace the trustee has, by attribution, the powers of the trustee. This is because the power-holder can effectively exercise those powers by continuing to remove and replace the trustee until the power-holder finds one who will comply with the power-holder's wishes. If a discretionary distribution power would cause grantor trust status if held by the grantor, vesting that power in another trustee will be ineffective if that power is attributed to the grantor. The IRS has ruled that a removal and replacement power will not cause attribution of the trustee's powers to the power-holder if the power-holder cannot appoint, as successor trustee, either himself or herself or someone who is "related or subordinate" to him or her. Hence, to avoid grantor trust status, the grantor must either relinquish his or her revolving door power.

e. The grantor is treated as the owner of any portion of a trust whose income may be distributed or accumulated for future distribution to the grantor's spouse. To terminate grantor trust status during the marriage, the grantor's spouse must release his or her right to distributions. The grantor is treated as holding any power or interest held by "any individual who was the spouse of the grantor at the time of the creation of such power or interest."

f. The grantor is treated as the owner of any portion of a trust whose income "may be" applied to the payment of premiums on insurance on the life of the grantor or the grantor's spouse. The grantor is taxable only on trust income actually used to pay the premiums, and not on excess trust income. Not paying insurance premiums could terminate grantor trust status in these circumstances.

g. Since income tax rates of trusts have increased, the tax on undistributed income is subject to higher taxes than beneficiaries, so minimizing income tax on trust income will involve making distributions to beneficiaries, some or all of whom may be in a lower bracket than the trust. At best, the trustee may have the flexibility to distribute trust assets.

E. What should be considered in 2024

1. Review existing documents

The single most important thing to do for a client is to review or have reviewed existing documents. Because of the federal estate exemption and unlimited marital deduction, most wills are drafted using formulae that refer to the federal estate tax law. Wills must be amended to accommodate clients with existing wills, and forms in use must be amended for new clients. The potentially perverse effects of existing formulae are enough to make will drafters give up on formulaic will drafting.

a. One version of a formulaic will first distributes the **maximum amount** that can pass free of federal estate tax to a children's trust referred to as the credit-shelter property trust. The residue is distributed to a §2056(b)(7) qualified terminable interest property (QTIP) trust that gives a life estate to the surviving spouse. If a decedent whose will uses this formula died in 2024, the credit-shelter trust would get the lesser of the federal exemption amount or the entire estate. This higher number could result in no part of the decedent's estate going into the QTIP.

b. The QTIP disposition is often phrased as the **minimum amount necessary as the marital deduction** to reduce the federal estate tax to zero, with the residue going to the credit-shelter trust. Since the higher applicable exclusion amount allows more of the estate to pass tax-free without regard to a qualifying marital disposition, the minimum amount to zero out the marital gift is further reduced or even eliminated; again, nothing might pass to the marital trust.

Planning point:

Clients with smaller estates may want to eliminate trusts that were added for tax purposes. A client with modest wealth who still wants to create a credit-shelter trust but is concerned about his or her spouse having sufficient assets may wish to name his or her spouse as sole beneficiary of the credit-shelter trust, with a power of appointment in favor of descendants.

2. What does the client really want?

Practitioners probably need to contact married clients to discuss how they want their property disposed of if they die and no marital formula is necessary to zero out the estate tax. Some marital gift may be appropriate even where not necessary (and, as discussed below, may be appropriate in certain cases to reduce or eliminate state death taxes).

a. Leave the estate to a QTIP eligible trust that qualifies for the estate tax marital deduction to the extent the executor so elects.

b. The surviving spouse could make a qualified (or possibly a nonqualified) disclaimer of all or a portion of the QTIP trust and have it pass over to a credit-shelter trust (or other alternative disposition). This suggests a waterfall structure in the will that passes property down in tiers (generally of trusts), each one having an opportunity to disclaim. The spouse may make a formula disclaimer of the entire QTIP trust above the amount needed to allocate that basis increase and have the disclaimed assets pass into a credit-shelter trust that may provide more flexibility with respect to distributions than a QTIP trust does.

F. Why the credit shelter still has legs

Is portability a good reason to undo estate plans already in place? There are other benefits of trusts, including asset protection, providing management, and restricting transfers of assets by the surviving spouse. However, leaving everything to the surviving spouse and relying on portability offers the advantages of simplicity and a stepped-up basis at the surviving spouse's death that a bypass trust cannot offer.

1. Creditor protection

Leaving property to a spouse or other heirs outright exposes the property to the claims of creditors of such beneficiary. A properly drafted bypass trust never accords such creditors access to the funds that may be distributed to such beneficiaries; and a trust is a classic asset-protection device. This is in addition to the investment and money management expertise of professional trustees. And it may be of particular value to entrepreneurs, doctors, lawyers, accountants and other professionals; construction contractors and real estate developers; executors and trustees; and directors of public companies, all of whom engage in work that is often the subject of lawsuit. In addition, separation of the legal title from the objects of one's bounty provides a shield against the machinations of ex-spouses seeking to draw down on the family wealth.

2. Remarriage

Remarriage presents particular problems, including the possibility that the children of the deceased spouse will be disinherited by a second spouse of the survivor. The QTIP trust largely reflects this quandary and permits the decedent to provide for a spouse while not according a possibility of overreaching second spouses to alter the anticipated ultimate descent of the property to the decedent's children. Because the disposition of property placed in trust is not subject to the will of a surviving spouse, it can preclude such possibility by the terms of the trust. Beyond that, remarriage can, from a tax perspective, change or eliminate the DSUEA of the first deceased spouse should the surviving spouse's second spouse predecease the surviving spouse and cause the survivor to succeed to the separately calculated DSUEA of the second spouse, which may be lower than that of the first deceased spouse.

3. Managing the size of the surviving spouse's estate

The bypass trust, in contrast to a marital trust or outright gift, is not included in the spouse's estate, and this includes the appreciation on such assets. This means that the size of the surviving spouse's estate is more limited than an outright or marital deduction trust disposition. A bypass trust reduces – but does not eliminate – the possibility that by the time the surviving spouse dies the estate will exceed the exemption amount. However, by not being included in the estate of the surviving spouse, a bypass trust does not permit a basis adjustment on the death of the surviving spouse. So, the estate-tax advantages to the spouse must be balanced against the potential or ultimate income tax that will be paid. By contrast, property passing to the spouse outright or to a qualified marital deduction trust would have been included in the gross estate of the surviving spouse, but would have generated no income tax because of the concomitant basis increase. Of course, in smaller estates, one would find the basis increase more important because the estate tax is zero; but in very large estates, the capital-gains tax may well be less than the substantial estate taxes due on the death of the surviving spouse.

4. Generation-skipping transfers

Portability applies to the estate and gift tax but not the generation-skipping transfer tax; unused GST exemption is not passed on. This suggests that lifetime gifts to GST beneficiaries and use of a bypass trust with generation-skipping transfer beneficiaries, such as grandchildren, are more tax efficient in a number of circumstances than an estate plan that allows a full GST exemption to go to waste.

5. Formula clauses

Instead of naming a specific sum that will go into a trust, many documents refer to an amount up to the exemption or express the sum as a percentage of whatever the limit happens to be when the person dies—designed to be self-correcting clauses to take maximum advantage of the estate-tax exemption, which kept increasing. But in the light of the current exemption, less money will go to the spouse than one finds appropriate, or too much would go to grandchildren.

In a stable first marriage, one could leave everything to the spouse outright, but give him or her the right to disclaim all or part of the inheritance and provide a bypass trust in the will to which such disclaimed property will pass. This, however, requires the spouse to disclaim property in accordance with another set of rules that conflicts somewhat with any need for administrative simplicity.

6. Administrative convenience

Portability, like a QTIP, requires the executor of the spouse who dies first to make an election in order to pass the unused exemption to the survivor by filing an estate tax return when the first spouse dies, even if no tax is due, which is due nine months (a six-month extension is available) after death. Now many executors may be tempted not to do so, given the state of affairs that exist at the death of the first spouse, but no one can predict the future for the survivor, which may include other inheritances or windfalls that would have made a DSUEA available for lifetime gifts or bequests tax-advantageous. But if the executor does not file the return or misses the deadline, the surviving spouse loses the right to use her late spouse's remaining exemption. By contrast, one locks up the effective use of the deceased spouse's exemption amount by funding the bypass trust to the fullest extent.

7. Joint ownership

Joint ownership has been one of the biggest impediments to establishing individually owned assets necessary to fund a credit shelter (bypass) trust. This is not so much a problem with cash or marketable securities, but the bulk of wealth for most clients today lies in retirement funds and personal residences.

To fund a bypass trust with qualified retirement assets means giving up on the benefits of stretch outs of distributions under the minimum distribution rules. The home is usually jointly held and to free it up as an individually owned asset requires the surviving spouse to disclaim the portion of the interest that otherwise passes by operation of law (while retaining the one-half interest the survivor owned from the inception of its acquisition). Thus, the one-half interest disclaimed now can fund the bypass trust. This is imperfect in the perception of the surviving spouse because the sense of ownership is lessened by the presence of the other party, the trustee. Now the surviving spouse could be named the trustee.

Depending on the arrangement, the trust may need to share the cost of maintenance and repairs, it cannot deduct property taxes, and if the house is sold, a valuable income tax break could be lost.

If a couple lacks sufficient appropriate assets, the couple may have to concede the bypass trust and buy second-to-die life insurance so that the proceeds can be used to pay the federal and state estate taxes, if any are owed. By making use of the deceased spouses' unused exemption, instead of a bypass trust, the surviving spouses' estate will be able to step up the basis of the assets that would not have been stepped up through use of a bypass trust. Planners should be aware, however, that a bypass-type trust may still be useful for sheltering appreciation in assets placed in the trust, as well as for all of the reasons that trusts are typically used, such as creditor protection and divorce/second marriage protection.

Tax Ideas for the Family

Tax Ideas for the Family

Learning objectives

Upon reviewing this chapter, the reader will be able to:

- Explain the tax implications of virtual currency transactions;
- Discuss the American Opportunity credit and extent to which it may be refundable;
- Explain the income and gift tax consequences of loans made within the family;
- Identify the benefits that may be available when a spouse is employed by the taxpayer's business, including medical, pension, and Social Security;
- Explain the income-tax issues related to the travel and entertainment of a taxpayer's spouse as a business expense;
- Discuss the effect of earned income of a child on the kiddie tax, the taxpayer's income tax, and the creation of benefits;
- Explain the consequences of shifting equity in a taxpayer's business to a child; and
- Describe the use of a Roth IRA by a child.

I. Virtual currency

Virtual currency, cryptocurrency, blockchain, mining… what do these terms really mean? The IRS defines virtual currency as "a digital representation of value that functions as a medium of exchange, a unit of account, and/or a store of value". In some environments, it operates like "real" currency (i.e., the coin and paper money of the United States or of any other country that is designated as legal tender, circulates, and is customarily used and accepted as a medium of exchange in the country of issuance), but it does not have legal tender status in any jurisdiction. [1] When virtual currency has an equivalent value in real, tangible currency, it is considered a "convertible virtual currency." Cryptocurrency is a specific type of virtual currency that uses "cryptography" to validate and secure transactions that are digitally recorded on a distributed ledger or record keeper. A "blockchain" is a chain or blocks that store digital information in a public database, that functions similar to a ledger. The individual blocks making up the chain contain information about transactions including the date, time, and dollar amount of a transaction. The individual block also contains information about the parties participating in a transaction (via unique digital signatures) as well as a unique "hash," or string of text and numbers, updated for each transaction. A single block can hold up to a few thousand transactions. Transactions are pseudonymous as accounts and transactions are not connected to individual identities. As such, one cannot easily connect the identity of a user with an address or transaction. Each transaction on a network must be confirmed by a miner, and once a transaction is confirmed, it cannot be reversed. Anyone can become a miner – for Bitcoins, miners can confirm a transaction through solving a cryptologic puzzle. Once the miner solves the problem and confirms the transaction, he or she is rewarded with a specific number of Bitcoins. The only legitimate way that Bitcoins are created are through mining / confirming transactions. Bitcoin is the first and most well-known cryptocurrency, although there are several other cryptocurrencies available. The Bitcoin is not unique in that transactions must be mined in order to be verified; all cryptocurrency transactions require a puzzle or problem to be solved by a miner before the transaction is verified. Like Bitcoin miners, all cryptocurrency miners are rewarded with payment in the form of cryptocurrency as an incentive for solving the problem and verifying the transaction. The entire legitimacy of the cryptocurrency network depends on the legitimacy of the underlying blockchain.

[1] IRS website, "Virtual Currencies""

In order to send and receive cryptocurrency, an individual must have a cryptocurrency wallet. The wallet stores the individual's public, and possibly private, keys that are used to send or receive cryptocurrency. Unlike a traditional wallet that one uses to hold cash or credit cards, the cryptocurrency wallet does not hold the actual cryptocurrency. The cryptocurrency is stored and maintained on the blockchain. The public key provides a public address that is capable of receiving cryptocurrency transactions, and acts as the spot where funds are deposited. The corresponding private key is unique to an individual user. Without the private key, the individual won't be able to withdraw any cryptocurrency. A simple way to think about cryptocurrency keys is to think about a physical mailbox. Anyone can insert mail into the mailbox slot – neighbors, postal workers, even strangers; however, only the individual who owns the mailbox and has a private key is able to open the mailbox to retrieve the contents. It is important for individuals to keep their private key safe so as to not compromise their wallet. If a private key is lost, there is no way to access the cryptocurrency.

A. Notice 2014-21

In March 2014, the IRS issued Notice 2014-21 in the form of a FAQ document for taxpayers. Below is a summary of some of the key highlights of the Notice:

- The IRS determined that virtual / cryptocurrency is considered property for federal tax purposes and as such is subject to general tax principles applicable to property transactions.
- Virtual currency is not treated as currency that could generate foreign currency gain or loss.
- A taxpayer who receives virtual currency as payment for goods or services must include in gross income the FMV of the virtual currency, measured in U.S. dollars, as of the date the currency was received.
- The basis of virtual currency that a taxpayer receives as payment for goods or services is the FMV of the virtual currency as of the date of receipt.
- For U.S. tax purposes, transactions using virtual currency must be reported in U.S. dollars. If the virtual currency is listed on an exchange with the exchange rate established by market supply and demand, the FMV of the virtual currency is determined by converting the virtual currency into U.S. dollars at the exchange rate, in a reasonable manner that is consistently applied.
- When FMV of property received in exchange for virtual currency exceeds the taxpayer's adjusted basis of the virtual currency, the taxpayer has taxable gain. Similarly, the taxpayer has a loss if the FMV of the property received is less than the adjusted basis of the virtual currency.
- The character of the gain depends on whether the virtual currency is a capital asset in the hands of the taxpayer. If so, capital gain or loss treatment is used. Ordinary gain or loss is recognized on the sale or exchange of virtual currency if it is not a capital asset in the hands of the taxpayer.
- When a taxpayer successfully mines virtual currency, the fair market value of the virtual currency as of the date of receipt is includible in gross income.
- If a taxpayer's "mining" of virtual currency constitutes a trade or business, and the "mining" activity is not undertaken by the taxpayer as an employee, the net earnings from self-employment resulting from those activities constitute self-employment income and are subject to the self-employment tax.

- The fair market value of the virtual currency received for services performed as an independent contractor, measured in U.S. dollars as of the date of receipt, constitutes self-employment income and is subject to the self-employment tax.
- The fair market value of virtual currency paid as wages is subject to federal income tax withholding, FICA, and FUTA, and must be reported on Form W-2.
- A payment made using virtual currency is subject to information reporting to the same extent as any other payment made in property.
- A person who, in the course of a trade or business, makes a payment of $600 or more to an independent contractor for the performance of services is required to report the payment on Form 1099-MISC (Note: This information is now reported on Form 1099-NEC). The amount that should be reported can be determined using the fair market value of the virtual currency in U.S. dollars as of the date of payment.
- Payments made using virtual currency are subject to backup withholding to the same extent as other payments made in property.
- In general, a third party that contracts with a substantial number of unrelated merchants to settle payments between the merchants and their customers is a third-party settlement organization and is required to report payments made to a merchant on a Form 1099-K if the number of transactions exceeds 200 and the gross amount of payments made to the merchant exceeds $20,000 (Note: ARPA modified the two-step de minimis standard and instead created a single standard with a single $600 reporting threshold. As of January 1, 2022, third party settlement organizations are required to file a Form 1099-K for participating payees receiving over $600).
- Taxpayers may be subject to penalties for failure to comply with tax laws. Underpayments may be subject to accuracy-related penalties under §6662. Failure to timely or correctly report transactions may be subject to information reporting penalties under §6721 and §6722. Penalty relief may be available to persons required to file an information return who are able to establish that the underpayment is due to reasonable cause.

The key takeaways from Notice 2014-21 are that cryptocurrency is treated as property, rather than currency. As such, it is critical for individuals to track the underlying basis of each unit of cryptocurrency in order to correctly calculate any potential gain or loss triggered upon sale or transfer. The tracking of each unit of cryptocurrency can be very complex, as there is a lack of reporting requirements. The IRS requested comments in response to Notice 2014-21 but did not take any action to address such comments and remained silent. In September 2016, the Treasury Inspector General for Tax Administration (TIGTA) issued a report calling attention to the IRS's lack of further guidance on virtual currency transactions and recommending the IRS take action.2 Spoiler alert: the IRS did not take immediate action.

B. Notice 2023-34

Most recently, on April 24, 2023, the IRS issued Notice 2023-34, modifying Notice 2014-21. Notice 2014-21 originally stated that virtual currency did not have legal tender status in any jurisdiction. Notice 2023-34 notes that certain foreign jurisdictions have enacted laws that characterize Bitcoin as legal tender, and as a result, Notice 2023-34 clarifies that it is no longer accurate to state that virtual currency had no legal tender status in any jurisdiction, as it relates to Bitcoin.

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2 *"As the Use of Virtual Currencies in Taxable Transactions Becomes More Common, Additional Actions Are Needed to Ensure Taxpayer Compliance"* TIGTA Report (9/21/2016).

Additionally, Notice 2023-34 clarifies Notice 2014-21 by stating: “In certain contexts, virtual currency may serve one or more of the functions of “real” currency -- i.e., the coin and paper money of the United States or of any other country that is designated as legal tender, circulates, and is customarily used and accepted as a medium of exchange in the country of issuance -- but the use of virtual currency to perform “real” currency functions is limited.”

C. Notice 2023-27

After years of speculation, in March 2023, the IRS announced its intent to issue guidance on the tax treatment of certain nonfungible tokens (NFTs). Per the guidance outlined in Notice 2023-27, a nonfungible token (NFT) is a unique digital identifier that is recorded using distributed ledger technology and may be used to certify authenticity and ownership of an associated right or asset. When an individual has ownership of an NFT, they hold the right to a digital asset that represents a “real-word” physical asset such as artwork, a musical composition, memorabilia, or film/video.

Similar to cryptocurrency, NFTs are stored on a blockchain and can be traded or sold. However, unlike cryptocurrency, NFTs are not fungible (hence the name), as they are not interchangeable. Cryptocurrency is fungible, like fiat currency, as it can be traded interchangeably, and the value is easily determinable.

An interesting aspect regarding NFTs is that purchasing or owning an NFT does not grant the purchaser copyright or reproduction rights to the digital asset, only ownership rights. For example, only one person owns an original Van Gogh piece, but many people can buy print copies of the same piece. The real “value” provided by an NFT is the satisfaction of ownership, and the value of a specific NFT is determined by what an individual is willing to pay for the ownership rights.

Notice 2023-27 states that the IRS and Department of the Treasury intend to issue guidance related to the treatment of certain NFTs as collectibles under IRC §408(m).

Per §408(m)(2), the term “collectible” means:

- Any work of art;
- Any rug or antique;
- Any metal or gem;
- Any stamp or coin;
- Any alcoholic beverage; or
- Any other tangible personal property specified by the Secretary for purposes of this subsection.

The sale or exchange of a §408(m) collectible that is a capital asset held for more than one year is subject to a maximum 28% capital gains tax rate.

The IRS intends to determine whether an NFT is a §408(m) collectible by conducting look-through analysis, meaning they will analyze whether the NFT’s associated right or asset is a §408(m) collectible. Using look-through analysis methodology, an NFT constitutes a §408(m) collectible if the NFT’s associated right or asset is a §408(m) collectible.

Notice 2023-27 provides the following examples of look-through analysis:

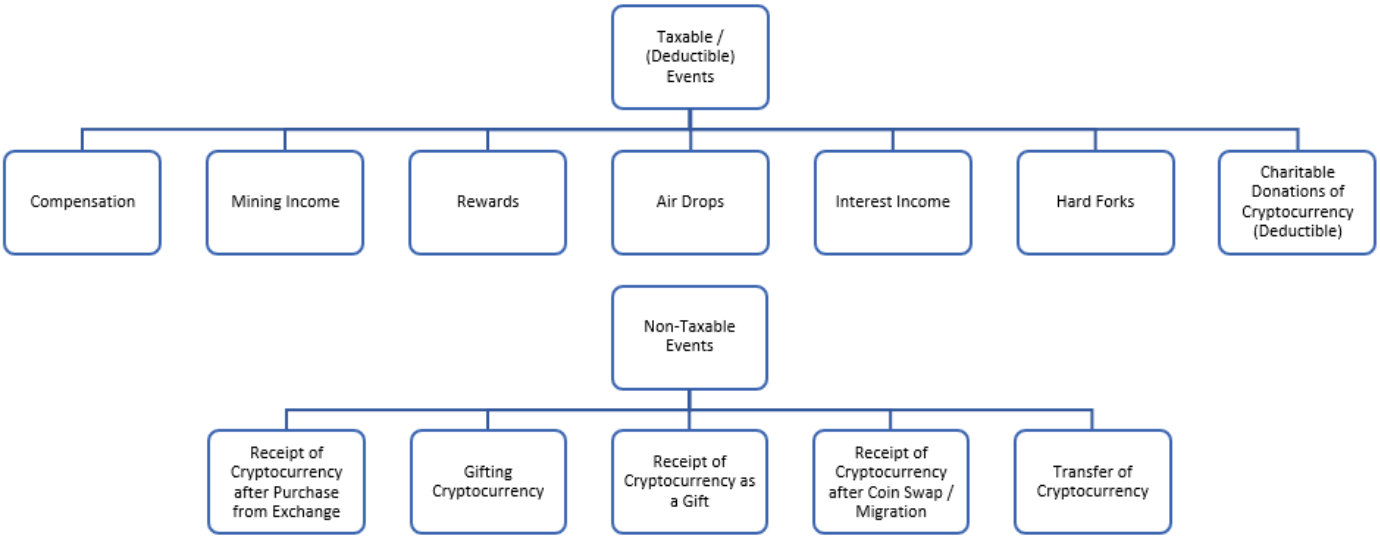
- If a gem is considered a §408(m) collectible, an NFT that certifies ownership of a gem is considered a §408(m) collectible.

- The right to use or develop a plot of land in a virtual environment is not considered a §408(m) collectible, and as a result, any NFT that provides the right to develop a plot of land in a virtual environment is not considered a §408(m) collectible.

As a result of the guidance provided in Notice 2023-27, individuals who sell collectible NFTs could potentially be subject to higher tax rates than individuals who sell non-collectible NFTs.

D. Virtual currency taxation

Notice 2014-21 and Revenue Ruling 2019-24 established that cryptocurrency is subject to taxation. In a broad sense, cryptocurrency can be taxed as either capital gain/loss or ordinary income/loss. Investors who trade and exchange cryptocurrency are taxed according to capital gain rates and are subject to a maximum $3,000 capital loss per year. Alternately, those who are actively involved in acquiring cryptocurrency, including miners, traders, dealers, and those who receive cryptocurrency as compensation or hard forks, are taxed at ordinary income rates, and can only deduct ordinary losses if associated with a §162 trade or business.



Up until recently, there has been very little regulation in the cryptocurrency community. Some US taxpayers may receive a 1099-K, *Payment Card and Third Party Network Transactions*, from an exchange if they had gross payments exceeding $600 on the exchange.[3] A Form 1099-K includes the gross amount of all reportable payment transactions. The dollar amount of each transaction is determined on the date of the transaction. As only a small segment of the population will receive a 1099-K for their cryptocurrency activity, some taxpayers may wrongly believe they have no reporting obligations due to not receiving any documents. In addition, those who receive a 1099-K from a cryptocurrency exchange cannot rely solely on the document to calculate their tax liability, as it does not contain information about the basis of each asset. On the other hand, some individuals may wrongly believe that they have a reporting obligation due to receipt of a 1099-K. If a taxpayer transfers cryptocurrency between exchanges, there is no taxable event.

[3] www.irs.gov *Understanding Your Form 1099-K.*

Other exchanges may issue Form 1099-MISC to certain individuals.

a. **Compensation** -- As with any other form of compensation, any individual who receives compensation in the form of cryptocurrency must include the compensation on Form 1040, taxed at ordinary rates. This applies to both employees (W-2), contractors (Form 1099), or any other individual receiving compensation. Even if the employer does not issue a W-2 or Form 1099, the individual receiving compensation in the form of cryptocurrency must report it at the FMV at the time of receipt.

b. **Mining Income** -- As discussed earlier, cryptocurrency miners verify and authenticate cryptocurrency transactions in exchange for cryptocurrency. Cryptocurrency miners can be broadly categorized into two main categories: professional miners (as part of a trade or business) and hobby miners.

   Professional miners conduct mining activity as part of a §162 trade or business. Professional miners must include the FMV of the mined cryptocurrency as part of their ordinary income. Additionally, as with any §162 trade or business, professional miners can deduct mining-related expenses on Schedule C.

   Hobby miners may mine cryptocurrency in their spare time, but it is not their main source of income. Hobby miners must include the FMV of the mined cryptocurrency in their gross income. Since the hobby mining does not rise to the level of a §162 trade or business, hobby miners cannot deduct mining-related expenses.

c. **Rewards** -- Staking rewards are earned by individuals who hold a cryptocurrency for a specified period of time. The individual who earns a staking reward should include the FMV of the cryptocurrency reward at the time of receipt in their taxable income. Similarly, if an individual receives a “reward” in the form of cryptocurrency while shopping on an online platform, the individual should err on the side of caution (no clear IRS guidance exists) and include the FMV of the cryptocurrency reward received in taxable income.

d. **Airdrops** -- The IRS recently released guidance (Rev. Rul. 2019-24) confirms that individuals are liable for taxes on cryptocurrencies resulting from an airdrop, regardless of whether or not the cryptocurrency is actually received. Airdrops occur when a company distributes cryptocurrency to an individual’s wallet, usually free of charge, to promote a new cryptocurrency or draw awareness. Sometimes airdrops are unsolicited, and other times individuals may complete small tasks (like sending a tweet) in exchange for the airdrop. The IRS defines an airdrop as “a means of distributing units of a cryptocurrency to the distributed ledger addresses of multiple taxpayers.” Individuals should recognize ordinary income at the FMV of the airdropped cryptocurrency at time of receipt.

e. **Interest Income** -- Some cryptocurrency platforms allow users to generate interest income on the cryptocurrency held. Individuals receiving interest income should report the amount as interest income on Form 1040.

f. **Hard Fork** -- Similar to how computers require software updates or phones require app updates, cryptocurrency networks also require updates in order to improve performance and resolve any known issues. This “update” is often referred to as a “fork” in the cryptocurrency community. Forks arise when there are two different blocks in the same blockchain that have an identical set of blocks preceding it. In Rev. Rul. 2019-24, the IRS defines a “hard fork” as “unique to distributed ledger technology and occurs when a cryptocurrency on a distributed ledger undergoes a protocol change resulting in a permanent diversion from the legacy or existing distributed ledger. A hard fork may result

in the creation of a new cryptocurrency on a new distributed ledger in addition to the legacy cryptocurrency on the legacy distributed ledger. Following a hard fork, transactions involving the new cryptocurrency are recorded on the new distributed ledger and transactions involving the legacy cryptocurrency continue to be recorded on the legacy distributed ledger." Hard forks arise if a software or network update is not backwards-compatible with the previous non-updated software. If buyer A purchases 100 units of cryptocurrency X using non-updated software, the transaction would not be recognized by the updated software. Similarly, if buyer A purchases 100 units of cryptocurrency X using updated software, the transaction would not be recognized by the non-updated software. In the event a hard fork results in the creation of a new cryptocurrency, all transactions involving the old ("legacy") cryptocurrency remain recorded on the legacy cryptocurrency ledger, but all new cryptocurrency transactions are recorded on the new cryptocurrency ledger. Both blockchains continue to develop separately.

Sometimes an airdrop occurs after the hard fork, distributing the new cryptocurrency to the individual who owned the original ("legacy") cryptocurrency. The IRS clarifies that if an individual receives an airdrop of new cryptocurrency resulting from a hard fork and has complete control over the new cryptocurrency, the individual must include the FMV of the new cryptocurrency in ordinary income.

Example: ***Hard Fork***
Kathy purchased 500 units of cryptocurrency X on blockchain A. A few months later, a hard fork occurs, and Kathy receives 500 units of cryptocurrency X on new blockchain B for free. Additionally, as a result of the hard fork, Kathy receives an airdrop of 100 units of cryptocurrency Y on blockchain B for free. At the time Kathy receives new cryptocurrency Y, it has an FMV of $1/unit. Under Rev. Rul. 2019-24, Kathy must recognize $100 of ordinary income, the equivalent FMV of new cryptocurrency Y upon receipt.

Revenue Ruling 2019-24 outlined a scenario in which an airdrop followed a hard fork, but this caused some confusion amidst the cryptocurrency community, as airdrops do not always follow hard forks. A legal memorandum, released by the IRS on April 9, 2021, clarified that "the specific means by which the new cryptocurrency is distributed or otherwise made available to a taxpayer following a hard fork does not affect the Revenue Ruling's holding." [4]

g. **Charitable Donations of Cryptocurrency** -- Questions 33 through 36 of the IRS FAQs on Virtual Currency transactions address Charitable Donations of cryptocurrency. An individual who donates cryptocurrency to a charitable organization will not recognize income, gain, or loss from the donation. If the individual held the cryptocurrency for more than a year, the amount of the charitable deduction is equal to the FMV of the cryptocurrency at the time of donation. If the individual held the cryptocurrency for less than a year, the amount of the charitable deduction is equal to the lesser of the basis in the cryptocurrency or the FMV of the cryptocurrency at the time of donation. Because cryptocurrency and digital/virtual assets are treated as property for income tax purposes, such donations will be considered "non-cash" and need to be reported on Form 8283, *Noncash Charitable Contributions*. If the individual donor claims a charitable deduction of

[4] ILM 202114020.

more than $5,000, the charity is required to sign the donor's Form 8283. The signature of the donee on Form 8283 does not substantiate the appraised value of the contributed property, it only acknowledges receipt of the property.

h. **Crowdsourcing** – An IRS legal memorandum, dated June 29 and released August 28, states that taxpayers who receive convertible virtual currency in exchange for performing a microtask through a crowdsourcing platform have received consideration that is taxable as ordinary income.[5] Crowdsourcing involves outsourcing various assignments, usually small tasks, to a large group of individuals. After the assignments are broadcasted, workers can accept the microtask, perform the work, and receive compensation, often in the form of a "reward." Oftentimes, the reward amount may be minimal, potentially even less than $1 in value. The memo provided a few examples of what is considered a "microtask," including workers processing data, reviewing images, downloading apps and leaving positive reviews, downloading games to unlock a certain level, completing online surveys or quizzes, and registering accounts with various service providers. If a worker completed any of these microtasks in exchange for convertible virtual currency, such as Bitcoin, the IRS considers the worker to have performed a task with the expectation of receiving compensation, and as such, the value of the virtual convertible currency is taxable as ordinary income.

i. **Purchases** – As cryptocurrency becomes more mainstream, individuals may make purchases using Bitcoin. Even certain gas stations, restaurants, or retailers accept cryptocurrency as a valid payment type. While many individuals assume that a simple purchase is not a taxable event, they may be mistaken. A de minimis exception does not exist for cryptocurrency reporting purposes, and as a result, common transactions could be subject to reporting requirements. For example, if an individual purchases a cup of coffee with Bitcoin, they would be required to recognize a capital gain or loss.

Other events fail to rise to a taxable receipt of cryptocurrency, including:

- **Receipt of Cryptocurrency after Purchase from Exchange:** If an individual purchases a cryptocurrency on an exchange, it is not a taxable event. However, this purchase will be helpful for calculating basis.
- **Receipt of Cryptocurrency as a Gift:** Receiving cryptocurrency as a gift does not constitute a taxable event. However, similar to purchasing cryptocurrency from an exchange, the recipient must note the FMV of the cryptocurrency on the date the gift was made as well as the donor's basis in the gifted cryptocurrency. These items are critical for future basis calculations.
- **Gifting Cryptocurrency:** Just as the receipt of cryptocurrency does not constitute a taxable event, the gifting of cryptocurrency is not a taxable event.
- **Receipt of Cryptocurrency after Coin Swap / Migration:** Coin swaps function similarly to stock splits and thus are not considered a taxable event. However, the individual should allocate basis among the new coins in order to properly calculate basis going forward.
- **Transfer of Cryptocurrency:** The transfer of cryptocurrency between exchanges or wallets is not a taxable event.

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[5] ILM 202035011.

Below is a table summarizing some of the forms and schedules that taxpayers involved with cryptocurrency should consider when reviewing cryptocurrency compliance obligations.

Cryptocurrency Compliance

Form 1040	Schedule 1	Schedule A	Schedule B	Schedule C	Schedule D	Form 8949

• "Check the box" question on page 1 of Form 1040
• Report Ordinary Income (Wages / Compensation)
  • Line 1
• Report Capital Gains / Losses
  • Line 6
	• Report Ordinary Income (Other Income)
	  • Line 8z
		• Report Charitable Deductions of cryptocurrency donations
		  • Line 12
			• Report Interest Income
			  • Part I
			• Report Rewards (Staking)
			  • Part I
				• Report income generated as part of §162 trade or business
				  • Line 1
				• Deduct any expenses associated with §162 trade or business
				  • Part 2
					• Summarize cryptocurrency Capital Gains / Losses from Form 8949	• Report cryptocurrency gains and losses

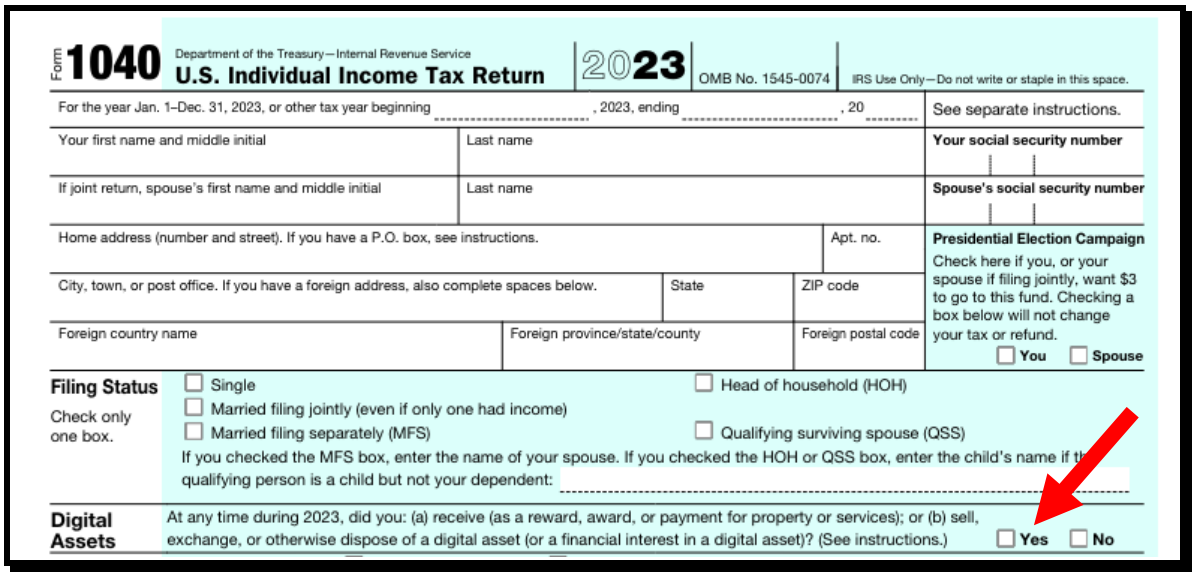
As time goes on, cryptocurrency compliance will continue to be a top area of interest of IRS inquiries and audits. More and more individuals are investing in cryptocurrency as its popularity grows. It is important for practitioners to familiarize themselves with common cryptocurrency situations and verify with clients whether or not they engaged in any cryptocurrency activity.

E. IRS Form 1040 – Digital asset question

The Virtual Currency question remains on Page 1 of Form 1040. The placement on the first page of Form 1040 means that all taxpayers are required to answer this question. In fact, the Form 1040 Instructions specifically state “Do not leave this question unanswered. You must answer “Yes” or “No” by checking the appropriate box.” Additionally, the Form 1040 Instructions state that an individual should check “Yes” if at any time during the tax year they:

- Received digital assets as payment for property or services provided;
- Received digital assets as a result of a reward or award;
- Received new digital assets as a result of mining, staking, and similar activities;
- Received digital assets as a result of a hard fork;
- Disposed of digital assets in exchange for property or services;
- Disposed of a digital asset in exchange or trade for another digital asset;
- Sold a digital asset; or
- Otherwise disposed of any other financial interest in a digital asset.

The wording of the digital assets question changed slightly for the 2023 tax year, but the position on the return remains unchanged. The question reads: “At any time during 2023, did you: (a) receive (as a reward, award, or payment for property or services); or (b) sell, exchange, or otherwise dispose of a digital asset (or a financial interest in a digital asset)?”



Form **1040** Department of the Treasury—Internal Revenue Service **U.S. Individual Income Tax Return** 2023 OMB No. 1545-0074 IRS Use Only—Do not write or staple in this space.

For the year Jan. 1–Dec. 31, 2023, or other tax year beginning ..... , 2023, ending ..... , 20 ..... See separate instructions.

Your first name and middle initial | Last name | Your social security number

If joint return, spouse's first name and middle initial | Last name | Spouse's social security number

Home address (number and street). If you have a P.O. box, see instructions. | Apt. no. | Presidential Election Campaign

City, town, or post office. If you have a foreign address, also complete spaces below. | State | ZIP code

Foreign country name | Foreign province/state/county | Foreign postal code

Check here if you, or your spouse if filing jointly, want $3 to go to this fund. Checking a box below will not change your tax or refund. ☐ You ☐ Spouse

Filing Status Check only one box.

☐ Single ☐ Head of household (HOH)
☐ Married filing jointly (even if only one had income)
☐ Married filing separately (MFS) ☐ Qualifying surviving spouse (QSS)

If you checked the MFS box, enter the name of your spouse. If you checked the HOH or QSS box, enter the child's name if th qualifying person is a child but not your dependent: .....

Digital Assets At any time during 2023, did you: (a) receive (as a reward, award, or payment for property or services); or (b) sell, exchange, or otherwise dispose of a digital asset (or a financial interest in a digital asset)? (See instructions.) ☐ Yes ☐ No

F. The Infrastructure Investment and Jobs Act

On November 15, 2021, President Biden signed into law The Infrastructure Investment and Jobs Act (IIJA), containing provisions that significantly expand cryptocurrency reporting requirements. The IIJA amended and expanded the definition of a "broker." Pursuant to §6045(c)(1)(C), brokers are "any person who (for consideration) regularly acts as a middleman with respect to property." The definition of a broker was also expanded to include "any person who (for consideration) is responsible for regularly providing any service effectuating transfers of digital assets on behalf of another person." A digital asset is "any digital representation of value which is recorded on a cryptographically secured distributed ledger or any similar technology as specified by the Secretary." Section 80603 of the IIJA modified the definition of specified securities subject to basis reporting under §6045(g) to explicitly include digital assets and to provide that these specified securities are treated as covered securities for purposes of basis reporting if they are acquired on or after January 1, 2023.

Such brokers must report cryptocurrency transactions or any other digital asset transactions on Form 1099-B, *Proceeds from Broker and Barter Exchange Transactions*. This Form 1099-B reporting requirement could prove problematic, as certain information that is reported on Form 1099-B, such as the individual's demographic information (name, address, SSN), cost basis, and acquisition date may not be readily known.

The IIJA expanded §6050I(a) to include digital assets, meaning individuals engaged in a trade or business will be required to report cryptocurrency transactions over $10,000. Any person engaged in a trade or business that has a single transaction or related transaction in excess of $10,000 must file Form 8300, *Report of Cash Payments Over $10,000 Received in a Trade or Business*, within 15 days.

Per §6045, brokers are required to file information returns and furnish payee statements for each customer for whom they sold stocks, commodities, or other specified assets in exchange for cash. These returns and statements often require the broker to provide information such as customer names and addresses, gross proceeds, and adjusted basis of assets sold.

Per §6045A, a broker who transfers to another broker securities that are covered securities in the hands of the transferring broker is required to furnish to the receiving broker a written statement setting forth

information required by the regulations. Such information generally includes specified information about the customer, the brokers involved, and the original acquisition information about the covered security. The IIJA clarified that reporting under §6045A applies to transfers between brokers of covered securities that are digital assets.

As currently defined, a broker could potentially include a broad number of individuals, including stakers, cryptocurrency exchanges, miners, or digital wallet companies. On February 11, 2022, Jonathan Davidson, Treasury Assistant Secretary for Legislative Affairs, issued a letter in response to senators who requested additional guidance on the definition of a broker. Davidson states that the Treasury intends to address the scope of the definition of a broker and the extent to which other parties in the digital asset market should be treated as brokers. Davidson acknowledged that "ancillary parties who cannot get access to information that is useful to the IRS are not intended to be captured by the reporting requirements for brokers." Examples that Davidson cited of persons who are not carrying out broker activities include those who validate transactions through a consensus mechanism, those who sell storage devices to hold private keys, and those who write software code.

IR 2023-2 (released December 23, 2022) states that the IRS and Department of Treasury intend to announce changes implemented by the IIJA by publishing regulations specifically addressing the application of §§6045 and 6045A to digital assets and providing forms and instructions for broker reporting.

Per IR 2023-2, brokers are not required to report additional information with respect to dispositions of digital assets until final regulations are issued under §§6045 and 6045A. Until new final regulations are issued:

- A broker may report gross proceeds and basis as required under existing law and regulations as of December 23, 2022 pursuant to §6045; and
- A broker may furnish statements on transfers of covered securities as required under existing law and regulations as of December 23, 2022 pursuant to §6045A.

Announcement 2024-4, released January 16, 2024, provides transitional guidance under §6050I with respect to reporting transactions involving receipt of digital assets and clarifies that, at this time, digital assets are not required to be included when determining whether cash received in a single transaction (or two or more related transactions) meets the reporting threshold.

G. Voluntary compliance

Form 14457, *Voluntary Disclosure Practice Preclearance Request and Application*, allows taxpayers who face criminal prosecution to voluntarily disclose information to the IRS that they failed to previously disclose. Voluntary disclosure does not automatically guarantee immunity from prosecution. Taxpayers who provide voluntary disclosure must agree to cooperate with the IRS in determining their correct tax liability and make a good faith arrangement to pay any tax, interest, or penalties that may arise out of the voluntary disclosure. A voluntary disclosure must be timely made prior to any of the following events:

- Prior to the commencement of a civil or criminal investigation;
- Prior to any receipt of any information from a third party related to the taxpayer's noncompliance; or
- Prior to the acquisition of any information from a criminal enforcement action, such as a search warrant or grand jury subpoena, directly related to the taxpayer's specific noncompliance.

On February 15, 2022, the IRS released revised Form 14457, which included an expanded section on reporting virtual currency. The addition of the virtual currency section to Form 14457 is in line with predictions that the IRS will ramp up its virtual currency compliance efforts within the upcoming years.

13. Schedule of virtual currency
- List ALL domestic and foreign noncompliant virtual currency you owned or controlled or were the beneficial owner of, either directly or indirectly.
  - The listings must cover the entire disclosure period as outlined in the instructions below.
  - This includes assets acquired or disposed of during the disclosure period.
  - This includes assets held through entities you owned or controlled or were the beneficial owner of, either directly or indirectly. **Note**: The entities will be further identified in Part II of this application.
- Click "Add Virtual Currency" button below for additional assets.

Virtual Currency 1

Name of virtual currency			
Identifying number or other designation *(see instructions)*	Date asset acquired	Date asset disposed	Check appropriate box ☐ Domestic ☐ Offshore
Account holders			

Add Virtual Currency
Hide Part II

Catalog Number 61637F www.irs.gov Form **14457** (Rev. 2-2022)

The Form 14457 Instructions state that for purposes of the form, virtual currency encompasses assets beyond what many define as virtual currencies. Taxpayers should report noncompliant virtual currency on line 13 of Form 14457. A noncompliant virtual currency is an asset that should have been reported on a federal income tax return or other required federal information return and was not previously reported. The taxpayer should provide details for all noncompliant virtual currency owned or controlled, or that they were the beneficial owner of, either directly or indirectly.

Additionally, Form 14457 instructs taxpayers to provide details if they used a cryptocurrency mixer or tumbler in connection with any of their cryptocurrency transactions. As discussed earlier, cryptocurrency mixers essentially work as money laundering services for cryptocurrency, obscuring the ownership trail of potentially illicit cryptocurrency. Taxpayers who used a cryptocurrency mixer or tumbler must identify the mixer or tumbler that they used and explain why they used it.

II. Donor-advised funds

A. Overview

In the realm of tax planning for high-net worth taxpayers and families ("HNW"), clients are asking more questions or pursuing investment tools known as donor-advised funds ("DAF") as a means of receiving tax benefits for charitable giving without the current burden of designating gifts and executing funding to various organizations. In a general sense, a DAF is a charitable giving investment vehicle used to manage charitable funds for families, individuals, and organizations. The investment vehicle is administered and operated by §501(c)(3) public charities known as sponsoring organizations.

Taxpayers can participate with a DAF by opening an account with the sponsoring organization by making contributions to the account in the form of cash or other financial instruments. Once the funds are contributed to the account, the contributions are owned and controlled by the sponsoring organization;

however, the taxpayer **retains advisory privileges** over the account with respect to how the funds are invested and both how and when distributions to charities are made.

Contributions to the DAF are irrevocable, and as a result, the contributions to the DAF are usually qualified charitable deductions for tax purposes, though the final destination of the funds is undetermined. In a practical sense, DAFs represent a convenient and flexible means to make contributions to charities without the need to give directly to organizations or creating a private foundation. As a practical consideration, private foundations are more costly and administratively burdensome making them a less attractive means in executing planned charitable giving.

B. DAFs, private foundations and supporting organizations

The first DAF is noted to have been created in 1931 by the New York Community Trust, though the DAF term was not codified until the Pension Protection Act of 2006.[6] As codified in §4966(d)(2), a DAF is a fund or account, owned and controlled by a sponsoring organization ("SO"), that is separately identified by reference to contributions of a donor or donors who retain advisory rights over the account with respect to the distribution of or investment of amounts held in such fund or account by reason of the donor's status as a donor.

As noted above, the funds of a DAF are owned and controlled by an SO, and for purposes of a DAF, SOs are defined as any organization described in §170(c), is not a private foundation under §509(a), and maintains 1 or more DAFs.[7] Section 170 distinguishes types of donors between individuals and corporations, donees between public charities and private foundations, property contributed, the applicable limitations regarding charitable contribution deductions, and the carryover of the excess contributions related to excess charitable contribution deductions.

In general, §501(c)(3) provides tax-exempt charity status to both public charities and private foundations, including SOs. Though SOs can sometimes look like private foundations, they are separate and distinct from private foundations in that they are specifically treated as public charities for tax purposes under §509 with applicability of all relevant regulations as well as the tax benefits available to donors. With that, organizations funded by only a few donors exercising control usually are private foundations. Organizations funded by many donors with limited advisory privileges and no control tend to be considered supporting organizations.

The distinction between public charities and the private foundations relates primarily to the oversight of the organization and the extent to which public support provides for the operation of the entity. Some key distinctions are highlighted below.

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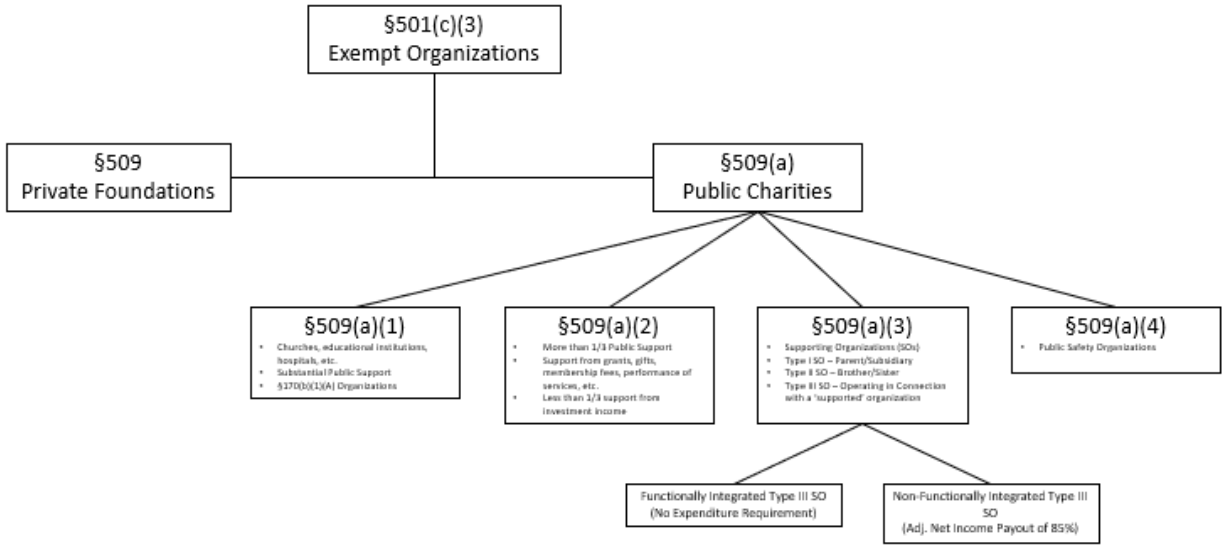
6 See Victoria B. Bjorklund, "The Emergence of the Donor-Advised Fund," 3 Paul Streckfus' EO Tax J. 15 (May 1998) and Victoria B. Bjorklund, "Choosing Among the Private Foundation, Supporting Organization and Donor Advised Fund," (May 2003), p. 27.

7 §4966(d)(1)

Features	Public Charity	Private Foundation
Mandatory Distribution Requirements	Generally, No	Yes
Limitations on Contribution Deductions	Generally, 60% through 2027	30% Limitation
Excise Tax	No for qualifying distributions	Yes
Restrictions on investments and distributions	No	Yes
Donor control of Investments and Distribution	No	Yes

SOs in a general sense qualify as public charities under §501(c)(3) because of the relationship the organization shares with other charities that carry out more traditional tax-exempt activities. SOs keep their tax-exempt status by passing tests based on organization, operation, control, and relationship tests. Section 509 provides definitions of different types of SOs, and the underlying requirements for each type of charitable organization, and the structure of charitable organizations can generally be thought of as is illustrated graphically below.



1. Regulation of donor-advised funds and supporting organizations

As noted above, prior to 2006, there was no formal definition of a DAF, and because of this, abusive practices arose in the industry. A mainstay example can be found in the *New Dynamics Foundation v. U.S.* case of 2006.

New Dynamics Foundation (NDF) was a California, public benefit, nonprofit entity granted state tax exemption in California. The entity, when formed, planned to work with tax and other financial professionals to establish individual accounts where the funds could be directed for charitable purposes. This was consistent with the NDF's articles of incorporation that indicated its purpose was to promote and contribute to public good causes as defined §170(c). The issues arose both in marketing materials as well as in the oversight and administration of the funds. Several promotional materials of NDF sought investment by marketing "tax-free" growth of funds within a public charity.

As funds were contributed to NDF and operational manuals were reviewed by contributors, several nuances demonstrated inconsistencies with the entity's purpose of public benefit with how the funds were actually administered. Operational manuals outlined that directors of the funds could be contributors themselves (resulting in conflicts of interests) and that administrative expenses could include personal expenses of the contributors and fund directors. Further, the NDF founder indicated on several occasions to donors that the administrative/personal expenses could account for 95% of the money contributed to the funds, indicating the identified purpose of the organization and the actual administration were inconsistent.

NDF filed an application with the IRS for federal, tax-exempt status under §501(c)(3). Section 501(c)(3) requires entities to be organized and operated for religious, education, or charitable purposes exclusively, and no part of the earnings can be directed for private individual or shareholder benefit. Entities unable to meet the requirements will not be granted tax exemption. In the case of NDF, the IRS found insufficient cause for tax-exempt status and denied the application.

Subsequently, NDF filed suit to have the IRS's determination overturned on the grounds of it being a DAF as upheld in the National Foundation, Inc. case of 1987. The court agreed with the IRS citing an intent from formation to accrue inappropriate tax benefits by reducing and eliminating estate taxes, avoiding taxes on capital gains, and using the funds as a tax-free vehicle for accruing retirement benefits. Furthermore, while some of the contributed funds were eventually used to fund legitimate and recognized tax-exempt organizations, these donations represented fewer than 5% of contributions. In the National Foundation, Inc. case, it was demonstrated that great efforts were taken to ensure expenditures of the fund were legitimate and not personal in nature. Similar facts were not present in the NDF case.

These abusive practices were curtailed with the Pension Protection Act of 2006 (PPA) codifying DAFs. The goal was to take steps in regulating the supporting organizations owning and controlling the accounts. This came about by amending §509 of the code, which as noted, above, provides the framework for tax-exempt entities along with the general responsibilities applicable to maintain tax-exempt status. The PPA defined SOs along with the distinction of applicable regulations for Type I, II, and III SOs; provided guidance on functionally and non-functionally integrated SOs; and imposed excess business holdings excise taxes on non-functionally integrated Type III SOs along with certain Type II SOs. To the extent practitioners are advising supporting organizations, the regulations are complex and require specialized experience to appropriately navigate compliance.

C. Tax planning and DAFs

As a review, contributions to a DAF are generally treated the same as donations to any other public charity as defined under §501(c)(3) and are generally subject to the general charitable contributions limitations as outlined §170. Strategies around charitable giving are most often highly subjective to the goals of the taxpayer, but general strategies exist during the donate, growth, and support phases of a DAF.

1. **Donate** -- As many practitioners know, taxpayers become much more interested in total taxes and taxes expected to be due at the end of a tax year and often seek to implement tax reduction strategies when it is somewhat after-the-fact. The general advice to generate more deductions, usually through charitable contributions, is the same for nearly every filer with taxable income. However, to the extent a taxpayer appreciates a more proactive approach, a DAF is a good way to automate charitable donations without having to make specific charitable giving decisions throughout the year. This can be

done by setting up automatic drafts to the DAF. With contributions made throughout the year rather than just at year-end, there is greater potential for compounding and growth on the contributed funds, which provides greater funding opportunities for charitable causes.

DAFs also provide charitably minded taxpayers the opportunity to pre-fund charitable giving to be executed in retirement years and or to pre-fund charitable giving in tax years of higher income. To the extent a taxpayer is aware of higher income years, this becomes a greater planning opportunity, and educating our clients on economic events triggering higher income years can be an effective strategy in planning. Taxpayers that may be selling a business, selling appreciated real estate, or exercising stock options are great candidates for considering DAFs.

2. **Grow** -- As a contributor to a DAF, the donor usually has input into how the funds are invested and can make recommendations for capital preservation. The funds in the DAF grow tax-free according to the investment strategy implemented by a specific DAF. The strategies can range from money market, growth, emerging markets, fixed-income, etc.

   Because there are investment opportunities with DAFs, it can sometimes be used to rebalance a portfolio of assets while also securing charitable contribution deductions. In the rebalancing process, a donor can select the most appreciated assets in a portfolio, contribute them to DAF for a deduction of the fair value of the assets (subject to limitations), and avoid the capital gain that would have been generated if the asset had been sold. This allows the donor to realign their portfolio with the overall strategy, gain access to charitable contribution deductions, and fund future charities with tax-free growth.

   Additionally, taxpayers trying to avoid §1091 wash sale transaction rules may consider using charitable deductions to dispose of securities and subsequently purchasing the stock for a different basis in a loss-harvesting strategy for capital gains.

   With the investment component of DAFs, there is great potential for tax efficiency, but there is also potential for loss on investments resulting in a reduction in ability to fund future charitable grants. This reminds advisors and taxpayers alike to remember the market exposure on DAF accounts and to plan accordingly for down markets.

3. **Support Charitable Operations and Grants** -- As individuals are so inclined, they can make recommendations regarding when and how those funds are paid out. Because of this, DAFs are a great opportunity to provide charitable support to organizations when needed most in economic downturns without pressuring the cash-flow of individual taxpayers also subject to the same economic environment. In a sense, the charitable support is prepaid and available when a cause close to a taxpayer is in need.

   Donors should remember that the contributions are irrevocable, and the funds are ultimately controlled and liquidated as the discretion of the board overseeing the supporting organization and/or the underlying DAFs, though most supporting organizations and DAF boards executing giving as directed if permissible under IRS regulations. This leaves all due diligence and reporting responsibilities to the supporting organization and simplifying the reporting requirements of individual donors. Taxpayers

utilizing DAFs will receive consolidated contribution support for contribution deductions from the DAF directly rather than need to obtain and retain documentation charitable activities for each organization supported. With annual fees sometimes less than 1% and some individual donor entry points as low as $5,000, DAFs have become and continue to be tools growing in popularity for all levels of income and assets.

1. Tax efficiency example

A donor has long-term appreciated stock in Publicly Traded, Inc. with a basis of $125,000 and market price of $200,000. The donor is interested in making a charitable donation to DAF, Inc., his donor-advised fund, with a value of $200,000. He approaches his tax advisor to understand what the best way is to maximize the deduction, and the tax advisor demonstrates the following scenario.

	Sell Stock / Donate Cash	Donate Stock
(A) FMV	$200,000	$200,000
(B) BASIS	$125,000	$125,000
(C) Capital Gain	$75,000 (A - B)	$0
(D) Applicable Capital Gain Rate	20%	0%
(E) Capital Gain Tax	$15,000	$0
(F) Charitable Deduction	$200,000	$200,000
(G) Marginal Tax Rate	37%	37%
(H) Tax Saved with Charitable Contribution	$74,000 (F * G)	$74,000 (F * G)
(I) Total Cost to Donor	$141,000 (E + F – H)	$126,000 (E + F – H)
This example assumes marginal tax rate of 37% and no applicable limitation of contribution deductions of capital gain property.		

As illustrated above, there can be a notable advantage to donating stock rather than selling stock and donating the cash. Because some charitable organizations are not set up to receive stock, a DAF can be great to donate stock, liquidate the stock within the DAF tax-free, and subsequently donate the funds to the desired charitable organization.

III. Individual

A. Estimated taxes

For the year 2024, estimated taxes paid must be at least 110 percent (100 percent for taxpayers with AGI less than $150,000) of the 2023 tax liability or 90 percent of the actual 2024 tax liability in order to qualify for the safe harbor against the penalty for the underpayment of income tax. Many clients who have a high rate of return on capital are reluctant to pay taxes to the government any earlier than is required.

Discussion question:

How would taxes withheld from an IRA distribution affect this?

1. In general

Taxpayers are subject to rather significant penalties for failure to pay estimated taxes in a timely fashion. Ordinarily, this requires equal quarterly payments. The pre-funding of the estimated tax liability is the difference between having to pay possibly only additional tax with no penalty and possibly having to pay even more additional tax and penalty.

a. The penalty is equal to the product of the applicable federal short-term rate plus three percentage points and the amount of the underpayment over the period in which the underpayment is outstanding. The first issue that must be addressed is whether on an after-tax basis the taxpayer may be better off just paying the penalty. This in general is a function of the taxpayer's **after-tax rate of return** on the excess of the 110-percent safe-harbor estimated taxes over the estimated taxes actually paid (this excess is referred to as the deferred estimated taxes) in comparison to the effective penalty rate on the **underpayment**.

b. Despite potential after-tax benefits in not making the full estimated tax payments, some clients blanch at the sound of the word "penalty," and accountants may have a hard sell in explaining why the penalty may be financially advantageous.

2. Planning tactics

Because the penalty is computed based on the total underpayment when the taxpayer cannot use the safe harbor, the greater the income actually earned, the greater the penalty -- while the amount of the taxpayer's benefit is based on the deferred estimated taxes only. This means that if the client does too well, the benefit of the deferred estimated taxes may be completely overwhelmed by the increased underpayment of tax penalty.

For purposes of the following discussion, ATROR is the taxpayer's after-tax rate of return, PRATE is the penalty rate, and PYTAX is the prior year's tax liability.

a. The opportunity cost of paying the estimated tax is equal to (ATROR - PRATE) x 1.1 x PYTAX. How much tax liability above the amount determined can the taxpayer have before the additional penalty exceeds the opportunity cost?

$$(X - 1.1 \times PYTAX)\ PRATE = (ATROR - PRATE) \times 1.1 \times PYTAX$$
$$X = \frac{(ATROR - PRATE) \times 1.1 \times PYTAX}{PRATE} + 1.1 \times PYTAX$$

Suppose the taxpayer's ATROR is 5 percent, the penalty rate is three percent,[8] and the prior year's tax liability is $100,000.

$$X = \frac{0.02}{0.03} \times \$110,000 + \$110,000$$

$$X = \$73,333 + \$110,000 = \$183,333$$

Thus, only when the tax liability increases to more than $183,333 does it make sense to pay any estimated tax at all! Under the facts of this case, all income is taxed to the taxpayer at the 37-percent rate.

[8] IR-2021-50.

b. When a safe harbor is not available, the required quarterly **estimated tax payments** are determined by 90 percent of the actual tax liability for 2024. End-of-the-year estimated tax payments, although sufficient to meet the taxpayer's tax liabilities in amount, will generally subject the taxpayer to underpayment penalties because the underpayment penalty began running on the deficiency in required payments on earlier quarterly estimated tax due dates. Such payments are always treated as paid when they are actually paid.

3. The W-2 solution

In contrast, the amount of the **income-tax withholding** for the taxable year is deemed a payment of estimated tax, and an equal part of such amount is deemed paid on each due date for such taxable year, unless the taxpayer establishes the dates on which all amounts were actually withheld, in which case the amounts so withheld are deemed payments of estimated tax on the dates on which such amounts were actually withheld.[9] Hence, the taxpayer can make up any deficiency at the end of the year by having up to 100 percent of the net salary after the payment of other employment taxes withheld, throwing back the withholding to each due date of estimated taxes.

Planning point:

This can always be accomplished if the taxpayer controls the taxpayer's employer and generally through most payroll departments. Of course, it is not available if the taxpayer is solely a self-employed person. And even where the extra withholding is available, the taxpayer cannot have withheld any more than the aggregate net salary to be paid to the taxpayer over the balance of the year. Depending on the absolute size of the amount of estimated taxes to be made up and/or the remaining net salary, the taxpayer may not be able to escape the penalty entirely. But the taxpayer can still employ the 110-percent safe harbor, so the amount of the deficiency to be made up is not 90 percent of the 2024 actual tax liability over the estimated taxes actually theretofore made, but 110 percent (and in some cases, 90 percent, as discussed below) of the 2022 actual tax liability over the estimated taxes actually theretofore made.

4. The qualified-plan solution

Individuals who are in current payout status from a qualified plan or IRA may alleviate the timing problem by directing the plan administrator to withhold up to the entire amount of any required or permitted distributions (grossed-up for the income-tax effect of the distributions). The distribution from a qualified plan or IRA is a designated distribution that is generally treated as the payment of wages.[10] Therefore, any taxes withheld are treated as income taxes withheld in an equal amount on each due date of estimated tax for the taxable year.

a. The taxpayer may use distributions from a qualified plan only if the taxpayer is over a certain age; otherwise, the distributions may be prohibited by the terms of the plan or be subject to an additional 10-percent penalty that may exacerbate rather than relieve a penalty situation. The amount that can be withdrawn in pension plans may be limited by the joint-and-survivor annuity or single-life annuity under the terms of the plan. Moreover, such distributions are prohibited until the participant has reached the retirement age under the plan, usually age 65. There is more flexibility in a profit-sharing plan or §401(k) plan because distributions prior to retirement are generally available, but such withdrawal rights must be available to all participants, not just for the taxpayer, particularly when the taxpayer is an owner of the employer. IRAs are generally more flexible because access

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9 I.R.C. §6654(g)(1).
10 I.R.C. §3405(f).

to the account can be tailored to the individual, and any amounts up to the entire account can be withdrawn at any time, subject to penalties for premature withdrawals.

b. In either case, taking more than the required minimum distribution from a qualified plan or IRA has its own disadvantages that may outweigh the underpayment of tax penalty that may otherwise have to be paid. Moreover, the amount that must be taken is increased by the fact that any amount taken from either one increases the income-tax liability and the potential underpayment that must be rectified.

5. The IRA solution

If the taxpayer is not already in pay out status, the taxpayer has two options: (i) if the taxpayer is employed, the taxpayer may have up to the entire amount of any before-the-end-of-the-year bonus withheld; or (ii) if the taxpayer has an IRA, the taxpayer can use the IRA-rollover rules. Here it is assumed that the taxpayer has sufficient cash to make a year-end payment of estimated tax from the taxpayer's own funds. An individual who holds amounts in an IRA may request a distribution of any amount up to the full account balance and also withholding on up to 100 percent of that distribution. Because a designated distribution includes distributions from an IRA, the withheld tax is treated as paid from wages in equal amounts on the due dates of the estimated tax during the taxable year.

Caution:

A distribution from an IRA prior to age 59-1/2 may be subject both to income tax and to a penalty tax on a premature distribution. Both of these adverse tax consequences, which otherwise would outweigh the avoidance of the underpayment penalty on estimated taxes, do not arise if the taxpayer returns the amount of the distribution (including the amount withheld) to the IRA within **60 days** of the date of the distribution. Thus, suppose the taxpayer finds on December 1 that there will be an underpayment of $15,000 (from the 110 percent of 2023 tax liability or 100 percent of actual 2024 liability) and he has $15,000 in the bank account and $15,000 in an IRA. If the taxpayer merely deposits $15,000 from the bank account with the federal government on December 30, there will nonetheless be an underpayment penalty. But there is no underpayment penalty if the taxpayer requests a $15,000 distribution from the IRA with 100-percent withholding. Fifteen thousand dollars is paid to the government and treated as though paid pro rata on the due dates for the estimated tax payments. This eliminates the penalty but for the underpayment of taxes attributable to the deemed distribution of $15,000 to the taxpayer (and the penalty, if any, if the distribution is premature). This hypothetical additional underpayment is eliminated by the taxpayer's deposit of the $15,000 from the bank account into the IRA no later than February 28 of the following calendar year. This converts the deemed distribution into a simple rollover, not subject to income tax and generating no additional penalty since there is no distribution, let alone a premature one.

B. Loans with below-market interest rates

1. In general

In general, the interest rates now applicable to inter-family loans have reached historic lows. Loans entered into in recent months need only bear small amounts of interest to avoid the imputation of interest under §7872.

2. Gifting

Estate planning has become more favorable in many respects by reason of the higher ($13,610,000) exclusion amount in 2024. The 2012 tax legislation once again reunited the two (three) transfer-tax systems permanently, again providing the same exclusion from the gift tax as is available in the estate tax. Thus, with a $13,610,000 lifetime-transfer limitation, meaningful transfers during lifetime can again

proceed apace often without resort to leveraging except for the very wealthy where discounting will be necessary to reduce or eliminate transfer tax liability.

The health care law further imposes on individuals, estates, and trusts, a new tax that is in addition to any other tax imposed. This tax is applied annually in an amount equal to 3.8 percent of the lesser of **net investment income** for such taxable year,[11] or the excess (if any) of: (i) the **modified adjusted gross income** (MAGI) for such taxable year;[12] over (ii) the **threshold amount**.[13] For these purposes, the threshold amount means:

- In the case of a taxpayer making a joint return or a surviving spouse, $250,000;
- In the case of a married taxpayer filing a separate return, 1/2 of that dollar amount determined under paragraph (i); and
- In any other case, $200,000.

Planning point:

Net investment income does not include any distribution from a plan or arrangement described in §§401(a) (qualified plans), 403(a) (qualified annuity plans), 403(b) (tax-deferred annuities), 408 (IRAs, SIMPLEs, and SEPs), 408A (Roth IRAs), or 457(b) (governmental and tax-exempt organization deferred-compensation plans).[14]

HOWEVER, distributions from such plans are generally fully taxable (in contrast to, say, a Roth IRA or Roth §401(k) plan) and add to the taxpayer's AGI (and MAGI). Thus, the effect is secondary. Although retirees will not be taxed on retirement distributions themselves, the distributions may cause some or all of the taxpayer's other investment income, traditionally a large percentage of a retiree's income, to be subject to the additional 3.8-percent Medicare tax.

Increase tax-favored income by converting taxable interest to tax-exempt interest. This will serve to reduce AGI and MAGI, which will accomplish the following:

- Reduce the effect of certain phase outs based on AGI;
- Limit the excess over the $250,000 threshold to minimize or eliminate any additional Social Security tax on wages or unearned income; and
- Limit the exposure to a higher tax bracket through rate increases.[15]

Planning point:

One has to take the costs of conversion into account. The sale of a corporate bond could produce gain or loss, while withdrawal of funds from a money-market account into tax-exempt bonds or fund (or a tax-exempt money-market account) would not.

Family income-shifting and C corporation income-splitting must be more seriously considered. Shifting earned income to a child serves the goals of reducing the compensation subject to additional Medicare tax, spreading the AGI around to reduce or eliminate the potential for excess MAGI for any member of the economic unit, and reducing the overall tax burden by shifting income to a taxpayer in a lower tax bracket. Since the kiddie tax applies only to **unearned income** of a young child, the shifting of **earned income** to the child by paying the child a salary through the family business is not affected by the kiddie tax.

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11 I.R.C. §1411(a)(1)(A)(i).
12 I.R.C. §1411(a)(1)(B)(i).
13 I.R.C. §1411(a)(1)(B)(ii).
14 I.R.C. §1411(b)(5).
15 However, it will be included in the side computation of determining the amount of Social Security benefits included in gross income.

Tactics to Reduce AGI
Converting taxable compensation into nontaxable fringe benefits.
Shifting income to others.
Splitting income with a C corporation.
Deferring income through nonqualified deferred compensation in a non-pass-through business.
Using installment reporting (if available, on sales of property).
Reducing business income by reimbursement of employee-paid expenditures.
Reducing business or rental real estate, S corporation, and partnership income by maximizing expensing allowance and bonus depreciation (if then available).
Tax-exempt interest income.
Exclusions of gain on the sale of principal residence.
Exclusions of gain on like-kind exchanges (now limited to real property).
Exclusions of gain on the sale of business structured as a reorganization.
Making charitable contributions directly from an IRA to the charity rather than receiving a distribution that is included in income but only offset below the line.
Increasing elective deferrals and contributions to qualified plans.
Changing qualified plan to defined benefit plan to increase the amount deductible.
Increasing contributions to IRAs, if not phased out.
Increasing contributions to HSAs.

Planning point:

Family-income splitting or deferral of current income in a C corporation may enable the taxpayer to structure the tax profile that may enable a more efficient use of itemized expenses in that year.

Note:

Gains are generally included in net investment income and thus may subject a taxpayer to an additional Medicare tax on gains recognized in 2013 and later years.

A GRAT becomes more favorable because the lower discount rate makes the annuity payments more valuable; this means that the gift-tax value of the remainder is reduced. When a GRAT is established, the grantor retains an annuity interest and transfers the remainder interest in the contributed property to third-person beneficiaries. Only this latter interest is subject to the gift tax. Because the annuity and the remainder always add up to the total value of the property transferred, two simple rules emerge: the larger the value of the retained annuity, the smaller the value of the gifted remainder; conversely, the smaller the value of the annuity, the larger the gifted remainder. As the annuity value goes down as discount rates go up, the transfer to a GRAT causes the least gift per dollar of value transferred when the discount rates are the lowest.

Planning point:

Reduction of the future gain, if recognized in 2013 or later years, can serve to reduce both the gain included in investment income and in the taxpayer's MAGI. A similar analysis should be applied for 2024 to determine whether a sale will then effectively reduce the impact on the excess Medicare tax going forward.

Another advantage of the GRAT arises from the deflationary forces that have devalued much property solely due to the current credit markets. For those who believe the markets will rebound and that prices will recover, the amount of the transfers and correspondingly the value of the remainder interest is reduced at the time of the transfer but will rebound (appreciate) from the restoration of the capital markets

apart from fundamentals. Because the value of a gift is determined by a valuation at the time of the transfer, the depressed prices offer opportunities to transfer value at bargain prices.

The collapse of the real estate market generally and the housing market specifically made realty a prime gifting category (even in 2024 there may be some advantages). Analogous to a GRAT, the GRIT or Personal GRIT involves the retention of the use of the transferred property by the grantor and the gift of the remainder interest to a beneficiary. The transfer tax does not change even as the value of the transferred property increases with the recovery of the economy.

A general principle of gifting from a purely tax perspective is the removal of the property transferred from the estate of the transferor. Property that is held until death is included in the estate, including both the current value, the future income from the property, and any subsequent appreciation. A completed gift for estate-tax purposes does not avoid the current value as it is applied against the taxpayer's gift-tax exclusion; but what does escape both taxes is the subsequent appreciation of the property. In a GRAT, the future income during the term remains in the donor's gross estate, but outright transfers will remove the future income from the transfer at death. Given the choice between two properties of like current value, the gift of the property with the higher appreciation potential saves more taxes. In an era of deflation, gifts of property have greater potential of appreciation not only in contrast to gifts of cash but also in contrast to property in non-deflationary times, just because of the value depression that may disappear with a change in the credit market.

Note:

This is not to suggest that transfers of cash serve no function in this situation. Such gifts are usually limited to the annual exclusion amount ($18,000, $36,000 with gift-splitting, in 2024). This has had the effect of limiting transfers to donees. But transfers made as bona fide loans are not taxable gifts.

As noted in the following item, there are restrictions placed on loans to guarantee that they are not used to shift income in appropriate ways. What is required is that the purported loan bear **at least some resemblance** to what a loan with an unrelated third party would look like. The Congress has chosen the interest rate as the metric by which to determine if related parties are gaming the system or not. The Service publishes interest rate minimums for various length-of-term loans monthly and the taxpayer or tax advisor must use such minimum interest rate level or suffer adverse tax consequences that are determined by restructuring the purported loan into another kind of transaction.

Example: Peggy makes a below-market loan to Linc that results in foregone interest of $5,000. Peggy includes $5,000 in income as taxable interest but Linc cannot deduct the $5,000 interest he is deemed to have paid her.

Accordingly, §7872 recharacterizes a below-market loan as two transactions:

- An arm's-length transaction in which the lender makes a loan to the borrower in exchange for a note requiring the payment of interest at the applicable Federal rate; and
- A transfer of funds by the lender to the borrower ("imputed transfer").

Note:

If the imputed transfer by the lender is characterized as a gift, the provisions of chapter 12 of the Internal Revenue Code, relating to gift tax, also apply.

In the case of a gift, the lender is treated as making a gift of the interest to the borrower but the borrower nonetheless still is treated as transferring that amount to the lender as interest. However, if a taxpayer makes a gift loan that is a term loan, the excess of the amount loaned over the present value of all payments which are required to be made under the terms of the loan agreement is treated as a gift from the lender to the borrower on the date the loan is made. If a taxpayer makes a gift loan that is a demand loan, the amount of foregone interest attributable to that calendar period is treated as a gift from the lender to the borrower.

The **de minimis exception** applies to the gift-tax treatment of a gift loan. This excepts from the application of the income tax or gift tax a below-market loan that does not exceed $10,000. In the case of a term-gift loan, however, once §7872 applies to the loan, the de minimis exception will not apply to the loan at some later date regardless of whether the aggregate outstanding amount of loans does not continue to exceed the limitation amount.

3. Loans to children

Persons can enhance their investment return by providing funds at above the historically low current interest rates to children or other related parties at rates that also are below the rate that the related party might otherwise have to pay. The Code provides a backstop to such loans by also requiring generally that they bear a market rate of interest or trigger adverse income-tax consequences. Section 7872 generally treats certain loans in which the interest rate charged is less than the applicable federal rate as economically equivalent to loans bearing interest at the applicable federal rate, coupled with a payment by the lender to the borrower sufficient to fund all or part of the payment of interest by the borrower. Such loans are referred to as “below-market loans.” This has the effect of including taxable interest in the income of the lender and treating the borrower as paying interest, a payment that is generally not deductible. Not only is the interest income taxable at the lender’s highest rate, but even if the borrower is in the same tax bracket -- and this is generally not the case -- there is a creation of net income out of nothing.

a. Ideally, these loans could be made at very low or no interest. Up to $10,000 can be loaned interest-free without income-tax consequences. However, generally, such loans do have an income-tax effect. Due to relatively low interest rates, now is the time to take advantage of them at very little tax cost. This tactic can be used now to lock-in current interest rates before the rates return to higher levels.

Note:

Care should be taken in documenting the transaction to preserve any potential bad-debt deduction in the event of nonrepayment.

b. The rules regard foregone interest in the context of a gift as a gift loan. The forgone interest on a gift loan is treated as having been transferred by the lender to the borrower as a gift, and then transferred back by the borrower to the lender as interest. In determining the amount of the gift, the AFR discount rate is applied to the required payments to be made. The differences in valuation for different types of loans are discussed below.

Note:

In many cases, the amount of the interest deduction would be largely irrelevant to a low-bracket taxpayer, and in cases not involving the mortgaging of the principal residence largely precluded by reason of the interest-tracing rules. While the borrower has no interest income, the lender can have interest income and potential gift-tax liability (or application of some part of the applicable exclusion amount). However, if the foregone interest is less than the annual exclusion, the entire amount may escape the gift-tax system.

c. Another opportunity lies in making gift loans that do not exceed $100,000. As long as the aggregate principal amount of loans between the borrower and the lender do not exceed $100,000, the interest deemed transferred by the borrower to the lender is limited to the borrower's net investment income.

Planning point:

This is particularly appropriate in circumstances when the borrower has little or no investment income. In fact, if the borrower has investment income of less than $1,000, the borrower is treated as having no investment income, so in that case, the lender has no imputed interest income at all. (Of course, because investment income is defined the same as that used in the context of the investment-interest-expense provisions, the election by the borrower to include capital-gains income could have adverse income-tax consequences to the lender either by increasing investment income above the $1,000 floor or by increasing the amount that may be treated as imputed interest.)

Example: On January 1, 2024, parent P makes a $50,000 below-market gift loan to C, P's child, who uses the calendar year as the taxable year. Assume that C's net investment income for 2024 is $500. The limitation on the amount of imputed interest payment applies to the $50,000 loan for the entire year beginning on January 1, 2024. Accordingly, the imputed interest payment on the $50,000 loan for 2024 is $0.

d. The mechanics of §7872 turns on the concept of the applicable federal rate (AFR), which depends upon the term of the loan.

Term of the loan	Interest rate[16]
No more than three years	Federal short-term rate
More than three years, but no more than nine years	Federal midterm rate
More than nine years	Federal long-term rate

Note:

The interest rate is generally lower the shorter the term and higher the longer the term. Currently, regardless of the term, the rates are at or near historic lows. Such "loans" then that are below such minimums of actual interest rates will result in small tax effects in terms of imputed income. Many clients may be more receptive to a plan that requires them only to include a tax hit in lieu of a transfer of actual cash.

e. In the case of a term loan, the interest rate is considered **below market** if the amount loaned exceeds the **present value** of all payments received under the loan.[17] Generally, the present value is determined by using a discount rate equal to the applicable Federal rate compounded semiannually, that is, the AFR in effect the day the loan was made.[18]

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16 I.R.C. §7872(e)(1)(A). Adjusted monthly.
17 These are the same as used in original-issue-discount rules under I.R.C. §1274.
18 I.R.C. §7872(e)(1)(B).

Planning point:

What is often a disadvantage of a term loan may be advantageous in the current environment. The entire amount of the imputed interest over the term of the loan is included but will be calculated using only the interest rate when the loan is entered into. This creates a tax arbitrage where the rate of return on the borrowed money is greater than the AFR. It shifts the taxation on such income to the lower-bracket child.

f. A demand loan is considered as carrying a below-market interest rate if its interest rate is below the applicable Federal short-term interest rate (i.e., three years or less) that is in effect during the period for which the interest rate is being determined.[19] Amounts are treated as transferred on a daily basis. Thus, the AFR for any day is the relevant rate for the month in which such day falls. This is in contrast to term loans in which the AFR is always the rate in effect for the day in which the loan was made.

Note:

If interest rates rise, the interest differential and imputed interest will rise for a demand loan and will be recalculated each year the loan is outstanding, while the benefits of a low-interest rate may be fixed in a term loan.

g. Now might be the time for clients to facilitate the purchase of a starter home for those children who have reached that stage in their lives by funding the down payment by a $18,000 gift shielded by the annual exclusion ($36,000 if gift-splitting is applicable). Alternatively, the client can make a low-interest-rate loan of the down payment or the full mortgage amount. Such loans are generally subject to §7872 rules that require a minimum (or will be deemed to have) interest rate at the AFR. This produces taxable interest income to the parent's tax rate, thereby reducing the amount of the subsidy as calculated above. The child, even if the loan from the parent is collateralized by the residence, may not be able to deduct the interest if the child cannot itemize deductions. However, no interest rate need be (and none will be deemed to be) applicable if the gift loan does not exceed $10,000 and applies to loans in excess of $10,000 but not in excess of $100,000 only to the extent of the child's net investment income for the year.

Note:

The economic condition also makes real estate values at depressed (hopefully, bargain) values. In addition, the mortgage market rates appear to be headed down with many government-sponsored restructurings aimed at the 4.5-percent level. Low mortgage, low price – the time is nigh.

IV. Spouse

A. Employing the spouse

1. In general

Payments made to a spouse as an employee are subject to Social Security. Consequently, whatever W, a self-employed spouse, may save in reduced self-employment taxes will be offset by the burden of FICA that W must pay by hiring the spouse. However, this cost may be offset to a degree if, as noted above,

[19] I.R.C. §7872(f)(2)(B).

such payments would qualify her husband, H, for certain Social Security benefits to which he might not otherwise be entitled. If H pays Social Security taxes for a sufficient period, H would be eligible for retirement and survivor benefits.

2. Social Security

Because the Social Security benefit is based on the high 35 years of indexed wages, without participation for at least 35 years, many years will be zero, reducing the benefit. But the wages, while generating new Social Security benefits, will be subject to a full FICA withholding at the full FICA rate, because this involves shifting wages from the taxpayer, presumably subject only to the 2.9 percent rate on wages above the taxable wage base. Thus, shifting compensation or earned income to a spouse generally entails an additional 12.4-percent Social Security charge, while if the compensation paid, if equal to the then-average indexed wages for the years of service, only increases the benefit by 1/35 (about 2.857 percent). The added benefit in some cases may be worth the cost of funding. In others, the hiring of the spouse may be justified in terms of other benefits.

Example: Jean had previously worked for 20 years and would be entitled to a Social Security benefit of $3,000. If Jean goes back to work and receives compensation of $16,000, assume the benefit increases by $457, while the additional cost to Jean and her husband Gene is $1,984. If Jean were paid the full amount of the taxable wage base, assume her annual benefit increases by $1,000, while the additional Social Security tax rises to $10,788.

Note:

The Social Security tax for the year purchases a life annuity in the amount of the added benefit. The cost must be compared to the actual benefit to the spouse. Remember that the spouse may already be entitled to an amount equal to 50 percent of the worker's benefit; in some cases, this amount may still be larger than the recomputed benefit of the spouse as a worker, and thus, marginally no or a very small life annuity is being purchased by the investment of the additional Social Security benefits.

For example, if Gene was then entitled to an annual benefit of $7,000, Jean in her capacity as a spouse would already be entitled to an annual benefit of $3,500, so she accrues no additional benefit, as $3,500 is greater than $3,457. If she were paid the wage base, the economics are different because now her benefit as a worker ($4,000) would exceed her benefits as a spouse ($3,500); the issue then is whether a $500 life annuity ($4,000 - $3,500) justifies a $10,788 investment in Social Security. But if Gene's benefit were then $9,000, Jean would accrue no additional benefit even if she were paid the maximum wage base.

Related to this issue is the issue of whether the marginal increase in the worker's benefit may be more valuable than the increase in the spouse's benefit (and the spouse is, after all, entitled to 50 percent of the additional benefit that accrues to the worker). Thus, if Gene's benefit would increase by $200 by paying the $16,000 to him rather than her, doing so instead of hiring the spouse results in a $300 increase in benefits ($200 to Gene and $100 to Jean) and saves $1,964 in Social Security tax. In the event that Gene's benefit was (as of the beginning of the year) $6,000 (Jean's spousal benefit is $3,000, the same as her worker's benefit), so that Jean would accrue the entire $457 increase as a new benefit, the net benefit would now by only $157 ($457 increase to Jean over the sum of the $300 increase that would accrue to the couple) at the cost of the $1,964 additional Social Security payment.

3. Pension benefits

Employing a spouse may also be used to provide a spouse with pension benefits.[20]

[20] The repeal of the family aggregation rules permits the usage of the compensation of all family members up to the maximum compensation that can be taken into account.

a. A spouse may be eligible to receive a $10,000 retirement annuity without regard to the spouse's compensation in a defined-benefit plan if the spouse has never participated in the employer's defined-contribution plan. Of course, the nondiscrimination rules will require a similar offer be offered to all other employees, but it may be well-suited in the case of a sole proprietor.

Note:

The major limitation is that the participant in the defined-benefit plan must not have ever been a participant in any contribution plan of the employer. This life annuity is treated as meeting the limitations on the amount of the annual-benefit maximums, which depend on the level of compensation and the years of service; this limit in turn may be cut back for a participant having participation or years of service less than 10. But since the $10,000 annuity is deemed to meet the limitations on annual benefits, a spouse could work for as little as one year and for as little as $1. Now in practical terms, the compensation should probably be enough for the spouse to fund a Roth (if not phased out). And the nondiscrimination rules would require the same definition of "years of service" for the spouse as any other employee for participation purposes.

Also consider eligibility. The spouse can be a participant for service on day one, as long as every other employee is likewise eligible. The Code provides that the eligibility requirements cannot delay participation more than one year from the time service commenced, but an employer is free to adopt more liberal (from the employee's perspective) eligibility and participation standards.

b. A spouse may have access to §401(k) elective deferrals that can be as much as $23,000, as much as doubling the amount the couple could defer.

Note:

While the rule is generally that the employer contribution (for all employees) cannot exceed 25 percent of participants' compensation, employee contributions are not counted in this calculation; the operable limitation is that the annual addition (which includes both employer contributions and elective deferrals) for the participant cannot exceed 100 percent of compensation. Now in a §401(k) plan with no employer match or other contributions, the spouse could be "paid" $23,000 (net of employment taxes) and defer the entire amount as an elective contribution. In that case, the spouse has no taxable income. As noted later in these materials, if the spouse is at least 50 years of age, an additional $7,500 catch-up contribution is available without regard to any of these limitations; in that case, the spouse could be "paid" $30,500 (net of employment taxes) and still not incur any income tax.

c. The spouse may have access to a profit-sharing plan, which could defer up to an additional $69,000 of income.

Note:

The employer contribution to a profit-sharing plan cannot exceed the dollar annual addition limitation for a participant; at the same time, except in certain age-weighted or cross-tested plans discussed later in these materials, the employer cannot deduct a contribution in excess of 25 percent of compensation. This means that the $69,000 would only be available if the spouse were making at least $276,000. For the very serious employment of the spouse, the business owner should consider shifting duties and salary to the spouse. The compensation that can be taken into account for plan purposes cannot exceed $345,000; so, in many cases, a business owner can reduce his or her own wages without suffering any reduction in his or her own retirement contribution while reducing the company's (or in the case of an S corporation shareholder/partner/member/proprietor, the individual's own) income tax by reason of the additional contribution. The couple's income otherwise remains the same.

Note:

There is one major disparity between corporate plans and Keogh plans concerning employment taxes. While a self-employed person may deduct his or her retirement plan contribution, this deduction is on page one of the Form 1040, not on Schedule C. That contribution is subject to self-employment tax (which in turn is deductible in part). However, the contribution to the retirement plan for employees (including a spouse) is deductible on Schedule C and reduces the self-employment income of the proprietor/partner. Thus, for example, for a self-employed person splitting income with a spouse may also benefit from a reduction of the self-employment tax.

d. The spouse may have access to a SIMPLE plan that could defer up to an additional $30,500.

Planning point:

SIMPLE plans are not subject to the special ADP nondiscrimination rules that are applied to §401(k) arrangements, and thus, do not suffer from the potential loss of qualification that can happen to a §401(k) plan when non-highly compensated employees fail to participate in sufficient numbers and relative amounts.

Caution:

The limitation on elective deferrals to a SIMPLE or §401(k) plan is applied by an aggregation of all of a participant's SIMPLE and §401(k) plans, regardless of whether the sponsors or employers are related. Thus, if a spouse already has a SIMPLE plan as an employee of an unrelated company to which the maximum deferral has been made, the spouse could only defer $7,000 ($23,000 §401(k) maximum contribution - $16,000 actual SIMPLE contribution) if hired as an employee. If the spouse were a participant in the §401(k) plan of an unrelated employer and had made the maximum $23,000 contribution, no deferral to the spouse's company SIMPLE plan could be made.

Planning point:

Maximizing the deductions for a spouse inures to the benefit of a married couple who have a problem with either earned income or MAGI and net investment income. In an elective deferral scenario, the amount of the earned income reduction can be doubled in various cases when the spouse is employed and each maximizes contributions; presumably this amount paid to the spouse would have been paid to the principal. The income on the amounts placed in the qualified plan and invested in turn replaces income that would generally have been included in the couple's net investment income, thus removing it from the Medicare (and income) tax base. Eventually, when the distributions are made from the plan (unless the plan is a Roth contribution plan), the amount will be included in MAGI but not net investment income.

e. The investment income tax provides an additional reason to bring a spouse onto the payroll for pension benefits. Under the NII tax, distributions from a qualified plan are not subject to the NII tax, although, unless the vehicle is of the Roth variety, will increase the taxpayers' AGI. However, two wrappers of investments are better than one, and the plans will by their tax-exemption shield various income types that would otherwise be included in the 3.8 percent tax base when earned, and through the exemption when distributed out of the plan.

4. Medical benefits

A technical advice memorandum approved of a creative method for obtaining a Schedule C (above-the-line) deduction for a family's medical costs.[21] This will be very helpful for many sole proprietors.

Example: Paula Smith is a well-known jury consultant who operates as a sole proprietor. She is married to Oliver James Smith, a part-time substitute high-school teacher. When Oliver is not teaching, he works for Paula on analyzing jury profiles for murder trials and also performs certain administrative duties. Oliver regularly works more than 30 hours per week for Paula and is paid a reasonable wage for his time. Paula has adopted a written employer-provided accident and health plan that, by its terms, covers all employees of the business. Under the plan, medical insurance and certain medical expense reimbursements are available to the employees (all in accordance with the applicable code requirements). Oliver receives medical insurance (including dependent coverage) and medical-expense reimbursements (including some for his dependents) under the plan during the current year. Under the rulings cited above, the IRS has indicated that both the medical-insurance premiums and the medical-expense reimbursements would be deductible as a business expense on Schedule C. In addition, Oliver does not have to include any of these items in his gross income.

***Note*:**

The example above embodies the basic principles set forth in the cited technical advice memorandum (TAM) and revenue ruling. However, the TAM does not indicate whether the husband's services were full-time or part-time. In addition, the TAM did not indicate the nature of the husband's services and whether there were other employees. The TAM dealt with the medical-expense-reimbursement plan (MERP) aspect of the above example. The cited revenue ruling involved a sole proprietor with several full-time employees, including the spouse, and medical-insurance benefits provided to the employees.

Planning point:

The application of the nondiscrimination rules depends on whether health benefits are provided under a **self-insured medical reimbursement plan** or under an insurance policy provided by an employer through an insurance company. Insured medical plans may benefit top executives or other highly compensated employees **exclusively**. Insured plans are **not** tested for discrimination. Premium payments by an employer on a policy of accident or health insurance or contributions to a separate trust providing accident or health benefits may be excluded from the gross income of employees if the plan merely covers **one or more** of the company's employees. Benefits received under the plan are also tax-free. In contrast, self-insured medical-reimbursement plans may not discriminate in favor of **highly compensated employees**, either as to eligibility or as to benefits.[22] A **self-insured medical-reimbursement plan** is a separate written plan designed to reimburse employee medical expenses.[23] A plan is self-insured if reimbursement for expenses is not provided under a policy of accident or health insurance.[24] A **highly compensated employee** means an individual who is one of the following:

- Among the employer's five highest paid officers;
- A shareholder who owns (with the application of §318 attribution rules) more than 10 percent in value of the employer's stock; or
- Among the highest paid 25 percent of all employees (other than **excludable employees** who do not participate).[25]

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21 TAM 9409006. See also Rev. Rul. 71-588, 1971-2 C.B. 91.
22 I.R.C. §105(h)(2). Treas. Regs. §1.105-11(c)(1).
23 Treas. Regs. §1.105-11(b)(1).
24 I.R.C. §105(h)(6).
25 I.R.C. §105(h)(5).

Now the implications are that one can adopt an insured plan that covers only the spouse and no other employees, but this is **not** possible in a self-insured plan covering only the owner's spouse. In the case of a C corporation plan there are no further implications (and the spouse could be covered by the insurance policy on the owner). However, in the case of an S corporation, the payment of the medical premiums on behalf of the spouse will still be grossed up in W-2 wages, while avoiding FICA, and be deductible above the line (because the spouse is treated as owning the stock owned by the actual owner). The 100-percent deduction in 2024, however, is limited to the earned income of the participant. If the business is running a loss, it may be advisable to pay the spouse an amount at least equal to the cost of the insurance coverage; otherwise, the deduction may be limited to what is deductible below the line with a 7.5-percent-of-AGI haircut. In the case of an LLC or partnership, the 100 percent of premium payment is not deductible on Schedule C or as a net on a Schedule K-1 but as a separate page one of Form 1040 deduction on; this means that the medical premiums paid for the business owner remain subject to self-employment tax, but premiums paid in respect of the spouse (whose coverage may include the owner as the spouse's spouse) would reduce Schedule C income and self-employment income. (This may have a reducing effect on the owner's pension, if any, but also an increasing effect on the spouse's pension.) In addition, if a proprietorship/partnership is operating at a loss, the premium paid for the owner would not be deductible above the line, but a premium for the spouse might be, as a deduction on Schedule C or on Form 1065.

Note:

If the spouse is already working for another employer, there may be coordination-of-coverage issues in connection with the policies. In some cases, the business owner may be able to be covered by the spouse's first employer's medical plan; in others, the coverage may be superseded by the availability of coverage from the business owner's own policy. The spouse may not be covered by the business owner's plan if the insurer does not permit coverage of someone covered by another plan, and this, in turn, could perhaps deny the dependent coverage the business owner seeks.

5. Long-term care

Long-term-care insurance contracts are taxed similarly to accident and health insurance contracts. Thus, certain benefits received under a long-term insurance contract provided by an employer may be received tax-free. As an insured medical plan, it is not tested for discrimination. If the long-term-care insurance contract is an indemnity policy (one that reimburses actual long-term-care costs), all benefits received under the policy are tax-free. If, on the other hand, the long-term-care insurance contract is a per-diem policy (one that pays a set amount per day regardless of actual expenses), a taxpayer can exclude the greater of $410 per day or actual daily expenses.

a. A certain amount of the premiums paid on long-term-care insurance contracts qualify as medical expenses for purposes of the medical expense deduction. The qualifying amount is limited on the basis of the insured's age as follows (all ages refer to the insured's age as of the end of the taxable year) in 2024.

Age	Annual Limit
40 or less	$470
More than 40 but not more than 50	$880
More than 50 but not more than 60	$1,760
More than 60 but not more than 70	$4,710
More than 70	$5,880

These amounts are indexed for inflation.

Note:

With respect to pass-through employers (S corporations, partnerships, and multimember LLCs), the Service has previously ruled that special rules apply. In the case of an S corporation, the payment of such (medical) insurance premiums (as limited by the annual dollar limit in the above table) is treated as taxable income to the more-than-two-percent shareholder and deductible by such shareholder as a medical insurance premium above-the-line (not in excess of the shareholder's share of the earned income of the business, including any wages paid to the shareholder), with any balance deductible below-the-line subject to the 7.5-percent-of-AGI threshold.

b. Unreimbursed long-term-care expenses qualify as medical expenses for purposes of the medical-expense deduction as long as the long-term-care services are not provided by a relative who is unlicensed to provide such services. Long-term-care expenses include:
   - Expenses for necessary diagnostic, preventative, therapeutic, curing, treating, mitigation, and rehabilitative services required by a chronically ill individual; and
   - Expenses for maintenance or personal-care services required by a chronically ill individual.

c. For these purposes, a chronically ill insured is one who has been certified within the previous 12 months by a licensed health-care practitioner as:
   - Being unable to perform, without substantial assistance, at least two activities of daily living for at least 90 days due to a loss of functional capacity;
   - Having a similar level of disability as determined by the Secretary of the Treasury in consultation with the Secretary of Health and Human Services; or
   - Requiring substantial supervision to protect from threats to health and safety due to severe cognitive impairment.

***Note*:**

It is important to note that long-term-care insurance is not merely for the elderly; there are many younger people, unable to care for themselves, who would benefit from this type of insurance.

Planning point:

Employer contributions for long-term-care insurance are deductible as business expenses and are not included in the employee's income. However, if an employer provides long-term-care coverage under a cafeteria plan, benefits received are included in the employee's income. In addition, long-term-care coverage cannot be provided under a flexible spending account, although premiums can be paid through the use of health spending accounts (HSAs). Once you are 65, you can use HSA funds for any purpose you want.

6. Miscellaneous

In addition to other benefits, hiring the spouse for the client's business can provide the following.

- Disability coverage for the spouse.
- Dependent care FSA.
- A second company car can be provided to the spouse as an employee.
- Group-term life insurance can be offered to the spouse as an employee on a tax-free basis to the extent of the premium paid attributable to the first $50,000 of coverage.

B. Travel

1. Entertaining spouses

For amounts after December 31, 2017, deductions for entertainment expenses are generally disallowed, including obviously any entertainment of a spouse. Most business meals will be deductible at 50%.

2. Hiring the spouse

No deduction is allowed for travel expenses paid or incurred with respect to a spouse, dependent, or other individual accompanying the taxpayer (or an officer or employee of the taxpayer) on business travel, unless: (i) the spouse, dependent, or other individual is an **employee** of the taxpayer; (ii) the travel of the spouse, dependent, or other individual is for a **bona fide business purpose**; and (iii) the expenses would otherwise be deductible by the spouse, dependent, or other individual.[26]

Note:

If this rule applies, it only applies to preclude such deductions as travel expenses.

Planning point:

In the case of a corporate entity, a spouse could be elected a director. Since the corporation must have an annual meeting of the board of directors, expenses for travel by the spouse can be legitimately justified in general. More specifically, however, is just where the meeting can be held. Can a company headquartered in Pennsylvania hold its meeting in Aspen? Does it matter whether the company does all of its business in Pennsylvania? What if it does some business in the Southwest? Colorado? Is there a level of business activity the company must have in the geographic market to justify the holding of the meeting there, and if so, what? What if the company has a director who lives in the Southwest? Colorado? Aspen? Or who owns a condo in Aspen and winters there when the annual meeting is held? Aggressive tax planners may push the envelope in any of the above to sustain travel deductions.

V. Children

A. Earned income

1. In general

Employing a family member enables:

- The taxpayer to take advantage of the child's full standard deduction;
- The child to make contributions to an IRA;
- The child to receive money that is not subject to the kiddie tax; and
- The taxpayer to reduce adjusted gross income, thereby preserving personal exemptions and itemized deductions.

B. The adjusted-gross-income rules

1. Personal exemption suspended

For tax years beginning after December 31, 2017, and before January 1, 2026, the personal exemption is suspended by reducing the exemption amount to zero.

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[26] I.R.C. §274(m)(3); Treas. Regs. §1.274-2(g).

2. Itemized deduction suspended

For tax years beginning after December 31, 2017, and before January 1, 2026, the Pease limitation is suspended. That limitation limited the amount of otherwise itemized deductions for certain individuals with high adjusted gross income.

a. However, for purposes of the alternative minimum tax, the itemized deductions are not disallowed merely by reason of this reduction for purposes of the regular tax. Thus, deductions that are deductible for purposes of the AMT can be deducted in full without regard to the three-percent/80-percent phase out.[27]

b. These rules resurrect visions of the marriage penalty.

3. Other phaseouts

The importance of reducing a taxpayer's adjusted gross income to preserve other tax benefits cannot be overstated. As previously illustrated, when otherwise allowable tax benefits are phased out because the taxpayer has reached a certain income level, **effective** marginal rates of tax on income within the various phase-out ranges can be dramatically higher than the taxpayer's **statutory** marginal rate of tax. In addition to the phase out of personal exemptions and the phase out of itemized deductions, many other exclusions, deductions, and credits are subject to phaseout rules. These phase outs are virtually always based upon the level of the taxpayer's adjusted gross income, or adjusted gross income with certain modifications. In 1997 tax legislation alone, there were at least five major tax benefits enacted that are subject to phase-out rules based upon adjusted gross income. These include:

- The tax credit for children under §24;
- The "Hope" and "Lifetime" education tax credits under §25A;
- The deduction for interest on higher-education loans under §221;
- Contributions to "education IRAs" under §530; and
- Contributions to "Roth" IRAs under §408A.

These tax benefits are phased out under a number of different phase-out ranges based upon adjusted gross income. Other important tax benefits that are still present in the tax law and are subject to phase-out rules include:

- Deductible IRA contributions under §219;
- The adoption credit under §23;
- The active participation exception to the passive-loss limitations under §469;
- The exclusion for income from U.S. savings bonds under §135;
- The child-care credit under §21; and
- The earned income credit under §32.

Although the foregoing list is not all-inclusive, it clearly indicates that Congress has become "phase out-happy" in recent years and is showing no signs of reversing this trend. By enacting important tax breaks subject to phase-out rules, Congress is wreaking havoc on effective marginal rates of tax for many taxpayers, and not just those with six-figure incomes. Many of the phase-out ranges begin and end with adjusted gross incomes of less than $100,000. It has become hair-pulling complex to determine a taxpayer's effective rate of tax when one, two, three, or more of these phase outs are operating on the taxpayer simultaneously. This situation creates hidden tax traps as taxpayers incrementally increase their income or decrease their deductions.

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[27] I.R.C. §56(b)(1)(F).

As a general rule, however, perhaps the most effective tax-planning technique of all in the current legislative environment is to **reduce income**. That is why the income-shifting and income-reducing techniques discussed in this course, even though subject to significant restrictions, are more important than ever. A taxpayer's adjusted gross income may have become the single most important figure in a taxpayer's overall financial picture, with the exception, perhaps, of net worth. All tax advisors should take to heart the importance of minimizing adjusted gross income without sacrificing actual economic income and preserving as much as possible the tax benefits provided by the Code.

C. Understanding the effect of the kiddie tax

1. Earned income

Because the kiddie tax applies only to **unearned income** of a young child, the shifting of **earned income** to the child by paying the child a salary through the family business is not affected by the kiddie tax. For tax years beginning after December 31, 2017, the taxable income of a child attributable to earned income is taxed at the rates for a single individual. The tax on unearned income is taxed at the parents' marginal rates. The TCJA provision, taxing at the trust and estate tax rates, has been repealed by the SECURE Act for 2020 (with the option to file amended returns for 2018 and 2019).

a. The reasonable compensation standard has been a long-standing obstacle to this **income-shifting** technique. As a practical matter, however, the reasonable compensation standard may no longer be important in such cases. With much lower individual income-tax rates and increasing payroll taxes, generous salary payments from the family corporation to the children may no longer be attractive.

b. The maximum amount of savings can be achieved with salary payments of $14,600. This is the regular standard deduction amount for 2024; after the first $14,600 is paid ($21,600 if an IRA is set up), the income-tax savings to the family unit decline. Note that although substantial salary payments from the family corporation to the child, regardless of age, may not generate substantial income-tax savings, they do offer transfer-tax savings.

2. Unearned income

Section 501 of the SECURE Act eliminates the TCJA definition of "Kiddie Tax" on children's unearned income in excess of $2,600 at the highest trust and estate tax rates**.** The **kiddie tax** applies not only to children under age 18 (regardless of any other circumstance) but also to children who are 18 years old or who are full-time students over age 18 but under age 24, but only if such children's earned income does not exceed one-half of the amount of their support. Payroll taxes apply only to employee compensation. Therefore, both the kiddie tax and any payroll taxes can be avoided by shifting unearned income to **certain children** age 18 or over, particularly if the parents are in a 37-percent tax bracket. However, if the child has not reached the age and circumstance that would allow them not to be treated as a kiddie, the unearned income of the child in excess of $2,600 (for 2024) will be taxed at the marginal rate of the parents.

Note:

One potential planning point is to structure the child's relationship to familial businesses to generate earned income, rather than unearned income, sufficient to meet the one-half threshold for children age 18 and above.

3. Shifting income

The shifting of **unearned income** to a child under 18 years of age will generally offer immediate tax savings; in the future, steps taken now may help to achieve the more significant tax savings available when a child is no longer a kiddie. The time horizon will now depend on whether the child will become a student or not. Shifting income by transfer of income-producing property to the children has three advantages. First, the income produced may be subject to somewhat-lower income-tax rates, at least if the amount of unearned income is low. The repeal of the TCJA "kiddie tax" taxes excess income at the parents' marginal rate. Second, such shifting of income is effective for reducing the taxpayer's AGI. Third, the shifting of income to the child may create taxable income and an income tax, but it is an income tax that in some circumstances may be reduced by deductions or credits.

a. The Hope credit may be available to the extent of $2,500 for each student while the Lifetime Learning credit may not exceed $2,000 for each taxpayer. Both the Hope and Lifetime Learning credits are phased out for upper-income taxpayers proportionately (and simultaneously if both credits are claimed) for taxpayers with modified adjusted gross income (MAGI) within specified ranges. Married taxpayers filing separately cannot claim the credits. MAGI is determined in the same way as under the child-credit rules. However, the Hope credit, as redesignated the **American Opportunity tax credit** ("AOTC"), has a higher phase-out range than the Lifetime Learning credit. It now applies to all four years of college.

Planning point:

It may be possible for taxpayers with income close to these levels to manipulate their adjusted gross incomes by deferring income to a future year or accelerating deductions into a current year.

b. The fundamental concept in most planning is the deferral of income and the acceleration of deductions. For a cash-method individual, income is **generally deferred** by not receiving cash or cash equivalent in the year of the conversion. This general principle is limited by the application of the constructive-receipt doctrine (and may be accelerated in other circumstances for deferrals occurring after 2004). This usually limits certain compensation strategies for employees. The aggressive taxpayer, however, has adequate support in the case law to permit the deferral of any compensation to a later year if the deferral election is made prior to the earning of the income. Moreover, if compensation is received in the form of nontransferable stock subject to a substantial risk of forfeiture beyond the current year, the employee can control the timing of the income by making or not making the §83(b) election.

(i) Since the deductions must reduce AGI to preclude the phase out, they generally must be business-related. Retirement plans are another source of potential AGI reduction. A self-employed individual may establish a Keogh plan that could enable a reduction of as much as $69,000 for a defined-contribution plan, and depending on the age of the self-employed, even more for a defined-benefit plan, where the maximum annual benefit that can be provided is $275,000. As noted elsewhere, the amount of the reduction available may be enhanced by the new rules that permit maximum limits in combined plans. This can permit the income level before planning to be perhaps much greater than the phase-out limits.

However, the nondiscrimination rules will require similar benefits and contributions for rank-and-file employees. The situation in which this makes most sense is where the self-employed has no other employees. Alternatively, an employee may increase, within certain limits, the amount of salary reduction in a SIMPLE, SARSEP, or §401(k) plan to reach the AGI limit.

Planning point:

Because married persons cannot claim the credits filing separately, it is not enough to reduce the AGI of one spouse below the requisite levels, because AGI will be combined. However, this is a situation in which the taxpayer may gain tax advantage by employing the spouse and: (a) shifting compensation income to the spouse; and (b) providing the spouse with the maximum combined plan benefits and contributions for that level of compensation. This will reduce the overall compensation by as much as the additional contributions to the plans on behalf of the spouse if the taxpayer still makes compensation in at least the amount of the maximum amount of compensation that may be taken into account for such plans, currently set at $345,000 in 2024.

(ii) In certain circumstances, the taxpayer may prepay during one tax year for educational periods beginning during the first three months of the next tax year in order to take advantage of a credit that will not, by the phase out rules, be available in the following year. This can also extend overall credit eligibility to five years for four years of college education, but only if the student commences college in the spring semester.

Example: The taxpayer has one dependent child beginning college in January 2024. Qualified expenses are over $5,000 per semester. The taxpayer uses the AOTC for the 2023 tax year and the 2024 tax year by prepaying tuition in December of 2023 and 2024. In the years 2025, 2026, and 2027, the taxpayer claims the Lifetime Learning credit for expenses incurred during each of those years. The child finishes the four-year program in December of 2027.

4. The Taxpayer Certainty and Disaster Relief Act of 2020 (the Act)

Before the Act, an unfavorable income phase-out rule applied to the Lifetime Learning Credit, which can be worth up to $2,000 annually. For 2021 and beyond, the Act aligns the phaseout rule with the American Opportunity Act, which can be worth up to $2,500 per student. In turn, the Act repeals the tuition write-off for 2021 and beyond. In effect, the Act would trade the old-law write-off for the more favorable new-law Lifetime Learning Credit phase-out.

For 2024 and beyond, the MAGI phase-out for both the LLC and AOC is $80,000 and $90,000 for individuals and $160,000 and $180,000 for married couples filing jointly.

See the following graph.

Qualified expenses	American Opportunity credit (in force for 2024)	Lifetime Learning credit
$500	$500	$100
$1,000	$1,000	$200
$1,200	$1,200	$240
$1,500	$1,500	$300
$2,000	$2,000	$400
$2,400	$2,100	$480
$2,500	$2,125	$500
$3,000	$2,250	$600
$3,500	$2,375	$700
$4,000	$2,500	$800
$5,000	$2,500	$1,000
$9,000	$2,500	$1,800
$10,000	$2,500	$2,000

5. Partial refundability

The Hope credit is a nonrefundable personal credit. However, the Act treats 40 percent of so much of the education credit allowed as is attributable to the American Opportunity credit (after taking into account the income phase out, but without regard to the limitation of the credit against the AMT or regular tax liability, as the case may be) as a refundable credit.[28]

Note:

This means that the American Opportunity tax credit must be bifurcated into the refundable and nonrefundable portions after computing the aggregate amount after income phase out, then the nonrefundable portion of the credit must be applied against the AMT or the regular tax liability in excess of tentative tax[29] and then the refundable portion must be applied as other refundable credits are.

However, no portion of the modified credit is refundable if the taxpayer claiming the credit is a **child to whom the kiddie tax applies for such taxable year** (generally, any child under age 18 or any child under age 24 who is a student providing less than one-half of his or her own support who has at least one living parent and does not file a joint return).

6. SECURE Act and SECURE Act 2.0 Updates

Section 302 of the SECURE Act expanded §529 education savings accounts coverage to include expenses associated with registered apprenticeship programs and distributions for qualified education loan repayments.

Prior to the SECURE Act passage, §529 education savings accounts could be established for a designated beneficiary's qualified higher education expenses. These expenses include tuition, fees, books, computers and peripheral technology, and supplies needed for higher education. Room and board are also eligible expenses for such plans for beneficiaries who are at least half-time students.

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[28] I.R.C. §25A(i)(6). It is not treated as a Hope credit, so the limitations (other than the income phase out) of §25A do not apply.

[29] Any reference in §25A or §§24, 25, 26, 25B, 904, or 1400C to a credit allowable under this subsection shall be treated as a reference to so much of the credit allowable as is attributable to the Hope Scholarship Credit.

The SECURE Act expands the coverage of qualified expenses to include apprenticeships and trade schools. With the rising costs of college, it has become increasingly common for individuals to go into trades or apprenticeships, and now §529 accounts can be used to pay related expenses. In addition, the SECURE Act allows for up to $10,000 (lifetime maximum) to be withdrawn from a §529 plan to pay student loan principal amounts and related interest expenses for the beneficiary or the beneficiary's siblings. This provision applies to distributions made after December 31, 2018.

Individuals should note that the deduction for interest paid by the taxpayer during the tax year on a qualified education loan is disallowed to the extent that the interest was paid from a tax-free distribution from a §529 plan.[30]

Some states allow individuals to take an income tax deduction for contributions made to §529 plans. However, individuals should be cautious when taking distributions, as not all states conform to federal laws regarding qualified distributions. There may be a gap period between when federal law is enacted and when state law is updated to conform. During this period, individuals may be at risk of incurring state tax penalties for non-qualified distributions, despite being qualified distributions for federal purposes.

In addition to the SECURE Act, SECURE 2.0 permits beneficiaries of 529 college savings accounts to rollover up to $35,000 over the course of their lifetime from any 529 account in their name to their Roth IRA. Such rollovers are subject to Roth IRA annual contribution limits, and the 529 account must have been open for more than 15 years.

The rollover cannot exceed the total amount contributed to the account more than five years before the rollover. Roth income limit restrictions are not applicable to the 529 plan Roth conversion. As a result of this new provision, individuals will have the option to avoid the penalty on a non-qualified withdrawal of leftover 529 plan funds. This new SECURE 2.0 provision applies to distributions after December 31, 2023.

D. The self-employed parent and the salaried child

Planning point:

Family income-shifting and C corporation income-splitting must be more seriously considered. Shifting earned income to a child serves the goal of reducing the compensation subject to **additional Medicare tax**, **spreading the AGI around** to reduce or eliminate the potential for excess MAGI for any member of the economic unit, and **reducing the overall tax burden by shifting income to a taxpayer in a lower tax bracket**.

- However, this may have the effect of **increasing the Social Security tax burden** because the higher-income taxpayer may have already passed the taxable wage base and is only subject to the Medicare tax, while a child is likely to have the first dollar of wages subject to both Medicare and Old Age and Supplemental Disability Income tax.
- Compensation may permit an additional IRA/retirement plan participant.

[30] The "Setting Every Community Up for Retirement Enhancement Act of 2019," §302(b)(2).

1. Income-tax savings

a. By hiring the family member, the taxpayer as sole proprietor removes income from taxation at his rates by obtaining a deduction for the salary.
b. The taxpayer will reduce his self-employment income by the same amount that may produce savings in self-employment tax.
c. As salary constitutes earned income, it is not subject to the kiddie tax if the employed family member is a minor.
d. As earned income, the standard deduction normally available to dependents is increased to the greater of $1,300 or earned income but not in excess of $14,600.
e. Thus, if a child of the taxpayer receives $14,600 of compensation, the standard deduction eliminates all tax on this income.
f. A salary paid to a child younger than age 18 is not subject to Social Security tax, thus eliminating a significant payroll tax.

Example: Father employs son (age 16) to handle stock and take inventory in his retail establishment. Father previously gifted a $100,000 bond, generating a yield of $7,000 annual interest to Son. Son receives $14,600 compensation. Son may contribute $7,000 to an IRA, giving him $14,600 AGI. Because of his $14,600 of earned income, Son is also entitled to $14,600 standard deduction. Son pays no income tax, as he has zero taxable income. If Father was in the 37-percent tax bracket and had received the income from the bond and kept the wages paid to Son, Father would have paid $7,992 (or more) in income tax.

2. Fringe benefits

Another advantage of employing a child can be found in the availability of fringe benefits. The employing parent could provide:

- Group-term life insurance;
- Accident and health insurance;
- Educational assistance;
- Contributions on behalf of the child to a qualified pension plan;
- Travel; and
- Meals and lodging.

3. Contribution to IRA

a. A child could make a deductible contribution of up to the lesser of earned income or $7,000.
b. In combination with the standard deduction, the child could receive as much as $21,600 gross income ($14,600 earned, $7,000 unearned) and pay no tax.

4. Self-employment tax savings

If the parent had self-employment income less than the wage base ($168,600 in 2024), the parent would also have saved the OASDI portion of the self-employment tax. The Medicare tax will always be saved where the child employed is younger than age 18.

5. FICA taxes

Once the child becomes 18, savings would be reduced because FICA payments will then be required for the child's salary. However, the child may then become qualified for certain Social Security benefits, such as disability benefits.

Planning point:

From a practical standpoint, what are the possible withholding requirements when a parent hires his or her child to work in their unincorporated business (e.g., Schedule C/F or partnership/LLC)? What is hoped for is that this earned income will not be taxed to the extent that it does not exceed the standard deduction amount otherwise available to any individual taxpayer (i.e., $14,600 for 2024), even if they can be claimed as a dependent on another's tax return. And, since an *unincorporated* business is involved, there would be no employment tax withheld, as long as the child is *under age 18* at the time the wages were earned. Finally, if the child is also eligible to set up an IRA, another $7,000 could be sheltered from both income and employment taxes, for a total of $21,600.

The key is whether the business owner's child would be entitled to file a W-4E, so as to be exempt from income-tax withholding on their wages. And, as mentioned above, assuming that the child is under age 18, there would be no employment taxes to withhold as well. As a result, a Schedule C business owner, for example, could simply list the wages paid to his or her child as an "Other Deduction," perhaps labeling the expense as "wages paid to a child under age 18." But suppose the child had a tax liability for his or her most recent tax year. For instance, a trust set up in his or her name generated more than $1,250 of net unearned income for the prior year (i.e., unearned income greater than the standard deduction otherwise available). Because the child would *not* be exempt from the tax-withholding rules (i.e., because he had a tax liability for the prior year), he would have to have the normal calculations required by Circular E performed (e.g., annualization of his weekly wages) with the necessary income tax being withheld from his paycheck. This is true even though employment tax withholding might not have been taken out of his pay at all. And, once an employer has withheld tax from an employee's paycheck, then the monies must be remitted to the government with all of the normal paperwork requirements being met. Simply making estimated payments on the child's behalf would not suffice either, since this is not the type of gross income (i.e., self-employment or other types of unearned income, such as interest, dividends, capital gains, etc.) where one can meet his or her anticipated tax liability in such a fashion.

So, as a tax professional advising your client, you might want to alert them that potential employment tax savings (i.e., up to 15.3 percent, or 2.9 percent, if the parent already has earned income in excess of the FICA cap (i.e., $168,600 in 2024)) and income-tax savings (i.e., 10-percent and 12-percent marginal-tax rate for the child vs. 22 percent, or above, for the parent) would have to be offset by the possible accounting fees caused by the administrative tasks associated with withholding taxes. Of course, if the parent had any other employees who were also subject to withholding tax on their pay, then this child's hiring should not result in significant incremental administrative costs. And, if the child's unearned income could be diminished below the standard deduction amount by converting their assets from being income-producing (e.g., investing in growth-type stocks, municipal bonds, etc.) so that an income-tax liability would not have arisen in the prior tax year, then a Form W-4E could then be filed. As a result, the necessary forms associated with income and employment tax withholding (i.e., Forms 940, 941, W-2, and W-3) could then be avoided after maybe just one year.

Caution:

The Tax Court has reminded taxpayers that claimed business expense deductions for compensation paid to minor children will invite scrutiny. The claimed wage payments to his children, ages 10 and 5, were disallowed because he failed to prove the amounts paid were reasonable compensation for services.[31] The taxpayer operated a vending machine business for which the services provided by his children included: Riding along on the weekly routes to the vending machines, putting candy bars into the machines, sorting the totes full of candy, breaking down the cardboard and sorting out the recyclable products of waste produced by the business. The older child also helped with counting money. While the taxpayer claimed that his children worked approximately 10 hours per week, he did not know for sure how often his children worked every week nor did he keep any record of their hours.

Although the Tax Court seemed to suggest that the reasonableness was not shown, it further noted that it was not clear that the taxpayer had even paid the children. The checks made out to the children in December were not cashed until at least two months later because there was not enough capital in the business to cash the checks when they were issued. Even after the checks were endorsed, it appeared the parent taxpayer retained control of the proceeds. The taxpayer did not set up separate accounts for his children in which to deposit their alleged wages; instead, he kept the proceeds and either reinvested the proceeds into his business or deposited said proceeds into his own personal account. The children were paid a set amount for both years at issue, which corresponded to the maximum amount they could receive without paying any federal income tax.

6. What does the law portend for the definition of a kiddie?

a. Keep in mind that the definition of a kiddie, while patterned after the age thresholds for a child to be treated as a qualifying child for purposes of the dependency deduction, does not require that the child in fact be a dependent. Note also that it is not necessary that the child actually apply the earned income (or any other income) towards his support, so a child can avoid the kiddie tax at the same time his parent can still qualify for the dependency exemption deduction.

b. In the definition, earned income will take on a larger and larger role in consideration of income shifting planning. A child within the new suspect age ranges can avoid the kiddie tax if he or she has enough earned income.

Note:

The amount of earned-income could be somewhat uncertain if the amount paid is unreasonable. In addition, and probably a thornier issue, an accountant must be prepared to substantiate the base amount of support against which the earned income will be compared.

c. For planning purposes, the possibilities grow dim if the parent does not own a business through which he can reasonably assure the child will obtain such earned income. In addition, where an S corporation is involved, the mix between compensation and pass-through income will need to be planned more precisely, as the former class will provide a child with earned income, but the latter may well not.

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[31] *Dumond v. Commissioner*, T.C. Summ. Op. 2005-11.

Planning point:

In some cases, the owner will be subject to both the Medicare tax (1.45 percent) and the additional Medicare tax (.9 percent), and the employer a 1.45 percent, yet the shifting of earned income to the younger family member will trigger generally the full 15.3-percent OASDI/Medicare tax for both the employer and employee. But this not only shifts the tax burden to a lower bracket but also reduces the owner's AGI, which could help the owner to avoid the additional Medicare tax on investment income. This is an example of spreading the AGI around to lower the overall taxes of the economic unit.

E. Roth IRAs

1. Background

A Roth IRA is an individual retirement plan (as defined in §7701(a)(37)) that is designated (in such manner as the IRS may prescribe) at the time of establishment of the plan as a Roth IRA.[32] The basic idea of this IRA is that contributions are **nondeductible**[33] and "qualified distributions" are tax-free. In addition to tax-free qualified distributions, the Roth IRA offers other benefits: (i) no minimum required distributions during lifetime; (ii) **no maximum age for making contributions**;[34] and (iii) even a tax-favored rule for "nonqualified" distributions.

2. Unavailability of a Roth IRA

Client, age 45, has sufficient discretionary disposable income to meet all current and future needs but cannot qualify for a Roth IRA by reason of excess AGI. Client has Child, age 12. Client seeks advice as to how to reduce income and estate taxes. Client has a financial profile such that if he could qualify for a Roth IRA, he would not draw it down at all during lifetime.

a. The Roth's advantage lies not so much in what can accumulate in the account by the first-generation owner as **not** having the minimum-distribution rules apply during the lifetime of the owner. This advantage is accentuated by the amount of the accumulation at the time the minimum-distribution rules would otherwise apply. In the case when the client would only be passing the account down to the next generation anyway, it is more appropriate to establish the Roth in the name of a younger-generation member, and this can be even more important when there are multiple members.

b. Although income-producing property can be given to a member of the younger generation to shift the income- and estate-tax burden to that generation, such property is not as tax-efficient as a Roth IRA because of the special tax advantage of tax-excluded qualifying distributions.

c. Each member of the younger generation can contribute $7,000 (in 2024) each year to a Roth **if** that member has **compensation** includable in gross income of at least that amount.[35] For these purposes, compensation includes any earned income.[36]

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32 I.R.C. §408A(b).
33 I.R.C. §408A(c)(1).
34 I.R.C. §408A(c)(4).
35 I.R.C. §219(b)(1).
36 I.R.C. §219(f)(1).

d. How does the child obtain compensation or earned income? The client may be in a position to hire the child in perhaps various capacities to perform services. The issue that is raised by this strategy is the extent to which the amounts received by the child can be denominated "compensation" or "earned income" given the non-arm's-length relationship of the parties**. This is a question of fact that depends on the child's age and abilities**. The same factors also inform the decision as to what services the client will ask the child to perform for compensation. For example, consider lawn-mowing. The child, at age 12, may be competent enough to manage this task at the client's personal residence or vacation home and, in a more business-oriented decision, the client's rental property. Depending on the frequency, size of lot, prevailing rates in the community, length of the mowing season, and other like factors, lawn-mowing can provide a basis for the child making a contribution to a Roth IRA. Other potential options include babysitting and other landscaping. Some children can obtain employment from others in modeling jobs.

Note:

Although not expressly called for by any statute or regulation, it is prudent to substantiate the work of the child, including dates, hours spent in the activity, and the nature of the activity. Many, many tax issues arise not because of the law but because of lack of substantiation.

Note:

Different issues under state and federal child labor laws are involved when the child is working for a business and is not employed by a parent.

e. A related benefit of a child having earned income is that: (i) such income is not subject to the kiddie-tax rules (as noted above); and (ii) the minor is entitled to a standard deduction to the extent of the lesser of the earned income and the general standard deduction for single taxpayers. In general, a child who is claimed by a parent as a dependent is only entitled to a standard deduction of $1,300. The payment by Client to Child followed by a contribution to a Roth IRA in the name of the Child has some of the same effects as Client contributing to Client's own Roth IRA. The payment is nondeductible, and the current income tax is not affected at least as long as Child is earning in total no more than the standard deduction for an unmarried taxpayer. One major difference is that if the Roth IRA were in the name of Client, the fund would have to be liquidated beginning at the death of Client (or Client's spouse). In contrast, the account does not have to begin liquidation until the death of Child. In addition, the federal estate tax attributable to the Roth IRA does not have to be paid until the later date as well.

f. The tax position for Client can be improved to the extent the compensation is deductible. Payments for services for personal matters, such as lawn-mowing, are not deductible by Client, even though such payments are compensation to Child. However, such payments must be trade or business expenses (or to a more limited extent, production-of-income expenses). Lawn-mowing Client's rental property would qualify as a deductible expense because it is related to the taxpayer's business.

g. Suppose the client has a business whose principal location is in the residence or he or she uses a home office strictly for business and to meet and receive clients. Deductions have been granted when the child was employed by the business to wash windows, clean screens, pick up and sort mail, answer the telephone, and empty trash, but at least one case characterized light tasks, running errands, washing windows, taking down and cleaning screens, shoveling snow, mowing grass, tending shrubs, trees, and underbrush, assembling various papers, picking up mail, and stuffing, stamping, and labeling envelopes as household chores "in the main part of parental training and discipline rather than the services rendered by an employee for an employer" causing the court to reduce, **but not disallow in total**, the amount of the deduction.[37] It is clear that payments to children are far more likely to be considered bona fide salaries if they are in exchange for tasks directly related to the taxpayer's business and are reasonable for the service performed.

h. For federal income-tax withholding purposes, wages do not include domestic service in a private home.[38] Domestic service includes lawn-mowing and babysitting. Thus, none of the child's earnings with respect to those services at the client's principal residence or vacation home is subject to federal income-tax withholding. Social Security taxes are payable with respect to wages paid as remuneration for employment. However, for these purposes, employment does not include any service performed by a child under the age of 18 in the employ of his father or mother or domestic service in a private home of the employer, performed by an individual under the age of 21 in the employ of his father or mother.[39] Thus, none of the child's earnings is subject to Social Security tax. The requirement for filing Form W-2 is based on either: (i) the withholding of Social Security and income taxes from an employee; or (ii) that income tax would have been withheld if the employee had claimed no more than one withholding allowance or had not claimed an exemption from withholding. As neither occurs in this context, the client need not file Form W-2 in respect of the child (nor withhold any Social Security, unemployment compensation, or federal income tax).

i. With respect to lawn-mowing and other services performed at client's rental property, as long as the child is younger than age 18, remuneration for these services is not subject to Social Security taxes. However, federal withholding may be required if the amount is sufficient to trigger withholding. Although likely to be rare, it is possible that in cases when the deduction is sought it may come at the additional administration of a W-2, federal income-tax withholding, or both.

Note:

Neither Child's nor Client's Roth IRA balances are considered in financial-aid applications.

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37 *Denman v. Commissioner*, 48 T.C. 439 (1967). But see *Eller v. Commissioner*, 77 T.C. 934 (1981) (permitting significant deductions to minors for similar activities).

38 I.R.C. §3401(a)(3).

39 I.R.C. §§3121(b)(3)(A) and (B).

Planning point:

When considering earned income opportunities not from one's own business activities, babysitting, paper routes, life-guarding, mowing lawns, cleaning garages, painting someone's porch, and similar activities all count. It is even better if children have been paid reasonable compensation in the business to open and sort mail, do janitorial and clean-up work, mow the lawn, or other jobs that their age, talents, and the law permit them to perform. Or, in lieu of their allowance, put them on the payroll as domestic workers. The advantages of this strategy include:

- The children will likely have to pay no income tax; and
- If the taxpayer employs them in a sole proprietorship (single-member LLC) or partnership with his spouse or as domestic workers, they generally do not have to pay Social Security taxes. The taxpayer also generally gets a deduction for the compensation paid in the business.

3. Why the Roth?

A child's Roth IRA offers special advantages in college funding. First, it will **not** be counted as an asset of the child in the college-aid formulas. Second, contributions may be withdrawn first, if need be, tax- and penalty-free, to provide needed cash flow during college, to make a down payment on that first home, and similar financial needs.

Planning point:

The children will probably want to keep what they earn, rather than make contributions to a Roth IRA, but:

- The taxpayer can also make gifts to them not in excess of the annual exclusion equal to the lesser of their earned income or the IRA contribution limit, which can be contributed to a Roth IRA; and
- Probably most importantly, the Roth IRA will accumulate tax-free, potentially for a very long time and the economic benefits of starting early are *HUGE!*

Example: **The early start** -- Suppose that beginning in 2024, when the child is age 12, the taxpayer hires her to help the taxpayer out in the business part-time on weekends during the school year and half-time during the summer until she finishes college at age 22. Assume she earns just enough each year so that she can contribute a $5,000 annual IRA contribution to a Roth IRA. The taxpayer helps her set up the account, and with the advice of the taxpayer's accountant, also helps her to invest in a broadly diversified group of domestic and foreign equity funds with an average annual compound rate of return of 8 percent. This means that she will contribute $5,000 at the beginning of ages 13 through 22, for a total of $50,000.

If the funds earn 8 percent, the balance will be over $78,000 by the end of the year the daughter reaches age 22!

Age	Contribution	Total
13	$5,000	5,400
14	$5,000	11,232
15	$5,000	17,531
16	$5,000	24,333
17	$5,000	31,680
18	$5,000	39,614
19	$5,000	48,183
20	$5,000	57,438
21	$5,000	67,433
22	$5,000	78,227

And if the daughter absolutely has to, she can withdraw up to $50,000 absolutely tax-free at any time!

But, better yet, if she leaves the money in her Roth IRA and lets it grow, it will grow to over $3.6 million by the time she reaches age 72.

Age	Contribution	Total
22	------	78,227
---	------	
72	------	3,668,993

Even better still, assume the daughter leaves it in her account until she dies, say at age 85, bestowing the balance to HER children -- the taxpayer's grandchildren.

If the daughter continues to earn an average compound rate of return of 8 percent, by the time she dies the balance will grow to just under $10 million!

Age	Contribution	Total
72	------	3,668,993
---	------	
85	------	9,978,280

So, assuming there is no estate tax at the time of your or your child's death, by employing your child for 10 years now, you may ultimately be giving your grandchildren 10 million tax-free dollars.

Planning point:

Convince your children what a little hard work for dear old Mom or Dad can do!

Planning point:

The Roth contribution program can increase the contribution by more than a factor of three because its contribution limit in 2024 is $23,000 rather than $7,000 (for a Roth IRA). If a higher compensation base is justified -- remember that the contributor must have earned income of at least the amount of the contribution -- then these staggering numbers above can be multiplied even further. Of course, the levels of income make the child subject to income tax, even if they are above age 18.

Surgent Sidebar: HSAs

A taxpayer with self-coverage can contribute $4,150 to an HSA in 2024. The amount rises to $8,300 for family coverage. An additional $1,000 can be contributed if taxpayer is 55 or older. The additional $1,000 is per plan as accounts must be in individual names. The only way for a couple both 55 or older to each contribute the additional amount is for each to have a separate HSA.

The HSA is probably the most tax advantaged vehicle available. Your W-2 clients probably are aware their 401(k) contributions reduce their Line 1 W-2 income dollar for dollar. HSA contributions do as well. But maybe not so well understood, HSA contributions have the added advantage of not incurring Social Security or Medicare taxes for the employee. The 401(k) does not escape those. In addition, once the client reaches age 65, HSA balances will basically work like a regular IRA, with the ability to use the funds for any purpose, not just medical ones.

The future is very bright for HSAs. Contemplated legislation will probably raise the annual contribution limits. Despite having high deductibles before coverage is initiated, monthly premiums are cheaper compared to conventional plans. Employers often will take those savings and contribute to the employee's HSA account.

Additionally, the CARES Act §3702 expanded coverage for health savings accounts (HSAs), health reimbursement arrangements (HRAs), health flexible spending accounts (health FSAs), and Archer medical savings accounts (Archer MSAs), allowing for tax-free reimbursement of feminine hygiene products.

The Affordable Care Act, signed into law over 10 years ago on March 23, 2010, repealed the ability for individuals to use HSA accounts to purchase OTC drugs. In addition to expanding coverage for tax-free reimbursement of feminine hygiene products, the CARES Act eliminates the provision of the Affordable Care Act that limited the use of HSAs to only prescribed medicines or drugs. In other words, individuals will be able to use their HSAs, HRAs, health FSAs, and Archer MSAs to purchase over-the-counter medicine. This provision is effective for expenses incurred after December 31, 2019.

The IRS announced that the purchase of personal protective equipment, including masks, hand sanitizer and sanitizing wipes, used to prevent the spread of COVID-19, are deductible medical expenses. The amounts paid for PPE are also eligible to be paid or reimbursed under health FSAs, Archer MSAs, HRAs, and HSAs.

Specific advantages of HSAs include:

- HSA contributions are not subject to federal income tax;
- HSAs can be invested similar to 401(k) plans, and the initial investment and earnings grow tax-free;
- Employers can contribute to an HSA on the employee's behalf;
- Distributions for qualified medical expenses are tax-free;
- Unused HSA funds are not forfeited at year end; and
- Individuals keep their HSA when they change employers.

It is important to note that there are some potential drawbacks to HSAs. If an individual withdraws funds for non-qualified purposes before age 65, they will owe taxes on the withdrawn amount as well as a 20% penalty. Additionally, HSAs are only available with high-deductible health plans.

Some HSAs even offer debit cards, making it easy to pay for qualified medical expenses online or at the store. Certain online retailers, such as Amazon, clearly label products that are HSA eligible, making it easy to pay for medical supplies. If an individual does not have their HSA debit card and makes an out-of-pocket purchase for something that is a qualified medical expense, they may reimburse themselves through the HSA. Typically, the individual must request a reimbursement from his or her HSA administrator. Qualified medical expenses can be reimbursed at any point after they occur, provided the expenses were incurred after the HSA was established.

A planning opportunity exists for certain children. A child who is not a tax dependent can still be enrolled in the parental health plan until they turn 26, even if they are married, do not live with the parents, have a benefits-eligible job, or are not financially dependent on the parents. A parent with an HSA can keep their health care dependents on their HDHP until they turn 26. Once a child is no longer the parents' tax dependent, the child is eligible to open their own HSA, even if they are still enrolled in the parental HDHP. Since the child is part of a family HDHP, he or she can contribute up to the family maximum. A parent can contribute to their child's HSA on their behalf if they choose to. The child receives a tax deduction for the HSA contribution.

F. Shifting equity

Note:

Apart from hiring children to shift some of what would have otherwise been the earned income of the parent, the taxpayer can shift unearned income from income-producing assets to children, or in the case of business interests, earned income of the parent to unearned income of the child by transfers of property.

1. Property

The simplest case is a transfer of publicly traded stocks and bonds. This shifts both the income and the transfer-tax burden to the children.

Planning point:

In the case of a minor under age 18 (and some children between 18 and 23), some or all of the income is still taxed at the parent's tax rate. However, for a parent subject to the alternative-minimum-tax, the removal of the income reduces the taxpayer's adjusted gross income, and the income shifted to the child is not added back in determining the taxpayer's alternative-minimum-taxable income; therefore, the taxpayer's alternative minimum tax base is reduced dollar-for-dollar by the income shifted. In some cases, this could provide net tax savings, but when the child is at least 24 years of age, the income will be taxed at the child's own tax rate, and this is almost certain to be lower than the taxpayer's marginal alternative-minimum-tax rate.

Note:

While the outright transfer of income-producing property is the cleanest from a legal standpoint, may clients believe it suffers from two problems. The first is a general lack of control over the property, and the second is that publicly traded stocks are valued at a high value relative to other interests wrapped in a business entity, such as a partnership/LLC or an S corporation. These latter structures may not only be conducive to discounts for gift-tax purposes but also to a measure of retained control.

Planning point:

The 3.8-percent tax on unearned income gives a taxpayer an additional incentive of shifting unearned income to a lower-bracket taxpayer, or more precisely to a taxpayer with a lower AGI, one low enough that the addition of the unearned income shifted will not cause his or her AGI to exceed the applicable $200,000/$250,000 level. This not only reduces the amount of the regular income-tax liability but reduces or eliminates in some cases the additional 3.8-percent Medicare tax on such income.

2. Family partnerships

Family partnerships have been created to reduce the effects of the progressive income-tax rates by allowing a portion of the income earned by a business to be shifted to their families, usually spouses and children, often at lower tax brackets. This can result in an overall income-tax savings for the family.

Planning point:

To reduce taxes by splitting income, it is essential that the family partnership be recognized under federal tax law. Partnership treatment assures that the share of income attributable to the partner will result in tax to that partner whether distributed or not.[40]

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[40] I.R.C. §702(a).

Caution:

The family partnership area is fairly well developed and stands as a bar in many cases to the achievement of income-splitting. S corporations, which first appeared in 1958, are of more recent vintage, and while having similarities to a partnership in establishing bars to income-splitting, these impediments are not identical.

a. The partnership tax law has two sets of rules, one that turns on whether capital is a material income-producing factor and one that turns on whether a partnership interest is "really" owned and whether it was acquired by purchase.

Note:

When capital is a material income-producing factor, allocations to a partner with a capital interest will generally be respected for tax purposes.

b. A capital interest is evidenced by a partner's **capital account**, which reflects an amount to which the partner will be entitled upon liquidation of the partnership or that partner's partnership interest. It does not include a profits interest. When the partners are not related and deal with each other at arm's length, the existence of a capital account for that partner is sufficient to establish ownership. In the case of a partner who receives a partnership interest by gift, which ordinarily would involve two members in the same family, the question of "real" ownership becomes a complex facts-and-circumstances inquiry. Among the criteria for determining whether there is "real" ownership are the following.

(i) **Irrevocable deeds or instruments** of gift that are legally sufficient under state law to convey the partnership interest to the donee.

(ii) **Nonretention** of certain controls by the donor with respect to the partnership interest, including:

- Control of the distribution of income;
- Limitation of the right of the donee to liquidate or sell the partnership interest in the donee's discretion and without financial detriment. A buy-sell agreement that binds both the donor and the donee in the same manner, however, is permissible;
- Control of assets essential to the business; and
- Management powers inconsistent with normal relationships among partners. A donor may continue to manage the business in accordance with the donor's partnership interest as long as a donee is free to liquidate the donee's partnership interest. This in turn requires the donee to be independent of the donor and have the maturity and understanding of the rights of a partner so that the donee is capable of deciding whether to exercise, and capable of exercising, the donee's right to withdraw the capital interest in the partnership.

(iii) **Substantial participation** by the donee in the control and management of the partnership's business, if in fact the partner has sufficient maturity and experience to deal with the business problems or, if, as mentioned below, an independent trustee holds the interest in a fiduciary capacity. Actual distributions of the distributive share of the partnership's income must be made for the sole benefit and use of the donee partner. Distributions will not be considered used for the donee's sole benefit if, for example, they are deposited, loaned, or invested in

such manner that the donor controls or can control the use or enjoyment of the funds. Use of the partnership interest or income for the support of the donee will be considered used for the benefit of the person who has the legal obligation to support the donee.

(iv) **Recognition of the donee** as a partner by the partnership in its activities, as evidenced by:

- The donee's being held out publicly as a partner in relations with outsiders;
- A written partnership agreement;
- The filing of partnership tax returns;
- Treatment of the donee as a partnership in litigation and in business contracts;
- Recognition of the donee's rights in distributions of partnership property and profits;
- Control of business bank accounts; and
- Compliance with local partnership, fictitious-names, and business-registration statutes.

Note:

When a minor child is the donee, the nonretention of management controls and substantial participation will be difficult to establish because of the presumed lack of maturity, understanding, and ability to act independently. The child will generally only be treated as a partner if control of the partnership interest is exercised by a fiduciary for the child's sole benefit. Use of the partnership income or interest for support of the child, however, is for the benefit of the child's parent. The trustee of a trust for the benefit of the child who is independent of the grantor and who participates as a partner in its affairs will be treated as the owner. If the trustee is the grantor or is not independent of the grantor, then the trustee may be a partner only if the participation by the trustee actively represents the interests of the beneficiaries in accordance with the obligations of a fiduciary and does not subordinate those interests to those of the grantor.

c. **Capital interest acquired by purchase** -- If a capital interest in a partnership is owned by a partner as a result of a purchase, the tax allocations between the partners under the partnership agreement will generally be respected. However, for these purposes a capital interest in a partnership purchased by one member of a family from another is considered to be created by gift, and the purchasing partner's capital account to be donated capital, even if full and adequate consideration is paid. However, the rule does not apply to a partnership interest acquired **from** the partnership.

d. **Capital interest acquired by gift** -- In the case of a partnership capital interest that is "really owned" by a partner who acquired it by gift, §704(e) states that the allocations under the partnership agreement will be respected, but with two modifications.

Example 1: A father gives property to his son, who shortly thereafter conveys the property to a partnership consisting of the father and the son. The partnership interest of the son may be considered created by gift and the father may be considered the donor of the son's partnership interest.

Example 2: A father, the owner of a business conducted as a sole proprietorship, transfers the business to a partnership consisting of his wife and himself. The wife subsequently conveys her interest to their son. In such case, the father, as well as the mother, may be considered the donor of the son's partnership interest.

Example 3: A father makes a gift to his son of stock in the family corporation. The corporation is subsequently liquidated. The son later contributes the property received in the liquidation of the corporation to a partnership consisting of his father and himself. In such case, the son's partnership interest may be considered created by gift and the father may be considered the donor of his son's partnership interest.

(i) The first modification is required if the donor has performed services for the partnership but no, or an inadequate amount of, compensation is paid to the donor. In this event, a guaranteed payment to the donor in the amount of the inadequacy will be deemed made. The guaranteed payment will be treated as ordinary income to the donor and reduce in amount certain partnership items that are allocated in accordance with distributive shares.

(ii) The second modification is required whenever the partnership agreement purports to allocate an item to the donee partner in a relatively higher proportion than the donee's relative interests in partnership capital relative to the donor partner's interest. While all of the partnership items will be allocated to all partners other than the donor and donee in accordance with their respective distributive shares, the total amount of each partnership item to be allocated between the donor and donee will be apportioned solely on the basis of their respective interests in partnership capital.

Example: Father sells Son a 60-percent interest in a partnership with Father's brother, Brother. Brother acquired his interest in the partnership with his own funds. Capital is a material income-producing factor in the partnership.

Partner	Capital Account	Distributive Share
Father	$3,000	10 percent
Son	12,000	60 percent
Brother	5,000	30 percent
Total	$20,000	100 percent

This year, the partnership has taxable ordinary income of $120,000. Father performed services for the partnership having a fair market value of $20,000 for which he is not being paid.

Because the partnership interest of Son is deemed acquired by gift (even though Son paid Father adequate consideration), Father must be allocated a $20,000 guaranteed payment, which reduces the partnership income to be distributed to the partners to $100,000. Of that $100,000, $30,000 may be allocated to Brother even though it is disproportionate to his relative 25-percent interest in capital ($5,000 Brother's capital account/$20,000 total capital), because Brother did not acquire the interest by gift. Having allocated 30 percent of the partnership items to Brother, the residual partnership items, representing 70 percent of all partnership items (100-percent partnership items - 30-percent partnership items allocated to other partners), must be allocated between Father and Son. They share the residual capital of $15,000 ($20,000 total capital - $5,000 Brother's capital account) in the relative proportions of 20 percent ($3,000 Father's capital account/$15,000 residual capital) and 80 percent ($12,000 Son's capital account/$15,000 residual capital). Because the partnership agreement purports to allocate to Son 83.33 percent of the residual partnership items (60-percent distributive share/70-percent residual partnership items), which exceeds 80-percent relative interest in capital, the residual partnership items must be divided 80-20. Consequently, Father must be allocated $14,000 ($70,000 residual taxable income x 20-percent interest) and Son $56,000 ($70,000 residual taxable income x 80-percent interest).

Distributive Shares				
	Partnership	**Brother**	**Father**	**Son**
Taxable income	$120,000			
Less reasonable compensation	- $ 20,000		$20,000	
	$100,000			
Less Brother's share	- $ 30,000	$30,000		
	$70,000			
Less Father's share	-$14,000		$14,000	
Less Son's share	- $ 56,000			$56,000
	$ 0	$30,000	$34,000	$56,000

3. S corporations

a. By dividing ownership in the corporation among several members of the family group, the income and deductions of the corporation may be allocated to them on a pro rata basis.[41] As a result, the income of the electing corporation is taxed to the family as a whole at the lowest possible marginal rates.

Note:

Unlike a partnership where there is a somewhat more flexible ability of allocating income (unless otherwise limited by the family-partnership rules), the income in an S corporation is rigidly determined by mechanical rules even if the "family S corporation" rules do not apply.

b. Each shareholder's pro rata share of corporate income is determined by assigning an equal portion of income, losses, deductions, and credits to each day of the taxable year and then by dividing that portion proportionately among the shares outstanding on such day.[42] As a result of this "per day/per share" allocation, a transfer near the end of a taxable year shifts only a small amount of the income for that year to the transferee. Such year-end transfers are still effective, however, for shifting income in future tax years.

c. The division of corporate ownership among members of the family group is normally accomplished by a transfer of stock. The typical arrangement involves transferring the stock to a parent as custodian under the Uniform Gifts (or Transfers) to Minors Act.

d. The children must hold legal title to the stock. The regulations do not provide any discussion of "real ownership" as the family partnership regulations do. The prior regulations of the Service suggested that the minors must act as true beneficial owners of the S corporation stock or it would continue to treat the parent or other donor to be the owner for tax purposes.[43] The absence of any requirement in the new regulations could be taken as an invitation for a somewhat less cumbersome administration than in family partnerships, allowing the minor to be truly passive yet be respected as a shareholder.[44]

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41 I.R.C. §1366(b).

42 I.R.C. §1377(a).

43 Treas. Regs. §1.1373-1(a)(2) [prior law].

44 In the *Kirkpatrick* case, the donor successfully overcame the Commissioner's contention under the prior regulations that he had retained beneficial ownership over stock in a Subchapter S corporation that had been transferred to his children. In finding for the taxpayer, the Court noted that the transferor's wife had been appointed as custodian for the minor children. The Court ruled that the wife-custodian had effectively protected the ownership rights of the minor children by: (i) actively serving as a corporate officer and director; and (ii) maintaining separate custodial bank accounts for each child-stockholder. In addition, the Court held that the transferor had relinquished dominion and control over the stock and dealt with the corporation in an arm's-length manner. As a result, the children were found to be the true beneficial owners of the stock. This case is yet another example of how the facts control the result. Obviously, the donor got some really good advice.

Note:

While all shares in an S corporation must be identical with respect to corporate income and assets, they may be different as to voting rights.[45] As a result, parents may shift income to their children without losing control of the corporation and the underlying assets in the corporate wrapper. The example below illustrates this technique.

Example: Ralph is the sole shareholder of T, an S corporation. Ralph wishes to shift half of T's income to his son, Ralph Jr., but does not want to relinquish any of his control in the corporation. To accomplish his goal, Ralph should recapitalize T with equal shares of voting and nonvoting common stock. The nonvoting shares could then be transferred to Ralph Jr. As a result of this transaction, Ralph will effectively maintain control of T while shifting half of the corporate income to Ralph Jr.

e. There is no provision that deals with the situation when the interest in the S corporation is acquired by gift, unlike a partnership. The regulations do not refer to the distinction between a gift or a purchase of the interest. The issue solely is whether compensation for services is reasonable or not. This means that S corporation may be gifted with more effect than in a partnership. The S corporation has "family S corporation" rules that provide that when an individual, who is a member of the family of one or more shareholders of an S corporation, renders services for, or furnishes capital to, the corporation without receiving reasonable compensation, the Commissioner shall prescribe adjustments to those items taken into account by the individual and the shareholders as may be necessary to reflect the value of the services rendered or capital furnished.

   (i) For these purposes, in determining the reasonable value for services rendered, or capital furnished, to the corporation, consideration is given to all the facts and circumstances, including the amount that ordinarily would be paid in order to obtain comparable services or capital from a person (other than a member of the family) who is not a shareholder in the corporation.

   (ii) In addition, for these purposes, if a member of the family of one or more shareholders of the S corporation holds an interest in a pass-through entity (e.g., a partnership, S corporation, trust, or estate), that performs services for, or furnishes capital to, the S corporation without receiving reasonable compensation, the Commissioner shall prescribe adjustments to the pass-through entity and the corporation as may be necessary to reflect the value of the services rendered or capital furnished.

Example: Consider the situation when Mr. X decides to form an S corporation by transferring $1,028,570 of investment assets to it in return for all its stock. Mr. X is 60 years old, has an estate worth $4 million, and is in a 40-percent marginal income-tax bracket (after considering state taxes). Mr. and Mrs. X can gift-split and thereby transfer $36,000 (3.5 percent) of their S corporation stock to each of their two children and the children's spouses, which equals $144,000 of stock in total each year, without any gift-tax consequences.[46] If Mr. X chooses, the stock that he gives away can be nonvoting S stock. Consequently, Mr. X will continue to control the corporation as long as he retains any stock interest. At the close of Year 1, Mr. X owns 86 percent of the stock, and his children and their spouses own 14 percent in the aggregate. Assume that the S corporation earns $100,000

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45 I.R.C. §§1361(b)(1) and 1361(c)(4).

46 This example assumes no valuation discounts.

of income each year. Accordingly, Mr. X will pay taxes on $86,000 and his children on $14,000.

Mr. X's tax will be reduced by $5,600 (40 percent of $14,000). Each of his children and their spouses will have to pay tax on the $3,500 each receives but at tax rates lower than the tax rate that Mr. X pays. Remember that there are no gift-tax consequences because of the $18,000 per-donee, per-annum exclusion. Of course, gift-splitting has doubled the exclusion to $36,000 per donee. In addition, it should be noted that these gifts and any subsequent appreciation in their value have been removed from the donor's gross estate. During the ensuing years, Mr. X can decide how much of the stock he wants to give away in order to shift the income-tax consequences and lower the estate-tax impact.

Planning point:

In order to realize the maximum income-tax savings, sufficient stock should be transferred to the children by or in the year of their eighteenth (or, in some cases, twenty-fourth) birthday. The parents could make a large gift of stock in that year.

A trust to hold S stock for the child will not further reduce income taxes. In order to maintain S status, the trust must either distribute income or pass the income through the trust to the beneficiary.[47] From an **income-tax** standpoint, this achieves no more than a direct transfer of the stock to the child. However, there may be other reasons to establish such a trust.

Planning point:

For planning purposes, compensation should be based on the low end of reasonable compensation for the older-generation shareholders. Even if there is a readjustment for income-tax purposes, the allocable shares of income are passed to the other younger-generation shareholders without any apparent incidence of transfer (estate or gift) tax.

Planning point:

In addition, when the child is old enough to be compensated for services, the technique of paying reasonable compensation on the high end of reasonableness to younger-generation employees has benefits as well.

First, the more compensation that is reasonably paid out, the lower the taxable income that will be distributed to the shareholders. In some cases, the compensation payments may create a taxable loss. Such a loss may be deductible to the shareholders if there is sufficient basis in stock or debt. In a situation in which the corporation is owned solely or predominantly by an older-generation family member, the payment of compensation to the younger generation has the effect of shifting income in a manner that gives the older generation a current deduction while causing the younger generation to pay tax on a similar amount of income.

Second, the payment of such compensation may reduce the net worth of the corporation and to some extent the value of the shares in the S corporation without any immediate gift-tax consequences.

Example: All the stock of T, an S corporation, is owned in equal portions by a father and his three children. Only the father is active in the business, and his salary for the taxable year is $100,000. After deducting such salary, the corporation's taxable income for the year is $100,000, and each shareholder reports $25,000 of income from the corporation. On audit, the IRS determines that a reasonable salary for the father would have been $160,000. If such salary had actually been paid, the corporation's taxable income would have been reduced to $40,000, and each shareholder would have reported $10,000 of income from the corporation.

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47 I.R.C. §1361(d).

The father's total income from the corporation would have been $170,000 rather than $125,000. Therefore, to place the shareholders in the position they would have been in if a reasonable salary had been paid to the father, the IRS can attempt to reallocate $15,000 of income from each of the three children to the father.

f. Unlike C corporations, the issue is not excessive or unreasonable compensation, but rather if **adequate compensation** has been paid.

Note:

The final regulations offer some guidance in the application of the family S rules that attribute some reasonable level of compensation to any individual family member who renders services for or provides capital to an S corporation.[48] All the circumstances are considered in determining a reasonable allowance for services rendered for, or capital furnished to, the S corporation, including the amount that ordinarily would be paid to obtain comparable services or capital from a person who is neither a member of that family nor a shareholder in the S corporation. They extend this rule to cases where the services are rendered, or capital furnished, to an S corporation through a pass-through entity in which a member of a shareholder's family owns an interest.[49]

Example 1: The stock of an S corporation is owned 50 percent by F and 50 percent by T, the minor son of F. For the taxable year, the corporation has items of taxable income equal to $70,000. Compensation of $10,000 is paid by the corporation to F for services rendered during the taxable year, and no compensation is paid to T, who rendered no services. Based on all the relevant facts and circumstances, reasonable compensation for the services rendered by F would be $30,000. In the discretion of the Service, up to an additional $20,000 of the $70,000 of the corporation's taxable income, for tax purposes, may be allocated to F as compensation for services rendered. If the Service allocates $20,000 of the corporation's taxable income to F as compensation for services, taxable income of the corporation would be reduced by $20,000 to $50,000, of which F and T each would be allocated $25,000. F would have $30,000 of total compensation paid by the corporation for services rendered.

Example 2: The stock of an S corporation is owned by A and B. For the taxable year, the corporation has paid compensation to a partnership that rendered services to the corporation during the taxable year. The spouse of A is a partner in that partnership. Consequently, if, based on all the relevant facts and circumstances, the partnership did not receive reasonable compensation for the services rendered to the corporation, the Service, in its discretion, may make adjustments to those items taken into account by the partnership and the corporation as may be necessary to reflect the value of the services rendered.

g. The family S corporation rules also apply to loans made to the corporation at below-market rates of interest. Even if a family member-lender does not own stock in the S corporation, the Service apparently has the right to increase the lender's gross income to reflect a market rate of interest.[50] Any increase in interest income to the family member could result in a corresponding increase in interest expense to the other family members owning shares of the S corporation.[51]

h. A recent Fact Sheet issued by the Service identifies its position and criteria for determining a reasonable salary in this context.

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48 I.R.C. §1366(e).
49 Treas. Regs. §1.1366-3(a).
50 This power apparently exists in addition to the rules of relating to below-market loans.
51 The shift in the allocation may cause a change in the character of interest for deductibility purposes.

(i) The instructions to the Form 1120-S, *U.S. Income Tax Return for an S Corporation*, state "Distributions and other payments by an S corporation to a corporate officer must be treated as wages to the extent the amounts are reasonable compensation for services rendered to the corporation."

(ii) The amount of the compensation will never exceed the amount received by the shareholder either directly or indirectly. However, if cash or property or the right to receive cash and property did go to the shareholder, a salary amount must be determined and the level of salary must be reasonable and appropriate.

(iii) There are no specific guidelines for reasonable compensation in the Code or the Regulations. The various courts that have ruled on this issue have based their determinations on the facts and circumstances of each case.

(iv) Some factors considered by the courts in determining reasonable compensation are:

- Training and experience;
- Duties and responsibilities;
- Time and effort devoted to the business;
- Dividend history;
- Payments to non-shareholder employees;
- Timing and manner of paying bonuses to key people;
- What comparable businesses pay for similar services;
- Compensation agreements; and
- The use of a formula to determine compensation.

i. The following are factors that one should consider.

(i) The nature of the business is important because when professional services, such as law, accounting, or consulting are involved, profits are generated primarily by the personal efforts of the employees; as a result, a significant portion of the profits should be paid out in compensation rather than distributions. No reported cases involve a business typically driven less by a shareholder's personal efforts and more by the corporation's capital and assets where a lower salary for the shareholder-employees and a dividend as a return on invested capital may be justified.

(ii) A court will focus on what the principal was doing and not doing, so documentation of the extent of the principal's services must be considered in determining reasonable compensation. The corporation is not required to, and would not be penalized, paying salary to a shareholder who provides limited services. In addition, the greater the experience, responsibilities, and effort of the shareholder-employee, the larger the salary that will be required; but a reduced role for a once full-time shareholder-employee may justify a decrease in salary or compensation to less than industry norms.

(iii) A comparison of compensation to rank-and-file employees, if any, with that of the principal should not be unfavorable. Similarly, if a shareholder-employee has more responsibilities than the highest paid non-shareholder, the shareholder's wage should logically be higher than the non-shareholder's wage. If the corporation has enjoyed rising revenues but the shareholder-employee's salary has not increased, this may be an indication that compensation is unreasonably low. In addition, if the corporation recently elected S status and correspondingly

reduced its amount of shareholder compensation, this will raise questions about whether the motivation behind the salary reduction was to avoid payroll taxes.

(iv) Basic benchmarking tools from sources such as Bureau of Labor Statistics wage data will be useful in determining the relative reasonableness of the shareholder-employee's compensation when compared with industry norms.

(v) The financial ratios published in the RMA and industry-specific publications should be used to determine both the corporation's overall profitability and the shareholder-employee's compensation as a percentage of sales or profits. Whenever possible, these comparisons should be with similarly sized companies within the same geographic region. If the resulting ratios indicate that the S corporation is more profitable than its peers but is paying less salary to the shareholder-employee, in the absence of any other factors, such as the shareholder's reduced role or the corporation's need to retain capital for expansion, an increase in compensation to the industry and geographic norms provided for in the publications likely will be necessary.

(vi) While large distributions coupled with a small salary may increase the likelihood of IRS scrutiny, there is no requirement that an S corporation pay out all profits as compensation. There is some indication reading between the lines that a court may stop at the taxable wage base for reasonable compensation, allowing amounts in excess of that level to escape the Medicare tax.

(vii) If a careful analysis of the factors supports compensation equal to or above the Social Security wage base, setting a shareholder's compensation below that amount likely leaves a greater likelihood of IRS scrutiny. Conversely, as the salary amounts equal or exceed that wage base, the tax savings of the salary-for-distribution trade diminish greatly, and this may reduce the risk of an IRS challenge.

(viii) The Service implicitly recognizes that an S corporation must pay a reasonable compensation but up to the amount that is paid, regardless of what the corporation may call it, may be recharacterized as compensation. Forgoing distributions or making written documented bona fide loans from the corporation that are recognized by the shareholder as loans avoid the employment-tax issue. That said; payment of no compensation to officers is a **clear audit red flag**. If the client pays a given amount as reasonable compensation, the Service will have to contend that the number is too low, but if the client pays no compensation, the Service will contend that its **own** number is right. The client will have to contend that the Service is wrong, putting the client immediately on the defensive.