NEW YORK STATE BAR ASSOCIATION

Elder Law and Special Needs Section
July 12-14, 2018

Part 1: Overview of Tax Planning for the Elder Law Practitioner
Part 2: Advanced Tax: Understanding the New Tax Laws

Presented by:

Vincent J. Russo

J.D., LL.M. in Tax, CELA, CAP

Offices: Long Island and New York City
Phone: 800-680-1717 | www. vjrussolaw.com

Table of Contents

I.

Overview of Tax Planning for the Elder Law Practitioner – Part 1

Presented by:

Vincent J. Russo
J.D., LL.M. in Tax, CELA, CAP

Russo Law Group, P.C.
Estate Planning, Elder Law & Special Needs

Offices: Long Island and New York City
Phone: 800-680-1717 | www. vjrussolaw.com

Today's Workshop: Basic Tax Planning

- Income Taxation
- Deductibility of Expenses
- SNTs and Grantor Trusts
- Estate and Gift Taxation

 2

General Income Tax Rules

 3

2018 Federal Income Tax Brackets

Tax Rate	Single	Married-Joint	Estate or Trust
10%	$ 0 – 9,525	$ 0 – 19,050	N/A
12%	$ 9,526 – 38,700	$ 19,051 – 77,400	$ 0 – 2,550
22%	$ 38,701 – 82,500	$ 77,401 – 165,000	N/A
24%	$ 82,501 – 157,500	$ 165,001 – 315,000	$2,551 – 9,150
32%	$157,501 – 200,000	$ 315,001 – 400,000	N/A
35%	$416,701 – 418,400	$ 416,701 – 470,700	$9,151 – 12,500
37%	$500,001 + over	$600,001 + over	over $12,500

Reporting of Income and Expenses

- Sources of Income
  - Income Earned
  - Passive Income
  - Trust payments to or for the benefit of the Individual
    - May be subject to reporting as Income
- Types of Expenses
  - Itemize versus Standard Deduction
  - Medical Expense Deduction

2018: Income Taxation

- Tax Cuts and Jobs Act
  - 2017 Tax Act or Reconciliation Act of 2017
- Most provisions
  - Effective January 1, 2018
  - Sunset at the end of 2025 – in eight years.

TAX CUTS & JOBS ACT

2018: Will You Pay More or Less in Taxes

- What Tax Bracket will you be in and at what rate?
- Will you benefit from the Standard Deduction?
- Will you be hurt by the Elimination of Certain Itemized Deductions?

Russo Law Group, P.C.
Copyright 2018 7

2018: Will You Pay More or Less in Income Taxes

- Lower Tax Rates
- Increased Standard Deduction
  - Plus the Blind and Elderly Deduction
- Eliminated the Personal Exemption
- Child Tax Credit and the Dependent Tax Credit

Russo Law Group, P.C.
Copyright 2018 8

2018: If You Itemize…

- Elimination of Most Itemized Deductions
- Mortgage Interest - modified
- State and Local Taxes - limited
- Charitable Deductions - modified (plus)
- Medical Deduction – modified (plus)

Russo Law Group, P.C.
Copyright 2018 9

If You Itemize… Medical Expense Deduction

Adjusted Gross Income	$ 60,000
Medical Expenses	$ 15,000
7 ½ % of AGI	4,500
Deduction Amount	**$ 10,500**

(Medical Expenses less 7.5% of the AGI)

IRAs, Retirement Accounts and Trusts

Early Withdrawal of IRAs

- General Rule: Withdrawal before age 59 ½ - 10% Penalty
- Exception to the General Rule
  - Annuity – 72(t) payments
  - Excess Medical Expense
  - Health Insurance
  - Permanent Disability

Income: Qualified Retirement Funds

- Reporting of the Income
  - Amount and Timing
- Use of Special Needs Trusts as Beneficiary of IRAs
- Qualifying for the Stretch Pay Out

Retirement Death Benefits

- Annual Distributions over Life Expectancy of Designated Beneficiary
- Beneficiary may be a Trust for Purposes of the Minimum Distribution Rules

Two Types of "See Through" Trusts

- Conduit Trust
  - Trustee has no Power to Accumulate Plan Distributions
- Accumulation Trust
  - Trustee has the Discretion to Pay Out or Accumulate the Plan Distributions

"See Through" Trusts as Beneficiary

- Benefits are Distributed to the Trust
  - in Annual Installments
  - over the Life Expectancy of the Oldest Trust Beneficiary (referred to as the "Applicable Distribution Period")
- Just as if left Outright to the Designated Beneficiary

Third Party Designation of SNT as IRA Beneficiary

- Bob' has three Children
  - Daughter - Krista, is 35 years old and has CP
- Options to Fund SNT with 1/3: Bob creates:
  - A Living Third Party SNT for Krista
  - A Revocable Trust with SNT for Krista
  - A Will with SNT for Krista
- Bob Designates the Trust, Sub-Trust or his Estate as the Beneficiary with a Provision for 1/3 to SNT for Krista

Taxation of Trusts

Taxation of Trusts: Overview

- Federal Income Tax Return – Form 1041
- Trust Tax Rates
- Type of Trust for Tax Purposes
  - Grantor Trust
    - Informational Statement of Income and Expenses
    - Taxpayer Identification Number or Social Security Number
  - Non-Grantor Trust
    - Schedule K-1 issued to the Beneficiary
    - Taxpayer Identification Number

 19

Reporting of Trust Income

- Must be Reported on the Trust Income Tax Return (unless an exception is met)
- If Exception is met,
  - All income may be reported on the grantor's personal income tax return
  - All or part of the income may be reported on the beneficiary's personal income tax return
  - All or part of the income may be reported on the trust income tax return

 20

2018 Federal Income Tax Brackets

Tax Rate	Single	Married-Joint	Estate or Trust
10%	$ 0 – 9,525	$ 0 – 19,050	N/A
12%	$ 9,526 – 38,700	$ 19,051 – 77,400	$ 0 – 2,550
22%	$ 38,701 – 82,500	$ 77,401 – 165,000	N/A
24%	$ 82,501 – 157,500	$ 165,001 – 315,000	$2,551 – 9,150
32%	$157,501 – 200,000	$ 315,001 – 400,000	N/A
35%	$416,701 – 418,400	$ 416,701 – 470,700	$9,151 – 12,500
37%	$500,001 + over	$600,001 + over	over $12,500

 21

2018 Income Tax Traps

Taxable Income	Single	Married- Joint	Estate or Trust
$10,000	$1,009.50	$1,000.00	$2,136.50
$20,000	$2,209.50	$2,019.00	$5,786.50
$50,000	$6,939.50	$5,619.00	$16,886.50
$100,000	$18,289.50	$13,879.00	$35,386.50
$200,000	$45,689.50	$36,579.00	$72,386.50
$10,000	$1,009.50	$1,000.00	$2,136.50

Taxation of Grantor Trusts

Income Taxes: Examples of Grantor Trusts

- All
  - Revocable Third Party Special Needs Trusts
  - First Party Special Needs Trust [D(4)(a) Trust]
- Optional
  - Medicaid Asset Protection Trust
  - Third Party Irrevocable Special Needs Trust

Income Taxes: Grantor Trust (Taints)

- Reversionary Interest in the Trust (IRC § 673)
- Power to Add Beneficiaries (IRC § 674)
- Grantor may Exchange Property of Equivalent Value in Non-Fiduciary Capacity (IRC § 675)
- Use Trust Income to Pay Premiums of Insurance on Life of Grantor / Grantor's Spouse (IRC § 677)

Income Taxes: Grantor Trust (Taints)

- Power to Revoke (IRC § 676)
  - Do not use the Power to Revoke if a First Party Special Needs Trust (where the beneficiary is accessing or seeking to qualify for Supplemental Security Income and/or Medicaid)
- Income Payable by Grantor or Non-Adverse Party (Trustee) to the Grantor (IRC § 677)
  - Without the consent of an Adverse Party (Trustee)
    - any person who has a substantial beneficial interest in the trust which would be adversely affected (IRC § 672)

Medicaid Asset Protection Trust as a Grantor Trust - Taint

- **Power of Substitution***
  - While I am living, I may direct my Trustee to transfer any property of my trust to me in exchange for property of equivalent value. My Trustee must follow any such directive.

    ** Excerpt from Elderdocx (Eldercounsel, LLC)*

Medicaid Asset Protection Trust as a Grantor Trust - Taint

- **Power to Add Charities as Beneficiaries**
  - While I am living, I may add beneficiaries to my trust by designating any charitable organization described in Section 170 of the Internal Revenue Code, other than any charitable organization to which I am indebted, as an additional beneficiary of the net income or principal of the trust. After designating any additional charitable beneficiary, my Trustee may distribute trust income or principal to the designated charitable beneficiary in amounts and proportions determined in my Trustee's sole and absolute discretion. However, if my Trustee is an adverse party, as defined in Section 672(a) of the Internal Revenue Code, then I may direct my Trustee to distribute net income or principal to the additional charitable beneficiary in amounts and proportions determined in my sole and absolute discretion, and my Trustee must follow such direction.

** Excerpt from Elderdocx (Eldercounsel, LLC)*

Taxation of Non-Grantor Trusts

Income Taxes: Non-Grantor Trusts

- All
  - Testamentary Trusts
  - Qualified Disability Trust
- Optional
  - Third Party Irrevocable Special Needs Trusts
  - MAPT

Taxation of Non – Grantor Trusts Distributable Net Income (DNI)

- Distributable net income (DNI) is used to Allocate Income between a Trust and its Beneficiaries.
  - Trusts are allowed to deduct the lesser of DNI or the sum of the trust income required to be distributed and other amounts "properly paid or credited or required to be distributed" to beneficiaries.
  - The Beneficiary will be taxed on the DNI amount and any amount above will be tax-free.

Income Taxes: Advantages of a Grantor Trust

- Income Tax Consequences stay with the Grantor
- Consider the Tax Bracket of the Grantor
  - Single Individual reaches 37% at $500,001 for 2018
  - Trust reaches 37% bracket at $12,501 for 2018
- Simpler Tax Filings
- Easier to Explain to the Client

Income Taxes: Advantages of a Non-Grantor Trust

- Grantor does not have to come up with funds to pay tax on "phantom income"
- Spread out the income tax consequences
- Beneficiary who receives the income pays the income tax in beneficiary's tax bracket
- Exemption Amount as a "Qualified Disability Trust"

Income Taxes: Disadvantages of a Non-Grantor Trust

- If not Careful, Higher Overall Taxes
- Beneficiary does not Understand that they need to come up with Income Tax Payments
- More Complicated
  - Trustee needs to pay attention to calendar year-end distributions

Gift and Estate Taxation

Estate and Gift Tax System

- Unified Federal Tax System
- Exemption Amount
  - $11,180,000
- Tax Rate
  - 40%

NYS Estate Tax System

- Estate Tax Rate
  - Estate tax rates start at five percent, and goes up to 16%, subject to the “estate tax cliff”
  - Exemption Amount
    - $5,250,000 for Decedents dying on or after 4/1/2017 and before 1/01/2019
    - $5,600,000 (est.) for Decedents dying on or after 1/1/2019
- No Gift Tax

Medicaid Planning and Estate and Gift Taxation

- Asset Transfers
- Gift Tax Consequences
  - Carryover in Basis v. Step Up in Basis

Sale of Primary Residence

Case Study – Sale of Residence

House purchased
in 1970 for $60,000

Improvements
of $40,000

FMV in 2018:
$500,000

Capital Gain Exclusion on a Sale of Primary Residence

- Capital Gain Exclusion of $250,000 or $500,000 (if married – filing joint)
- You must own and Live in (used) the residence as your principal residence an aggregate of 2 out of the last 5 years before the sale
- Available once every two years

Income Taxation – Sale of a Primary Residence

- Sold During Lifetime
  - Outright Ownership
  - Owned in a MAPT
  - Owned by Donee
- Sold After Death
  - Owned Outright
  - Owned by Donee
  - Owned by MAPT

Case Study
Sale of Primary Residence During Lifetime

	Sale by Senior	Sale by MAPT	Sale by Donee
Selling Price	$ 500,000	$ 500,000	$ 500,000
Less: Basis	$ 100,000	$ 100,000	$ 100,000
Gain	$ 400,000	$ 400,000	$ 400,000
Less Capital Gain Exclusion	$ 250,000	$ 250,000	$ 0
Gain for Tax Purposes	$ 150,000	$ 150,000	$ 400,000
Tax at 27%*	**$ 40,500**	**$ 40,500**	**$ 108,000**

**Assumes a combined tax rate of 27%*

Case Study
Sale of Residence After Death

	Sale by the Estate	Sale by MAPT	Sale by Donee
Selling Price	$ 500,000	$ 500,000	$ 500,000
Less: Basis	$ 500,000	$ 500,000	$ 100,000
Gain	$ 0	$ 0	$ 400,000
Less Capital Gain Exclusion	$ 0	$ 0	$ 0
Gain for Tax Purposes	$ 0	$ 0	$ 400,000
Tax at 27%*	**$ 0**	**$ 0**	**$ 108,000**

**Assumes a combined tax rate of 27%*

Obtaining Grantor Trust Status Over Principal

- Important Trust Provisions when Dealing with Appreciated Assets
  - To allow the Grantor to Maintain IRC § 121 exemption on sale of primary residence
  - To ensure that individual capital gains tax rates apply when trust assets are sold
    - For example, Sale of Stock and Bonds

Sale of Residence with a Retained Life Estate: Capital Gain Exclusion

- The Capital Gain Exclusion will only apply to the sale proceeds determined by the value of the life estate interest
- This is a disadvantage when compared to a Sale during life time of the residence from a MAPT (with grantor trust status for tax purposes)

In Summary

Comprehensive Planning for Seniors and Individuals with Disabilities…

…Requires Consideration of the Tax Implications when Planning for Medicaid and SSI Benefits

Questions

Overview of Tax Planning for the Elder Law Practitioner – Part 1

Stay Tuned for Part 2
Have a Great Day!

Russo Law Group, P.C.
Estate Planning, Elder Law & Special Needs
Offices: Long Island and New York City
Phone: 800-680-1717 | www. vjrussolaw.com

II.

Advanced Tax: Understanding the New Tax Laws – Part 2

Presented by:

Vincent J. Russo

J.D., LL.M. in Tax, CELA, CAP

Russo Law Group, P.C.

Estate Planning, Elder Law & Special Needs

Offices: Long Island and New York City

Phone: 800-680-1717 | www. vjrussolaw.com

Today's Workshop: Advanced Tax Planning

- Tax Cuts and Jobs Act
- Qualified Disability Trusts
- New Business Tax Options
- Planning Options Available under the New Federal Income Tax Structure

Russo Law Group, P.C.
Copyright 2018 2

Tax Cuts and Jobs Act

Russo Law Group, P.C.
Copyright 2018 3

Individual Income Tax Changes

- Tax Rates Reductions
- Standard Deduction - 12k single, 24k for married
- Personal Exemption - eliminated, except:
  - for Dependent exemption is zero
  - for Elderly and Blind still available;
  - for Qualified Disability Trust still available
- Credit for Qualifying Dependents
  - $500, Non-Refundable (in addition to the Child Care Tax Credit)

2018 Federal Income Tax Brackets

Tax Rate	Single	Married-Joint	Estate or Trust
10%	$ 0 – 9,525	$ 0 – 19,050	N/A
12%	$ 9,526 – 38,700	$ 19,051 – 77,400	$ 0 – 2,550
22%	$ 38,701 – 82,500	$ 77,401 – 165,000	N/A
24%	$ 82,501 – 157,500	$ 165,001 – 315,000	$2,551 – 9,150
32%	$157,501 – 200,000	$ 315,001 – 400,000	N/A
35%	$416,701 – 418,400	$ 416,701 – 470,700	$9,151 – 12,500
37%	$500,001 + over	$600,001 + over	over $12,500

Income Tax: Changes

- Capital Gain Exclusion for Sales of Primary Residence
  - Home sale exclusion test remains two out of the last five years
- Medical Expense Deduction
  - Medical expenses: 7.5% of AGI limit through 2018
- Health Care
  - Individual Mandate under Affordable Care Act
    - repealed after 2018

Income Tax: Changes

- Elimination of Most Itemized Deductions
- Limit on the State and Local Tax (SALT) Deduction
  - Up to $10,000 ($5,000 married filing separately)
- Limit on Mortgage Interest Deduction - $750K
  - No deduction for Home Equity Loans
- Charitable Contributions
  - Continues with a 60 percent of AGI limit (increased from 50%)

Income Tax: Able Accounts

- Increased Contribution Limits to ABLE accounts through 2025
  - The total annual contribution limit to an ABLE account will be increased from $14,000 per tax year to $15,000 per tax year beginning in 2018
- Section 529 Rollover to an Able Account
  - Permit rollovers from 529 plans to ABLE accounts through 2025

Small Business Owners

- 20% Deduction in Flow Thru Business Income
  - Includes rental income
  - Formula for calculating the 20 percent deduction from qualified business income
- Limitation on Service Businesses
  - List includes: Law, Accounting, Financial Services
  - Any business where principal asset is reputation and skill of employees or owners

Trusts and Estates Tax Considerations

- Kiddie Tax – *Applies Trust Tax Rates*
- Personal Exemption for Trusts *Retained*
- State and Local Tax Deduction Limitation *Applies*
- Executor and Trustee Fees allowed – *Not Clear*
- Excess Deductions on Termination *Eliminated*
- Deduction for Estate Taxes Attributable to Income in Respect of a Decedent *Retained*

Russo Law Group, P.C.
Copyright 2018 10

Qualified Disability Trusts

Russo Law Group, P.C.
Copyright 2018 11

Qualified Disability Trust

- Requirement for Qualified Disability Trust (QDisT)
  - Disability Trust – sole benefit for beneficiaries who are under age 65
  - All of the beneficiaries must be disabled
  - Must be a Non-Grantor Trust for tax purposes
- Qualifies for an Exemption
  - $4,150 for 2018 (indexed for inflation)
- Exempts Income from the Kiddie Tax
  - Treated as earned income

Russo Law Group, P.C.
Copyright 2018 12

Qualified Disability Trust Election

Form **1041** Department of the Treasury—Internal Revenue Service
U.S. Income Tax Return for Estates and Trusts **2016** OMB No. 1545-0092
▶ Information about Form 1041 and its separate instructions is at *www.irs.gov/form1041.*

A Check all that apply:
☐ Decedent's estate
☐ Simple trust
☐ Complex trust
☒ Qualified disability trust
☐ ESBT (S portion only)
☐ Grantor type trust
☐ Bankruptcy estate-Ch. 7
☐ Bankruptcy estate-Ch. 11
☐ Pooled income fund

For calendar year 2016 or fiscal year beginning , 2016, and ending , 20
Name of estate or trust (If a grantor type trust, see the instructions.)
Name and title of fiduciary
Number, street, and room or suite no. (If a P.O. box, see the instructions.)
City or town, state or province, country, and ZIP or foreign postal code

C Employer identification number
D Date entity created
E Nonexempt charitable and split-interest trusts, check applicable box(es), see instructions.
☐ Described in sec. 4947(a)(1). Check here if not a private foundation . . . ▶ ☐
☐ Described in sec. 4947(a)(2)

B Number of Schedules K-1 attached (see instructions) ▶
F Check applicable boxes: ☐ Initial return ☐ Final return ☐ Amended return ☐ Net operating loss carryback ☐ Change in trust's name ☐ Change in fiduciary ☐ Change in fiduciary's name ☐ Change in fiduciary's address
G Check here if the estate or filing trust made a section 645 election . . . . . . ▶ ☐ Trust TIN ▶

Russo Law Group, P.C.
Copyright 2018 13

QDisT Case Study - Exemption

	Non-Grantor Trust	QDisT	Beneficiary
Income	$ 22,500	$ 22,500	$ 22,500
Exemption	$ 100	$ 4,150	$ 0
Standard Deduction	$ 0	$ 0	$ 12,000
Taxable Income	$ 22,400	$ 18,350	$ 10,500
Tax	$ 6,675	$ 5,176	$ 1,070

Russo Law Group, P.C.
Copyright 2018 14

QDisT Exemption Benefit

- If $4,150 of Trust Income is Offset by the Exemption and Hence not Taxed, then
  - With a 7% return over a 14 year period, the fund would be over $95,000 (which would be available for the benefit of the beneficiary)
- The QDisT can be a Good Vehicle as a Beneficiary of IRAs
  - Due to the exemption amount and beneficiary's tax Bracket

Steven J. Silverberg blog on QDisT

Russo Law Group, P.C.
Copyright 2018 15

QDisT and the Kiddie Tax

- Three Prong Test for the Kiddie Tax to Apply
- Taxed at the Trust Rates and the Parents' Rates
- Treatment of the Income Distributed to the Beneficiary as Earned Income
  - Not subject to the Kiddie Tax

Russo Law Group, P.C.
Copyright 2018 16

Capital Gains – 2018 Tax Rates

QDisT Trust Tax Rates	
If Income is:	Capital Gain Tax Rate
Up to $ 2,600	0%
$ 2,601 to $ 12,700	15%
Over $ 12,700	20%

QDiST Beneficiary Tax Rates	
If Income is:	Capital Gain Tax Rate
Up to $ 38,600	0%
$ 38,601 to $ 425,800	15%
Over $ 425,800	20%

Russo Law Group, P.C.
Copyright 2018 17

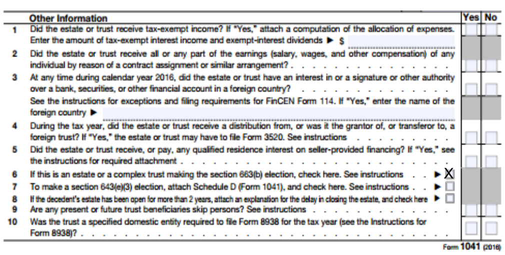
The 65 Day Rule

Russo Law Group, P.C.
Copyright 2018 18

65 Day Rule

- If within the first 65 days of any taxable year of an estate or a trust, an amount is properly paid or credited, such amount shall be considered paid or credited on the last day of the preceding taxable year.
- Section 663(b) Election Requirements
  - I.R.C. § 663. Special rules applicable to sections 661and 662

Section 663(b) Election
Form 1041 Page 2



	Other Information	Yes	No
1	Did the estate or trust receive tax-exempt income? If "Yes," attach a computation of the allocation of expenses. Enter the amount of tax-exempt interest income and exempt-interest dividends ▶ $		
2	Did the estate or trust receive all or any part of the earnings (salary, wages, and other compensation) of any individual by reason of a contract assignment or similar arrangement?		
3	At any time during calendar year 2016, did the estate or trust have an interest in or a signature or other authority over a bank, securities, or other financial account in a foreign country? See the instructions for exceptions and filing requirements for FinCEN Form 114. If "Yes," enter the name of the foreign country ▶		
4	During the tax year, did the estate or trust receive a distribution from, or was it the grantor of, or transferor to, a foreign trust? If "Yes," the estate or trust may have to file Form 3520. See instructions		
5	Did the estate or trust receive, or pay, any qualified residence interest on seller-provided financing? If "Yes," see the instructions for required attachment		
6	If this is an estate or a complex trust making the section 663(b) election, check here. See instructions ▶ X		
7	To make a section 643(e)(3) election, attach Schedule D (Form 1041), and check here. See instructions ▶ ☐		
8	If the decedent's estate has been open for more than 2 years, attach an explanation for the delay in closing the estate, and check here ▶ ☐		
9	Are any present or future trust beneficiaries skip persons? See instructions		
10	Was the trust a specified domestic entity required to file Form 8938 for the tax year (see the Instructions for Form 8938)?		

Form 1041 (2016)

Benefits of the 65 Day Rule:
Case Study

- Trust has Taxable Income of $30,000 in 2017, but only $10,000 was Paid out to Beneficiaries in 2017.
- Under the 65 Day Rule, the Trustee can Distribute up to $20,000 more to the Beneficiaries in February of 2018 and Elect to Treat that Amount as Having been Distributed on December 31st of the Prior Year for Income Tax Purposes.

ABLE Accounts

Russo Law Group, P.C.
Copyright 2018
22

Able Account

- Eligibility
  - Disabled (prior to age 26)
- Funding
  - $15, 000 per year (in 2018)
- Qualified Expenses
  - Any expenses related to the beneficiary
- Tax Benefits
  - Income Tax free growth for qualified expenses

Russo Law Group, P.C.
Copyright 2018
23

Estate and Gift Tax

Russo Law Group, P.C.
Copyright 2018
24

Estate and Gift Tax Changes

- Doubling of Estate and Gift Tax Exemption Amount after 12/31/2017
  - Projected to be $11,180,000 (subject to inflation adjustment)
  - Sunset Provision: Expires after 2025
- Paradigm Shift
- Planning: Revise Estate Plans

Review Formula Clauses

- Review Credit Shelter / Marital Trust Planning
  - For estates under the Estate Tax Exemption, does the client want to fully fund a Credit Shelter Trust?
    - Also, may generate New York State Estate Taxes

Testamentary Planning

- Couples with Assets under $5.5 million
  - Address assets outright to spouse or in trust
- Couples with Assets over $5.5 million but less than $11 million
  - Consider Disclaimer / Clayton Provisions
- Couples with Assets over $11 million
  - Consider Disclaimer / Clayton Provisions
  - Also consider gifting of assets outright or to trusts

NYS State Estate Tax System

- Estate Tax Rate
  - Estate Tax rates start at five percent, and goes up to 16%, subject to the "Estate Tax Cliff"
  - Exemption Amount
    - $5,250,000 for Decedents dying on or after 4/1/2017 and before 1/01/2019
    - $5,600,000 (est.) for Decedents dying on or after 1/1/2019
- No Portability for a Surviving Spouse
- No Gift Tax

Russo Law Group, P.C.
Copyright 2018 28

Generation Skipping Transfer Tax

- GST Tax is still Applicable
- GST Exemption Allocation
  - Proper allocation of GST Trusts
  - Review automatic allocation
  - Review trusts not fully GST-Exempt for additional allocation

Russo Law Group, P.C.
Copyright 2018 29

Section 199A

Russo Law Group, P.C.
Copyright 2018 30

The New Section 199A - 20% Small Business Deduction

- Deduction for 20% of Domestic **Qualified Business Income** for Pass Through Businesses
  - Available for a "trade or business"
- Effectively, a 29.6% Tax Rate
- Applies to Individuals, Trusts and Estates
  - The deduction cannot exceed taxable income (reduced by the net capital gains) of the taxpayer

Russo Law Group, P.C.
Copyright 2018 31

Business Owners

- All Business Owners except owners of C Corps
- For Example,
  - Sole Proprietorships
  - Interest in LLCs
  - Interest in S- Corps
  - Interest in Partnerships
- Owner Must use Allocable Share for the 20% Deduction Calculations

Russo Law Group, P.C.
Copyright 2018 32

Business Classifications

Type of Business	Threshold Amount Married – Joint	Threshold Amount - Other
Service / Non- Service	< $ 315,000	< $ 157,500
Service / Non- Service	> $ 315,000 up to $415,000	> $ 207,500 up to $ 257,500
Non- Service	> $ 415,000	> $ 257,500

Russo Law Group, P.C.
Copyright 2018 33

Specified Service Business

- 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 trade or business where the principal asset of such trade or business is the reputation or skill of 1 or more of its employees.
  - Exception: Architects and Engineers

Modified Deduction

- Deduction Equals the Lesser of:
  - QBI x 20% or
  - The greater of:
    - 50% of W-2 wages of with respect to the qualified trade or business, or
    - 25% of W-2 wages with respect to the qualified trade or business plus 2.5% of unadjusted basis immediately after acquisition of all qualified property
      - W-2 Wages - S-Corp may be preferable
      - Wages do not include guaranteed payments or payments to independent contractors

Qualified Property

- The term "qualified property" means, with respect to any qualified trade or business for a taxable year, tangible property of a character subject to the allowance for depreciation undersection 167—
  - (i) which is held by, and available for use in, the qualified trade or business at the close of the taxable year,
  - (ii) which is used at any point during the taxable year in the production of qualified business income, and
  - (iii) the depreciable period for which has not ended before the close of the taxable year.

Depreciable Period

- The term "depreciable period" means, with respect to qualified property of a taxpayer, the period beginning on the date the property was first placed in service by the taxpayer and ending on the later of—
  - (i) the date that is 10 years after such date, or
  - (ii) the last day of the last full year in the applicable recovery period that would apply to the property undersection 168(determined without regard to subsection (g) thereof).

Formula Definitions - Clarifications

- Qualified Property
  - Does not include land
  - Depreciation period is the latter of the regular depreciation period or 10-years
- Unadjusted Basis for Tangible Property
  - Equal to basis immediately after acquisition
  - Not adjusted for depreciation

Phase Out Formulas

- MFJ
  - (1 – taxable income–$315,000/$100,000) X QBI X 20%
- All others
  - (1 – taxable income–$157,500/$50,000) X QBI X 20%

Planning Approaches: Maximizing the 20% Deduction

- Split the Business into Separate Entities
  - Service Business v. Office Building /Equipment /Non-Legal Services
- Add Owners to the Business
  - Moving Property into Non-Grantor Trusts or to individuals
- Use Retirement Accounts to Reduce Income
  - Defined Benefit or Contribution Plan

199A - In Summary

- NOW, Estate Tax Planning Should Consider how to Minimize Income Taxation on Qualified Business Income
  - This is an opportunity to work closely with your client and your client's accountant

Questions

Advanced Tax: Understanding the New Tax Laws – Part 2

Have a Great Day!

Russo Law Group, P.C.
Estate Planning, Elder Law & Special Needs

Offices: Long Island and New York City
Phone: 800-680-1717 | www. vjrussolaw.com

II. Taxes

20:1. Overview

This chapter covers the basic federal tax concepts and issues encountered in an elder law practice, including income taxes, real estate taxes, gift taxes and estate taxes. Although many topics are addressed in detail, the practitioner must consider the specific facts surrounding any transaction and, where relevant, refer to the New York State Tax Code. However, as a general rule, New York's Tax Code follows the Internal Revenue Code.

The Internal Revenue Code of 1986 ("I.R.C."), the tax laws of New York State, and those of local jurisdictions often contain age-linked provisions designed to reduce the tax burdens of the elderly. In addition, there are other specific tax provisions which, while not age-linked, offer important planning opportunities to reduce or eliminate income, gift and estate taxes.

Identifying the need for estate and tax planning is a necessary step in the representation of elder law clients. The attorney must be familiar with various planning alternatives and the tools available to meet the client's objectives and be able to explain in a clear and understandable manner the purpose and necessity for the plan, the tools to implement the plan and the alternatives that are available to the client. A client who understands his or her objectives and how they can be met will be better able to make intelligent choices among various alternatives. This will result in an estate and tax plan that is the client's plan as well as the attorney's plan.

IRS Circular 230. In June 2005, the IRS promulgated Circular 230,[1] and instituted procedures designed to ensure that tax practitioners comply with rules governing written tax advice. Under these rules, a failure to comply with the IRS procedures could result in sanctions up to and including disbarment from practice before the IRS. Included within the ambit of "written tax advice" was covered opinions, limited scope opinions and marketed opinions. The IRS's rationale for these rules, collectively known as "Circular 230,"" was to regulate tax shelter advisors and promoters. However, the practical effect of the Circular 230 regulations has been the inclusion of innocuous and routine tax advice within its restriction, subjecting the elder law attorney to onerous procedures for composing a simple summary letter to a client. Compliance with the new procedures could convert a simple letter into a complicated and expensive formal tax memorandum.

Tax practitioners concerned about their letters and informal tax advice being characterized as "listed opinions" have routinely included, at the end of their correspondence and emails, the following suggested "opt-out" language:

> IRS Circular 230 Disclosure: In order to ensure compliance with IRS Circular 230, we must inform you that any U.S. tax advice contained in this transmission and any attachments hereto is not intended or written to be used and may not be used by any person for the purpose of (i) avoiding any penalty that may be imposed by the Internal Revenue Code or (ii) promoting, marketing or recommending to another party any tax-related matter(s) addressed herein.

However, on June 12 2014, the IRS issued final regulations *(Reference: Circular No. 230 (Rev. 6-2014)* under Circular 230 modifying, among other things, the rules for practitioners

[1] 2005-4 I.R.B. 357, 69 Fed. Reg. 75839.

providing written tax advice. The preamble to the regulations clarify the Treasury's intent to eliminate practitioners' use of Circular 230 disclaimers in e-mail and other written client communication. Furthermore, the IRS Office of Professional Responsibility issued formal announcements that practitioners no longer have to include the Circular 230 disclaimers in client communications stating that the detailed "covered opinion" rules for tax opinions under Circular 230 contributed to overuse as well as misleading use of disclaimers on most practitioner communications. Notwithstanding, practitioners are encouraged to provide reasonable limitations when providing written advice, where applicable.

Under the new regulations, the covered opinion rules have been abandoned and replaced with more practical written advice rules. Under the new rules, practitioners are required to base all written advice on "reasonable factual and legal assumptions; exercise reasonable reliance on the statements, representations, finding, agreements, and advice of taxpayers and others; and consider all relevant facts that the practitioners know or reasonably should know".

20:2. 2011-2018 Federal Gift and Estate Tax Laws

The New Law. On December 22, 2017, President Trump signed into law the Tax Cuts and Jobs Act (TCJA). *(Reference: Public Law Number 115-97, H.R.1 - An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018, commonly referred to as the 'Tax Cuts and Jobs Act of 2017', the 'Tax Cuts and Jobs Act', the 'TCJA').* The new law made broad changes to the Federal tax code. Notably, the Tax Cuts and Jobs Act increased the federal estate and gift tax exemption to $10,000,000 (indexed for inflation) per person beginning January 1, 2018. Under the new law, it is expected that for 2018 the inflation adjusted exemption will be approximately $11,200,000 per person, or $22,400,000 for a married couple. *(Reference: 26 U.S.C. §2010(c)(3), as amended by the Tax Cuts and Jobs Act).*

The Tax Cuts and Jobs Act left in effect certain provisions previously included in the American Taxpayer Relief Act of 2012.[2] The step up in basis rules in IRC 1014 which had been restored in 2011, remain in effect under the new law. The highest marginal federal gift and estate tax rate also remained at 40 percent.

The 2013 Law.[1] On January 2, 2013, President Obama signed into law the American Taxpayer Relief Act of 2012.[2] This law permanently extended the estate and gift tax exclusion amounts set at $5 million for tax year 2011.

This amount was adjusted for inflation, as follows:

Tax Year 2012, $5,120,000
Tax Year 2013, $5,250,000
Tax Year 2014, $5,340,000
Tax Year 2015, $5,430,000
Tax Year 2016, $5,450,000
Tax Year 2017, $5,490,000

[1]Pub. L. No. 112-240 H.R. 8, 126 Stat. 2313.

[2]American Taxpayer Relief Act of 2012, Pub. L. No. 112-240 H.R. 8, 126 Stat. 2313.

Tax Year 2018, $11,200,000 *(Reference: The federal estate tax exemption for 2018 will be $11,200,000 (estimated); however, the actual inflation adjusted amount has not yet been confirmed).*

The step up in basis rules in IRC 1014 which had been restored in 2011, remain in effect under the new law. The law also raised the highest marginal gift and estate tax rate from 35% to 40%.[4]

The new law continues the portability of the spousal estate tax exemption (called Deceased Spouse Unused Exemption Amount or "DSUEA"); that is, if a predeceased spouse did not fully utilize his or her $11,180,000 (for 2018) estate tax exemption, the surviving spouse could utilize the unused exemption of her predeceased spouse.[5]

Estate, Gift and Generation-Skipping Transfer (GST) Tax Exemptions and Rates. Under the new law, in 2018, the estate, gift and GST exemptions amounts will increase to $11,200,000 for individuals and $22,400,000 for married couples, with the highest marginal tax rate remaining at 40%.[6]

For 2010, the gift tax exemption remained at $1 million with a 35% tax rate, but the GST exemption was reinstated at $5 million with a 0% tax rate for 2010 only. The gift and GST exemption was $5 million for 2011 and $5,120,000 for 2012 with a top rate of 35%. For the year 2012, the gift, estate and GST tax exemptions were unified again, with the exemption set at $5,120,000 and the tax rate at 35%. For 2013, the unified exemption was $5,250,000 and for 2014, $5,340,000. The unified exemption was $5,430,000 for 2015, $5,450,000 for 2016, $5,490,000 for 2017 and $11,200,000 *(Reference: The federal estate tax exemption for 2018 will be $11,200,000 (estimated); however, the actual inflation adjusted amount has not yet been confirmed for 2018).*

Portability of Estate Tax Exemptions Between Spouses. For individuals dying after 2010, the executor of the estate may elect to transfer any unused estate tax exemption to a surviving spouse by filing a timely estate tax return.

Only the last deceased spouse's unused exemption may be used by the surviving spouse, which could impact the decision of a surviving spouse to remarry because, if the new spouse should die first, the unused exemption of the second deceased spouse, if any, would replace that of the first deceased spouse.[7]

Tax Year 2010. Prior to the enactment of the Tax Relief, Unemployment Insurance

[4]American Taxpayer Relief Act of 2012, Pub. L. No. 112-240 H.R. 8, 126 Stat. 2313.

[5]American Taxpayer Relief Act of 2012, Pub. L. No. 112-240 H.R. 8, 126 Stat. 2313.

[6]26 U.S.C.A. §2001(c), Public Law Number 115-97, H.R.1 – An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018, commonly referred to as the "Tax Cuts and Jobs Act of 2017" the "TCJA"; see Tax Cuts and Jobs Act, Pub. L. No. 115-97 H.R.; The federal estate tax exemption for 2018 will be $11,200,000 (estimated); however, the actual inflation adjusted amount has not yet been confirmed.

[7]American Taxpayer Relief Act of 2012, Pub. L. No. 112-240 H.R. 8, 126 Stat. 2313.

Reauthorization, and Job Creation Act of 2010,[8] the estate tax had been repealed for tax year 2010. Notwithstanding the retroactive reinstitution of the estate tax for 2010, the new law allows the estates of decedents who died in 2010 the opportunity to elect out of the new estate tax law which provided a $5,000,000 federal estate tax exemption and a full step up in basis, and elect that the prior tax law which provided no federal estate tax and a carryover basis regime be applied instead.

20:3. Overview-- Primary goals of the senior client

This chapter addresses tax ramifications of the planning techniques available to meet the needs of elderly clients.

Seniors have multiple concerns when implementing a health care and estate plan. Often, the goals of the senior client are:

1. protecting and preserving assets;
2. minimizing taxes;
3. financing of long term care; and
4. disposing of assets upon demise in an appropriate manner.

Clearly, these goals are interrelated. It is essential that estate tax planning be part of an overall plan for the senior. Depending upon the value of the senior's assets and his or her particular health and personal situation, estate tax planning may be the first priority or it may be a lesser priority.

When planning for seniors, the planner should always review the estate plan in the context of potential estate tax liability. Since the federal estate tax applicable exemption amount is $11,200,000 for 2018,[1] this amount is an identifiable threshold amount in the context of federal estate tax planning. For estates over $11,200,000 in 2018, there is a significant need for the senior to implement estate tax planning. Under the Tax Cuts and Jobs Act, each dollar over $11,200,000 will be taxed at a rate of 40% in 2018.[2] For estates under $10 million, there is typically no need for the senior to implement estate tax planning for the purpose of minimizing federal estate taxes. However, one should be aware of potential state estate tax and income tax issues (such as income taxes on highly appreciated assets).

The planner must also not ignore the impact of the estate tax laws of New York State, even though the New York State gift tax law was repealed effective January 1, 2000. The New York State applicable exclusion amount for estate tax is $3,125,000 (for decedent's dying on or after April 1, 2015 and before April 1, 2016). The New York State applicable exclusion amount for estate tax is $4,187,500 (for decedent's dying on or after April 1, 2016 and before April 1, 2017). The New York State applicable exclusion amount for estate tax is $5,250,000 (for

[8]Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010[0], Pub. L. No. 111-312, §303, 124 Stat 3296.

[1]The federal estate tax exemption for 2018 will be $11,200,000 (estimated); however, the actual inflation adjusted amount has not yet been confirmed; *See supra* §20:2; *See infra* §§20:20 and 20:76 for Federal and N.Y.S. Gift and Estate Tax Applicable Exclusion Amount Schedule.

[2]The federal estate tax exemption for 2018 will be $11,200,000 (estimated); however, the actual inflation adjusted amount has not yet been confirmed; *See supra* §20:2; *See infra* §20:76 for Federal Unified Transfer Tax Schedule.

decedent's dying on or after April 1, 2017, and on or before December 31, 2018). The New York State applicable exclusion amount for estate tax is scheduled on January 1, 2019 to equal the amount of the Federal estate tax exemption as determined under the Federal rules in effect prior to the enactment of the Tax Cuts and Jobs Act. Both New York State applicable exclusion amounts are in contrast to the federal estate tax exemption of $11,200,000 (in 2018).[3]

For an estate of $5,490,000 with the decedent dying on or after January 1, 2017 through March 31, 2017, a New York State estate tax of $449,600 will be due, despite the fact that the same estate will not be subject to federal estate taxes. But if the $5,490,000 estate consists of $1,302,500 in taxable gifts (made more than three years prior to the date of death) then this results in a $4,187,500 New York taxable estate, and no New York State estate tax will be due.[4]

For an estate of $5,490,000 with the decedent dying on or after April 1, 2017, through December 31, 2018, a New York State estate tax of $435,830 will be due, despite the fact that the same estate will not be subject to federal estate taxes. But if the $5,490,000 estate consists of $240,000 in taxable gifts (made more than three years prior to the date of death) then this results in a $5,250,000 New York taxable estate, and no New York State estate tax will be due.[5]

For New York estates under $5 million ($6 million on or after April 1, 2017), there is typically no need for the senior to implement estate tax planning. However, this is not to say that there are no tax issues with which the senior must be concerned (such as income taxes on highly appreciated assets).

20:4. Overview-- Planning techniques to minimize or eliminate estate taxes

There are a number of estate tax planning techniques which should be explored with the client. Depending upon the client's objectives, one or more of these approaches or a combination of them may be appropriate. This chapter will briefly refer to a few of the more popular techniques and provide sample language the planner can provide to the senior for his or her consideration.[1]

20:5. Overview-- Inter-relationship of tax and Medicaid planning

During the early stages of estate and tax planning, the client's need for long term care must be determined. Because Medicaid is the primary provider of long term care, and because Medicaid is a means-tested program,[1] planning for long term care, which typically involves asset transfers, may not be good estate or tax planning.

The elder law attorney must therefore analyze with the client the probable duration and cost of the long term care, as compared to what transfers for Medicaid eligibility will cost the

[3]The federal estate tax exemption for 2018 will be $11,200,000 (estimated); however, the actual inflation adjusted amount has not yet been confirmed; *See supra* §20:2.

[4]N.Y. Tax Law §952.

[1]*See infra* §§20:72, 20:73, 20:74, and 20:75 for form letters to seniors regarding estate tax planning.

[1]*See supra* Medicaid Income, Resources, Transfers and Spousal Impoverishment Ch 14.

client in taxes. If the client must divest himself or herself of assets to become Medicaid eligible, and such divestment will create a tax liability during lifetime or at the time of death, then the client should be advised of the extent of the tax liability as compared to the probable savings on long term care, so that an informed choice may be made. A client whose life expectancy is six (6) months and who is in need of long term care, may be better advised to favor estate and tax planning to achieve tax savings which will be in excess of the cost of medical care for six (6) months. Hence, the elder law attorney must be familiar with the tax and the long term care aspects of elder law to properly advise his or her clients.

20:6. Overview-- Estate tax planning tools and resources

It is important that the planner utilize available resources such as treatises and software to assist him or her in the tax analysis for the senior. In addition, these tools can also assist the planner in the presentation of the tax analysis and the overall estate plan to the senior.

20:7. Income taxation considerations-- Overview (Federal)

When implementing estate and long term care planning, income taxes must be considered, both at the federal and state level. Restructuring assets can impact on whether income taxes will have to be paid, by when and by whom.

20:8. Income taxation considerations-- Tax return requirements

Seniors must file federal income tax returns if their income is above the basic standard deduction amount, and any additional standard deduction.[2] The standard deduction depends upon the taxpayer's filing status.[3] Two additional deductions are available for a senior who is both elderly and blind.[4] A taxpayer, who reaches age 65 at any time during the tax year or on December 31 of the prior year, qualifies for the additional standard deduction. The Tax Cuts and Jobs Act has repealed all personal exemptions for tax years beginning December 31, 2017, and before January 1, 2026. *(Reference: Code Sec. 151(d)(5), as added by the Tax Cuts and Jobs Act).*

The following is a summary of the filing thresholds and deductions for taxable years beginning 2018:[5]

Filing Status	**Item**	**Amount**	**2018 Thresholds**
Single,	Standard Deduction	12,000	
65 or over	Additional Standard	1,600	

[2]26 U.S.C.A. §6012.

[3]26 U.S.C.A. §§151(d) and 63(c).

[4]Note that each deduction is equal to $ 1,300. These amounts are increased to $1,600 if the individual is also unmarried and not a surviving spouse.

[5]*See* Sec. 11041(f) of the Tax Cuts and Jobs Act.

	Deduction		
Blind	Additional Standard Deduction	1,600	
FILING THRESHOLD:			$15,200
Married,	Standard Deduction	24,000	
Both age 65or older	Additional Standard Deduction	2,600	
FILING THRESHOLD:			$26,600
Married,	Standard Deduction	24,000	
One age 65 or older	Elderly Deduction	1,300[6]	
FILING THRESHOLD:			$25,300

One should note that the personal exemption has been repealed under the Tax Cuts and Jobs Act. Historically, the personal exemption was phased out based on the level of adjusted gross income.[7] For tax year 2017, the exemption amount was phased out based on the taxpayer's adjusted gross income ("AGI"). For every $2,500 of AGI (or portion thereof) above the beginning phase out amount depended upon your filing status, the $4,050 exemption was reduced by 2%.[8]

The Federal Income Tax rates in 2018 are listed in the Tables as follows:[10]

[6]There is an additional $1,250 deduction if one of the married taxpayers is blind, $2,500 if married taxpayers are both blind. The additional deduction (for an elderly or blind taxpayer) increases to $1,550 if the taxpayer is unmarried and not a surviving spouse.

[7]I.R.C. §151.

[8]IRS Publication 501 (2016).

[10]Rev. Proc. 2017-58, 2016-45 I.R.B. 707.

TABLE 1--Section 1(a)--Married Individuals
Filing Joint Returns and Surviving Spouses

If Taxable Income is:	The Tax Is:
Not over $19,050	10% of the taxable income
Over $19,050 but not over $77,400	$1,905 plus 12% of the excess over $19,050
Over $77,400 but not over $165,000	$8,907 plus 22% of the excess over $77,400
Over $165,000 but not over $315,000	$28,179 plus 24% of the excess over $165,000
Over $315,000 but not over $400,000	$64,179 plus 32% of the excess over $315,000
Over $400,000 but not over $600,000	$91,379 plus 35% of the excess over $400,000
Over $600,000	$161,379 plus 37% of the excess over $600,000

TABLE 2--Section 1(b)--Heads of Households

If Taxable Income Is:	The Tax Is:
Not over $13,600	10% of the taxable income
Over $13,600 but not over $51,800	$1,360 plus 12% of the excess over $13,600
Over $51,800 but not over $82,500	$5,944 plus 22% of the excess over $51,800
Over $82,500 but not over $157,500	$12,698 plus 24% of the excess over $82,500
Over $157,500 but not over $200,000	$30,698 plus 32% of the excess over $157,500
Over $200,000 not over $500,000	$44,298 plus 35% of the excess over $200,000
Over $500,000	$149,298 plus 37% of the excess over $500,000

TABLE 3--Section 1(c)--Unmarried Individuals
(other than Surviving Spouses and Heads of
Households)

If Taxable Income Is:	The Tax Is:
Not over $9,525	10% of the taxable income
Over $9,525 but not over $38,700	$952.50 plus 12% of the excess over $9,525

Over $38,700 but not over $82,500	$4,453.50 plus 22% of the excess over $38,700
Over $82,500 but not over $157,500	$14,089.50 plus 24% of the excess over $82,500
Over $157,500 but not over $200,000	$32,089.50 plus 32% of the excess over $157,500
Over $200,000 not over $500,000	$45,689.50 plus 35% of the excess over $200,000
Over $500,000	$150,689.50 plus 37% of the excess over $500,000

TABLE 4--Section 1(d)--Married Individuals Filing Separate Returns

<u>If Taxable Income Is</u>:	<u>The Tax Is</u>:
Not over $9,525	10% of the taxable income
Over $9,525 but not over $38,700	$952.50 plus 12% of the excess over $9,525
Over $38,700 but not over $82,500	$4,453.50 plus 22% of the excess over $38,700
Over $82,500 but not over $157,500	$14,089.50 plus 24% of the excess over $82,500
Over $157,500 but not over $200,000	$32,089.50 plus 32% of the excess over $157,500
Over $200,000not over $300,000	$45,689.50 plus 35% of the excess over $200,000
Over $300,000	$80,689.50 plus 37% of the excess over $300,000

TABLE 5--Section 1(3)--Estates and Trusts

<u>If Taxable Income Is</u>:	<u>The Tax Is</u>:
Not over $2,550	10% of the taxable income
Over $2,550 but not over $9,150	$255 plus 24% of the excess over $2,550
Over $9,150 but not over $12,500	$1,839 plus 35% of the excess over $9,150
Over $12,500	$3,283 plus 37% of the excess over $12,500

20:9. Income taxation considerations-- Medical expense deductions

As a general rule, medical expenses are deductible by seniors who are younger than 65 years old and who itemize their deductions, where non-reimbursed medical expenses exceed 10% of the taxpayer's adjusted gross income (formerly 7.5% prior to 2013). However, the threshold to claim an itemized deduction for taxpayers 65 years old and older is reduced to 7.5% of adjusted gross income for tax years beginning after December 31, 2016 and before January 1, 2019. In 2019, the threshold is scheduled to go up to 10% of adjusted gross income.[1]

The term "medical expense" is broadly defined to include amounts paid for the diagnosis, cure, mitigation, treatment or prevention of disease and amounts paid for the purpose of affecting any structure or function of the body. While this section does not provide a comprehensive checklist of all types of expenses which qualify for deduction, the elder law practitioner should be aware of the tax status of the following deduction categories:[2]

Qualified Long Term Care Services. The Health Insurance Portability and Accountability Act of 1996 ("HIPAA") clarified the deduction of the cost of "qualified long term care services"[3] as a medical expense under I.R.C. §213 for tax years after 1996. Qualified long term care services are deductible from gross income as an itemized deduction, subject to the limitation that when added to any other un-reimbursed medical expenses for the year, only that amount which exceeds 7.5% of adjusted gross income (or 10% for taxpayers younger than 65 years of age) is an itemized deduction.

Qualified long term care services are defined as "necessary diagnostic, preventive, therapeutic, curing, treating, mitigating and rehabilitative services, and maintenance and personal care services, which (A) are required by a chronically ill individual, and (B) are provided pursuant to a plan of care prescribed by a licensed health care practitioner."

A chronically ill individual is defined as someone who is unable to perform (without substantial assistance from another individual) at least two out of five activities of daily living (ADLs) for a period of at least 90 days (in the future) due to a loss of functional capacity, or requiring substantial supervision to protect such individual from threats to health and safety due to severe cognitive impairment. The individual must be certified each year as meeting such requirements by a licensed health care practitioner.

The congressional conference committee report indicates those individuals with cognitive impairment such as Alzheimer's disease, but who are physically able should be treated similarly to an individual who is unable to perform (without substantial assistance) at least two ADLs.

Residence Expenses Incurred to Accommodate the Condition of a Physically Handicapped Person. Seniors may deduct the cost of home modifications made to accommodate their own physical handicaps or those of a handicapped person residing with them for the following:[4]

[1] *See* Sec. 11027(c) of the Tax Cuts and Jobs Act; 26 U.S.C.A. §213. These deductions are not subject to the 2% floor on miscellaneous itemized deductions. *See* 26 U.S.C.A. §67(b).

[2] The deduction calculation appears on Schedule A, Internal Revenue Service ("IRS") Form 1040.

[3] 26 U.S.C.A. §7702B.

[4] Rev. Rul. 87-106, 1987-2 C.B. 67; Committee Reports to Pub. L. No. 99-154.

1. constructing entrance or exit ramps;
2. widening doorways at entrances or exits;
3. widening or otherwise modifying hallways and interior doorways;
4. installing railing, support bars, or other modifications to bathrooms;
5. lowering or making other modifications to kitchen cabinets and equipment;
6. altering the location of or otherwise modifying electrical outlets and fixtures;
7. installing porch lifts and other forms of lifts (generally, this does not include elevators), as they may add to the fair market value of the residence and any deduction would have to be decreased to that extent;[5]
8. modifying fire alarms, smoke detectors, and other warning systems;
9. modifying stairs;
10. adding handrails or grab bars whether or not in bathrooms;
11. modifying hardware on doors;
12. modifying areas in front of entrance and exit doorways; and
13. grading of ground to provide access to the residence.

Capital Expenditure as Medical Expense. Generally, capital expenditures are not deductible for federal income tax purposes.[6] However, an expenditure which otherwise qualifies as a medical expense under I.R.C. §213 shall not be disqualified merely because it is a capital expenditure. For example, the following items are deductible: eyeglasses, a wheelchair, crutches,[7] an inclinator or an air conditioner which is detachable from the property purchased only for the use of a sick person.[8]

Transportation Expenses. Medical expenses include amounts paid for transportation "primarily for and essential to medical care" which includes ambulance hire, taxi, train, bus, and airplane fares to and from the point of treatment.[9] Other medical expense deductions include expenditures for handicap controls[10] and for automobile equipment to accommodate wheelchair passengers.[11]

Accident and Health Insurance, Medical Insurance. Where a medical insurance contract (such as accident and health insurance) provides for the payment of benefits for other than medical care, such as an income benefit for the loss of income due to the loss of life, sight or limb, no medical deduction is allowable unless a separately stated premium for medical

[5]26 C.F.R. §1.213-1(e)(1)(iii).

[6]26 U.S.C.A. §263; 26 C.F.R. §1.213-1(e)(1)(iii).

[7]*See* 26 C.F.R. §1.213-1(e)(1)(iii).

[8]26 C.F.R. §1.213-1(e)(1)(iii).

[9]26 U.S.C.A. §213(d)(1)(B).

[10]Weinzimer v. C. I. R., T.C. Memo. 1958-137, T.C.M. (P-H) 58137, 17 T.C.M. (CCH) 712, 1958 WL 796 (T.C. 1958).

[11]Rev. Rul. 70-606, 1970-2 C.B. 66; Priv. Ltr. Rul. 8024169, CCH IRS Letter Rulings Reports.

coverage is provided.[12]

Medical Care Insurance Premiums. Medical care insurance premiums paid by a taxpayer are added to the taxpayer's other medical expenses which are deductible to the extent they exceed 7.5% of the adjusted gross income. This threshold increased to 10% of the taxpayer's adjusted gross income in January 2013 for taxpayers younger than 65 years old, but will remain at 7.5% through 2018 for taxpayers 65 years old and older. *(Reference: 26 U.S.C.A. §213(f) as amended by the Tax Cuts and Jobs Act)*. The exemption will also apply where only one spouse is age 65 or older.[13]

In addition, premiums paid during the taxable year before the taxpayer reaches 65, which cover expenses after he or she reaches 65, are deductible when paid if the premiums are payable (on a level payment basis) under a contract for either: (i) a period of 10 years or more; or (ii) a period lasting until the year in which the taxpayer reaches age 65 (but in no case for a period of less than five years).[14]

Medicare Part B payments, which provide supplementary insurance, are deductible. Medicare part A premiums are deductible when paid by a taxpayer otherwise ineligible for coverage.[15] Amounts withdrawn from wages for Medicare hospital insurance under the Social Security program or from self-employment income are not deductible.[16]

The Health Insurance Portability and Accountability Act of 1996 allows for premiums paid for "a qualified long term care insurance contract" to be deductible as a medical expense effective for taxable years after December 31, 1996. For 2018, the deduction is limited as follows: $420 for those 40 years of age or less, $780 for those 41 through 50 years of age, $1,560 for those between 51 through 60, $4,160 for those 61 through 70 years of age and $5,200 for those over 70.[17] These limitations are indexed for inflation each year. These expenses will be combined with other medical expenses and the amount in excess of 10% of adjusted gross income will be deductible.

Nursing Home Care Costs. Since nursing home care costs often exceed 7.5% or 10% of AGI, as the case may be, and are usually not reimbursed by private insurers, it is important to determine whether fees and expenses incurred by or on behalf of a resident are deductible medical expenses. The deductibility of fees paid to institutions other than hospitals depends upon the facts.[18] Where a senior is a nursing home resident because his or her condition is such that

[12]26 U.S.C.A. §213(d)(6); Rev. Rul. 68-212, 1968-1 C.B. 91.

[13]*See* I.R.C. §213; *See supra* §18:36.

[14]26 U.S.C.A. §213(d)(7); 26 C.F.R. §1.213-1(e)(4)(i)(b).

[15]Rev. Rul. 79-145, 1979-1 C.B. 117.

[16]Rev. Rul. 66-216, 1966-2 C.B. 100.

[17]Rev. Proc. 2017-58, 2016-45 I.R.B. 707.

[18]26 C.F.R. §1.213-1(e)(1)(v)(a).

the availability of medical care is *a*, as opposed to *the* principal reason for his or her presence there, and meals and lodging are furnished as a necessary incident to that care, the entire cost of the medical care, meals and lodging is deductible.[19]

In *Havey v. C.I.R.*,[20] the following tests were set forth: (i) Was the expense incurred at the direction or suggestion of a physician? (ii) Did the attendance or the treatment at the place bear such a direct or proximate therapeutic relation to the bodily condition as to justify a reasonable belief that it would be efficacious? (iii) Was the attendance or the treatment so proximate in time to the onset or recurrence of the disease or condition as to make the expense specifically related to the individual's physical or mental improvement?

In *Counts v. C.I.R.*,[21] the taxpayer sought to deduct the nursing home care costs of his father, who suffered from high blood pressure and a gall bladder condition. The father was not ambulatory and he required nursing assistance for bathing and took his meals in bed. The nursing home itemized charges for medical items such as drugs, injections and dressings and rendered a lump sum "maintenance" charge that included the costs of nursing services, food and room fees. Residents of the home had available the services of registered and practical nurses. The maintenance fee was found to be incidental to medical care and deductible.

Where a senior is in an institution and his or her condition is such that the availability of medical care is not a principal reason for his or her presence, then only the cost for care which is attributable to medical care or nursing attention furnished to him or her is deductible.[22]

When the taxpayer is unable to establish medical reasons as a primary reason for his or her nursing home residency, but where there is a demonstrable percentage of the budget of the facility devoted to medical and nursing services that are guaranteed to residents, both lump-sum and periodic fees will be deductible on a consistent basis. In Rev. Rul. 75-302, 1975-2 C.B. 86, the taxpayer was able to demonstrate that 30% of the lifetime care fees were historically budgeted for the cost of nursing and medical care. There was no mention of the taxpayer's physical condition except to note that he was 78 years old. The IRS ruled that a 30% deduction allocation was permissible, even though the services would be provided in future years, if at all.[23]

20:10. Income taxation considerations-- Credit for the elderly and disabled

I.R.C. §22 provides for a tax credit for any senior who has attained the age of sixty-five (65) before the close of the taxable year or who retired on disability before the close of the taxable year and who, when he or she retired, was permanently and totally disabled. Proof of disability must be provided.[1] The tax credit is equal to 15% of the senior's "Section 22 amount" which is defined by the Code Section.

[19]26 C.F.R. §1.213-1(e)(1)(v)(a).

[20]Havey v. C.I.R., 12 T.C. 409, 1949 WL 172 (T.C. 1949).

[21]Counts v. C. I. R., 42 T.C. 755, 1964 WL 1230 (T.C. 1964), acq., 1964-2 C.B. 3.

[22]26 C.F.R. §1.213-1(e)(1)(v)(b).

[23]In Rev. Ruls. 68-525, 1968-2 C.B. 112 and 81, 1976-2 C.B. 82, the deduction for fees allocable to construction costs was denied.

[1]See Part II to the Instructions of IRS Form 1040, Schedule R.

The maximum base amount on which the credit is applied is $5,000 for a single senior or a married couple with only one spouse eligible for the credit, $7,500 for a married couple with both spouses eligible for the credit, and $3,750 for a married couple filing separate returns.[2] For seniors under age 65, the maximum base amount will be further limited to the amount of disability income.[3]

The base amount is further reduced by one-half of the excess of adjusted gross income over $7,500 for a single senior, $10,000 for a married couple filing joint and $5,000 for a married couple filing separate returns.[4]

In addition, the base amount is reduced by the amount of any pension, annuity, or disability benefit received under the Social Security Act, the Railroad Retirement Act of 1974, or a law administered by the Veterans Administration, which is excluded from gross income, or which is excluded under any other provision of law.[5]

20:11. Income taxation considerations-- Dependent credit and exemption

Family members may receive an income tax benefit for supporting and/or taking care of their parents.

Child and Dependent Care Expense Credit. Often, family members, such as children, will pay for the care of parents who live in their households, thus allowing the children to be gainfully employed.

I.R.C. §21 allows for a nonrefundable credit for the portion of dependent care expenses paid for the purpose of allowing a taxpayer to be gainfully employed. The dependent senior will be considered a dependent even if he or she has income above the tax exemption amount ($4,150 per annum in 2018), where the taxpayer could have claimed the person as a dependent except for the income aspect (i.e., over one-half of the dependent's support must have been furnished by the taxpayer, he or she must be a citizen, and must not have filed a joint return with his or her spouse). For tax year 2018, the exemption amount is phased out based on adjusted gross income (AGI).[1]

Hence, this credit is sometimes available where a dependent parent has working adult care-provider children who hire household assistance, or pay for respite or community care to enable them to work.[2] The credit is equal to 35% of employment related expenses for taxpayers with AGIs of $15,000 or less. The credit is reduced by one percentage point for each $2,000 of AGI (or fraction thereof) over $15,000 until it decreases to twenty percent (20%) for taxpayers with AGIs of over $45,000. Employment related expenses are limited to $3,000 for one qualifying person receiving care, and $6,000 for two or more qualifying persons receiving care.

[2]26 U.S.C.A. §22(c)(2)(A).

[3]26 U.S.C.A. §22(c)(2)(B).

[4]26 U.S.C.A. §22(d).

[5]26 U.S.C.A. §22(c)(3).

[1]Rev. Proc. 2017-58, 2016-45 I.R.B. 707.

[2]*See* 26 U.S.C.A. §21; The credit is claimed on IRS Form 2441.

Amounts cannot be taken as both a medical expense and a dependent care expense credit if they qualify as a medical expense.

Support of a Dependent. An individual may be able to take an additional exemption on his or her personal income tax return of $4,150 (in 2018) for each dependent.[3] A child may take a dependency exemption for a parent if he or she meets certain requirements.

20:12. Income taxation considerations-- Taxation of benefits from retirement plans

Generally, distributions from qualified retirement plans are subject to income tax when received by the participant of the plan. Distributions before age 591/2 from qualified plans including annuity plans and individual retirement accounts ("IRAs") are subject to a 10% excise tax for early withdrawal.[1]

There are exceptions to the excise tax, including distributions upon the death or disability of the participant and distributions on account of certain medical expenses under I.R.C. §213.[2] However, the medical expense exception does not apply to withdrawals from IRAs.[3] The definition of disability[4] is being unable to engage in any substantial gainful activity by reason of a medically determinable physical or mental impairment which can be expected to result in death or be of long-continued and indefinite duration. This is essentially the same definition used in qualifying for the credit for the elderly or disabled.[5]

Minimum Required Distributions must be taken from the qualified retirement plan or IRA by the participant or IRA owner by April 1 of the year following the year that the individual reaches age 701/2.[6] Under the Treasury Regulations, revocable trusts can be used as beneficiaries of an IRA without adverse tax consequences, similar to Irrevocable Trusts, as long as certain conditions are met.[7]

The regulations require that:

[3] 26 U.S.C.A. §§151 and 152. Rev. Proc. 2017-58, 2016-45 I.R.B. 707.

[1] 26 U.S.C.A. §72(t)(1). Please note that the tax, and the exception to the tax, are reported on IRS Form 5329.

[2] 26 U.S.C.A. §72(t)(2)(A)(i)-(vi). Medical expenses allowable under Section 213 are those incurred by the taxpayer, the taxpayer's spouse or dependents, which are not compensated for by insurance or otherwise, to the extent the expenses exceed 10% of the taxpayer's adjusted gross income.

[3] 26 U.S.C.A. §72(t)(3)(A).

[4] 26 U.S.C.A. §72(m)(7).

[5] *See supra* §20:10.

[6] Please note that in accordance with section 201 of the Worker, Retiree and Employer Recovery Act of 2008, no minimum distributors were required to be taken in 2009.

[7] Treas. Reg. §1.401(a)(9)-1.

1. The trust becomes irrevocable upon the IRA's owner's death.
2. A copy of the trust must be provided to the plan administrator.
3. The IRA owner must agree to provide the plan administrator with any future trust amendments.
4. The trust beneficiaries must be identifiable.
5. All trust beneficiaries must be individuals.
6. The trust must be valid under state law.

The 15% excise tax on excess distributions (received after December 31, 1996) and the 15% excise tax on excess retirement accumulations (applicable to estates of decedents who die after December 31, 1996) from qualified retirement plans, tax-sheltered annuities and IRAs have been repealed.[8]

20:13. Income taxation considerations-- Taxation of accident and health plan benefits

I.R.C. §105(a) requires the inclusion as income of benefits paid under accident or health plans for personal injuries or sickness, attributable to employer contributions, to the extent that: (i) the contributions from the employer to an insurance plan were not includable in the gross income of the employee; or (ii) are paid directly by the employer. An exclusion as to income applies to medical care payments that are made to reimburse the taxpayer, not only for the taxpayer's own medical expenses, but also for the medical expenses of a spouse or any dependents. Where a portion of the contributions is paid by the employer and a portion by the employee, a consistent proportion of taxable and nontaxable benefits should be computed.[1]

20:14. Income taxation considerations-- Step up in basis concept

For income tax purposes, the basis of property acquired from a decedent is its fair market value ("FMV") at the time of death,[1] or, if subject to the alternate valuation date election, the alternate valuation authorized.[2] This is referred to as a step up in basis. It is important to recognize that the income tax benefit is a corollary to estate planning valuation considerations.

For individuals dying in 2010, there is an option for the Executor to elect by September 17, 2011, that the estate will not be subject to estate tax. However, if this election is made, the modified carryover basis rules instead of the step up in basis rules will apply.[3]

Where a husband and wife own property as tenants by the entirety, one-half of the property is included in the deceased spouse's estate, resulting in a step up in basis as to one-half of the property.[4] This rule has been in effect since 1982 and replaced the "contribution" rules

[8]Taxpayer Relief Act of 1997 §1073(a) to (c).

[1]26 C.F.R. §1.105-1(c). *See supra* §20:2.

[1]26 U.S.C.A. §1014.

[2]26 U.S.C.A. §2032; *see infra* §20:30.

[3]*See supra* §20:2.

[4]26 U.S.C.A. §2040(b)(1).

which required tracing of interests.[5]

There is an exception to the above rules when real estate jointly owned between spouses was acquired prior to 1977. Such real property is fully includable in the estate of the first spouse to die, which inclusion results in a full step up in basis.[6]

Where there is a joint tenant other than a husband or wife, for example, a son or daughter, there is full-inclusion in the estate of the first to die, and a corresponding 100% income tax step-up, unless the property had been inherited by the decedent and the survivor as joint tenants with right of survivorship and their interests had been specified by law, or the survivor can prove he or she supplied part or all of the consideration.[7] For income tax purposes, when a non-spouse joint tenant is added, the tracing rule must be used to establish the basis of joint tenant holders.

Where an owner reserves a life estate in real property and transfers the remainder to another party, there is a 100% tax step-up in basis upon the life tenant's demise.[8]

20:15. Income taxation considerations-- Sale of residence

Effective for transactions after May 6, 1997, taxpayers who sell property that they owned and occupied as a principal residence for at least two of the last five years preceding the sale can elect a $250,000 exclusion of gain subject to income tax.[1]

There is an exception to the two out of five-year rule for taxpayers who are "physically or mentally incapable of self-care" who reside in a licensed care facilities (e.g., a nursing home). In such case, the taxpayer need only reside in his or her primary residence for one out of five years preceding the sale or exchange.[2]

The amount of excludable gain is increased to $500,000 for a married couple filing jointly if: (1) either spouse meets the ownership test; or (2) both spouses meet the use test; and (3) neither spouse is ineligible for exclusion due to a sale of a primary residence within the last two years.[3]

A pro rata amount of $250,000 (or $500,000) will be allowed if a taxpayer does not meet

[5]26 U.S.C.A. §2040(b)(1); *see infra* §20:30; 26 U.S.C.A. §2040(b) which makes the amount eligible for the stepped-up basis rules under 26 U.S.C.A. §1014(b)(9); *see also* Gallenstein v. U.S., 975 F.2d 286, 92-2 U.S. Tax Cas. (CCH) P 60114, 70 A.F.T.R.2d 92-5683 (6th Cir. 1992).

[6]*See* Gallenstein v. U.S., 975 F.2d 286, 92-2 U.S. Tax Cas. (CCH) P 60114, 70 A.F.T.R.2d 92-5683 (6th Cir. 1992), followed by Patten v. U.S., 96-1 U.S. Tax Cas. (CCH) 60231, 77 A.F.T.R.2d 96-1877, 1996 WL 303257 (W.D. Va. 1996), aff'd, 116 F.3d 1029, 80 A.F.T.R.2d 97-5108 (4th Cir. 1997); Marvin H. Anderson, Richard G. Anderson v. U.S., 96-2 U.S. Tax Cas. (CCH) 60235, 78 A.F.T.R.2d 96-6555, 1996 WL 809449 (D. Md. 1996).

[7]26 U.S.C.A. §2040(a).

[8]26 U.S.C.A. §1014(a).

[1]Taxpayer Relief Act of 1997 §312(a) to (e) and IRS Form 8853.

[2]26 U.S.C.A. §121(d)(7) (applying to sales or exchanges occurring after May 6, 1997).

[3]26 U.S.C.A. §121(b)(2) (applying to sales or exchanges occurring after May 6, 1997).

the ownership or use requirements due to a change in place of employment, health or unforeseen circumstances.

This exclusion of gain replaces the rollover of gain provision[4] and the one-time $125,000 exclusion for taxpayers age 55 or older.[5]

20:16. Income taxation considerations-- Taxation of long term care benefits

Benefit payments received under a qualified long-term care insurance contract are excluded from an individual's gross income in an amount of up to $360[1] per day. Amounts in excess of $360 per day may also be excluded to the extent that the individual has incurred actual costs for qualified long-term care services[2] that were not covered by other insurance.

Under the Health Insurance Portability and Accountability Act of 1996 ("HIPAA"), long-term care insurance contracts issued before 1997 are automatically grandfathered as "Qualified Long Term Care Insurance Contracts."

Most policies approved by a state after January 1, 1997, will highlight on the first page that the policy "is intended to be a qualified policy under HIPAA."

20:17. Income taxation considerations-- Capital gains and net investment tax

Capital Gains. Taxpayers may benefit from the sale of certain assets by a lower tax rate being applied to the gain on the sale (referred to as a "capital gain"), if certain requirements are met, such as the holding period.

For tax years 2013 and 2014 the maximum capital gain tax rate is 0% for individuals in the 10% and 15% income tax brackets, 15% in the 25% and 35% brackets and 20% for the 39.6% bracket.[1] For tax years 2015 and 2016 the maximum capital gain tax rate is 0% for individuals in the 10% and 15% income tax brackets, 15% in the 25%, 28%, 33% and 35% brackets, 20% for individuals in the 39.6% income tax bracket, 25% for certain gains under I.R.C. Section 1250, and 28% for collectibles gain and certain gains under I.R.C. Sections 1202 and 1250.

Net Investment Tax. For 2013 and thereafter, there is a new tax: the net investment tax. Please note that the 3.8% tax will be added to this bracket for taxpayers whose modified adjusted gross income exceeds certain amounts. The calculation of the tax is 3.8% of the lesser of the taxpayer's investment income and the excess of the taxpayer's modified adjusted gross income over $200,000 (single or head of household), $250,000 (married filing jointly or qualifying widow(er) with dependent child) or $125,000 (married filing separately).[2] The tax also applies to

[4]26 U.S.C.A. §1034.

[5]Former 26 U.S.C.A. §121 (predates the Taxpayer Relief Act of 1997).

[1]*See* I.R.C. §213(d)(10), I.R.C. §7702B(b), Rev. Proc. 2017-58, 2014-47 I.R.B. 831.

[2]*See supra* §20:9.

[1]See I.R.C. §1(h)(1)(B) to (h)(1)(F).

[2]*See* I.R.C. §1411(a)(1).

estates and trusts.[3]

20:18. Unified gift and estate tax system

Since 1976 there has been a Federal Unified Gift and Estate Tax System.[1] One tax is imposed on all transfers, lifetime or testamentary.[2] New York Gift and Estate Tax Law is based on the gift and tax provisions of the I.R.C., with modifications for New York purposes.

20:19. Unified gift and estate tax system-- Unified tax rate

The federal gift and estate tax is computed under a unified graduated rate schedule applicable to both gifts during lifetime and transfers at death on a cumulative basis.[1]

For transfers made in 2013-2018--the top rate is 40%, in 2010-2012 the top rate is 35%, in 2007-2009--18% to 45%, in 2006--18% to 46%, in 2005--18% to 48%, in 2004--18% to 48%, in 2003--18% to 49%, in 2002--18% to 50%.

For transfers made between 1983 and 2001, the rate ranged from 18% to 55% with the highest rate applying to transfers of $3 million or more.[2]

20:20. Unified gift and estate tax system-- Unified credit against federal gift and estate tax

Under the Tax Cuts and Jobs Act, for estates of decedents dying and gifts made after 2017 and before 2026, the applicable exclusion amount for federal estate and gift tax will be doubled from $5,000,0000 to $10,000,000, before being adjusted for inflation. As a result, the applicable federal exclusion for estates is $11,200,000 for 2018 (Reference: The federal estate tax exemption for 2018 will be $11,200,000 (estimated); however, the actual inflation adjusted amount has not yet been confirmed), $5,490,000 for 2017, $5,450,000 for 2016,[1] $5,430,000 for 2015, $5,340,000 in 2014,[2] $5,250,000 for 2013,[3] and $5,120,000 for 2012.[4] Between 2002-2010, the gift tax exclusion equivalent remained constant at $1 million while the estate tax exclusion equivalent rose in stages from $1,500,000 in 2005 to $5,120,000 in 2012. The

[3]I.R.C. §1411(a)(2).

[1]26 U.S.C.A. §§2001 and 2501.

[2]26 U.S.C.A. §§2001(c) and 2502(a).

[1]26 U.S.C.A. §§2001(c) and 2502(a).

[2]26 U.S.C.A. §2001(c).*See infra* §20:76 for Federal Unified Transfer Tax Schedule.

[1]Rev. Proc. 2017-58, 2016-45 I.R.B. 707. Applicable exclusion for 2018 was calculated based on the inflation adjusted amount of $5,600,000.

[2]Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, Pub. L. No. 111-312, §303, 124 Stat 3296. Rev. Proc. 2014-61.

[3]American Taxpayer Relief Act of 2012, Pub. L. No. 112-240 H.R. 8, 126 Stat. 2313.

[4]*See supra* §20:2.

applicable exclusion amount and applicable credit amount has been phased in from 1998 to 2009.[5]

The gift tax exemption equivalent for years 2012 through 2018 are as follows:

$11,200,000 in 2018, *(Reference: The federal estate tax exemption for 2018 will be $11,200,000 (estimated); however, the actual inflation adjusted amount has not yet been confirmed).*

$5,490,000 in 2017,
$5,450,000 in 2016,
$5,430,000 in 2015,
$5,340,000 in 2014,
$5,250,000 in 2013, and
$5,120,000 in 2012.

For gifts made after December 31, 1997, and estates of decedents who die after December 31, 1997, the previous unified credit of $192,800, which was the equivalent of a $600,000 exemption, has been replaced by an "applicable credit amount."[6] The applicable credit amount is the amount of the tentative tax that would be determined under the rate schedule in I.R.C. §2001(c) if the amount with respect to which such tentative tax is to be computed were the "applicable exclusion amount."[7]

20:21. Unified gift and estate tax system-- New York unified gift and estate tax system

The New York State Estate Tax Return is filed on Form ET-706 for estates of individuals dying on or after February 1, 2000. The New York State estate tax return (Form ET-706) must be filed and estate taxes must be paid within nine months after the decedent's death, unless an extension of time to file and pay is granted by New York State Tax Department. The one major difference between the federal and New York State gift and estate tax laws is that the New York State gift tax law was repealed effective January 1, 2000.

For New York residents dying on or after April 1, 2015, and before April 1, 2016, the New York State estate tax exclusion amount is $3,125,000. For New York residents dying on or after April 1, 2016, and before April 1, 2017, the New York State estate tax exclusion amount is $4,187,500. For New York residents dying on or after April 1, 2017, and on or before December 31, 2018, the New York State estate tax exclusion amount is $5,250,000.[1] On January 1, 2019, the New York State estate tax exclusion amount is scheduled to equal the Federal estate tax exemption amount as determined under the Federal rules in effect prior to the enactment of the Tax Cuts and Jobs Act. *(Reference: Rev. Proc. 2017-58, 2016-45 I.R.B. 707. Prior to the enactment of the Tax Cuts and Jobs Act, the federal estate exemption was expected to be $5,600,000).*

[5]*See infra* §20:77 for a schedule of New York State estate and Federal Estate and Gift Applicable Exclusion Amounts.

[6]26 U.S.C.A. §2010 (applicable to gifts made after December 31, 1997 and estates of decedents dying after December 31, 1997).

[7]26 U.S.C.A. §2010(c) (applicable to gifts made after December 31, 1997, and estates of decedents dying after December 31, 1997).
[1]See §20:77 for the Schedule--Federal and NYS Exclusion Amounts.

Prior to April 1, 2014, the New York's gift and estate taxes are computed under a unified rate schedule applicable to both gifts and transfers resulting from death on a cumulative basis.[2] This system is similar in concept to the federal gift and estate tax system.[3]

The New York State estate tax is equal to the maximum amount allowable against the federal estate tax, as a *credit for state death taxes* under §2011 of the Internal Revenue Code. This type of estate tax is sometimes referred to as a pickup tax, sponge tax, or sop tax, since the tax picks up or absorbs the portion of the federal estate tax allowed as a credit when paid to a state, that would otherwise be paid to the federal government if the state did not impose a tax on the estate.[4]

Generally, when a state imposes a pickup tax the total tax liability (federal and state combined) of the estate is no more than the federal estate tax liability before the credit for state death taxes. In 2005, the state death tax credit was replaced by a deduction reducing the federal taxable estate. The practical effect of this phase out in New York, in the absence of new state legislation, is that New York decedents will pay estate tax on estates that are valued at less than the federal applicable exclusion.

20:22. Gift tax considerations-- Overview (Federal)

Under the Tax Cuts and Jobs Act, gifts made after December 31, 2017 and before January 1, 2026, are subject to the same gift tax rate of 40% as applicable for calendar years 2013-2016. [1] For calendar years 2010-2012, the gift tax rate is equal to the highest individual tax rate which is 35%.[2]

The gift tax is an excise tax imposed upon the lifetime transfer of property, measured by the value of the property transferred in excess of the value of any consideration received therefor.[3]

The gift tax is paid by the donor who makes the gift.[4] If the donor fails to pay the tax when due, the donee is also liable for the tax to the extent of the value of the gift.[5]

Any transfer of property gratuitously bestowed is a gift. The general requirements are the following:

[2]*See infra* §20:37 for a further explanation of the New York State estate tax and §20:28 for a further explanation of the New York State gift tax.
[3]*See supra* §20:19.

[4]New York Tax Law §952.

[1]American Taxpayer Relief Act of 2012, Pub. L. No. 112-240 H.R. 8, 126 Stat. 2313.

[2] Economic Growth and Tax Relief Reconciliation Act of 2001 Pub. L. No. 107-16 §511, 115 Stat. 38.

[3]26 U.S.C.A. §§2501 through 2524.

[4]26 U.S.C.A. §2501(a).

[5]26 U.S.C.A. §6324(b).

1. a competent donor,
2. a donee capable of taking the gift,
3. a clear intent on the part of the donor to divest himself of control of the gift,
4. an irrevocable transfer of legal title barring further control by the donor,
5. a delivery to the donee of the gift or evidence of title, and
6. acceptance of the gift by the donee.[6]

There are exclusions,[7] deductions and credits[8] for federal gift tax purposes which must be considered.

20:23. Gift tax considerations-- Use of the gift tax exclusion

For gifts made during the calendar year 2018, the annual gift tax exclusion amount is $15,000 per donee per calendar year. *(Reference: Rev. Proc. 2017-58, 2016-45 I.R.B. 707)*; For gifts made during the calendar years 2013-2017, the annual gift tax exclusion amount is $15,000 per donee per calendar year.[1]

The annual exclusion amount is indexed annually for inflation.[2] The annual gift exclusion amount will be rounded to the next lowest multiple of $1,000.

To qualify for the annual exclusion however, the gift must be of a "present interest" and not of a "future interest."[3]

There is also an exclusion from gift tax for payment of tuition (not books, room, board, etc.) to a qualifying educational institution and payments for medical care directly to a provider or for medical insurance.[4] The gift tax does not apply to gifts to political organizations.[5] No gift tax return need be filed for these education or medical gifts or for gifts under the annual exclusion of $15,000 in 2018[6] because there is no taxable gift.[7]

In addition, contributions made to a qualified state college tuition program (sometimes referred to as a "Section 529 Plan") which exceed $15,000 in 2018 can be excluded over a five-year period as annual exclusion gifts. Thus, an aggregate of $70,000 (equal to five annual

[6]*See, e.g.* the cases cited at 62 N.Y Jur. 2d §27.

[7]*See infra* §20:23.

[8]*See infra* §§20:24 and 20:25.

[1]26 U.S.C.A. §2503(b); Rev. Proc. 2016-55, 2016-45 I.R.B. 707.

[2]Taxpayer Relief Act of 1997 §501(c), amending 26 U.S.C.A. §2503(b).

[3]26 C.F.R. §25.2503-3.

[4]26 C.F.R. §25.2503-6(b) and (c).

[5]26 C.F.R. §25.2501-1(a)(5).

[6]Rev. Proc. 2016-55, 2016-45 I.R.B. 707.

[7]26 C.F.R. §§25.2503-6(b)(2), (3), 25.2503-2. *See* I.R.C. §§2503(e)1, 2503(e)(2). *But see infra* §20:25 for split annual exclusion gifts.

exclusions) can be excluded from gift tax, if the donor so elects.[8]

Limited Powers of Withdrawal. In order to qualify a gift for the annual exclusion, the gift must be of a present interest. If assets are contributed into an Irrevocable Trust, they do not automatically qualify for the annual exclusion.

One method of qualifying the gift is to give the beneficiary(ies) of the trust the right to withdraw the funds contributed to the trust. For example, in order to qualify the money contributed to an Irrevocable Life Insurance Trust as a present interest gift,[9] so the trustees can pay the insurance premiums, a trust beneficiary can be given a limited power of withdrawal that permits the beneficiary to elect to withdraw his or her proportionate share of the contributions made to the trust each year (but not exceeding $15,0000).[10] This power can qualify the gifts for the $15,000 annual exclusion per year.[11]

Gifts to Grandchildren. Often, seniors are interested in making gifts to grandchildren. For example, if the senior has a taxable estate, he or she may want to reduce the estate by taking advantage of the $15,000 annual exclusion by making gifts to grandchildren. There are several options as to the manner of the gift.

1. The senior can make outright gifts directly to each grandchild. If the grandchild is a minor, then the senior can make the gift to the minor grandchild by placing the asset in the parent's name as custodian under the Uniform Transfer to Minors Act. The grandchild will have a right to access the asset at age 21 in New York.[12]

2. The senior can set up individual trusts for each grandchild. This type of trust is known as a "Minor's Trust" or a "2503(c) Trust" and the trust must meet certain requirements under §2503(c) of the Internal Revenue Code. Typically, the primary purpose will be to pay for a college education. The parent of the grandchild can be the trustee. The grandchild will have a right to access the asset at age 21. This trust will automatically qualify the gifts to the trust for the annual $15,000 gift tax exclusion each year.[13]

3. The senior can also set up one trust ("with separate shares") for each of his or her grandchildren with the trustee disbursing the funds for the benefit of each grandchild, in his or her discretion. There are additional administrative requirements as to this trust to qualify the gifts for the $15,000 annual exclusion.[14] The grandchildren must receive the balance of the funds as

[8]*See* I.R.C. §529(c)(2)(B).

[9]*See infra* §21:31.

[10]26 U.S.C.A. §2514(e).

[11]*See supra* §20:20 for gifts made after December 31, 1997.

[12]*See* EPTL §§7-6.1-7-6.26.

[13]26 U.S.C.A. §2503(c).

[14]Crummey v. C.I.R., 397 F.2d 82, 68-2 U.S. Tax Cas. (CCH) P 12541, 22 A.F.T.R.2d 6023 (9th Cir. 1968); Estate of Cristofani v. C. I. R., 97 T.C. 74, Tax Ct. Rep. (CCH) 47491, Tax Ct. Rep. Dec. (P-H) 97.5, 1991 WL 137858 (1991), acquiescence in result only recommended, AOD-1992-9, 1992 WL 794826 (I.R.S. AOD 1992) and acq., 1992-2 C.B.1 and acquiescence in result

provided for in the trust, for example, at a stated age or upon the occurrence of a stated event.[15]

20:24. Gift tax considerations-- Gift tax deductions and credits

Deductions. A marital deduction is allowed for all gifts between U.S. citizen or resident spouses.[1] There is also a charitable deduction for gifts, similar to those qualifying for an income tax deduction, except that deductible gifts are not limited to gifts to or for the use of U.S. recipients.[2]

Credits. After the tentative gift tax liability for a year has been computed, the donor's gift tax liability is determined by subtracting the available federal unified estate and gift tax credit.[3]

Valuation of Gifts. Where the gift is of an annuity, a life interest, a remainder or a reversion, the IRS requires that the gift's present value be determined according to IRS tables. Between December 1983 and May 1989, the tables were based on a 10% interest factor.[4] Thus one can give a gift of a future interest and value it below its true present value for tax purposes. Beginning in May 1989, the IRS published new tables with values that are dependent upon the interest rate at the time of the gift. The values on the table still afford the opportunity for some savings, but this is limited by the closer approximation of interest rates and the regular adjustment to the current index.[5]

Disclaimers. With respect to transfers made after December 31, 1976, a "Qualified Disclaimer"[6] can be made in which the property will be treated as if the interest had never been transferred to the person disclaiming. If a qualified disclaimer[7] is made, the disclaimed interest is treated as if there had never been a transfer to the person who made the disclaimer.

A qualified disclaimer means an irrevocable and unqualified refusal by a person to accept an interest in property but only if:[8]

only recommended, AOD-1996-10, 1996 WL 390089 (I.R.S. AOD 1996) and acq., 1996-2 C.B.1.

[15]Additionally, see I.R.C. §2503(c). A trust with separate shares for each grandchild may qualify for the annual exclusion from generation skipping tax. See I.R.C. §2642(c).

[1]26 U.S.C.A. §2523.

[2]26 U.S.C.A. §2522.

[3]26 U.S.C.A. §2505.

[4]26 C.F.R. §20.2031-7A(d).

[5]If the gift is of a remainder interest and a related party retains a life estate, the valuation of the gift will be made at the fair market value. The IRS will value at zero the transferor's retained interest. I.R.C. §2702.

[6]26 U.S.C.A. §2518.

[7]26 U.S.C.A. §2518(b).

[8]26 U.S.C.A. §2518(b).

1. Such refusal is in writing;
2. Such writing is received by the transferor, his or her legal representative or holder of the legal title to property to which the interest relates, not later than the date which is 9 months after the later of:
3. The date on which the transfer creating the interest in such person is made or;
4. The day on which such person attains the age of 21;
5. Such person has not accepted the interest or any of its benefits; and
6. As a result of such refusal, the interest passes without any direction on the part of the person making the disclaimer and passes either:
   a. To the spouse of the decedent; or
   b. To a person other than the person making the disclaimer.

20:25. Gift tax considerations-- Spousal gifts

For gifts made after September 30, 1983, there is an unlimited marital deduction for gifts between U.S. citizen or resident spouses.[1]

QTIP Living Trust. As an alternative to an outright gift to the spouse qualifying for the marital deduction, the donor spouse can make a gift to a living trust which meets the Qualified Terminable Interest Property ("QTIP") requirements so that the gift qualifies for the marital deduction.[2] The donor must make this QTIP election on the gift tax return.

Split Gifts. With the consent of one's spouse, a donor may "split" the gift with the spouse so that it will be treated as having been given one-half by each.[3] Since each spouse has a $15,000 annual exclusion per donee, the $15,000 can in effect be doubled. This can be extremely helpful when taxable gifts are made which can be offset by the exemption as well. For example, if a husband makes a gift of $810,000 to his son, and husband and wife split their gifts, the taxable gift of $780,000 is offset by the federal gift tax exclusion amount of $11,200,000 (in 2018) for each spouse leaving an unused exclusion of $10,810,000 ($11,200,000-$390,000) for each spouse. If the gift were only made by the husband, then the unused exclusion amount for the husband would be $10,420,000 ($11,200,000-$780,000).

With respect to gifts made after December 31, 1981, or before January 1, 1971, the spouse's consent may be signified (on a gift tax return) at any time following the close of the calendar year, subject to the following limitation:[4]

1. The consent may not be signified after the 15th day of April following the close of the calendar year, unless before such 15th day, no return has been filed for the year by either spouse, in which case the consent may not be signified after a return for the year is filed by either spouse;[5] and

[1]26 U.S.C.A. §§2056 and 2056A.

[2]*See infra* §20:31.

[3]26 U.S.C.A. §2513.

[4]26 C.F.R §25.2513-2(b)(1).

[5]26 C.F.R. §25.2513-2(b)(1)(i).

2. The consent may not be signified for a calendar year after a notice of deficiency in gift tax for that year has been sent to either spouse in accordance with §6212(a).[6]

20:26. Gift tax considerations-- Tax return filing requirements

If a reportable gift has been made, a federal gift tax return must be filed by April 15 of the year following the year of the gift.[1] A reportable gift is one that is not excluded by the marital deduction or the annual exclusion.[2] Form 709 is used to report the gifts to the federal government.

20:27. Gift tax considerations-- Interrelationship with income and estate taxation

Gift tax considerations should be tied in with income and estate tax considerations. The gift of high income producing property to a person in a lower income tax bracket may reduce the income taxes owed. Obviously many smaller estates can be transferred during the donor's lifetime (so as to qualify for Medicaid benefits in the future) and escape all taxation. Applicable state law must be reviewed for purposes of ascertaining the gift taxes which may be applicable to transfers during life. One should also consider planning in regard to clients who have residences in different states.

20:28. Gift tax considerations-- New York State gift taxation (Repealed)

One should always consider whether the taxpayer is subject to state gift taxation in the state in which the taxpayer resides. The New York State gift tax has been repealed without replacement for gifts made on or after January 1, 2000.[1] This allows taxpayers to implement a gifting program to minimize estate tax consequences without adverse New York State gift tax consequences.[2]

New York State did impose a gift tax for transfers by gift on or after January 6, 1972, and before January 1, 2000, by resident and nonresident individuals.[3] In the case of a New York resident, the gift tax did not apply to gifts of out-of-state real or tangible property.[4] In the case of a nonresident, the tax only applied to gifts of real or tangible personal property located in New York or intangible personal property within New York employed in carrying on any business in New York by the donor.[5]

[6]26 C.F.R. §25.2513-2(b)(1)(ii).

[1]26 U.S.C.A. §6075.

[2]26 U.S.C.A. §6019(a). If a spouse makes annual exclusion gifts and gift splitting is elected, then a gift tax return must be filed.

[1]New York State Budget Bill of 1997 Chapter 389, S. 5785, A. 6781.

[2]*See infra* §20:37.

[3]NYTL §§1001 to 1004.

[4]NYTL §1003(a)(1).

[5]NYTL §1003(a)(2).

New York State followed the federal rules as to exclusions and deductions. The New York State gift tax credit amount was similar to the New York State estate tax credit.[6]

20:29. Estate Tax Considerations-- Overview (Federal)

The federal estate tax is imposed on the transfer of a person's property at death.[1] The value of the gross estate is the aggregate fair market value of the various items of property included in the gross estate.[2] For this purpose, "fair market value" is defined as the price at which property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of all relevant facts,[3] and with the highest and best use of the property being considered. Certain property, such as farm business real estate, may be valued based upon its actual use rather than its highest and best use.[4]

20:30. Estate Tax Considerations-- Gross estate

The value of all property whether real or personal, tangible or intangible, and wherever situated, in which a United States citizen or resident decedent has a beneficial interest at death is includable in the gross estate.[1] This includes life insurance owned by the decedent, joint accounts and retirement plans.

This valuation is made at the date of the decedent's death, but an alternate valuation date of six months later may be elected if certain requirements are met.[2]

20:31. Estate Tax Considerations-- Deductions from gross estate

Certain deductions from the gross estate are available in calculating the taxable estate. These deductions include: expenses, debts, and casualty losses of the estate,[1] transfers to a charity,[2] and transfers to a surviving spouse.[3]

Expenses, Debts, and Casualty Losses of the Estate.[4] "Reasonable" and "bona fide"

[6]*See supra* §20:21.

[1]26 U.S.C.A. §2001(a).

[2]26 U.S.C.A. §2031.

[3]26 C.F.R. §2031-1(b).

[4]26 U.S.C.A. §2032A.

[1]26 U.S.C.A. §§2033 to 2046.

[2]26 U.S.C.A. §2032.

[1]26 U.S.C.A. §§2053 and 2054.

[2]26 U.S.C.A. §2055.

[3]26 U.S.C.A. §2056.

[4]26 U.S.C.A. §§2053 and 2054.

expenses attributable to the decedent's funeral and the administration of the decedent's estate, claims against the decedent's estate, mortgages on and debts due with respect to property included in the gross estate, and casualty losses of property included in the gross estate during administration are fully deductible.[5]

Charitable Deduction.[6] Bequests to qualifying charitable organizations are fully deductible from a decedent's gross estate for federal estate tax purposes.[7] The amount of the deduction is not limited to any portion of the estate, and charitable bequests can be used to avoid any estate tax. However, there are limitations when certain types of partial interests are transferred,[8] for example, when there are non-charitable and charitable interests in the same property.[9] In addition, special rules apply for the allowance of charitable deductions to exempt organizations, family or private foundations and nonexempt charitable trusts.

The same types of organizations which qualify as charities for income tax purposes also qualify for estate tax purposes,[10] so that transfers to the United States, a state, a local government, the District of Columbia, or a U.S. possession for exclusively public purposes, and transfers to a corporation, trust or community chest, fund or foundation, created or organized in the United States, and organized and operated exclusively for religious, charitable, scientific, literary or educational purposes are deductible.

The Marital Deduction.[11] The "marital deduction" is a deduction from the value of the gross estate in an amount equal to the value of property which passes from the decedent to his or her surviving spouse. If the surviving spouse is not a United States citizen, property passing to the surviving spouse is not deductible,[12] unless the property passes to a "Qualified Domestic Trust" for the benefit of the surviving spouse, whereupon it becomes fully deductible.[13] Accordingly, the citizenship of both spouses must be ascertained at the onset of any planning, and specialized planning may be required if either or each of them is not a United States citizen.

If property does not pass outright to the surviving spouse, then certain requirements must be met. The most common form of transfer is a special form of life income interest[14] given to a surviving spouse which qualifies for the marital deduction. This interest is referred to as a

[5] 26 U.S.C.A. §§2053 and 2054.

[6] 26 U.S.C.A. §2055.

[7] 26 U.S.C.A. §2055.

[8] 26 U.S.C.A. §2055(e).

[9] 26 U.S.C.A. §2055(e)(2).

[10] 26 U.S.C.A. §2055(a).

[11] 26 U.S.C.A.§§2056 and 2056A.

[12] 26 U.S.C.A. §2056(d).

[13] 26 U.S.C.A. §§2056(d) and 2056A.

[14] 26 U.S.C.A. §2056(b)(7).

"QTIP" or qualified terminable interest property.

If this type of life income is to qualify for the marital deduction, the following conditions must be met:[15]

1. the surviving spouse must be entitled to all of the income from the property payable at least annually for his or her life or have a usufruct interest for life in the property;
2. a QTIP interest in property not placed in trust must provide the survivor with rights to income that are sufficient to satisfy the rules applicable to marital deduction trusts;
3. there must be no power in anyone (including the spouse) to appoint any part of the property to any person other than the spouse during the spouse's life; and
4. the executor must elect on the decedent's estate tax return to have the interest treated as a QTIP.

The marital deduction is also available if the surviving spouse is entitled to the income of a specific portion of a trust for life, payable under like terms, and is possessed of like powers as to the specific portion.[16] The deduction applies only to that specific portion.

Another method of qualifying for the marital deduction is the general power of appointment.[17] This permits a life interest arrangement to qualify, whether it is in trust or not, if the survivor is entitled to all the income (payable at least annually) and has the power to appoint the property to herself (i.e., in the case of a trust, power to direct the trustee to pay her all of the principal) or has the power to appoint the property to her estate, (i.e., has a general power of appointment).

20:32. Estate Tax Considerations-- Credits against the estate tax

The federal tentative tax computed on the taxable estate may be reduced by the Unified Credit,[1] and various credits allowable for other taxes such as death taxes paid to the state (for decedents dying before 2005),[2] taxes paid on gifts made prior to 1977,[3] taxes on prior transfers,[4] and foreign death taxes.[5]

The Unified Credit.[6] Each person is allowed an applicable credit amount (the "Unified

[15] 26 U.S.C.A. §2056(b)(7).

[16] 26 U.S.C.A. §2056(b)(7).

[17] 26 U.S.C.A. §2056(b)(5).

[1] 26 U.S.C.A. §2010.

[2] 26 U.S.C.A. §2011 as amended by Economic Growth and Tax Relief Reconciliation of 2001, 115 Stat. 38.

[3] 26 U.S.C.A. §2012.

[4] 26 U.S.C.A. §2013.

[5] 26 U.S.C.A. §2014.

[6] 26 U.S.C.A. §2010.

Credit") against federal estate taxes,[7] which corresponds to an applicable exclusion amount ($11,200,000 for estates of decedents dying in calendar year 2018)This means that $11,200,000 can pass free of federal estate tax.[8] *(Reference: The federal estate tax exemption for 2018 will be $11,200,000 (estimated); however, the actual inflation adjusted amount has not yet been confirmed).* The amount of the credit cannot exceed the amount of the estate tax.[9]

Please note that, for spouses who die in 2018, the estate of the deceased spouse can elect to have any unused federal estate tax applicable exclusion carried over to the estate of the surviving spouse ("portability"), subject to certain restrictions.[10] In order to take advantage of this "portability," a United States Estate (and Generation-Skipping Transfer) Tax Return (IRS Form 706) for the deceased spouse must be filed timely with the portability election affirmatively taken.[11] This is true regardless of whether there is a federal estate tax due for the spouse who died in 2018.

In connection with planning for a married couple, it is important that each spouse take advantage of his or her unified credit. For example, if the first spouse to die (in 2018) has an estate of $8.47 million, and the surviving spouse has an estate of $2.51 million and the first spouse leaves the entire estate to the surviving spouse, then upon the death of the first spouse, the $8.47 million estate of the first spouse will not be subject to any federal estate taxes, because of the unlimited marital deduction. Assuming asset levels remain unchanged, and the second spouse dies in 2018, the second spouse to die will leave an estate of $10,980,000 which will be protected by the federal unified credit. Assuming the second spouse died on or before March 31, 2018, the second spouse's estate will have a zero federal estate tax but a New York estate tax of approximately $1,223,600. By leaving the entire estate outright to the second spouse, the first spouse failed to take advantage of his New York State unified credit, resulting in this example in the unnecessary payment of approximately $774,000 New York State estate taxes.

Credit for State Death Taxes.[12] Prior to 2005, with certain limits and restrictions, death

[7]Taxpayer Relief Act of 1997 §501(a), amending 26 U.S.C.A. §2010.

[8]26 U.S.C.A. §2001. The amount of the Unified Credit shall be reduced by any gifts which were made between September 9, 1976 and December 31, 1976 which were offset by the pre-1977 $30,000 exemption, but only to the extent of 20% of the amount of the exemption. This law was enacted as a transitional rule so that individuals did not benefit under the old and new tax systems by receiving the $30,000 exemption under the old system while receiving the post-1976 Unified Credit.

[9]26 U.S.C.A. §§2010(b) and 2010(c).

[10]*See supra* §20:2.

[11]26 U.S.C.A. §2010(c)(5)(A).

[12]In 2005, the credit for state death tax was eliminated and replaced by a deduction for state taxes actually paid. The $510,800 deduction for estate taxes actually paid to New York State reduces a $6 million taxable estate to $5,489,200. See Sanford J. Schlesinger and Dana L. Mark, "Changes in Estate and Gift Taxes Will Increase Exemption Amounts and Lower Federal Rates, 74 - SEP N.Y.S.B.J. 37, 51.

taxes imposed by any state on a decedent's estate may be credited against the decedent's federal estate taxes.[13]

Although New York State also permits an unlimited marital deduction, in the example above, in addition to the federal estate tax consequences, the estate of the second spouse to die would also be liable for New York State estate taxes since the value of the estate is in excess of $4,187,500 (for dates of death of January 1-March 31, 2017) and in excess of $5,250,000 (for dates of death of April 1, 2017-December 31, 2018). New York State does not have the deceased spouse unused estate tax applicable exclusion (DSUEA).

Credit for Gift Tax Paid.[14] Property may be included in a decedent's gross estate even though the decedent transferred it prior to death and paid a gift tax. For gifts made after 1976, the unified gift and estate tax system accounts for any gift tax paid on property included in the gross estate, and a separate credit is allowed for gift tax paid on gifts made prior to 1977.[15] Certain specific requirements apply with regard to the valuation of the gift at the time of the transfer or the decedent's death[16] and to gifts split between the decedent and his or her spouse.[17]

Credit for Tax on Prior Transfers.[18] Property which a decedent received by gift or transfer at the death of another will be included and taxed in the decedent's gross estate even if a gift or estate tax was paid on that earlier transfer to the decedent. To ameliorate the effect of this multiple taxation, a credit is allowed for prior estate taxes paid by another.[19]

If the decedent dies within two years after the death of the prior transferor, a credit is allowed in the amount of the full federal estate tax paid by the transferor with respect to the prior transferred property. If the decedent dies more than two years after the prior transferor, the credit is reduced by twenty percent (20%) for each two-year period, such that no credit is allowed after 10 years. Thus, if the decedent dies more than 10 years after the prior transferor, no credit is allowed.[20]

Credit for Foreign Death Taxes.[21] With certain limits and restrictions, death taxes imposed by a foreign country on a decedent's estate may be credited against the decedent's federal estate tax.[22]

[13]26 U.S.C.A. §2001.

[14]26 U.S.C.A. §2012.

[15]26 U.S.C.A. §2012.

[16]26 U.S.C.A. §2012(b).

[17]26 U.S.C.A. §2012(c).

[18]26 U.S.C.A. §2013.

[19]26 U.S.C.A. §2013.

[20]26 U.S.C.A. §2013(a)(1)-(4).

[21]26 U.S.C.A. §2014.

[22]26 U.S.C.A. §2014.

20:33. Estate Tax Considerations-- Federal estate tax computation

The tax is imposed on the "taxable estate" which is calculated as the value of the "gross estate" (the total property owned and transferred at death plus the value of other property considered to be transferred at death)[1] reduced by various deductions.[2]

There are five steps in computing the federal estate tax:

Step #1 Determine the value of the gross estate.

Step #2 Compute the taxable estate by reducing the gross estate by allowable deductions[3] including:[4]

a. funeral and administration expenses and claims against the estate, including certain taxes and charitable pledges;

b. losses from casualty or theft during the administration of the estate;[5]

c. transfers to public, charitable, and religious uses;[6]

d. certain bequests to the surviving spouse (the "marital deduction");[7] and

e. state death taxes.

Step #3 Calculate the "Adjusted Taxable Estate" as the sum of the Taxable Estate plus the aggregate value of all of the gifts made by the decedent after 1976 and not otherwise included in the gross estate.

Step #4 Calculate the "Tentative Tax" by applying the appropriate estate tax rate to the Adjusted Taxable Estate.[8] Reduce the Tentative Tax by the aggregate amount of gift taxes paid on gifts made by the decedent after 1976, including those gifts includable in the gross estate.[9]

Step #5 Calculate the "Net Estate Tax" by reducing the tentative tax by applicable tax credits,[10] including:

a. the applicable credit amount (the "unified credit"),[11]

b. any credit for gift tax paid on gifts made before 1977,[12]

[1] 26 U.S.C.A. §§2031, et seq.; *see supra* §§20:30 and 20:31.

[2] 26 U.S.C.A. §2051.

[3] 26 U.S.C.A. §2051; *see supra* §20:31.

[4] 26 U.S.C.A. §2053.

[5] 26 U.S.C.A. §2054.

[6] 26 U.S.C.A. §2055.

[7] 26 U.S.C.A. §2056.

[8] 26 U.S.C.A. §2001.

[9] 26 U.S.C.A. §2001.

[10] *See supra* §20:32.

[11] 26 U.S.C.A. §2010, *see also supra* §20:20.

[12] 26 U.S.C.A. §2012.

c. any credit for prior transfers, or[13]
d. any foreign death tax credit.[14]

20:34. Estate Tax Considerations-- Federal estate tax liability

The federal estate tax is due at the place for filing the return[1] nine months after date of death.[2] A district director may extend the time for payment of estate taxes in two situations:

1. For reasonable cause (illiquidity, for example) for up to 12 months from date fixed for payment,[3] or
2. For "special" reasonable cause for up to 10 years from date fixed for payment, i.e., undue hardship.[4] For example, a sale of property at a sacrifice price or in a depressed market would constitute undue hardship, but mere inconvenience would not.[5]

The IRS may also assess penalties under certain circumstances. There is a penalty for failure to pay an amount shown as tax due on the estate tax return in the amount of 1/2% of the tax per month up to a 25% maximum, unless failure to pay is due to a reasonable cause and not willful neglect.[6] There is also a penalty of 5% per month up to a 25% maximum for failure to file an estate tax return.[7] If the estate is subject to a 5% penalty for failure to file a return and to a 1/2% penalty for failure to pay tax in the same month, the 5% failure to file penalty is reduced by the amount of the failure to pay penalty of 1/2%,[8] thus, resulting in a maximum of total combined penalties of 5% per month.

20:35. Estate Tax Considerations-- Paying the federal tax

An extension of the time for payment of the federal estate tax may also be elected by the Executor if he or she meets certain requirements. This election must be made by letter to the Internal Revenue Service ("IRS") filed with a timely return for tax attributable to the following interests:

[13]26 U.S.C.A. §§2013.

[14]26 U.S.C.A. §2014.

[1]The place for filing is the IRS center where the decedent was domiciled at death. 26 U.S.C.A. §6091(b)(3).

[2]26 C.F.R. §§20.6151-1, 20.6075-1, and 20.6091-1.

[3]26 U.S.C.A. §6161(a)(1); *see* IRS Form 4768.

[4]26 U.S.C.A. §6161(a)(2); *see* IRS Forms 4768 and 1127.

[5]26 C.F.R. §20.6161-1(a)(2).

[6]26 U.S.C.A. §6651(a)(2). Penalties are not imposed if a valid extension is filed. 26 U.S.C.A. §6651(a)(1).

[7]26 U.S.C.A. §6651(a)(1).

[8]26 U.S.C.A. §6651.

1. For reversionary or remainder interests,[1] until six months after termination of the prior interest, which may be extended for an additional three years.

2. For estates of decedents dying after 1981, if the value of a farm or closely held business exceeds 35% of the adjusted gross estate, the estate taxes attributable to that interest may be deferred up to 15 years with the estate making annual interest payments (4%) for the first five years, and paying the balance in 10 annual installments of principal and interest.[2] A protective election may be made if it is not certain at the time of filing whether the estate qualifies.

The IRS will assess interest on the late payment of federal estate tax at a fluctuating rate as determined by the Secretary.[3]

If the estate of a decedent dying after August 5, 1997, is denied relief under I.R.C. §6166, the estate is entitled to seek a declaratory judgment before the U.S. Tax Court as to the estate's eligibility to make installment payments. This will be very helpful to estates that are at a financial disadvantage due to a lack of liquidity, since this judicial review is available without first paying the estate taxes due.[4]

20:36. Estate Tax Considerations-- Federal tax return filing requirements

If the value on the date of death of the gross estate of a decedent in a given year exceeds the applicable exclusion amount[1] ($11,200,000 in 2018, $5,490,000 in 2017, $5,450,000 in 2016, $5,430,000 in 2015, $5,430,000 in 2014, $5,250,000 in 2013 and $5,120,000 in 2012), then the representative of the estate must file a federal estate tax return. The threshold amount is reduced by post-1976 lifetime taxable gifts.[2]

20:37. Estate Tax Considerations-- New York State estate taxation

Estates after April 1, 2014. On April 1, 2014, the Executive Budget of 2014-2015 was signed into law by Governor Andrew Cuomo. This new law significantly altered the estate tax

[1]26 U.S.C.A. §§6163 and 6601(j).

[2]26 U.S.C.A. §6166.

[3]26 U.S.C.A. §6621(a)(2).

[4]Taxpayer Relief Act of 1997 §505, adding 26 U.S.C.A. §7479.

[1]26 U.S.C.A. §2010; *see also supra* §20:20; NYTL §971(a); The federal estate tax exemption for 2018 will be $11,200,000 (estimated); however, the actual inflation adjusted amount has not yet been confirmed.

[2]For decedents dying in 2012, for estates exceeding $5,120,000, an estate tax return must be filed, unless the executor, within 9 months of the enactment of the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 Pub. L. No. 111-312 (Sept. 17, 2011) (extended to September 19, 2011, as September 17 is a Saturday) has elected the no-federal-estate-tax option for 2010. If such an election is made (presumably on Form 8939 Allocation of Increase in Basis for Property Acquired from a Decedent) this election must also be made by September 19, 2011.

structure in New York.[1]

The new law immediately increased the New York State estate tax exemption from $1 million to $2,062,500 for the period of April 1, 2014 to March 31, 2015. Thereafter the exemption amount is set to increase gradually until January 1, 2019, when the New York exemption amount will equal the federal exemption amount as calculated prior to the enactment of the Tax Cuts and Jobs Act and increased each year for inflation.

Time Period	**New York Basic Exclusion Amount from Estate Tax**
Prior to the 2014-2015 NYS Budget	$1,000,000
April 1, 2014-March 31, 2015	$2,062,500
April 1, 2015-March 31, 2016	$3,125,000
April 1, 2016-March 31, 2017	$4,187,500
April 1, 2017-December 31, 2018	$5,250,000
On or after January 1, 2019	Same as federal exemption amount (indexed for inflation)

However, the new tax law is not without its disadvantages. The most significant disadvantage is that the law entirely eliminates the use of the New York estate tax exemption for estates that are valued at more than 5% of the exemption amount (105% of the estate tax exemption level).[2] This is commonly referred to as the "5% cliff."

In addition to this 5% cliff, New York's top estate tax rate of 16% still exists under the new law.[3] Another significant issue with the new law is that, unlike the federal law, there is no portability provision allowing a surviving spouse to shelter double the exemption.

Estates after December 31, 2004. For estates of decedents dying after December 31, 2004, the state death tax credit was phased out and the credit has been replaced by a deduction on the federal estate tax return for New York estate tax. The phase out of the state death tax credit has resulted in a higher tax bill for New York estates.

[1]N.Y. Tax Law §952.

[2]N.Y. Tax Law §952(c).

[3]N.Y. Tax Law §952(b).

Estates after January 31, 2000 to December 31, 2004. For estates of decedents dying after January 31, 2000, through December 31, 2004, the New York estate tax is equal to the state death tax credit under federal law.[4] Thus, the total amount of New York estate tax paid was deductible from any federal estate tax that may be payable. In 2004, the state death tax credit was 25% of the New York estate tax.

In addition to New York estate tax liability, real property owned by a decedent in another state may be subject to estate taxation by that state. Elder law attorneys are often required to interpret provisions of the Internal Revenue Code in light of local laws. Many legal questions need interpretation such as: domicile, effect of community property, and statutory rights of spouses.

Estates from October 1, 1998, to January 31, 2000. For estates of decedents dying from October 1, 1998, to January 31, 2000, the New York State Estate Tax is based upon the adjusted gross estate for federal estate taxes with certain modifications. The tax rates range from 2% to 21%.[5] The maximum rate applies to estates of $10,100,000 and over.[6] The estate tax credit is from $500 to $10,000 depending upon the preliminary tentative tax.

In addition, New York has an estate tax deduction of up to $250,000 for a principal residence for estates of decedents who died after June 9, 1994, and before February 1, 2000.[7]

20:38. Planning for the residence-- Overview

The residence is typically the most significant asset owned by the senior. In order to protect the residence in the context of a catastrophic illness, the senior may consider transferring the residence, and in such event, the tax consequences of such a transfer must be addressed.

The elder law attorney should advise the senior of the following considerations:

1. Ownership and Control. Is the senior comfortable giving up ownership and control? Should the senior retain a life estate, *i.e.*, the legal right to live in the residence for the senior's lifetime?
2. Income Taxes. The income tax consequences if the residence is sold during or after the senior's lifetime.[1]
3. Real Estate Taxes. The Senior Citizen's, Veteran's and/or the STAR exemption of real property taxes may be lost under certain circumstances if the property is transferred.
4. Gift and Estate Taxes. The tax consequences of transferring the residence during the senior's lifetime or upon his or her death. Will there be gift taxes due? What are the income tax consequences on a later sale of the residence?

20:39. Planning for the residence-- Outright transfers

There are several disadvantages of an outright transfer of a residence in the context of asset protection and tax planning:

[4]*See supra* §20:32.

[5]NYTL §952(a)(6).

[6]NYTL §952(a)(6).

[7]NYTL §955(f), (as amended in S.5279, sec.91, June 2, 1995).

[1]*See supra* §20:15.

1. There is no right to live in the house.
2. The donee obtains the donor's carryover basis.
3. There is the loss of the step up in basis upon the demise of the donor.
4. There is the loss of the senior's $250,000 exclusion from capital gains on a later sale of the residence during the donor's lifetime.[1]
5. There is the loss of any Senior Citizen's, Veteran's or School Tax Relief Exemption of real property taxes.

20:40. Planning for the residence-- Transfer to a Medicaid Asset Protection Trust

Another alternative is for the senior to transfer the residence to a Medicaid Asset Protection Trust.[1] This will also typically provide more protection and security for the senior and provide for preferential tax treatment.

20:41. Planning for the residence-- Comparison of residential transfers

When comparing a transfer of a residence with a retained life estate versus a transfer to a Medicaid Asset Protection Trust,[1] there are several advantages and disadvantages:

1. Unlike a transfer of a residence with a retained life estate, the funding of an Irrevocable Trust (containing a limited power of appointment)[2] with a residence would not constitute a taxable gift because of the incomplete nature of the transfer. This is not critical if the creator of the trust dies in 2018 with an estate of under $11,200,000.[3]
2. In the Medicaid Asset Protection Trust, the residence is still considered part of the grantor's estate subject to estate taxation.[4] The residence would receive a step up in basis for income tax purposes at the grantor's death.[5] With a retained life estate, upon the demise of the Grantor/Life Tenant, the transferee obtains a step up in basis.
3. If the residence is in the Medicaid Asset Protection Trust and is sold while the grantor is in a nursing home, then the sale proceeds would not be an available resource for purposes of Medicaid eligibility. A portion of the proceeds would be an available resource if the residence were transferred with a retained life estate.[6]

20:42. Use of Revocable Living Trusts-- Overview

[1]*See supra* §20:15.

[1]*See infra* §21:25.

[1]*See infra* §20:54 for a detailed discussion of the Medicaid Asset Protection Trust.

[2]*See infra* §21:22 regarding Medicaid consequences.

[3]*See supra* §20:20; The federal estate tax exemption for 2018 will be $11,200,000 (estimated); however, the actual inflation adjusted amount has not yet been confirmed.

[4]*See* I.R.C. §2036(a)(2).

[5]See I.R.C. §1014.

[6]*See supra* §14:31.

A Revocable Living Trust (sometimes referred to as a "Lifetime Trust" is a trust in which the grantor or the settlor (the individual establishing the trust)) reserves the right to revoke or amend the trust.[1] This reserved power causes the trust assets to be treated as the grantors for income[2] and estate tax purposes.[3]

The proper use of revocable living trusts can provide many advantages, such as:

1. Asset Management. The trustee can protect the assets, invest the principal and implement a sound investment policy.
2. Lower Estate Settlement Costs. The trust assets are not subject to a probate proceeding. Filing fees and legal fees may be reduced.
3. Delays in Distribution Avoided. The disposition of trust assets will not be prolonged by delays involved in estate settlement.
4. Assures Privacy. The trust is a private agreement and is not a public document.
5. Avoids Disputes. Unlike wills, dispositions of trust assets are more difficult to challenge on the grounds of incapacity and undue influence. The grantor's actions subsequent to the trust being set up will be evidence to support that: (i) the settlor had requisite capacity; and (ii) was not under any undue influence.
6. Tax Benefits. The trust may be drafted to achieve estate tax savings upon the demise of the grantor. For example, the trust may be divided upon the death of the grantor into a By Pass and Marital Trust which can reduce overall estate taxes for a married couple.[4]
7. Grantor Can Observe Estate Plan in Action. The grantor can observe and make modifications by actual personal experience.

20:43. Use of Revocable Living Trusts-- Income taxation

The grantor of a Revocable Living Trust will be treated as the owner for purposes of income taxation.[1] All of the income, deductions and expenses of the Trust are reported on the grantor's own personal income tax returns.

Upon the demise of the grantor, both the estate's executor and the trustee of the decedent's qualified revocable trust may make an irrevocable election to tax the revocable trust as part of the estate for federal income tax purposes.[2]

20:44. Use of Revocable Living Trusts-- Gift taxation

There is no federal gift tax due upon funding of a Revocable Trust,[1] Although a gift tax

[1] *See infra* §21:2.

[2] 26 U.S.C.A. §676.

[3] 26 U.S.C.A. §2038.

[4] *See infra* §20:60.

[1] 26 U.S.C.A. §676.

[2] 26 U.S.C.A. §646.

[1] 26 C.F.R. §25.2511-2(c).

return asserting that no tax is due appears to be required,[2] it is the authors' view that no return should be required because the transfer is a mere change of identity.

Distribution of trust assets may be subject to gift taxation. Uncompensated transfers made by the grantor to any person other than himself or herself will be treated as a completed gift by the grantor for gift tax purposes. A transfer becomes a completed gift when and if, during the lifetime of the grantor, the property ceases to be subject to the grantor's power to revoke. This can occur if the grantor simply releases the retained power or if the grantor holds the power as trustee and resigns from office. It can also occur if another person exercises a power of appointment that distributes or vests the property in such a way that the grantor's retained powers are negated or cancelled. Most commonly, a distribution from the trust to a beneficiary will place the distributed property beyond the control of the grantor. Thus, any distribution of income or corpus from a Revocable Trust is a completed gift by the original grantor.[3]

20:45. Use of Revocable Living Trusts-- Estate taxation

The assets of a Revocable Trust are included in the grantor's estate.[1] Hence, there are no estate tax benefits to placing assets in a Revocable Trust. Notwithstanding, a trust which provides for a Unified Credit Shelter Trust and a Marital Trust upon the demise of the grantor[2] can be a means of implementing estate tax planning for the benefit of a grantor's surviving spouse and family.

The trust may be set up so as to avoid a second death tax on the death of its beneficiaries.[3] For example, a Revocable Trust is set up for the senior's lifetime and then upon his or her death, the trust will terminate and the assets will be distributed to the senior's child. Then, upon the child's death, the former trust assets still held by the child will be subject to estate tax (a second estate tax) in her estate before passing to her children (the senior's grandchildren).

An alternative approach would be for the Revocable Trust to continue for the benefit of the child for her lifetime and then pass to the grandchildren. The trust assets would not be included in the child's estate upon her demise. Hence, a second estate tax would be avoided. This approach can result in significant estate tax savings, but must also take into account the generation skipping transfer tax.[4]

For example, if the senior has $11,200,000 in his living Revocable Trust (effectively all of his/her assets) and the child also has $11,200,000 of his/her own assets, and the trust provides for the assets to pass to the child, then there would be no federal estate tax on the death of the parent (in 2018). But if the child then passes away in 2018 with $22,400,000 as his/her taxable

[2]26 C.F.R. §25.2511-2(j).

[3]26 C.F.R. §25.2511-2(f).

[1]26 U.S.C.A. §2038.

[2]*See infra* §20:60.

[3]*See infra* §20:68; *see also infra* Living Trusts Ch 21.

[4]*See infra* §20:68.

estate, the child would be subject to both a federal and New York estate tax in 2018.[5]

In the alternative approach, where the trust continues for the benefit of the child during his/her lifetime, the child would only have $11,200,000 as his/her taxable estate because the $11,200,000 of trust assets would not be included in his/her estate. The federal estate tax *(Reference: The federal estate tax exemption for 2018 will be $11,200,000 (estimated); however, the actual inflation adjusted amount has not yet been confirmed)* on the senior's estate and the child's estate would be zero. A New York estate tax of $1,258,800 (in 2018) would be due upon the death of each of the senior and the child.

In an elder law practice, it is not uncommon to have clients in their eighties and nineties with children who are in their sixties. Thus it is very important to consider intergenerational estate planning. In addition to the estate tax savings, the elder law attorney should also consider asset protection planning for both generations in light of the high cost of long term care.[6] This approach must also take into account the generation skipping transfer tax.

There had been an issue as to whether gifts from the Revocable Trust to third parties made within three years of the grantor's demise are included in the grantor's estate for estate tax purposes.[7] In recent years there have been a number of case decisions and IRS private letter rulings which have not been consistent in the treatment of this issue. The IRS has basically taken a position that lifetime gifts made directly from the Trust are includable in the grantor's estate for estate tax purposes.[8] Inclusion of the gift for estate tax purposes can be avoided by the grantor withdrawing the trust property and then making a gift directly of the withdrawn property.

For estates of decedents who died after August 5, 1997, this issue has been resolved in favor of the taxpayer. Transfers from a revocable trust within three years of the decedent's death will be treated as if made directly by the decedent and, thus, the value of such transfers will not be includable in the decedent's gross estate.[9]

20:46. Use of Revocable Living Trusts-- Joint Revocable Living Trust

A Joint Revocable Living Trust is a Trust created by two persons (typically set up by a husband and wife) who are both grantors and trustees. This single Trust agreement provides for management of the Trust assets for the lifetime of both grantors and estate planning as well.

There are several advantages to this type of trust:

1. Ongoing management in the event of a disability; access by either spouse to all marital assets; and simplicity of asset management.
2. Estate planning, including avoidance of probate and tax planning.

[5]*See infra* §21:18.

[6]*See supra* Nursing Homes and Alternatives Ch 19.

[7]26 U.S.C.A. §2038.

[8]26 U.S.C.A. §§2035(d)(2) and 2038(a)(1). *See also* Estate of Barton v. C.I.R., T.C. Memo. 1993-583, T.C.M. (RIA) 93583, 66 T.C.M. (CCH) 1547 (1993); McNeely v. U.S., 16 F.3d 303, 94-1 U.S. Tax Cas. (CCH) 60155, 73 A.F.T.R.2d 94-2339 (8th Cir. 1994) Priv. Ltr. Rul. 9343003; Priv. Ltr. Rul. 9343004; TAM 9413002.

[9]Taxpayer Relief Act of 1997 §1310, amending 26 U.S.C.A. §2035.

However, there may be adverse consequences of this type of trust in the context of Medicaid eligibility.[1]

The following discussion provides a tax analysis of Joint Revocable Living Trusts in both non-taxable and in taxable estates.

Tax Analysis of Nontaxable Estates. A nontaxable estate is defined as a married couple's combined estate of $22,400,000 or less (in 2018).[2] Since $22,400,000 can pass federal[3] estate tax free to the beneficiaries of the estate due to the applicable exclusion amount, the federal estate tax consequences of such a trust for a couple both passing away in 2018 can be basically ignored. Notwithstanding, in 2018 there will be New York estate tax consequences on a combined estate of more than $4,187,500 for January 1, 2017, through March 31, 2017. There will be New York estate tax consequences on a combined estate of more than $5,250,000 for estates on or after April 1, 2017, through December 31, 2018.

For example, if the combined estate was $22,400,000, then upon the demise of both spouses in 2018 there are potential combined New York estate taxes of approximately $2,500,000 for both estates.

Typically, a husband and wife create a Joint Revocable Living Trust in which they are co-trustees and each has access to either income or principal during their lifetime. Upon the death of the first spouse, the trust continues for the benefit of the surviving spouse. Upon the demise of the second spouse, the assets pass to the children of the husband and wife. Upon the funding of the trust, property held as tenants by the entirety will be transferred. Ownership will be in the name of the trustees, as fiduciaries.

It may be important to consider how much is contributed by each spouse for gift and estate tax purposes. For example, the husband may contribute 75% of the property and the wife may contribute 25% of the property. This will be relevant if the funding of the trust is treated as a taxable gift.[4] A gift may be incurred because the husband and wife have transferred assets to the trust with a contingent remainder interest, which is dependent on surviving the other spouse even though they have retained a life estate in the trust property.[5]

Gift Taxation. As a general rule, any transfer to a trust in which someone other than the grantor has an interest creates the potential for a gift.[6] In order for a gift to be taxable, the transfer must be complete. A gift in trust is generally incomplete to the extent that the donor reserves a power over the distribution of trust assets.[7] A donor is not considered to have such a

[1]*See infra* §21:20.

[2]*See supra* §§20:2, 20:20; The federal estate tax exemption for 2018 will be $11,200,000 (estimated); however, the actual inflation adjusted amount has not yet been confirmed.

[3]*See supra* §20:21.

[4]*See supra* §15:21.

[5]*See* TAM 9308002.

[6]26 C.F.R. §25.2511-1.

[7]26 U.S.C.A. §2036.

retained power if it is exercisable only in conjunction with a person having a substantial adverse interest in the disposition of property.[8] A transfer to a trust which provides that the husband and wife jointly direct the distribution of trust income and principal during their lives, without the power to change the beneficiaries during their lifetimes, is a completed gift.[9]

There are also other potential gift tax problems with Joint Trusts. For example, if the trust provides that upon the demise of the first spouse the trust becomes irrevocable and the surviving spouse has limited access to principal based upon ascertainable standards, then the surviving spouse has made a completed gift of the remainder interest of that spouse's share of the trust property to their children.

One solution would be for the trust to provide that upon the demise of the first spouse, the trust remains revocable or, in the alternative, the surviving spouse retains a limited testamentary power of appointment. With either solution, there is no completed gift and, hence, no gift taxes. Note that the gift will not qualify for the marital deduction because the donor-spouse may enjoy the trust property after the demise of the donee-spouse.[10] The gift does not qualify for the QTIP treatment because: (i) the spouse is not entitled to all the income from the trust property; and (ii) the trust principal can be distributed to the other spouse.

Since each spouse has an interest in one-half of the income from the property contributed by the other spouse, and a remainder interest in the property if the spouse survives the other, these interests can be valued using applicable IRS valuation tables. The value of the interest will be based upon the value of property contributed and the age of each spouse.[11] If the value of the gift is less than the gift tax applicable exclusion amount of $11,200,000 (in 2018) *(Reference: The federal estate tax exemption for 2018 will be $11,200,000 (estimated); however, the actual inflation adjusted amount has not yet been confirmed)*, there would be no federal gift tax due. The trust can be drafted so that the funding of the trust will be treated as an incomplete gift. The following are some examples:

1. The trust provides that each spouse has the right to withdraw all of the trust assets, without the consent of the other spouse.
2. The trust provides that each spouse has the right to withdraw his or her separate contributions to the trust at any time, without the consent of the other spouse.
3. Husband and wife create separate shares within the Joint Trust for each spouse's contributions.

Estate Taxation. The trust assets may be included in the estate of the first spouse to die because he or she retained an interest in the trust.[12] Under I.R.C. §2036, a decedent's estate includes property to the extent of any interest therein of which the decedent has retained for his/her life or for any period not ascertainable without reference to his/her death or for any period which does not in fact end before his or her death: (1) the possession or enjoyment of, or the

[8]26 C.F.R. §25.2511-2(e).

[9]26 C.F.R. §25.2511-2(f).

[10]26 C.F.R. §25.2523(b)-(1)(c).

[11]26 U.S.C.A. §7520.

[12]26 U.S.C.A. §§2036 and 2038.

right to income from, the property; *or* (2) the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom. Since the deceased spouse retained an interest under I.R.C. §2036, the Trust assets would be includable in his or her estate.

In addition, under I.R.C. §2038, a decedent's estate includes property as to which the decedent made a transfer and retained "alone or ... in conjunction with any other person" the power to amend or revoke. Since the deceased spouse had the right to amend or revoke the trust, the trust assets would be includable in his or her estate.

There may be some relief available to offset the inclusion of trust assets due to the contributions of assets to the trust by the surviving spouse.[13] For example, if the surviving spouse contributed 25% of the trust assets, then 25% of the trust assets should not be includable in the estate of the first spouse to die.

Assuming the estate is less than the applicable exclusion amount ($11,200,000 in 2018), there are no federal estate taxes due, and the surviving spouse will receive a step up in basis,[14] as to the appreciated trust assets to the extent that they are included in the estate of the first spouse to die.[15] Hence, there are potential income tax savings to the surviving spouse on the later sale of Trust assets.

However, there may be potential estate tax problems. For example, if the value of the trust assets appreciates to an amount in excess of the applicable exclusion amount ($11,200,000 in 2018) *(Reference: The federal estate tax exemption for 2018 will be $11,200,000 (estimated); however, the actual inflation adjusted amount has not yet been confirmed)*, then there may be federal and New York estate taxes due.[16] Additionally, if the Trust provides that the grantor's powers are limited upon disability, or, if the trust provides that the trust becomes irrevocable upon the death of the first spouse then the transfer will not qualify for the marital deduction.[17] At the death of the first spouse, there may also be a gift by the surviving spouse of his/her remainder interest if the trust restricts his/her control under certain conditions.[18]

These problems can be avoided by drafting appropriate trust provisions. For example, the husband and wife could create separate trust shares for each spouse, providing each spouse with control over his or her respective share.

Income Taxation. As a general rule, a Joint Trust will be treated as a Grantor Trust for income tax purposes. In the event the husband and wife file separate returns, then it is necessary to allocate the trust income between the husband and wife in some manner. The grantors should

[13] 26 C.F.R. §20.2038-1(a).

[14] *See supra* §§20:2, 20:14; The federal estate tax exemption for 2018 will be $11,200,000 (estimated); however, the actual inflation adjusted amount has not yet been confirmed.

[15] 26 U.S.C.A. §1014.

[16] *See supra* §20:20; The federal estate tax exemption for 2018 will be $11,200,000 (estimated); however, the actual inflation adjusted amount has not yet been confirmed.

[17] *See supra* §20:31.

[18] *See* 26 C.F.R. §25.2511-2(f).

still retain benefits of ownership, such as deductions for real estate and mortgage interest and qualifications for the $250,000 ($500,000 for a married couple) exclusion of capital gain on the sale of the residence.[19]

Since all of the trust property is included in the estate of the first spouse to die, there is a step up in basis for the full value of the trust assets,[20] unless the trust is drafted so that only part of the trust assets are includable in the estate of the first spouse to die. In this respect, the Joint Trust operates like community property (a full step up notwithstanding ownership of only one-half of the community property). Hence, a Joint Trust may result in a full step-up in basis, while joint tenancy allows for only one-half of the value of the trust property to be increased to its fair market value.

If the contributions of the husband and wife to a Joint Trust are not segregated and each spouse has retained interests or powers over the entire trust, then all trust assets may be included in the estate of both spouses, with a full step up in basis in each estate. There may be some uncertainty as to the application of §§2036 and 2038 of the I.R.C. to both estates.

One solution may be for the trust to provide the first to die with a testamentary general power of appointment over all of the trust property. All of the trust assets would be included in the decedent's estate[21] and the trust assets would acquire a full step up in basis. This solution may backfire if the trust assets appreciate in value and exceed the applicable exclusion amount ($11,200,000 in 2018)[22] at the demise of the first spouse. The excess amount over the applicable exclusion amount ($11,200,000 in 2018) would result in federal and New York estate tax liability since this amount would not qualify for the marital deduction.[23]

Tax Analysis of Taxable Estates. A federal taxable estate is defined as a married couple's combined estate which exceeds the federal applicable exclusion amount ($11,200,000 in 2018).[24] Typically, the husband and wife create a Joint Revocable Living Trust in which they are co-trustees and each has access to either income or principal during their lifetime. Upon the demise of the first spouse, the trust provides that an amount up to the applicable exclusion amount be first funded into a separate irrevocable "Family Trust" (sometimes referred to as a By Pass or Unified Credit Shelter Trust) and the remaining assets be administered as a Revocable Trust for the surviving spouse. Upon the demise of the surviving spouse, the assets pass to the children. The entire Joint Revocable Living Trust assets will be included in the estate of the first spouse to die. The entire Trust may also be included in the estate of the surviving spouse upon his or her death.[25] The on-going revocable trust will not qualify for the marital deduction in the

[19]26 U.S.C.A. §121.

[20]26 U.S.C.A. §1014.

[21]26 U.S.C.A. §2041.

[22]*See supra* §20:20; The federal estate tax exemption for 2018 will be $11,200,000 (estimated); however, the actual inflation adjusted amount has not yet been confirmed.

[23]*See supra* §§20:2 and 20:31.

[24]*See supra* §20:20 and §20:2; The federal estate tax exemption for 2018 will be $11,200,000 (estimated); however, the actual inflation adjusted amount has not yet been confirmed.

[25]26 U.S.C.A. §2036.

estate of the first spouse to die, if the trust provides that the surviving spouse lacks a mandatory income interest, permits distributions to children or others, or puts restrictions on the surviving spouse, if disabled.[26]

The Joint Revocable Living Trust can be drafted to avoid subjecting the trust assets to estate taxation in both estates. One alternative is to qualify for the marital deduction by providing the surviving spouse with a mandatory income interest in the revocable trust portion or whatever is necessary to qualify the trust as a QTIP trust or a general power of appointment trust.[27]

Another alternative would be to create a Joint Trust with separate shares for each spouse. In effect, a married couple will have one Revocable Trust document, but each will have a separate Revocable Trust.[28]

Income Taxation. During the lifetimes of the husband and wife, the income tax consequences of the joint Revocable Trust will be the same as in a nontaxable estate. Upon the demise of the first spouse, the Unified Credit Shelter Trust would be treated as a separate taxpayer for income tax purposes.

In an effort to simplify a married couple's estate plan by using a single Revocable Trust, the elder law attorney must be careful to create a Joint Trust which takes into account income, gift and estate tax consequences. Such a trust may end up being more complex for the client than two separate revocable Trusts.[29]

20:47. Use of Revocable Living Trusts-- Convertible Trusts

A Convertible Trust is a Revocable Trust which becomes an Irrevocable Trust upon the incompetency or disability of the grantor.[1] If the grantor is the trustee, then he/she is replaced with a successor trustee and the grantor relinquishes all ability to revoke or amend the trust upon triggering the conversion. The trust typically provides for a definition of "disability." The trust should contain a medical procedure for establishing the existence of a "disability" and a procedure for the successor trustee to step in, if not already a co-trustee with the grantor.

Upon conversion, the trust would be treated as an Irrevocable trust for gift, income and estate tax purposes. For example, trust assets will be treated as a completed gift for gift tax purposes.[2] There may also be Medicaid eligibility consequences upon the conversion.[3]

[26]26 U.S.C.A. §2056(b)(5).

[27]*See supra* §20:31 for a discussion of qualifying the Trust for the marital deduction.

[28]In community property states, the need to maintain separate shares may be less compelling because the joint Trust probably will not change the ownership character of the Trust under state law.

[29]*See* Roy M. Adams, Thomas W. Abendroth, The Joint Trust: Are You Saving Anything Other Than Paper? Trusts and Estates, 8/92, vol.131, p.39.

[1]*See infra* §21:15.

[2]26 C.F.R. §25.2511-2(f).

[3]*See infra* §21:4 for a discussion of Trigger Trusts and §21:27 for Convertible Trusts.

20:48. Irrevocable Living Trusts-- Overview

An Irrevocable Living Trust is defined as a trust in which the grantor has no power to revoke or amend the Trust. This type of trust is often set up in the context of estate tax planning, but it can also be set up in the context of asset protection planning in the event of a catastrophic illness. The latter is the major concern of elder law clients.[1]

20:49. Irrevocable Living Trusts-- Income taxation

A trust is a separate taxable entity or a conduit through which income is passed to the beneficiaries. Income generated by the trust assets is taxable to the trust, the grantor or other beneficiaries of the trust, depending upon how the trust has been structured.[1]

Income is taxable to the trust if it is accumulated by the trust. The trust can be set up so that part of the income is taxable to the trust and part taxable to the beneficiaries. Income is generally taxable to the beneficiaries to the extent that the trust actually distributes the income to them or makes it available to them. Notwithstanding the above, the grantor may be taxed on trust income in accordance with any of the Grantor Trust rules.[2] The rationale is that the grantor is considered the owner of all or a portion of the trust and thus must pay tax on the trust's income.[3] In a Medicaid asset protection context, the Irrevocable Trust is typically drafted so that the trust is treated as a "Grantor Trust."[4] This is helpful when the grantor is in a lower income tax bracket than other beneficiaries named in the trust.

20:50. Grantor trusts-- Income taxation

If a grantor retains certain powers in a trust with respect to the property transferred to the trust as provided for in the Internal Revenue Code Sections 671 to 679, then the grantor will be treated as the owner of the trust property for federal income tax purposes. This type of trust is known as "Grantor Trust."[1] The grantor will report items of income, deduction and credit associated with the trust property on his or her own individual income tax return because the trust will not be treated as an independent taxpayer.[2]

Oftentimes the tax identification number of a Grantor Trust is the social security number of the grantor in lieu of an independent tax identification number for the trust.

A grantor includes any person to the extent such person either creates a trust, or directly or indirectly makes a gratuitous transfer of property to a trust.[3] The grantor can be a beneficiary

[1]*See infra* §21:26.

[1]26 U.S.C.A. §671; *see also* Ann I. Weber, Tax Consequences of the Use of Grantor and Non-Grantor Trusts in Medicaid Planning, The Elder Law Report, 1/92, vol. III, no.6.
[2]26 U.S.C.A. §§671 to 677.

[3]I.R.C. §§671 to 677.

[4]I.R.C. §§671, 672, 674, 675.

[1]*See supra* §20:49.

[2]I.R.C. §671.

[3]Treas. Reg. §1.672-2(e)(1).

of the trust who furnishes the trust funds, even if he or she is not the grantor in the trust agreement.[4] Therefore in the context of a trust set up for the purposes of Medicaid asset protection, the Medicaid recipient does not necessarily need to be named as grantor of the Trust agreement in order to obtain Grantor Trust status. In effect, the beneficiary is deemed to be the "grantor" of a Grantor Trust.

To determine if a trust qualifies as a Grantor Trust for income tax purposes the Elder Law attorney should review and be familiar with the Internal Revenue Code Sections 673 through 679. Each code section first sets out the general rule that must be followed in order to result in Grantor Trust status and then provides exceptions to the general rule.

There are four key terms relevant to Grantor Trusts:

1. Adverse Party--any person having a substantial beneficial interest in the trust which would be adversely affected by the exercise or nonexercise of the power which he possesses respecting the trust. A person having a general power of appointment over the trust property shall be deemed to have a beneficial interest in the trust.[5]

2. Nonadverse party--any person who is not an adverse party.[6]

3. Related or subordinate party--any nonadverse party who is (a) the grantor's spouse if living with the grantor and (b) any one of the following: the grantor's father, mother, issue, brother or sister, an employee of the grantor, a corporation or any employee of a corporation in which the stock holdings of the grantor and the trust are significant from the viewpoint of voting control; a subordinate employee of a corporation in which the grantor is an executive.[7]

4. Spouse--the grantor shall be treated as holding any power or interest held by: (a) any individual who was the spouse of the grantor at the time of the creation of such power or interest; or (b) any individual who became the spouse of the grantor after the creation of such power or interest, but only with respect to periods after such individual became the spouse of the grantor.[8]

a. Any individual legally separated from his spouse under a decree of divorce or of separate maintenance shall not be considered as married.[9]

The amount of the grantor's income, deductions, and credits, and the manner in which they are reported generally depends on the ownership of the Grantor Trust assets. There are three basic types of ownership:

<u>Grantor as owner of entire trust--</u>If the grantor or another person is treated as the owner of an entire trust (corpus and income), then all income, deductions and credits related to the trust

[4]Rev. Rul. 85-13, 1985-C.B. 184.

[5]I.R.C. §672(a).

[6]I.R.C. §672(b).

[7]I.R.C. §672(c).

[8]I.R.C. §672(e)(1).

[9]I.R.C. §672(e)(2).

assets are reported on his individual income tax returns.[10]

Grantor as owner of specific trust property--If the grantor treats as owning only a portion of the trust property and income related to such property, then he takes into account only the income, deductions, and credit against tax, and all capital gain or loss directly related to that specific property. Any income, deductions and credits derived from assets not related to the grantor or another person are reported on the trust's income tax return.[11]

Grantor as owner of undivided fractional interest--If the portion of a trust as owned by a grantor or another person consists of an undivided fractional interest in the trust, or of an interested represented by a dollar amount, a pro rata share of each item, deduction, and credit is normally allocated to the portion.[12] The treasury regulations under Section 671 provide details as to the calculation of allocation of these amounts.

Whether or not the Elder Law attorney actually prepares the income tax returns for the grantor or the trustee of the Grantor Trust, it is important to be familiar with the various types of income tax reporting methods available to a Grantor Trust which are detailed in Treasury Regulation Section 1.671-4 “Method of reporting.” This familiarity with the relevant regulations will allow the Elder Law attorney to provide comprehensive advice to clients about the administration of Grantor Trusts and will help when drafting key provisions to the Grantor Trust.

Upon the death of the grantor there is a deemed transfer of the assets held by the Grantor Trust to a non-grantor trust. At that time the trust will need to obtain a tax identification number if it does not already have one and all income, deductions, and credits will be reported under the new tax identification number. In the year in which the grantor dies the trust or the portion of the trust deemed to have been owned by the deceased grantor continues to report in the manner previously used for the taxable year that ends with the deceased grantor's death.[13]

The income, deductions, capital gains or losses will be attributed to the trust's tax identification number and the trustee of the non-grantor trust will need to file federal and relevant state fiduciary income tax returns for each year the trust income meets the filing threshold until the trust is terminated.

20:51. Irrevocable Living Trusts-- Gift taxation-- Funding of the Trust

Upon funding of the trust, there may be gift tax consequences, depending upon the terms of the trust.[1] If there is a completed gift, then the trust beneficiaries, rather than the trust or trustee, are treated as the donees. For example, once the grantor has parted with dominion and control over the property so that the grantor cannot change its disposition, the gift is deemed completed.[2]

[10] Treas. Reg. §1.671-3(a)(1).

[11] Treas. Reg. §1.671-3(a)(2).

[12] Treas. Reg. §1.671-3(a)(2).

[13] 26 C.F.R. §1.671-4(h)(2).

[1] 26 U.S.C.A. §2501.

[2] 26 C.F.R. §25.2511-2(b).

A gift is incomplete in every instance in which the donor reserves the power to re-vest the beneficial title of the property to him/herself. A gift is also incomplete if and to the extent that the grantor reserves a power to name new beneficiaries or a power to change the interests of the beneficiaries as between themselves, unless the power is a fiduciary power limited by a fixed or ascertainable standard.

If the grantor retains a power over the disposition of the assets, such as a testamentary limited power of appointment over the remainder upon death, then no portion of the transfer is considered a completed gift.[3] Therefore, gift taxes can be avoided upon funding of the trust or at the time a Revocable Trust becomes Irrevocable by providing for a limited power of appointment.[4] This also results in the trust assets being part of the grantor's estate.[5]

20:52. Irrevocable Living Trusts-- Gift taxation-- Distributions from the Trust

If the transfers of assets funding the trust were classified as "completed gifts" subject to gift tax, then the distributions from the trust are not "gifts."[1]

If the transfers funding the trust were classified as "incomplete gifts" and hence not subject to gift tax, then the distributions from the trust are treated as "gifts."[2]

20:53. Irrevocable Living Trusts-- Estate taxation

If the gift is incomplete or if the grantor has retained powers over the transferred property under I.R.C. §§2035 to 2042, such property will be included in the grantor's estate at death.[1]

For example, if the grantor retains a limited right to change the beneficiaries of the trust property, then the trust property will be includable in the estate.[2] Another example is if the grantor reserves an income interest for his/her life, then the trust will be fully includable in the grantor's gross estate for estate tax purposes.[3] In such event, the beneficiaries will receive the property with a full step up in basis.

20:54. Medicaid Asset Protection Trust

Income Tax. A Medicaid Asset Protection Trust can be structured as a Grantor Trust for income tax purposes under Internal Revenue Code §§671 to 678. The two most common provisions which will taint the trust as a Grantor Trust are the following:

1. The power to add charitable beneficiaries (I.R.C. §674).

[3]26 C.F.R. §25.2511-2(c).

[4]*See supra* §20:30 regarding Medicaid consequences.

[5]*See supra* §20:53.

[1]*See generally* 26 C.F.R. §25.2511-2(b).

[2]26 C.F.R. §25.2511-2(f).

[1]26 U.S.C.A. §§2035 to 2042.

[2]*See supra* §20:51.

[3]26 U.S.C.A. §2036(a)(1).

2. The power to substitute property of equivalent value under Internal Revenue Section 675(4)(C).

Please note that either of these power provisions may be challenged by the local Medicaid agency as to disqualifying the Trust; thus rendering the trust assets available for purposes of Medicaid eligibility, even though the authors do not believe that such a challenge will prevail. From a drafting standpoint, it may be less aggressive to choose on provision versus both provisions which create Grantor Trust status for income tax purposes.

Gift Tax. A Medicaid Asset Protection Trust can be used to achieve eligibility for Medicaid while protecting assets (subject to the Medicaid transfer penalty rules) without gift tax consequences. This can be achieved by having the grantor retain a testamentary right to change the beneficiaries of the trust, limited to a class of beneficiaries, excluding the grantor, the grantor's estate and creditors of the grantor or the grantor's estate.

Medicaid Asset Protection Trusts may also be used to achieve Medicaid eligibility subject to the gift tax laws. Contributions to the trust (i.e., gifts) may qualify for the $15,000 annual exclusion in 2018,[1] as long as the present interest requirement is satisfied. There are several methods of satisfying this requirement, such as: (i) providing for "Crummey Powers" in the trust wherein the beneficiary is given the right to demand an amount of corpus equal to the annual gift tax exclusion;[2] or (ii) mandating the distribution of income to the beneficiary of the trust.[3] However, such contributions will be considered transfers for Medicaid eligibility purposes.[4]

Contributions to the trust (i.e., gifts) may also qualify for the marital deduction if any distribution to a spouse constitutes qualified terminable interest property (QTIP).[5]

Estate Tax. A Medicaid Asset Protection Trust can be structured so that the trust assets are included in the estate of the grantor for federal and New York State estate taxes.[6] This will allow the beneficiary of the trust assets to receive a step up in basis which can save capital gains taxes on the sale of the assets.[7]

[1]*See supra* §15:21.

[2]*See* Crummey v. C.I.R., 397 F.2d 82, 68-2 U.S. Tax Cas. (CCH) 12541, 22 A.F.T.R.2d 6023 (9th Cir. 1968); Estate of Cristofani v. C. I. R., 97 T.C. 74, Tax Ct. Rep. (CCH) 47491, Tax Ct. Rep. Dec. (P-H) 97.5, 1991 WL 137858 (1991), acquiescence in result only recommended, AOD-1992-9, 1992 WL 794826 (I.R.S. AOD 1992) and acq., 1992-2 C.B.1 and acquiescence in result only recommended, AOD-1996-10, 1996 WL 390089 (I.R.S. AOD 1996) and acq., 1996-2 C.B.1.

[3]*See* Swetland v. C.I.R., T.C. Memo. 1978-47, T.C.M. (P-H) 78047, 37 T.C.M. (CCH) 249, 1978 WL 2754 (1978), recommendation regarding acquiescence, AOD-1983-65, 1983 WL 203726 (I.R.S. AOD 1983).

[4]*See supra* §14:28.

[5]26 U.S.C.A. §2523.

[6]26 U.S.C.A. §§2035 to 2038.

[7]26 U.S.C.A. §1014.

20:55. Use of Special Needs Trusts under OBRA 1993-- Overview

Dramatic changes were made with regard to the treatment of trusts for Medicaid eligibility purposes when the Omnibus Budget Reconciliation Act of 1993 ("OBRA '93") was signed into law by President Clinton on August 10, 1993.[1] Many elder law practitioners considered this law to be an attack on trusts, since many restrictions were placed on the use of trusts within the context of the elder law practice.

The Special Needs Trust is a trust funded with the assets of a disabled individual under the age of 65 which is established for the benefit of such individual by the parent, grandparent, legal guardian of the individual or a court, provided the state receives all amounts remaining in the trust upon the death of the disabled individual, up to an amount equal to the total medical assistance paid on behalf of the individual.[2]

The use of the Special Needs Trust can be an important planning tool to protect damages recovered in personal injury and medical malpractice lawsuits. This type of Trust can also be useful in the context of inheritances or to protect the assets possessed by a disabled senior at the time the disability is incurred.

Elder law attorneys are often asked by personal injury and medical malpractice attorneys to assist them in the structuring of the settlements of tort actions with the objective of optimizing the disabled person's recovery by maintaining eligibility for government programs such as Medicaid. This analysis must not only address entitlement planning, but also tax planning. The income, gift and estate tax implications of structured settlements need to be determined when the payments are made to a Special Needs Trust.[3]

It will be important for the elder law attorney to have a complete understanding of the tax and entitlement issues surrounding Special Needs Trusts. It is equally important to understand that the use of these trusts under OBRA '93 presents a wonderful opportunity for all elder law practitioners to advocate on behalf of the disabled and insure them a better quality of life.

20:56. Use of Special Needs Trusts under OBRA 1993-- Income taxation

Settlement Payments to an Individual. When an individual is to receive payment of a monetary award, whether as a lump sum or as periodic payments, as a result of damages received from a personal injury or medical malpractice action, how is such an award to be treated for income tax purposes? Generally, gross income includes all income from whatever source derived.[1] However, gross income does not include any damages received due to personal injury or sickness.[2]

[1]*See infra* §21:20.

[2]*See* 42 U.S.C.A. §1396p(d)(4)(A).

[3]Hindert, Rehner, Hindert, Structured Settlements and Periodic Payment Judgments, (1994) (Law Journal Seminars-Press, originally published in 1986); and Howard J. Atlas and Vincent J. Russo, The Tax Implications of the OBRA-93 Disability Trust, (May 1995) (The ElderLaw Report, Volume VI, Number 10).

[1]26 U.S.C.A. §61(a).

[2]26 U.S.C.A. §104(a)(2).

Periodic payments can provide the individual with disabilities with an opportunity for federal income tax savings that does not exist with a lump sum settlement, since the interest realized from investing the lump sum is not excluded from gross income.[3] Periodic payments, which include investment interest, are "exempt income" and thus are excluded from income taxation.[4] One issue for the practitioner to consider is whether or not an assignment of the periodic payments to a trust taints the tax-exempt status of the payments.[5] If payments are made to a "Grantor Trust" the payments should continue to be excluded because the disabled individual is treated as the owner of the trust for income tax purposes.[6]

Punitive damages recovered in a case not involving physical injury or sickness may not be excluded.[7] The law is currently unsettled however, as to whether punitive damages recovered in a case involving physical injury or sickness may be excluded from income. The IRS and the Tax Court have taken contrary positions. The IRS has stated that punitive damages are always included in gross income,[8] while a federal district court in Alabama and the Tax Court have ruled that all punitive damages are excludable regardless of whether they are compensatory or not, as long as the underlying claim qualifies as a personal injury pursuant to I.R.C. §104(a).[9] There is a small, but growing number of cases supporting this exclusion.[10]

Settlement Payments to the Special Needs Trust. Once the payments from the settlements are funded into the Special Needs Trust,[11] counsel must consider who will be taxed on the interest and dividends that the Trust assets generate. From a tax planning standpoint, under most circumstances, it is preferable for the tax to be reported by the disabled individual, instead of the Trust itself, since under current tax law the trust's higher tax brackets apply at lower levels of taxable income than for individuals.[12] The 2018 federal income tax rates range from 10% to 37% for individuals and 10% to 37% for trusts. An individual filing with the single filing status (i.e., other than surviving spouses and heads of household) will reach a 37% tax

[3]*See* Rev. Rul. 65-29, 1965-1 C.B. 59.

[4]26 U.S.C.A. §104(a)(2).

[5]26 U.S.C.A. §104(a)(2).

[6]26 U.S.C.A. §104(a)(2).

[7]26 U.S.C.A. §104(a).

[8]Rev. Rul. 84-108, 1984-2 C.B. 32.

[9]*See* Burford v. U.S., 642 F. Supp. 635, 86-2 U.S. Tax Cas. (CCH) 9724, 58 A.F.T.R.2d 86-5821 (N.D. Ala. 1986).

[10]*See* Horton v. C.I.R., 100 T.C. 93, Tax Ct. Rep. (CCH) 48856, Tax Ct. Rep. Dec. (RIA) 100.8, 1993 WL 28557 (1993), aff'd, 33 F.3d 625, 94-2 U.S. Tax Cas. (CCH) 50440, 74 A.F.T.R.2d 94-5934, 1994 FED App. 0301P (6th Cir. 1994).

[11]*See infra* §21:10.

[12]26 U.S.C.A. 1§(j), as added by the Tax Cuts and Jobs Act.

bracket at $500,000 of taxable income (in 2018), while a trust will reach the same bracket at a taxable income of only $12,500 (in 2018).[13]

In order for the trust income to be considered taxable to the disabled individual at the lower tax rate, the trust must be considered a "Grantor Trust" for income tax purposes.[14] To ensure Grantor Trust treatment, the disabled individual need not be named as grantor of the Trust document. The grantor of a trust can be the disabled beneficiary of the trust who furnishes the trust funds, not necessarily the individual named as grantor in the trust agreement.[15]

A Grantor Trust can be best described as a trust under which the individual has retained some level of interest or control in the trust which causes that individual to be considered the owner of the trust property. To ensure that the disabled individual is taxed on the trust income, it is critical that the trust be drafted in accordance with the Grantor Trust rules.[16]

The following are two suggestions for provisions the practitioner may want to utilize within the trust document to secure Grantor Trust status:

1. The trust may include a provision that would allow the disabled individual an unrestricted power to remove, substitute or add trustees and to designate any person including himself or herself as the replacement trustee. This type of power is deemed to be a "right to control the beneficial enjoyment of the trust property."[17] With this power, income will be taxed to the grantor.[18]
2. The trust may provide the disabled individual with a certain administrative power, such as the power to reacquire trust corpus by substituting other property of equal value.[19] With this administrative power, the trust income will be taxed to the grantor.[20]

Furthermore the IRS has held that for income tax purposes a minor will be treated as the owner of a trust which is created for the minor's benefit by court order as a result of a personal injury suit filed on the minor's behalf, if the trust contains provisions that fall under the Grantor Trust rules.[21]

20:57. Use of Special Needs Trusts under OBRA 1993-- Gift taxation

[13]26 U.S.C.A. §1(j), as added by the Tax Cuts and Jobs Act..

[14]26 U.S.C.A. §§671 to 677.

[15]*See* Blackman v. U.S., 98 Ct. Cl. 413, 48 F. Supp. 362, 43-1 U.S. Tax Cas. (CCH) 10010, 30 A.F.T.R. (P-H) P 846 (1943); *see also* Priv. Ltr. Rul. 9004007.

[16]26 U.S.C.A. §§671 to 677.

[17]26 C.F.R. §1.674(d)-2.

[18]26 U.S.C.A. §674.

[19]26 U.S.C.A. §675(4).

[20]26 U.S.C.A. §675.

[21]26 U.S.C.A. §§671 to 677; *see also* Rev. Rul. 83-25, 1983-1 C.B. 116; Priv. Ltr. Ruls. 9502019, 9502020, 9502024, 9502029, and 9502031.

With regard to gift tax liability, one must determine upon the payment of settlement proceeds into the Special Needs Trust whether a completed gift has been made by the person with disabilities. Generally, the essential elements of a valid *inter vivos* gift are:

1. a donor competent to make the gift;
2. a clear and unmistakable intention on his or her part to make it;
3. a donee capable of accepting the gift;
4. a conveyance, assignment, or transfer sufficient to vest the legal title in the donee, without power of revocation at the will of the donor; and
5. a relinquishment of dominion and control of the subject matter by delivery to the donee.[1]

The transfer of property constitutes a completed gift to the extent that the donor has parted with dominion and control of the property so as to leave him or her without a power to change the disposition, whether for his or her own benefit, or for the benefit of another.[2]

Since the Special Needs Trust must provide for a pay back to the State for Medicaid paid during the individual's lifetime, the funding of the trust with the assets of the individual will be treated as an incomplete gift. Under Rev. Rul. 76-103, when a trust allows for the grantor's creditor to be paid from the trust, then the funding of the trust is an incomplete gift. In addition, if the Special Needs Trust provides for the trust assets to pass to the grantor's estate on his or her demise, then the trust assets will be treated as an incomplete gift due to this reversion.[3]

To avoid the gift question entirely, the attorney should draft the trust document properly to insure that the funding of the Trust is not a completed gift. If the individual who is disabled retains a power over the disposition of trust assets, such as a testamentary power of appointment over the remainder upon death, then no portion of the funding should be considered a completed gift.[4]

Even if the individual who is disabled does not have the requisite legal capacity to execute a Last Will and Testament and thus, cannot exercise the limited power of appointment, the funding of the trust can still be considered an incomplete gift. Current case law and an IRS Revenue Ruling have taken the position that the mere possession at death of the power, rather than the exercise of, or inability to exercise the power, is the proper criterion to examine whether the transfer to the Trust is an incomplete gift.[5]

20:58. Use of Special Needs Trusts under OBRA 1993-- Estate taxation

Generally, if the individual who is disabled has retained an interest in the trust or sufficient powers over the trust property, then the trust will be included in the estate of the person

[1] Edson v. Lucas, 40 F.2d 398, 8 A.F.T.R. (P-H) 10743 (C.C.A. 8th Cir. 1930).

[2] 26 C.F.R. §25.2511-2(b).

[3] Treas. Reg. §20-2511-2(c).

[4] 26 C.F.R. §25.2511-2(b), *see also* Priv. Ltr. Rul. 9437034.

[5] *See* Boeving v. U.S., 650 F.2d 493, 81-2 U.S. Tax Cas. (CCH) P 13415, 48 A.F.T.R.2d 81-6248 (8th Cir. 1981).

with disabilities.[1] All assets in which an individual has an interest at the time of death, are part of his or her gross estate for purposes of estate taxation.[2] Conversely, if the individual who is disabled has retained no interest in, or control over the trust property, the funding of the trust could be considered a completed gift subject to gift tax and not part of the estate for estate tax purposes. As a result, the drafting of the trust agreement can have a significant impact on the gift and estate tax consequences of the trust.

Assets of the Special Needs Trust will be included in the estate of the individual who is disabled if: (i) the trust assets will be distributed to his or her estate;[3] or (ii) that individual retains a limited power of appointment over the trust assets. Drafting the trust to allow the individual who is disabled the power to determine who will receive the remainder of the trust property at his or her death, would cause estate inclusion pursuant to I.R.C. §2036(a)(2).

The IRS has officially agreed with this position in a private letter ruling.[4] This private letter ruling involved a personal injury settlement paid into an Irrevocable Trust for the benefit of a child who is disabled. The IRS held that the trust assets were includable in the disabled child's estate since the decedent child retained a special testamentary power of appointment over the trust (the power to alter the disposition of the trust corpus at his death). Thus, the transfer of the funds into the trust constituted an incomplete gift[5] and the trust corpus was includable in the child's estate.[6]

In Technical Advice Memorandum 9506004, issued November 1, 1994, the Internal Revenue Service took the position that the settlement proceeds of a tort action brought on behalf of a minor and placed in two irrevocable trusts by his guardians were includable in the minor's gross estate for estate tax purposes. The proceeds were includable not only under I.R.C. §2038 due to a testamentary power of appointment, but also under I.R.C. §2036 because the trust corpus could be consumed for the minor's needs. Under the terms of the trust agreement, the trustees had broad discretion to distribute income or principal for the minor. In a recent U.S. Court of Claims case, the court held that the trust assets of a Supplemental Needs Trust were included in the decedent's estate for estate tax purposes.[7]

If the estate of an individual who is disabled is valued under the applicable exclusion

[1] 26 U.S.C.A. §§2033 to 2041.

[2] 26 U.S.C.A. §2033.

[3] I.R.C. §2037

[4] Priv. Ltr. Rul. 9437034.

[5] 26 U.S.C.A. §2511.

[6] 26 U.S.C.A. §2038.

[7] Arrington v. U.S., 34 Fed. Cl. 144, 95-2 U.S. Tax Cas. (CCH) 60212, 76 A.F.T.R.2d 95-6762 (1995), aff'd, 108 F.3d 1393, 97-1 U.S. Tax Cas. (CCH) 60260, 79 A.F.T.R.2d 97-1341 (Fed. Cir. 1997).

amount ($11,200,000 in 2018),[8] then there is no federal estate tax.[9] If the date of death value of the trust is over the applicable exclusion amount, then the attorney must consider debts and expenses which will reduce the gross estate subject to tax. These include the claim of the state for medical reimbursement under the Medicaid program, as well as other debts and administrative expenses, which will reduce the gross estate[10] subject to estate taxation. If the estate is reduced to the applicable exclusion amount ($11,200,000 in 2018)[11] or less, then there would be no federal estate tax to be paid because of the applicable federal applicable exclusion.[12]

Estate Inclusion--Future Periodic Payments. If a personal injury lawsuit settlement is structured so that annuity payments continue to be paid to a disabled individual's parents upon his or her demise, the present value of the annuity payments to be received by the parents (the remainder beneficiaries) is included in the decedent's estate.[13]

Since the remaining annuity payments are includable in the disabled individual's estate, the continued payment stream must be valued. There are three potential approaches to valuing the amount to be included in the decedent's estate:

1. The cost of a commercial annuity;[14]
2. The value based on discounting future payments at 120% of the average federal midterm rate[15] on the date of death;[16] or
3. The price a willing buyer would pay a willing seller for the right to receive future payments.[17]

Although not involving periodic payments of personal injury settlements, two Tax Court

[8]*See supra* §20:20; The federal estate tax exemption for 2018 will be $11,200,000 (estimated); however, the actual inflation adjusted amount has not yet been confirmed.

[9]26 U.S.C.A. §2010. *See supra* §20:2.

[10]26 U.S.C.A. §2053.

[11]*See supra* §20:20 and §20:2; The federal estate tax exemption for 2018 will be $11,200,000 (estimated); however, the actual inflation adjusted amount has not yet been confirmed.

[12]Please note that an estate of $11,200,000 would generate a New York State estate tax of $1,258,800 for estates from April 1, 2017, through December 31, 2018.

[13]26 U.S.C.A. §2039.

[14]26 C.F.R. §20.2031-7.

[15]The federal midterm rate is promulgated on a monthly basis. *See* Rev. Rul. 2017-2, for January 2017 Rates. This rate is to assist in valuations for gift and estate tax purposes. 26 U.S.C.A. §§7520 and 1274(d)(1).

[16]26 U.S.C.A. §7520.

[17]26 C.F.R. §20.2031-1(b).

cases valued continuing annuity payments at the cost of a commercial annuity and not pursuant to the willing buyer/willing seller rule.[18] It is likely that the IRS will utilize the commercial annuity valuation or at a minimum, the valuation specified under I.R.C. §7520 and resist applying the willing buyer/willing seller approach.

If the settlement is structured as a payment stream which continues paying the deceased disabled individual's family over a number of years, there may be insufficient trust assets to pay the estate tax which is due within nine months after the decedent's death. Under this scenario, the estate may request that the estate tax be paid in installments over time.[19] If the IRS grants this request, there will be no penalty for not paying the estate tax within nine months from the decedent's date of death, but interest will have to be paid on each installment.[20]

20:59. Third-Party Trusts

Third-Party Trusts are set up by the grantor for the benefit of a third party. Typical situations in which Third-Party Trusts are used in an elder law practice would be where: (a) a spouse sets up a trust for the benefit of the other spouse;[1] (b) a child sets up a trust for his or her elderly or disabled parent; or (c) a parent sets up a trust for the special needs of a disabled child.[2] The trust usually provides for discretionary powers in the trustee to utilize income or principal for the benefit of a primary beneficiary, without replacing any government benefits. This type of trust is sometimes referred to as a "Third-Party Supplemental Needs Trust." This type of trust can be invaluable in protecting assets in the event that the third-party/beneficiary requires long term care.[3]

All of the trust tax rules apply to the Third-Party Trust.[4] Hence, taxation may depend upon on a number of factors such as grantor retained powers.

20:60. Use of Bypass/Marital Trusts

One common estate planning technique for married couples is to have wills or Living Trusts which contain Marital and/or Bypass Trusts (sometimes referred to as A/B Trusts

[18]Estate of Bell v. U.S., 80-2 U.S. Tax Cas. (CCH) 13356, 46 A.F.T.R.2d 80-6148, 1980 WL 1700 (E.D. Wash. 1980); Estate of Raimondi v. C.I.R., T.C. Memo. 1970-25, T.C.M. (P-H) 70025, 29 T.C.M. (CCH) 70, 1970 WL 1529 (1970).

[19]26 U.S.C.A. §6166.

[20]*See supra* §20:34.

[1]*See infra* §22:4.

[2]*See infra* §22:7.

[3]Estates, Powers and Trust Law §7-1.12 (McKinney's 1996 Interim Update); *see also* Estate of Escher, 94 Misc. 2d 952, 407 N.Y.S.2d 106 (Sur. Ct. 1978), decree aff'd by, 75 A.D.2d 531, 426 N.Y.S.2d 1008 (1st Dep't 1980), order aff'd, 52 N.Y.2d 1006, 438 N.Y.S.2d 293, 420 N.E.2d 91 (1981).

[4]*See supra* §§20:42 to 20:54 and *infra* §20:60.

respectively).[1]

In this type of plan, the first applicable exclusion amount ($11,200,000 in 2018) is first placed in the Bypass Trust which is subject to estate tax but is offset by the applicable credit amount,[2] which is the equivalent of $11,200,000. This allows the assets in the Bypass Trust to pass free of federal estate tax to the family upon the surviving spouse's demise.

The assets in excess of the applicable exclusion amount ($11,200,000 in 2018) are placed in the Marital Trust.[3] One type of Marital Trust is the Qualified Terminable Interest Property ("QTIP") Trust. This is the most commonly used form of Marital Trust. If a QTIP election is made by the executor of the estate of the first spouse to die, then the Marital Trust is not subject to estate tax, but will be taxed in the estate of the surviving spouse.[4] This amount can then be offset by the surviving spouse's federal applicable exclusion amount ($11,200,000 in 2018).[5] If certain requirements are met, the tax treatment above can be achieved with both trusts structured for the primary benefit of the surviving spouse during his or her lifetime.

This plan will allow a married couple to pass $11,200,000 (in 2018) of assets free of federal estate tax.[6]

Often, there must be a restructuring of ownership of the married couple's assets in order to achieve these estate tax savings. In a joint estate of $22,400,000 or more (in 2018), each spouse must have at least $11,200,000 in his or her name in order to maximize the use of the $11,200,000 federal exclusion amount *(Reference: The federal estate tax exemption for 2018 will be $11,200,000 (estimated); however, the actual inflation adjusted amount has not yet been confirmed)* in the estate of the first spouse to die. Notwithstanding the above, for spouses who die in 2018, the estate of the deceased spouse can elect to have any unused applicable estate exclusion carried over to the estate of the surviving spouse (“portability”), subject to certain restrictions.[7]

20:61. Use of Bypass/Marital Trusts-- Bypass Trusts: Overview

[1]*See infra* §21:16.

[2]26 U.S.C.A. §§2010 and 2505; *see supra* §20:20;The federal estate tax exemption for 2018 will be $11,200,000 (estimated); however, the actual inflation adjusted amount has not yet been confirmed.

[3]26 U.S.C.A. §2056, *see infra* §20:62 for definition of Marital Trust; The federal estate tax exemption for 2018 will be $11,200,000 (estimated); however, the actual inflation adjusted amount has not yet been confirmed.

[4]26 U.S.C.A. §2056(b)(7); 26 U.S.C.A. §2044.

[5]*See supra* §§20:2 and 20:20; The federal estate tax exemption for 2018 will be $11,200,000 (estimated); however, the actual inflation adjusted amount has not yet been confirmed.

[6]*See supra* §§20:20 and 20:37; The federal estate tax exemption for 2018 will be $11,200,000 (estimated); however, the actual inflation adjusted amount has not yet been confirmed.

[7]*See supra* §20:2.

The purpose of a Bypass Trust[1] is to allow assets to be available to a beneficiary such as a surviving spouse, without the assets being included in his or her estate. A Bypass Trust (sometimes referred to as a "Credit Shelter Trust") can be funded while the grantor is alive through the use of a Living Trust or upon the grantor's demise under his or her last Will and Testament. This device is typically used when there is a spouse and should be considered when the estate is over the federal applicable exclusion amount ($11,200,000 in 2018).[2]

Instead of passing the federal applicable exclusion amount ($11,200,000 in 2018) *(Reference: The federal estate tax exemption for 2018 will be $11,200,000 (estimated); however, the actual inflation adjusted amount has not yet been confirmed)* outright to a beneficiary (other than a spouse), the amount is placed in a trust, typically for the benefit of a surviving spouse. This trust can be wholly discretionary or provide for mandatory distributions of income or a portion of the principal to the trust beneficiaries.

20:62. Use of Bypass/Marital Trusts-- Marital Trusts: Overview

A Marital Trust can be defined as a trust set up for the benefit of the surviving spouse, which qualifies for the marital deduction.[1] This trust can be a Living Trust or a Testamentary Trust under a Last Will and Testament. Typically, the trust will provide for the surviving spouse to have a lifetime income interest and a limited power of appointment to alter the beneficiaries to a limited class of beneficiaries, excluding the surviving spouse and his or her estate and respective creditors. Upon the demise of the surviving spouse, the trust property is distributed to settlor's children.

The gift will qualify for the marital deduction if the trust property is "Qualified Terminable Interest Property" ("QTIP"). The grantor spouse must elect to qualify such interest and certain other prerequisites must be met:[2]

1. First, the spouse must be entitled, for a period measured solely by the spouse's life, to all of the income from the entire interest, or all of the income from a specific portion thereof, payable annually or at more frequent intervals. A usufruct interest in property will also qualify. An income interest granted for a term of years, or life estates subject to termination upon remarriage or the occurrence of a specified event, will not qualify.
2. Second, there must be no power in any person (including the spouse) to appoint any part of the property to any person other than the spouse during the spouse's life.

If these tests are met, then the surviving spouse has a "qualifying income interest for life."

The trustee may be permitted to invade corpus for the benefit of the spouse, but the value of property distributed to the spouse is subject to estate tax upon the spouse's death (or gift tax if

[1]*See infra* §21:29 for a detailed discussion of Bypass Trusts and *see infra* §20:68 for an example of the use of the Bypass Trusts in the context of generation skipping.

[2]*See supra* §§20:2 and 20:20; The federal estate tax exemption for 2018 will be $11,200,000 (estimated); however, the actual inflation adjusted amount has not yet been confirmed.

[1]26 U.S.C.A. §2523.

[2]26 U.S.C.A. §§2056 and 2523; *see also* Estate of Lamude, 4/8/2002 N.Y.L.J. 31, col. 4 (Surr. Ct. Queens County).

the spouse makes an earlier disposition). The settlor can create or retain powers over all or a portion of the corpus, provided such powers are exercisable only at or after the death of a spouse.

A QTIP trust may provide that the principal of the trust can be utilized for supplemental needs of the spouse without adversely affecting government benefits.[3]

Property which the settlor elects to be treated as qualified terminable interest property will be subject to transfer taxes at the earlier of: (1) the date on which the donee spouse disposes (either by gift, sale or otherwise) of all or part of the qualifying income interest for life; or (2) upon the donee spouse's death.

20:63. Use of Bypass/Marital Trusts-- Will versus Living Trust format

There are advantages and disadvantages to using a Will versus a Living Trust. Each case must be analyzed on an individual basis.[1] There can be different tax and Medicaid consequences.

20:64. Use of Bypass/Marital Trusts-- Trusts set up by a well spouse for a dying spouse

Where a well spouse has assets in excess of the federal applicable exclusion amount ($11,200,000 in 2018)[1] and a dying spouse has no assets, the objective is to maximize the applicable exclusion of the dying spouse for estate tax purposes.

Trust Provisions. The well spouse can set up a trust for the benefit of the dying spouse which qualifies for the marital deduction under I.R.C. §2523. For example, the trust could be funded with the assets in excess of the federal applicable exclusion amount ($11,200,000 in 2018).[2] The dying spouse will be given a lifetime income interest and a limited power of appointment to alter the beneficiaries to a limited class of beneficiaries excluding the dying spouse and his or her estate and respective creditors. Upon the demise of the dying spouse, the trust property is distributed to Settlor's children.

Marital Deduction. The gift will qualify for the marital deduction if the property is "Qualified terminable interest property" ("QTIP").

The grantor spouse must elect to qualify such interest and certain other prerequisites must be met.[3]

[3]*See* T.A.M. 199932001.

[1]*See infra* Living Trusts Ch 21 and Wills, Waivers and Renunciations Ch 22.

[1]*See supra* §20:20 for an explanation of the credits against federal gift and estate taxes and *infra* §20:77 for a schedule of Federal and N.Y.S. Gift and Estate Applicable Exclusion Amounts. *See also supra* §20:2 for 2010 federal estate tax repeal and carryover basis rules; The federal estate tax exemption for 2018 will be $11,200,000 (estimated); however, the actual inflation adjusted amount has not yet been confirmed.

[2]*See supra* §20:20 for an explanation of the credits against federal gift and estate taxes and *infra* §20:77 for a schedule of Federal and N.Y.S. Gift and Estate Applicable Exclusion Amounts. *See also supra* §20:2 for federal estate tax changes for years 2010 through 2018; The federal estate tax exemption for 2018 will be $11,200,000 (estimated); however, the actual inflation adjusted amount has not yet been confirmed.

[3]*See supra* §20:62.

The trustee may be permitted to invade corpus for the benefit of the spouse, but depending on the scope of the trustee's discretion, there may be adverse Medicaid consequences.

For decedent's dying in 2011 and thereafter, for example, if both spouses die in 2015, then the estate of the first spouse can elect to have the unused applicable exclusion amount carried over to the estate of the second spouse to die.[4]

20:65. Planning for the wealthy senior

It is critical for seniors with taxable estates to consider estate tax planning to minimize estate taxes. In addition to the use of Bypass/Marital Trusts,[1] there are a number of other planning techniques available. This chapter briefly highlights a few of the more popular ones. In addition to those mentioned, the use of family limited partnerships, private annuities and self-cancelling installment notes are also available as planning techniques to reduce estate taxes.

20:66. Planning for the wealthy senior-- Use of Grantor Retained Trusts

The senior can reduce his/her estate subject to tax by leveraged gifts to a particular type of Living Irrevocable Trust (referred to as a "Grantor Retained Trust"). There are several types of Grantor Retained Trusts available under Chapter 14 of the Internal Revenue Code, including the Grantor Retained Annuity Trust ("GRAT"), the Grantor Retained Unitrust ("GRUT"), the Personal Residence Trust ("PRT") and the Qualified Personal Residence Trust ("QPRT").[1]

GRATs and GRUTs. A Grantor Retained Annuity Trust ("GRAT") is an Irrevocable Trust in which the grantor retains the right to receive a fixed return on an annual basis for a fixed period of time (the "term").[2] Certain requirements must be met in order to reduce the value of the transfer by the value of the remainder interest for gift tax purposes.[3]

For example, the grantor can retain the right to receive a 5% annual return on the value of the trust for a ten-year term. Upon the expiration of the term, the grantor would no longer have an interest in the trust. At that point, the trust assets would not be includable in the grantor's estate because he would no longer retain an interest in the trust.[4]

The gift would be discounted because of the senior's term interest in the trust. The assets in the trust would be includable in the senior's estate if the senior does not outlive the fixed term (i.e., 10 years).[5] The trust can provide for a payout of the remaining term which may result in less than the full value of the trust being included in the estate. The amount included is the amount of GRAT principal that is needed to obtain the annuity payment that has been made on

[4]*See supra* §20:2. 26 U.S.C.A. §2010(c)(5)(A). *See* http://www.irs.gov/pub/irs-drop/n-2011-82.pdf.

[1]*See supra* §20:60.

[1]*See infra* §21:9.

[2]26 U.S.C.A. §2702(b).

[3]26 C.F.R. §25.2702-3.

[4]26 C.F.R. §25.2702-3.

[5]26 U.S.C.A. §7520.

the date of the settlor's death, using the §7520 rate that is in effect on the date of settlor's death.[6]

If a senior (age 72) funds the trust with $1,570,192 in liquid income producing assets and the term is eight years with a 5% annual return and a §7520 rate[7] of 2.20%, then the value of the assets contributed to the trust for gift tax purposes is $1 million.[8] If the senior survives the term, $400,000 in federal and New York State estate taxes would be saved by the establishment of the GRAT. The estate tax savings calculation assumes the current top estate tax rates and the state death tax deduction. The tax savings may be even greater if a combination of trust income and the trust asset appreciation exceeds a rate of 2.2% per annum.[9]

The tax benefits of a Grantor Retained Unitrust ("GRUT") are similar to those of a GRAT.[10] The trusts differ in that the GRUT must provide the grantor with a fixed annual (or more frequent) payment based upon a fixed percentage of the fair market value of the trust, valued annually.[11] The amount paid will, therefore, vary depending on the value of the trust assets. Whereas the GRAT pays a fixed return, without regard to the actual performance of the trust investments, the GRUT is market sensitive and varies the payment to the grantor according to the value of the trust assets. The GRUT will set a fixed percentage of value that is paid each year, and this fixed percentage is generally based upon the anticipated income of the trust. The GRUT provides a little more flexibility than the GRAT, in that payments to the grantor will increase or decrease as the value of the trust assets increase or decrease. Because this is a Grantor Retained Trust, a value is placed on the income retention provisions, which is then used to reduce the value of the gift created by funding the trust. The value is computed in the same way the value is computed for the annuity trust.

In the GRUT (similar to the GRAT), the trustee must make payments to the grantor for a defined period of time. If the grantor outlives the defined period, the assets in the trust will not be considered part of his or her estate for tax purposes. If the grantor does not survive the defined period established by the trust, the assets remain part of his or her estate subject to estate taxes. The tax results may vary depending on the trust provisions.

Once again, the maximum gift tax reduction is obtained by a combination of a higher percentage of payout to the grantor and a longer defined period. Obtaining the maximum gift tax reduction must be balanced against the actual earnings and value of the trust and the life expectancy of the grantor. Establishing the appropriate defined benefit period includes a degree of guess work. In order to keep the assets out of the grantor's estate, most elder law attorneys will

[6]I.R.B. 2007-28, REG-119097-05.

[7]The federal mid-term rate is calculated on a monthly basis. The §7520 rate is 120% of the applicable federal mid-term rate; 26 U.S.C.A. §§7520 and 1274(d)(1).

[8]Note: the applicable exclusion amount for federal gift tax purposes is $11,200,000 (estimated) for 2018; however, the actual inflation adjusted amount has not yet been confirmed . *See supra* §20:20.

[9]*See infra* §20:70 for a GRAT Worksheet.

[10]*See supra* §20:66.

[11]26 U.S.C.A. §2702(b)(2).

lean toward a shorter rather than a longer defined benefit period. However, the shorter the period, the lower the gift tax reduction, and the lower the savings to the grantor and his estate. As with all Grantor Retained Trusts, a balance must be achieved to maximize the federal gift and estate tax benefits. For example, a five-year term is likely more appropriate than a 10-year term for an individual aged seventy (70).

When estate tax planning involves the senior's residence, counsel must consult Chapter 14 of the I.R.C. which provides for the PRT and QPRT, discussed below. The QPRT tends to be more flexible because the trustee can sell the residence and convert the Trust to a GRAT.

QPRT. A Qualified Personal Residence Trust ("QPRT") is an Irrevocable trust which allows a senior to place his/her residence in trust for his/her use during a fixed period of time (the "term").[12] Certain requirements must be met in order to reduce the value of the transfer for gift tax purposes. For example, the residence must be held for the grantor's primary use and is not to be occupied by any other person (other than a spouse or a dependent), and the residence is to be available at all times for the grantor's use.[13]

The value of the gift (i.e., the residence) is reduced by the value of the grantor's term interest for gift tax purposes. If the grantor lives through the end of the term, an additional savings is achieved because the residence will not be considered part of the grantor's estate.[14] If the grantor fails to survive the term, the residence may be included in his or her estate. This necessitates a balancing when selecting an appropriate term. When the QPRT has a longer term, the value of the gift to the QPRT will be smaller. The smaller gift results in a greater reduction of the gift tax. However, the length of the term must be balanced against the grantor's life expectancy, because unless he or she outlives the term, there may be no estate tax savings.

If the trust is properly structured as a Grantor Trust, the residence can qualify for the $250,000 exclusion of capital gain (assuming the grantor satisfies the requirements under I.R.C. §121 and the trust is a grantor type trust as to income and principal).

Charitable Remainder Trust (CRT). This type of trust, as defined in I.R.C. §664, is designed for the individual who is interested in supporting a charity and who has significant income tax liability or highly appreciated assets. The trust must provide for the distribution of a specified payment, at least annually, to one or more persons (at least one of which is a non-charitable beneficiary).

The payment period must be for the life or lives of the individual beneficiaries (all of whom must be living at the time the Trust is created) or for a term of years, not in excess of 20 years.

Upon the termination of the non-charitable interest or interests, the remainder must either be held in continuing trust for charitable purposes or be paid to or for the use of one or more organizations described in I.R.C. §170(c).

[12]*See* 26 C.F.R. §25.2702-5(c). For an example of the gift and estate tax consequences of a Qualified Personal Residence Trust, *see* §20:71 for a QPRT worksheet.

[13]*See* 26 C.F.R. §25.2702-5(c). For an example of the gift and estate tax consequences of a Qualified Personal Residence Trust, *see* §20:71 for a QPRT worksheet.

[14]*See* 26 C.F.R. §25.2702-5(c). For an example of the gift and estate tax consequences of a Qualified Personal Residence Trust, *see* §20:71 for a QPRT worksheet.

A qualified Charitable Remainder Trust is exempt from income tax, and the grantor is entitled to a charitable, income, gift, and/or estate tax deduction based on the present value of the remainder interest ultimately passing to charity. The present value is calculated at the time of funding the trust.

There are two types of Charitable Remainder Trusts:

1. a Charitable Remainder Annuity Trust; and
2. a Charitable Remainder Unitrust.

In order to qualify as a Charitable Remainder Trust, certain requirements must be met.[15]

20:67. Planning for the wealthy senior-- Irrevocable Life Insurance Trusts

A senior can remove the proceeds of life insurance policies from his or her estate through the transfers of the insurance policies to an Irrevocable Life Insurance Trust ("ILIT"). In order to achieve the tax benefit of this trust, certain requirements must be met. This planning tool is very useful when the senior owns a significant amount of insurance or when the senior is interested in purchasing insurance to fund the payment of the estate tax.[1]

If the senior's estate is subject to tax and/or the senior is seeking to have liquidity in his or her estate, an Irrevocable Trust funded with insurance may be established to avoid the problems associated with an illiquid estate (e.g., desperation sales of real property or other types of property which are not readily marketable, such as business assets), provide for asset management, and exempt life insurance proceeds from federal estate taxation so that the insurance proceeds would be available for the benefit of the senior's spouse and children. This type of trust can play an important part in the senior's estate plan to achieve the maximum benefits available.

The trustee can purchase the policy from an insurance company or the senior can contribute an existing policy to the trust. An alternative to an Irrevocable Life Insurance Trust is for the senior to irrevocably transfer the ownership of the policy to a third party such as the senior's children.

If the policy is transferred into the trust or to the senior's children outright, then after the passage of three years the insurance would not be includable in the senior's estate.[2] However, depending upon the cash value of the policy, there may be gift tax consequences.

The use of *Crummey* powers will permit gifts to the trust to qualify for the $15,000 annual exclusion in 2018.[3] The planner must carefully review use of *Crummey* powers in the context of gift and estate taxes.[4]

[15]A Charitable Remainder Trust must meet all of the requirements set forth in 26 U.S.C.A. §664, and the requirements in Rev. Rul. 72-395, 1972-2 C.B. 340; as modified by Rev. Rul. 80-123, 1980-1 C.B. 205; Rev. Rul. 82-128, 1982-2 C.B. 71; and Rev. Rul. 88-81, 1988-2 C.B. 127.

[1]*See infra* §21:31.

[2]26 U.S.C.A. §2035(d)(2).

[3]*See supra* §20:54.

[4]*See supra* §20:23.

20:68. Planning for the wealthy senior-- Generation skipping

The federal generation-skipping transfer tax ("GSTT") is a tax imposed on three types of transfers:[1] taxable terminations, taxable distributions and direct skips. The GSTT is a separate tax imposed along with the gift or estate tax ordinarily due upon a transfer. It is applied at a flat rate (not a graduated rate) equal to the highest federal estate tax rate applicable at the time of the transfer.[2] The highest federal estate tax rate is 40% in 2017.[3] So any generation-skipping transfer will incur a GSTT at 40% (in 2017) of its value in addition to the ordinary gift or estate tax due.

Exemptions. A direct skip outright transfer which is exempt for federal gift tax because it falls within the $15,000 annual exclusion is also exempt from the GSTT.[4] However, a transfer in trust which qualifies for the annual gift tax exclusion will not necessarily qualify for the GST exemption, unless the trust was set up for the sole benefit of the grandchild and the trust proceeds will be includable in the grandchild's estate if the grandchild predeceases the settlor.[5] In addition, a transfer which is exempt from federal gift tax because it falls within the tuition or medical exclusion is also exempt from the GSTT.[6]

Furthermore, in 2018 every transferor has a $11,200,000 lifetime exemption,[7] (the "generation-skipping tax exemption" or "GST tax exemption").

One technique to minimize tax liability is to use generation-skipping Trusts funded with up to $11,200,000 (in 2018) *(Reference: The federal estate tax exemption for 2018 will be $11,200,000 (estimated); however, the actual inflation adjusted amount has not yet been confirmed)* which will allow the senior to pass estate assets to grandchildren, and hence, avoid estate taxation upon the death of the children. This technique can be used either during lifetime or at death.

Application of GST Tax. The GSTT applies to any transfer to a "Skip Person."[8] A Skip Person is defined as: a person who is two or more generations removed from the transferor or as a trust in which all of the interests are held by Skip Persons or in which no person holds an

[1]26 U.S.C.A. §§2601 to 2663.

[2]26 U.S.C.A. §§2602 and 2641.

[3]26 U.S.C.A. §2001(c).

[4]26 U.S.C.A. §2642(c).

[5]26 U.S.C.A. §2642(c)(2).

[6]26 U.S.C.A. §2611(b).

[7]26 U.S.C.A. §2631(a); Rev. Proc. 2002-70, 2002-46 I.R.B. 845; The federal estate tax exemption for 2018 will be $11,200,000 (estimated); however, the actual inflation adjusted amount has not yet been confirmed.

[8]26 U.S.C.A. §§2601 et seq.

interest but at no time can any distribution be made other than to a Skip Person.[9]

Types of Generation-Skipping Transfers. A Generation-Skipping Transfer can take any of three forms:

1. a Direct Skip;
2. a Taxable Distribution; or
3. a Taxable Termination.

A "Direct Skip" occurs upon an outright transfer for the benefit of a person at least two generations below the transferor or a transfer to a trust for one or more such beneficiaries (i.e., a "Skip Person").[10]

A "Taxable Distribution" is any distribution from a trust to a Skip Person which is other than a taxable termination or a direct skip.[11]

A "Taxable Termination" occurs upon the expiration of an interest in a trust if the transfer is not subject to federal gift or estate tax and if, after the termination, all interests in the property are held by Skip Persons and no subsequent distribution from the trust can be made to a Skip Person.[12]

The generation-skipping transfer tax rules are quite complex, and great care must be used in implementing any plan which includes generation skipping.

[9] 26 U.S.C.A. §2613.

[10] 26 U.S.C.A. §2612(c).

[11] 26 U.S.C.A. §2612(b).

[12] 26 U.S.C.A. §2612(a).

III. List of Internal Revenue Code Sections (Excerpts)

Medical Expense Deduction

Reg. Section 1.213-1(e)(1)(v) Medical, dental, etc., expenses.

(v) The cost of in-patient hospital care (including the cost of meals and lodging therein) is an expenditure for medical care. The extent to which expenses for care in an institution other than a hospital shall constitute medical care is primarily a question of fact which depends upon the condition of the individual and the nature of the services he receives (rather than the nature of the institution). A private establishment which is regularly engaged in providing the types of care or services outlined in this subdivision shall be considered an institution for purposes of the rules provided herein. In general, the following rules will be applied:

(a) Where an individual is in an institution because his condition is such that the availability of medical care (as defined in subdivisions (i) and (ii) of this subparagraph) in such institution is a principal reason for his presence there, and meals and lodging are furnished as a necessary incident to such care, the entire cost of medical care and meals and lodging at the institution, which are furnished while the individual requires continual medical care, shall constitute an expense for medical care. For example, medical care includes the entire cost of institutional care for a person who is mentally ill and unsafe when left alone. While ordinary education is not medical care, the cost of medical care includes the cost of attending a special school for a mentally or physically handicapped individual, if his condition is such that the resources of the institution for alleviating such mental or physical handicap are a principal reason for his presence there. In such a case, the cost of attending such a special school will include the cost of meals and lodging, if supplied, and the cost of ordinary education furnished which is incidental to the special services furnished by the school. Thus, the cost of medical care includes the cost of attending a special school designed to compensate for or overcome a physical handicap, in order to qualify the individual for future normal education or for normal living, such as a school for the teaching of braille or lip reading. Similarly, the cost of care and supervision, or of treatment and training, of a mentally retarded or physically handicapped individual at an institution is within the meaning of the term "medical care".

(b) Where an individual is in an institution, and his condition is such that the availability of medical care in such institution is not a principal reason for his presence there, only that part of the cost of care in the institution as is attributable to medical care (as defined in subdivisions (i) and (ii) of this subparagraph) shall be considered as a cost of medical care; meals and lodging at the institution in such a case are not considered a cost of medical care for purposes of this section. For example, an individual is in a home for the aged for personal or family considerations and not because he requires medical or nursing attention. In such case, medical care consists only of that part of the cost for care in the home which is attributable to medical care or nursing attention furnished to him; his meals and lodging at the home are not considered a cost of medical care.

(c) It is immaterial for purposes of this subdivision whether the medical care is furnished in a Federal or State institution or in a private institution.

Grantor Trust Rules
§671 - §678

26 U.S. Code § 671 - Trust income, deductions, and credits attributable to grantors and others as substantial owners

Where it is specified in this subpart that the grantor or another person shall be treated as the owner of any portion of a trust, there shall then be included in computing the taxable income and credits of the grantor or the other person those items of income, deductions, and credits against tax of the trust which are attributable to that portion of the trust to the extent that such items would be taken into account under this chapter in computing taxable income or credits against the tax of an individual. Any remaining portion of the trust shall be subject to subparts A through D. No items of a trust shall be included in computing the taxable income and credits of the grantor or of any other person solely on the grounds of his dominion and control over the trust under section 61 (relating to definition of gross income) or any other provision of this title, except as specified in this subpart.

26 U.S. Code § 672 - Definitions and rules

(a) Adverse party

For purposes of this subpart, the term “adverse party” means any person having a substantial beneficial interest in the trust which would be adversely affected by the exercise or nonexercise of the power which he possesses respecting the trust. A person having a general power of appointment over the trust property shall be deemed to have a beneficial interest in the trust.

(b) Nonadverse party

For purposes of this subpart, the term “nonadverse party” means any person who is not an adverse party.

(c) Related or subordinate party

For purposes of this subpart, the term “related or subordinate party” means any nonadverse party who is—

> **(1)** the grantor’s spouse if living with the grantor;
>
> **(2)** any one of the following: The grantor’s father, mother, issue, brother or sister; an employee of the grantor; a corporation or any employee of a corporation in which the stock holdings of the grantor and the trust are significant from the viewpoint of voting control; a subordinate employee of a corporation in which the grantor is an executive.

For purposes of subsection (f) and sections 674 and 675, a related or subordinate party shall be presumed to be subservient to the grantor in respect of the exercise or nonexercise of the powers conferred on him unless such party is shown not to be subservient by a preponderance of the evidence.

(d) Rule where power is subject to condition precedent

A person shall be considered to have a power described in this subpart even though the exercise of the power is subject to a precedent giving of notice or takes effect only on the expiration of a certain period after the exercise of the power.

(e) Grantor treated as holding any power or interest of grantor’s spouse

> **(1) In general**
>
> For purposes of this subpart, a grantor shall be treated as holding any power or interest held by—
>
> > **(A)** any individual who was the spouse of the grantor at the time of the creation of such power or interest, or
> >
> > **(B)** any individual who became the spouse of the grantor after the creation of such power or interest, but only with respect to periods after such individual became the spouse of the grantor.
>
> **(2) Marital status**
>
> For purposes of paragraph (1)(A), an individual legally separated from his spouse under a decree of divorce or of separate maintenance shall not be considered as married.

(f) Subpart not to result in foreign ownership

(1) In general

Notwithstanding any other provision of this subpart, this subpart shall apply only to the extent such application results in an amount (if any) being currently taken into account (directly or through 1 or more entities) under this chapter in computing the income of a citizen or resident of the United States or a domestic corporation.

(2) Exceptions

(A) Certain revocable and irrevocable trusts

Paragraph (1) shall not apply to any portion of a trust if—

(i) the power to revest absolutely in the grantor title to the trust property to which such portion is attributable is exercisable solely by the grantor without the approval or consent of any other person or with the consent of a related or subordinate party who is subservient to the grantor, or

(ii) the only amounts distributable from such portion (whether income or corpus) during the lifetime of the grantor are amounts distributable to the grantor or the spouse of the grantor.

(B) Compensatory trusts

Except as provided in regulations, paragraph (1) shall not apply to any portion of a trust distributions from which are taxable as compensation for services rendered.

(3) Special rules

Except as otherwise provided in regulations prescribed by the Secretary—

(A) a controlled foreign corporation (as defined in section 957) shall be treated as a domestic corporation for purposes of paragraph (1), and

(B) paragraph (1) shall not apply for purposes of applying section 1297.

(4) Recharacterization of purported gifts

In the case of any transfer directly or indirectly from a partnership or foreign corporation which the transferee treats as a gift or bequest, the Secretary may recharacterize such transfer in such circumstances as the Secretary determines to be appropriate to prevent the avoidance of the purposes of this subsection.

(5) Special rule where grantor is foreign person

If—

(A) but for this subsection, a foreign person would be treated as the owner of any portion of a trust, and

(B) such trust has a beneficiary who is a United States person,

such beneficiary shall be treated as the grantor of such portion to the extent such beneficiary has made (directly or indirectly) transfers of property (other than in a sale for full and adequate consideration) to such foreign person. For purposes of the preceding sentence, any gift shall not be taken into account to the extent such gift would be excluded from taxable gifts under section 2503 (b).

(6) Regulations

The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of this subsection, including regulations providing that paragraph (1) shall not apply in appropriate cases.

26 U.S. Code § 673 - Reversionary interests

(a) General rule

The grantor shall be treated as the owner of any portion of a trust in which he has a reversionary interest in either the corpus or the income therefrom, if, as of the inception of that portion of the trust, the value of such interest exceeds 5 percent of the value of such portion.

(b) Reversionary interest taking effect at death of minor lineal descendant beneficiary

In the case of any beneficiary who—

(1) is a lineal descendant of the grantor, and

(2) holds all of the present interests in any portion of a trust,

the grantor shall not be treated under subsection (a) as the owner of such portion solely by reason of a reversionary interest in such portion which takes effect upon the death of such beneficiary before such beneficiary attains age 21.

(c) Special rule for determining value of reversionary interest

For purposes of subsection (a), the value of the grantor's reversionary interest shall be determined by assuming the maximum exercise of discretion in favor of the grantor.

(d) Postponement of date specified for reacquisition

Any postponement of the date specified for the reacquisition of possession or enjoyment of the reversionary interest shall be treated as a new transfer in trust commencing with the date on which the postponement is effective and terminating with the date prescribed by the postponement. However, income for any period shall not be included in the income of the grantor by reason of the preceding sentence if such income would not be so includible in the absence of such postponement.

26 U.S. Code § 674 - Power to control beneficial enjoyment

(a) General rule

The grantor shall be treated as the owner of any portion of a trust in respect of which the beneficial enjoyment of the corpus or the income therefrom is subject to a power of disposition, exercisable by the grantor or a nonadverse party, or both, without the approval or consent of any adverse party.

(b) Exceptions for certain powers

Subsection (a) shall not apply to the following powers regardless of by whom held:

> **(1) Power to apply income to support of a dependent**
>
> A power described in section 677 (b) to the extent that the grantor would not be subject to tax under that section.
>
> **(2) Power affecting beneficial enjoyment only after occurrence of event**
>
> A power, the exercise of which can only affect the beneficial enjoyment of the income for a period commencing after the occurrence of an event such that a grantor would not be treated as the owner under section 673 if the power were a reversionary interest; but the grantor may be treated as the owner after the occurrence of the event unless the power is relinquished.
>
> **(3) Power exercisable only by will**
>
> A power exercisable only by will, other than a power in the grantor to appoint by will the income of the trust where the income is accumulated for such disposition by the grantor or may be so accumulated in the discretion of the grantor or a nonadverse party, or both, without the approval or consent of any adverse party.
>
> **(4) Power to allocate among charitable beneficiaries**
>
> A power to determine the beneficial enjoyment of the corpus or the income therefrom if the corpus or income is irrevocably payable for a purpose specified in

section 170 (c) (relating to definition of charitable contributions) or to an employee stock ownership plan (as defined in section 4975 (e)(7)) in a qualified gratuitous transfer (as defined in section 664 (g)(1)).

(5) Power to distribute corpus

A power to distribute corpus either—

> **(A)** to or for a beneficiary or beneficiaries or to or for a class of beneficiaries (whether or not income beneficiaries) provided that the power is limited by a reasonably definite standard which is set forth in the trust instrument; or
>
> **(B)** to or for any current income beneficiary, provided that the distribution of corpus must be chargeable against the proportionate share of corpus held in trust for the payment of income to the beneficiary as if the corpus constituted a separate trust.

A power does not fall within the powers described in this paragraph if any person has a power to add to the beneficiary or beneficiaries or to a class of beneficiaries designated to receive the income or corpus, except where such action is to provide for after-born or after-adopted children.

(6) Power to withhold income temporarily

A power to distribute or apply income to or for any current income beneficiary or to accumulate the income for him, provided that any accumulated income must ultimately be payable—

> **(A)** to the beneficiary from whom distribution or application is withheld, to his estate, or to his appointees (or persons named as alternate takers in default of appointment) provided that such beneficiary possesses a power of appointment which does not exclude from the class of possible appointees any person other than the beneficiary, his estate, his creditors, or the creditors of his estate, or
>
> **(B)** on termination of the trust, or in conjunction with a distribution of corpus which is augmented by such accumulated income, to the current income beneficiaries in shares which have been irrevocably specified in the trust instrument.

Accumulated income shall be considered so payable although it is provided that if any beneficiary does not survive a date of distribution which could reasonably have been expected to occur within the beneficiary's lifetime, the share of the deceased beneficiary is to be paid to his appointees or to one or more designated alternate takers (other than the grantor or the grantor's estate) whose shares have been irrevocably specified. A power does not fall within the powers described in this paragraph if any person has a power to add to the beneficiary or beneficiaries or to a class of beneficiaries designated to receive the income or corpus except where such action is to provide for after-born or after-adopted children.

(7) Power to withhold income during disability of a beneficiary

A power exercisable only during—

(A) the existence of a legal disability of any current income beneficiary, or

(B) the period during which any income beneficiary shall be under the age of 21 years,

to distribute or apply income to or for such beneficiary or to accumulate and add the income to corpus. A power does not fall within the powers described in this paragraph if any person has a power to add to the beneficiary or beneficiaries or to a class of beneficiaries designated to receive the income or corpus, except where such action is to provide for after-born or after-adopted children.

(8) Power to allocate between corpus and income

A power to allocate receipts and disbursements as between corpus and income, even though expressed in broad language.

(c) Exception for certain powers of independent trustees

Subsection (a) shall not apply to a power solely exercisable (without the approval or consent of any other person) by a trustee or trustees, none of whom is the grantor, and no more than half of whom are related or subordinate parties who are subservient to the wishes of the grantor—

(1) to distribute, apportion, or accumulate income to or for a beneficiary or beneficiaries, or to, for, or within a class of beneficiaries; or

(2) to pay out corpus to or for a beneficiary or beneficiaries or to or for a class of beneficiaries (whether or not income beneficiaries).

A power does not fall within the powers described in this subsection if any person has a power to add to the beneficiary or beneficiaries or to a class of beneficiaries designated to receive the income or corpus, except where such action is to provide for after-born or after-adopted children. For periods during which an individual is the spouse of the grantor (within the meaning of section 672 (e)(2)), any reference in this subsection to the grantor shall be treated as including a reference to such individual.

(d) Power to allocate income if limited by a standard

Subsection (a) shall not apply to a power solely exercisable (without the approval or consent of any other person) by a trustee or trustees, none of whom is the grantor or spouse living with the grantor, to distribute, apportion, or accumulate income to or for a beneficiary or beneficiaries, or to, for, or within a class of beneficiaries, whether or not the conditions of paragraph (6) or (7) of subsection (b) are satisfied, if such power is limited by a reasonably definite external standard which is set forth in the trust instrument. A power does not fall within the powers described in this subsection if any person has a power to add to the beneficiary or beneficiaries or to a class of beneficiaries designated to receive the income or corpus except where such action is to provide for after-born or after-adopted children.

26 U.S. Code § 675 - Administrative powers

The grantor shall be treated as the owner of any portion of a trust in respect of which—

(1) Power to deal for less than adequate and full consideration

A power exercisable by the grantor or a nonadverse party, or both, without the approval or consent of any adverse party enables the grantor or any person to purchase, exchange, or otherwise deal with or dispose of the corpus or the income therefrom for less than an adequate consideration in money or money's worth.

(2) Power to borrow without adequate interest or security

A power exercisable by the grantor or a nonadverse party, or both, enables the grantor to borrow the corpus or income, directly or indirectly, without adequate interest or without adequate security except where a trustee (other than the grantor) is authorized under a general lending power to make loans to any person without regard to interest or security.

(3) Borrowing of the trust funds

The grantor has directly or indirectly borrowed the corpus or income and has not completely repaid the loan, including any interest, before the beginning of the taxable year. The preceding sentence shall not apply to a loan which provides for adequate interest and adequate security, if such loan is made by a trustee other than the grantor and other than a related or subordinate trustee subservient to the grantor. For periods during which an individual is the spouse of the grantor (within the meaning of section 672 (e)(2)), any reference in this paragraph to the grantor shall be treated as including a reference to such individual.

(4) General powers of administration

A power of administration is exercisable in a nonfiduciary capacity by any person without the approval or consent of any person in a fiduciary capacity. For purposes of this paragraph, the term "power of administration" means any one or more of the following powers:

(A) a power to vote or direct the voting of stock or other securities of a corporation in which the holdings of the grantor and the trust are significant from the viewpoint of voting control;

(B) a power to control the investment of the trust funds either by directing investments or reinvestments, or by vetoing proposed investments or reinvestments, to the extent that the trust funds consist of stocks or securities of corporations in which the holdings of the grantor and the trust are significant from the viewpoint of voting control; or

(C) a power to reacquire the trust corpus by substituting other property of an equivalent value.

26 U.S. Code § 676 - Power to revoke

(a) General rule

The grantor shall be treated as the owner of any portion of a trust, whether or not he is treated as such owner under any other provision of this part, where at any time the power to revest in the grantor title to such portion is exercisable by the grantor or a non-adverse party, or both.

(b) Power affecting beneficial enjoyment only after occurrence of event

Subsection (a) shall not apply to a power the exercise of which can only affect the beneficial enjoyment of the income for a period commencing after the occurrence of an event such that a grantor would not be treated as the owner under section 673 if the power were a reversionary interest. But the grantor may be treated as the owner after the occurrence of such event unless the power is relinquished.

26 U.S. Code § 677 - Income for benefit of grantor

(a) General rule

The grantor shall be treated as the owner of any portion of a trust, whether or not he is treated as such owner under section 674, whose income without the approval or consent of any adverse party is, or, in the discretion of the grantor or a nonadverse party, or both, may be—

(1) distributed to the grantor or the grantor's spouse;

(2) held or accumulated for future distribution to the grantor or the grantor's spouse; or

(3) applied to the payment of premiums on policies of insurance on the life of the grantor or the grantor's spouse (except policies of insurance irrevocably payable for a purpose specified in section 170 (c) (relating to definition of charitable contributions)).

This subsection shall not apply to a power the exercise of which can only affect the beneficial enjoyment of the income for a period commencing after the occurrence of an event such that the grantor would not be treated as the owner under section 673 if the power were a reversionary interest; but the grantor may be treated as the owner after the occurrence of the event unless the power is relinquished.

(b) Obligations of support

Income of a trust shall not be considered taxable to the grantor under subsection (a) or any other provision of this chapter merely because such income in the discretion of another person, the trustee, or the grantor acting as trustee or co-trustee, may be applied or distributed for the support or maintenance of a beneficiary (other than the grantor's spouse) whom the grantor is legally obligated to support or maintain, except to the extent that such income is so applied or distributed. In cases where the amounts so applied or distributed are paid out of corpus or out of other than income for the taxable year, such amounts shall be considered to be an amount paid or credited within the meaning of paragraph (2) of section 661 (a) and shall be taxed to the grantor under section 662.

26 U.S. Code § 678 - Person other than grantor treated as substantial owner

(a) General rule

A person other than the grantor shall be treated as the owner of any portion of a trust with respect to which:

> **(1)** such person has a power exercisable solely by himself to vest the corpus or the income therefrom in himself, or
>
> **(2)** such person has previously partially released or otherwise modified such a power and after the release or modification retains such control as would, within the principles of sections 671 to 677, inclusive, subject to grantor of a trust to treatment as the owner thereof.

(b) Exception where grantor is taxable

Subsection (a) shall not apply with respect to a power over income, as originally granted or thereafter modified, if the grantor of the trust or a transferor (to whom section 679 applies) is otherwise treated as the owner under the provisions of this subpart other than this section.

(c) Obligations of support

Subsection (a) shall not apply to a power which enables such person, in the capacity of trustee or co-trustee, merely to apply the income of the trust to the support or maintenance of a person whom the holder of the power is obligated to support or maintain except to the extent that such income is so applied. In cases where the amounts so applied or distributed are paid out of corpus or out of other than income of the taxable year, such amounts shall be considered to be an amount paid or credited within the meaning of paragraph (2) of section 661 (a)and shall be taxed to the holder of the power under section 662.

(d) Effect of renunciation or disclaimer

Subsection (a) shall not apply with respect to a power which has been renounced or disclaimed within a reasonable time after the holder of the power first became aware of its existence.

(e) Cross reference

For provision under which beneficiary of trust is treated as owner of the portion of the trust which consists of stock in an S corporation, see section 1361 (d).

Subchapter S

§ 1361

26 U.S. Code § 1361 - S corporation defined

(a) S corporation defined

(1) In general

For purposes of this title, the term “S corporation” means, with respect to any taxable year, a small business corporation for which an election under section 1362 (a) is in effect for such year.

(2) C corporation

For purposes of this title, the term “C corporation” means, with respect to any taxable year, a corporation which is not an S corporation for such year.

(b) Small business corporation

(1) In general

For purposes of this subchapter, the term “small business corporation” means a domestic corporation which is not an ineligible corporation and which does not—

(A) have more than 100 shareholders,

(B) have as a shareholder a person (other than an estate, a trust described in subsection (c)(2), or an organization described in subsection (c)(6)) who is not an individual,

(C) have a nonresident alien as a shareholder, and

(D) have more than 1 class of stock.

(2) Ineligible corporation defined

For purposes of paragraph (1), the term "ineligible corporation" means any corporation which is—

(A) a financial institution which uses the reserve method of accounting for bad debts described in section 585,

(B) an insurance company subject to tax under subchapter L,

(C) a corporation to which an election under section 936 applies, or

(D) a DISC or former DISC.

(3) Treatment of certain wholly owned subsidiaries

(A) In general

Except as provided in regulations prescribed by the Secretary, for purposes of this title—

(i) a corporation which is a qualified subchapter S subsidiary shall not be treated as a separate corporation, and

(ii) all assets, liabilities, and items of income, deduction, and credit of a qualified subchapter S subsidiary shall be treated as assets, liabilities, and such items (as the case may be) of the S corporation.

(B) Qualified subchapter S subsidiary

For purposes of this paragraph, the term "qualified subchapter S subsidiary" means any domestic corporation which is not an ineligible corporation (as defined in paragraph (2)), if—

(i) 100 percent of the stock of such corporation is held by the S corporation, and

(ii) the S corporation elects to treat such corporation as a qualified subchapter S subsidiary.

(C) Treatment of terminations of qualified subchapter S subsidiary status

(i) In general For purposes of this title, if any corporation which was a qualified subchapter S subsidiary ceases to meet the requirements of subparagraph (B), such corporation shall be treated as a new corporation acquiring all of its assets (and assuming all of its liabilities) immediately before such cessation from the S corporation in exchange for its stock.

(ii) Termination by reason of sale of stock If the failure to meet the requirements of subparagraph (B) is by reason of the sale of stock of a corporation which is a qualified subchapter S subsidiary, the sale of such stock shall be treated as if—

(I) the sale were a sale of an undivided interest in the assets of such corporation (based on the percentage of the corporation's stock sold), and

(II) the sale were followed by an acquisition by such corporation of all of its assets (and the assumption by such corporation of all of its liabilities) in a transaction to which section 351 applies.

(D) Election after termination

If a corporation's status as a qualified subchapter S subsidiary terminates, such corporation (and any successor corporation) shall not be eligible to make—

(i) an election under subparagraph (B)(ii) to be treated as a qualified subchapter S subsidiary, or

(ii) an election under section 1362 (a) to be treated as an S corporation, before its 5th taxable year which begins after the 1st taxable year for which such termination was effective, unless the Secretary consents to such election.

(E) Information returns

Except to the extent provided by the Secretary, this paragraph shall not apply to part III of subchapter A of chapter 61 (relating to information returns).

(c) Special rules for applying subsection (b)

(1) Members of a family treated as 1 shareholder

(A) In general

For purposes of subsection (b)(1)(A), there shall be treated as one shareholder—

(i) a husband and wife (and their estates), and

(ii) all members of a family (and their estates).

(B) Members of a family

For purposes of this paragraph—

(i) In general The term "members of a family" means a common ancestor, any lineal descendant of such common ancestor, and any spouse or former spouse of such common ancestor or any such lineal descendant.

(ii) Common ancestor An individual shall not be considered to be a common ancestor if, on the applicable date, the individual is more than 6 generations removed from the youngest generation of shareholders who would (but for this subparagraph) be members of the family. For purposes of the preceding sentence, a spouse (or former spouse) shall be treated as being of the same generation as the individual to whom such spouse is (or was) married.

(iii) Applicable date The term "applicable date" means the latest of—

(I) the date the election under section 1362 (a) is made,

(II) the earliest date that an individual described in clause (i) holds stock in the S corporation, or

(III) October 22, 2004.

(C) Effect of adoption, etc.

Any legally adopted child of an individual, any child who is lawfully placed with an individual for legal adoption by the individual, and any eligible foster child of an individual (within the meaning of section 152 (f)(1)(C)), shall be treated as a child of such individual by blood.

(2) Certain trusts permitted as shareholders

(A) In general

For purposes of subsection (b)(1)(B), the following trusts may be shareholders:

(i) A trust all of which is treated (under subpart E of part I of subchapter J of this chapter) as owned by an individual who is a citizen or resident of the United States.

(ii) A trust which was described in clause (i) immediately before the death of the deemed owner and which continues in existence after such death, but only for the 2-year period beginning on the day of the deemed owner's death.

(iii) A trust with respect to stock transferred to it pursuant to the terms of a will, but only for the 2-year period beginning on the day on which such stock is transferred to it.

(iv) A trust created primarily to exercise the voting power of stock transferred to it.

(v) An electing small business trust.

(vi) In the case of a corporation which is a bank (as defined in section 581) or a depository institution holding company (as defined in section 3(w)(1) of the Federal Deposit Insurance Act (12 U.S.C. 1813 (w)(1)), a trust which constitutes an individual retirement account under section 408 (a), including one designated as a Roth IRA under section 408A, but only to the extent of the stock held by such trust in such bank or company as of the date of the enactment of this clause.

This subparagraph shall not apply to any foreign trust.

(B) Treatment as shareholders

For purposes of subsection (b)(1)—

(i) In the case of a trust described in clause (i) of subparagraph (A), the deemed owner shall be treated as the shareholder.

(ii) In the case of a trust described in clause (ii) of subparagraph (A), the estate of the deemed owner shall be treated as the shareholder.

(iii) In the case of a trust described in clause (iii) of subparagraph (A), the estate of the testator shall be treated as the shareholder.

(iv) In the case of a trust described in clause (iv) of subparagraph (A), each beneficiary of the trust shall be treated as a shareholder.

(v) In the case of a trust described in clause (v) of subparagraph (A), each potential current beneficiary of such trust shall be treated as a shareholder; except that, if for any period there is no potential current beneficiary of such trust, such trust shall be treated as the shareholder during such period.

(vi) In the case of a trust described in clause (vi) of subparagraph (A), the individual for whose benefit the trust was created shall be treated as a shareholder.

(3) Estate of individual in bankruptcy may be shareholder

For purposes of subsection (b)(1)(B), the term "estate" includes the estate of an individual in a case under title 11 of the United States Code.

(4) Differences in common stock voting rights disregarded

For purposes of subsection (b)(1)(D), a corporation shall not be treated as having more than 1 class of stock solely because there are differences in voting rights among the shares of common stock.

(5) Straight debt safe harbor

(A) In general

For purposes of subsection (b)(1)(D), straight debt shall not be treated as a second class of stock.

(B) Straight debt defined

For purposes of this paragraph, the term "straight debt" means any written unconditional promise to pay on demand or on a specified date a sum certain in money if—

(i) the interest rate (and interest payment dates) are not contingent on profits, the borrower's discretion, or similar factors,

(ii) there is no convertibility (directly or indirectly) into stock, and

(iii) the creditor is an individual (other than a nonresident alien), an estate, a trust described in paragraph (2), or a person which is actively and regularly engaged in the business of lending money.

(C) Regulations

The Secretary shall prescribe such regulations as may be necessary or appropriate to provide for the proper treatment of straight debt under this subchapter and for the coordination of such treatment with other provisions of this title.

(6) Certain exempt organizations permitted as shareholders

For purposes of subsection (b)(1)(B), an organization which is—

(A) described in section 401 (a) or 501 (c)(3), and

(B) exempt from taxation under section 501 (a),

may be a shareholder in an S corporation.

(d) Special rule for qualified subchapter S trust

(1) In general

In the case of a qualified subchapter S trust with respect to which a beneficiary makes an election under paragraph (2)—

(A) such trust shall be treated as a trust described in subsection (c)(2)(A)(i),

(B) for purposes of section 678 (a), the beneficiary of such trust shall be treated as the owner of that portion of the trust which consists of stock in an S corporation with respect to which the election under paragraph (2) is made, and

(C) for purposes of applying sections 465 and 469 to the beneficiary of the trust, the disposition of the S corporation stock by the trust shall be treated as a disposition by such beneficiary.

(2) Election

(A) In general

A beneficiary of a qualified subchapter S trust (or his legal representative) may elect to have this subsection apply.

(B) Manner and time of election

(i) Separate election with respect to each corporation An election under this paragraph shall be made separately with respect to each corporation the stock of which is held by the trust.

(ii) Elections with respect to successive income beneficiaries If there is an election under this paragraph with respect to any beneficiary, an election under this paragraph shall be treated as made by each successive beneficiary unless such beneficiary affirmatively refuses to consent to such election.

(iii) Time, manner, and form of election Any election, or refusal, under this paragraph shall be made in such manner and form, and at such time, as the Secretary may prescribe.

(C) Election irrevocable

An election under this paragraph, once made, may be revoked only with the consent of the Secretary.

D) Grace period

An election under this paragraph shall be effective up to 15 days and 2 months before the date of the election.

(3) Qualified subchapter S trust

For purposes of this subsection, the term “qualified subchapter S trust” means a trust—

(A) the terms of which require that—

(i) during the life of the current income beneficiary, there shall be only 1 income beneficiary of the trust,

(ii) any corpus distributed during the life of the current income beneficiary may be distributed only to such beneficiary,

(iii) the income interest of the current income beneficiary in the trust shall terminate on the earlier of such beneficiary’s death or the termination of the trust, and

(iv) upon the termination of the trust during the life of the current income beneficiary, the trust shall distribute all of its assets to such beneficiary, and

(B) all of the income (within the meaning of section 643(b)) of which is distributed (or required to be distributed) currently to 1 individual who is a citizen or resident of the United States.

A substantially separate and independent share of a trust within the meaning of section 663 (c) shall be treated as a separate trust for purposes of this subsection and subsection (c).

(4) Trust ceasing to be qualified

(A) Failure to meet requirements of paragraph (3)(A)

If a qualified subchapter S trust ceases to meet any requirement of paragraph (3)(A), the provisions of this subsection shall not apply to such trust as of the date it ceases to meet such requirement.

(B) Failure to meet requirements of paragraph (3)(B)

If any qualified subchapter S trust ceases to meet any requirement of paragraph (3)(B) but continues to meet the requirements of paragraph (3)(A), the provisions of this subsection shall not apply to such trust as of the first day of the first taxable year beginning after the first taxable year for which it failed to meet the requirements of paragraph (3)(B).

(e) Electing small business trust defined

(1) Electing small business trust

For purposes of this section—

(A) In general

Except as provided in subparagraph (B), the term "electing small business trust" means any trust if—

(i) such trust does not have as a beneficiary any person other than

(I) an individual,

(II) an estate,

(III) an organization described in paragraph (2), (3), (4), or (5) of section 170 (c), or (IV) an organization described in section 170(c)(1) which holds a contingent interest in such trust and is not a potential current beneficiary,

(ii) no interest in such trust was acquired by purchase, and

(iii) an election under this subsection applies to such trust.

(B) Certain trusts not eligible

The term "electing small business trust" shall not include—

(i) any qualified subchapter S trust (as defined in subsection (d)(3)) if an election under subsection (d)(2) applies to any corporation the stock of which is held by such trust,

(ii) any trust exempt from tax under this subtitle, and

(iii) any charitable remainder annuity trust or charitable remainder unitrust (as defined in section 664 (d)).

(C) Purchase

For purposes of subparagraph (A), the term "purchase" means any acquisition if the basis of the property acquired is determined under section 1012.

(2) Potential current beneficiary

For purposes of this section, the term "potential current beneficiary" means, with respect to any period, any person who at any time during such period is entitled to, or at the discretion of any person may receive, a distribution from the principal or income of the trust (determined without regard to any power of appointment to the extent such power remains unexercised at the end of such period). If a trust disposes of all of the stock which it holds in an S corporation, then, with respect to such corporation, the term "potential current beneficiary" does not include any person who first met the requirements of the preceding sentence during the 1-year period ending on the date of such disposition.

(3) Election

An election under this subsection shall be made by the trustee. Any such election shall apply to the taxable year of the trust for which made and all subsequent taxable years of such trust unless revoked with the consent of the Secretary.

(4) Cross reference

For special treatment of electing small business trusts, see section 641 (c).

IRS Circular 230 Disclosure: In order to ensure compliance with IRS Circular 230, we must inform you that any U.S. tax advice contained in this outline and any attachments hereto is not intended or written to be used and may not be used by any person for the purpose of (i) avoiding any penalty that may be imposed by the Internal Revenue Code or (ii) promoting, marketing or recommending to another party any tax-related matter(s) addressed herein.

IV. Internal Revenue Service Private Letter Ruling # 200620025

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

200620025

TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

FEB 2 1 2006

UICs: 691.00-00
691.01-00
401.06-00
401.06-02

SE:T:EP:RA:T3

LEGEND:

Taxpayer A:

Taxpayer B:

Taxpayer C:

Bank N:

Court T:

State W:

Date 1:

Date 2:

Date 3:

Date 4:

Date 5:

Trust T:

IRA X:

IRA Y:

Dear :

This is in response to the request for letter ruling submitted by your authorized representative on your behalf, as supplemented by correspondence dated

, , , , and , in which your authorized representative requests letter rulings under sections 401(a)(9) and 691(a)(2) of the Internal Revenue Code ("Code"). The following facts and representations support your ruling request.

Taxpayer A died on Date 1, at age 69 prior to attaining his required beginning date as that term is defined in Code section 401(a)(9)(C). Taxpayer B is one of his four surviving sons. At his death, Taxpayer A owned an individual retirement account (IRA X) with Bank N of which his four sons were equal named beneficiaries pursuant to a beneficiary designation dated Date 2, . Taxpayer B is disabled, and his mother, Taxpayer C, is his legal guardian ("Guardian"). Taxpayer B is eligible to receive Medicaid and other public benefits, and it is represented that such eligibility could lapse if he directly owned a portion of IRA X.

The IRA X custodian set aside the shares of Taxpayer B's three brothers in separate sub-IRAs (separate accounts) for their benefit on or about Date 4, . The shares of Taxpayer B's three brothers were not distributed as part of said set aside. Taxpayer B's share has not been distributed from IRA X except for required minimum distribution(s) (RMD(s)) made to the Guardian since calendar year on his behalf. It has been represented that the subdivision of IRA X into three separate IRAs (shares) for Taxpayer B's three brothers (with Taxpayer B's share remaining in IRA X) was done on an equal, pro rata, basis.

A State W court, Court T, a court of competent jurisdiction, acting on a petition by the Guardian, issued an order dated Date 3, , authorizing the creation of a trust for the Taxpayer's benefit, intended to qualify as a "special needs trust" ("Trust T") under state and federal law. It is represented that if Trust T qualifies as a "special needs trust," the trust assets will not be considered as assets of Taxpayer B in determining his eligibility to receive public benefits.

The terms of Trust T provide that the Guardian is the trustee and Taxpayer B is the sole beneficiary of Trust T during his lifetime. The Guardian may distribute to or apply for the benefit of Taxpayer B so much of the net income and principal of Trust T as appears advisable in her sole discretion. The Guardian may accumulate any or all of Trust T income; income not distributed in the current year shall be added to principal. Upon Taxpayer B's death, the balance of Trust T shall be distributed to the State W Department of Children and Families to the extent necessary to satisfy the total medical assistance paid for Taxpayer B's benefit by that department during his life. The remaining balance shall be distributed to Taxpayer B's heirs at law under the State W law of intestacy (in a manner and proportion provided in Trust T). The Guardian has disclaimed her contingent remainder interest (as one of Taxpayer B's heirs at law) in Trust T by means of a disclaimer dated Date 5, . For purposes of this letter ruling, the Service will assume that said disclaimer falls within Code section 2518.

The Guardian proposes to transfer, with state court approval, Taxpayer B's share, as ¼ beneficiary thereof, of IRA X to an IRA benefiting Trust T and the beneficiary(ies) thereof. It has been represented that, pursuant to said transfer, IRA X shall be re-titled IRA Y.

Based on the above facts and representations, you, through your authorized representative, request the following letter rulings:

1. That the transfer of IRA X (as described above) to Trust T will be disregarded for Federal income purposes, and will not be considered a transfer under Code section 691(a)(2); and

2. the trustee of Trust T, Guardian, may calculate the annual distributions required under Code section 401(a)(9) (made applicable to IRAs X and Y pursuant to Code section 408(a)(6)), to be made to Trust T from IRA Y using Taxpayer B's life expectancy.

With respect to your first letter ruling request, section 691(a)(1) of the Code provides that the amount of all items of gross income in respect of a decedent (IRD) which are not properly includible in respect of the taxable period in which falls the date of the decedent's death or a prior period (including the amount of all items of gross income in respect of a prior decedent, if the right to receive such amount was acquired by reason of the death of the prior decedent or by bequest, devise, or inheritance from the prior decedent) shall be included in the gross income, for the taxable year when received, of: (A) the estate of the decedent, if the right to receive the amount is acquired by the decedent's estate from the decedent; (B) the person who, by reason of the death of the decedent, acquires the right to receive the amount, if the right to receive the amount is not acquired by the decedent's estate from the decedent; or (C) the person who acquires from the decedent the right to receive the amount by bequest, devise, or inheritance, if the amount is received after a distribution by the decedent's estate of such right.

Section 691(a)(2) provides that if a right, described in § 691(a)(1), to receive an amount is transferred by the estate of the decedent or a person who received such right by reason of the death of the decedent or by bequest, devise, or inheritance from the decedent, there shall be included in the gross income of the estate or such person, as the case may be, for the taxable period in which the transfer occurs, the fair market value of such right at the time of such transfer plus the amount by which any consideration for the transfer exceeds such fair market value. For purposes of this paragraph, the term "transfer" includes sale, exchange, or other disposition, or the satisfaction of an installment obligation at other than face value, but does not include transmission at death to the estate of the decedent or a transfer to a person pursuant to the right of such person to receive such amount by reason of the death of the decedent or by bequest, devise, or inheritance from the decedent.

Revenue Ruling 92-47, 1992-1 C.B. 198, holds that a distribution to the beneficiary of a decedent's IRA that equals the amount of the balance in the IRA at the decedent's death, less any nondeductible contributions, is IRD under Code section 691(a)(1) that is includable in the gross income of the beneficiary for the taxable year the distribution is received.

Section 671 provides that where it is specified in subpart E of Part I of subchapter J that the grantor or another person shall be treated as the owner of any portion of a trust, there shall then be included in computing the taxable income and credits of the grantor or the other person those items of income, deductions, and credits against tax of the trust which are attributable to that portion of the trust to the extent that such items would be taken into account under chapter 1 in computing taxable income or credits against the tax of an individual.

Section 677(a) provides that the grantor shall be treated as the owner of any portion of a trust, whether or not he is treated as such owner under Code section 674, whose income without the approval or consent of any adverse party is, or, in the discretion of the grantor or a nonadverse party, or both, may be (1) distributed to the grantor or the grantor's spouse; (2) held or accumulated for future distribution to the grantor or the grantor's spouse; or (3) applied to the payment of premiums on policies of insurance on the life of the grantor or the grantor's spouse.

Rev. Rul. 85-13, 1985-1 C.B. 184, concludes that if a grantor is treated as the owner of a trust, the grantor is considered to be the owner of the trust assets for federal income tax purposes. Therefore, a transfer of the grantor's assets to the trust is not recognized as a sale or disposition for federal income tax purposes.

Based solely on the facts and representations submitted, we conclude, with respect to your first ruling request, that Trust T is currently a grantor trust all of which is treated as owned by Taxpayer B under §§ 671 and 677(a). Therefore, the transfer of Taxpayer B's share of IRA X to Trust T is not a sale or disposition of said share of the IRA for federal income tax purposes and is not a transfer for purposes of § 691(a)(2).

With respect to your second ruling request, Code section 401(a)(9)(A) provides, in general, that a trust will not be considered qualified unless the plan provides that the entire interest of each employee-

(i) will be distributed to such employee not later than the required beginning date, or

(ii) will be distributed, beginning not later than the required beginning date, over the life of such employee or over the lives of such employee and a designated beneficiary or over a period not extending beyond the life expectancy of such employee or the life expectancy of such employee and a designated beneficiary.

Code section 408(a)(6) provides that, under regulations prescribed by the Secretary, rules similar to the rules of section 401(a)(9) and the incidental death benefit requirements of section 401(a) shall apply to the distribution of the entire interest of an individual for whose benefit the trust is maintained.

Code § 401(a)(9)(B)(ii) provides, in general, that if a plan participant (IRA holder) dies before the distribution of his interest has begun in accordance with subparagraph (A)(ii) (prior to his required beginning date), then his entire interest must be distributed within 5 years of his death.

Code § 401(a)(9)(B)(iii) provides, in general, that if any portion of the interest of a deceased plan participant (IRA holder) is payable to (or for the benefit of a designated beneficiary), such portion will be distributed beginning not later than 1 year after the date of the deceased's death (or a later date as prescribed by the Secretary under Regulations) in accordance with regulations over the life of the designated beneficiary (or a period not extending beyond the life expectancy of the beneficiary).

Code § 401(a)(9)(C) provides, in relevant part, that, for purposes of this paragraph, the term "required beginning date" means April 1 of the calendar year following the calendar year in which the employee attains age 70 1/2.

Code section 401(a)(9)(E) defines "designated beneficiary" as any individual designated as a beneficiary by the employee (IRA holder).

With further respect to your second ruling request, "Final" Income Tax Regulations under Code sections 401(a)(9) and 408(a)(6) were published in the Federal Register at 67 Federal Register 18987-19028 (April 17, 2002), and in the Internal Revenue Bulletin at 2002-19 I.R.B. 852 (May 13, 2002). The Preamble to the "Final" Regulations, in relevant part, provide that the regulations apply for determining required minimum distributions for calendar years beginning after January 1, 2003. For determining required distributions for calendar year , taxpayers may rely on the 1987 proposed regulations, the 2001 proposed regulations, or the "Final" Regulations..

In addition, the "Final" Regulations have been modified in part (See 2004-26 I.R.B. 1082, 1098 (June 28, 2004)). The modification to the "Final" Regulations may also be relied upon with respect to required distributions for the calendar year.

Section 1.401(a)(9)-3 of the "Final" regulations, Q&A-3(a) provides, in general, that, with respect to the life expectancy exception to the 5-year rule described in Code § 401(a)(9)(B)(iii), and in A-1, distributions are required to begin to a non-spouse beneficiary on or before the end of the calendar year immediately following the calendar year in which the employee died. This rule also applies if another individual is a designated beneficiary in addition to the employee's (IRA holder's) surviving spouse.

Section 1.401(a)(9)-3 of the "Final" regulations, Q&A-4(a), provides, in relevant part, that in the absence of a plan provision to the contrary, with respect to an individual who dies prior to reaching his required beginning date, if said individual has designated a beneficiary, distributions from his plan or IRA are to be made in accordance with the life expectancy rule of Code sections 401(a)(9)(B)(iii) and (iv).

Section 1.401(a)(9)-5 of the "Final" regulations, Q&A-5(b), provides, in general, that if an employee dies before his required beginning date, in order to satisfy the requirements of Code § 401(a)(9)(B)(iii) or (iv) and the life expectancy rule described in A-1 of § 1.401(a)(9)-3, the applicable distribution period for distribution calendar years after the distribution calendar year containing the employee's date of death is determined in accordance with paragraph (c) of this A-5.

Section 1.401(a)(9)-5 of the "Final" regulations, Q&A-5(c)(1), provides, in general, that, with respect to a non-spouse beneficiary, the applicable distribution period measured by the beneficiary's remaining life expectancy is determined using the beneficiary's age as of the beneficiary's birthday in the calendar year immediately following the calendar year of the employee's death. In subsequent calendar years, the applicable distribution period is reduced by one for each calendar year that has elapsed after the calendar year immediately following the calendar year of the employee's death.

Section 1.401(a)(9)-4 of the "Final" regulations, Q&A-1, provides, in relevant part, that a designated beneficiary is an individual who is designated as a beneficiary under a plan either by the terms of the plan or by an affirmative election by the employee. Q&A-1 further provides that a person who takes under a will or otherwise under applicable state law will not be a designated beneficiary unless that individual also takes under a plan.

Section 1.401(a)(9)-5 of the "Final" regulations, Q&A-7(a) provides, in summary, that except as otherwise provided in paragraph (c) of this A-7 (not pertinent to this ruling request), if more than one individual is designated as a beneficiary with respect to an employee as of the applicable date for determining the designated beneficiary, the named beneficiary with the shortest life expectancy will be the designated beneficiary for purposes of determining the applicable distribution period.

Section 1.401(a)(9)-4 of the "Final" regulations, Q&A-4, provides, in relevant part, that in order to be a designated beneficiary, an individual must be a beneficiary as of the date of the employee's death. Generally, an employee's designated beneficiary will be determined based on the beneficiaries designated as of the date of death who remain beneficiaries as of September 30 of the calendar year following the calendar year of death. Q&A-4 further provides, that "consequently, any person who was a beneficiary as of the date of the employee's (IRA holder's) death, but is not a beneficiary as of that September 30 (e.g. because the person receives the entire benefit to which he is entitled before that September 30) is not taken into account in determining the distribution period for required minimum distributions after the employee's death. Accordingly, if a person disclaims entitlement to the employee's benefit pursuant to a disclaimer that satisfies section 2518 by that September 30 thereby allowing other beneficiaries to receive the benefit in lieu of that person, the disclaiming person is not taken into account in determining the person's designated beneficiary".

Section 1.401(a)(9)-8 of the "Final" regulations, Qs&As-2 and 3 provide the rules that apply if the IRA of a deceased IRA holder is divided into separate accounts for purposes of Code section 401(a)(9).

Section 1.401(a)(9)-8 of the "Final" regulations, Q&A-2(a)(2), provides that if an employee's (IRA holder's) benefit in a defined contribution plan is divided into separate accounts and the beneficiaries with respect to one separate account differ from the beneficiaries with respect to the other separate accounts of the employee under the plan, for years subsequent to the calendar year containing the date as of which the separate accounts were established, or date of death if later, such separate account under the plan is not aggregated with the other separate accounts under the plan in order to determine whether the distributions from such separate account under the plan satisfy section 401(a)(9). However, the applicable distribution period for each such separate account is determined disregarding the other beneficiaries only if the separate account is established on a date no later than the last day of the year following the calendar year of the employee's (IRA holder's) death.

Section 1.401(a)(9)-8 of the "Final" regulations, Q&A-3, defines separate accounts for purposes of Code section 401(a)(9), as separate portions of an employee's benefit reflecting the separate interests of the employee's beneficiaries under the plan as of the date of the employee's death for which separate accounting is maintained. The separate accounting must allocate all post-death investments, gains and losses, contributions, and forfeitures for the period prior to the establishment of the separate accounts on a pro rata basis in a reasonable and consistent manner among the separate accounts.

Section 1.401(a)(9)-9, of the "Final" Regulations, Q&A-1, sets forth the "Single Life Table" used to compute the life expectancy of an individual.

As previously noted, taxpayers must compute minimum required distributions for calendar years beginning with calendar year in accordance with the "Final" regulations referenced above.

With respect to your second ruling request, based on the facts contained herein, the Service believes that the "separate account" requirements of section 1.401(a)(9)-8 of the "Final" regulations, Qs&As-2, have been met for years subsequent to calendar year . Additionally, based on the facts contained herein, the representation that Trust T is intended to qualify as a "special needs trust" under state and federal law to preserve Taxpayer B's eligibility to receive public benefits, and with reference to the conclusion reached on the first ruling regarding the status of Trust T as a grantor trust, the Service believes that it is appropriate to calculate the annual distributions required under Code section 401(a)(9) (made applicable to IRAs X and Y pursuant to Code section 408(a)(6), made to Trust T from IRA Y by using Taxpayer B's life expectancy.

Our conclusion to this second ruling request does not change even after Taxpayer B's share of Taxpayer A's IRA X is transferred, by means of a trustee to trustee transfer, to IRA Y, an IRA set up and maintained in the name of Taxpayer A to benefit Taxpayer B through Trust T.

Thus, with respect to your second ruling request, the Service concludes as follows:

> the trustee of Trust T, Guardian, may calculate the annual distributions required under Code section 401(a)(9) (made applicable to IRAs X and Y pursuant to Code section 408(a)(6)), to be made to Trust T from IRA Y by using Taxpayer B's life expectancy.

This ruling letter is based on the assumption that IRA X either has met, is meeting, or will meet the requirements of Code § 408(a) at all times relevant thereto. Furthermore, it assumes that IRA Y will also meet the requirements of Code section 408(a) at all times relevant thereto. It also assumes that Trust T is valid under the laws of State W as represented. Finally, it assumes that the disclaimer referenced herein met the requirements of Code section 2518.

No opinion is expressed as to the tax treatment of the transaction described herein under the provisions of any other section of either the Code or regulations, which may be applicable thereto.

This letter is directed only to the taxpayer who requested it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

The original of this letter has been sent to your authorized representatives in accordance with a power of attorney on file in this office.

If you wish to inquire about this ruling, please contact , Esquire (ID: -)) at either - (Phone) or - (FAX). Please address all correspondence to SE:T:EP:RA:T3.

Sincerely yours,

Frances V. Sloan

Frances V. Sloan, Manager,
Employee Plans Technical Group 3

Enclosures:
Deleted copy of ruling letter
Notice of Intention to Disclose

V. Internal Revenue Service Private Letter Ruling # 201117042

Based on the above facts and representations, you, through your authorized representative, request the following letter rulings:

1. That, pursuant to section 408(d)(3)(I) of the Internal Revenue Code, the 60-day rollover period found at section 408(d)(3)(A) of the Code applicable to the distribution made on or about Date 3, 2008, from IRA X is waived; and

2. that Taxpayer A, is granted a period not to exceed 60 days as measured from the date of this ruling letter to roll over an amount not to exceed Amount U into an IRA.

Section 408(d)(1) of the Code provides that, except as otherwise provided in section 408(d), any amount paid or distributed out of an IRA shall be included in gross income by the payee or distributee, as the case may be, in the manner provided under section 72 of the Code.

Section 408(d)(3) of the Code defines, and provides the rules applicable to IRA rollovers. Section 408(d)(3)(A) of the Code provides that section 408(d)(1) of the Code does not apply to any amount paid or distributed out of an IRA to the individual for whose benefit the IRA is maintained if (i)the entire amount received (including money and any other property) is paid into an IRA for the benefit of such individual not later than the 60th day after the day on which the individual receives the payment or distribution; or (ii) the entire amount received (including money and any other property) is paid into an eligible retirement plan (other than an IRA) for the benefit of such individual not later than the 60th day after the date on which the payment or distribution is received, except that the maximum amount which may be paid into such plan may not exceed the portion of the amount received which is includible in gross income (determined without regard to section 408(d)(3)).

Section 408(d)(3)(B) of the Code provides that section 408(d)(3) does not apply to any amount described in section 408(d)(3)(A)(i) received by an individual from an IRA if at any time during the 1-year period ending on the day of such receipt such individual received any other amount described in section 408(d)(3)(A)(i) from an IRA which was not includible in gross income because of the application of section 408(d)(3).

Section 408(d)(3)(D) of the Code provides a similar 60-day rollover period for partial rollovers.

Code section 408(d)(3)(E) provides, in summary, that this paragraph does not apply to any amount required to be distributed in accordance with subsection (a)(6) or (b)(3) (Code section 401(a)(9) required distributions).

Section 408(d)(3)(I) of the Code provides that the Secretary may waive the 60-day requirement under sections 408(d)(3)(A) and 408(d)(3)(D) of the Code where the failure to waive such requirement would be against equity or good conscience, including casualty, disaster, or other events beyond the reasonable control of the individual subject to such requirement. Only distributions that occurred after December 31, 2001, are eligible for the waiver under section 408(d)(3)(I) of the Code.

Revenue Procedure 2003-16, 2003-4 I.R.B. 359, (January 27, 2003), provides that in determining whether to grant a waiver of the 60-day rollover requirement pursuant to section 408(d)(3)(I), the Service will consider all relevant facts and circumstances, including: (1) errors committed by a financial institution; (2) inability to complete a rollover due to death, disability, hospitalization, incarceration, restrictions imposed by a foreign country or postal error, (3) the use of the amount distributed (for example, in the case of payment by check, whether the check was cashed); and (4) the time elapsed since the distribution occurred.

The facts submitted in support of this ruling request indicate that, during calendar year 2008, Amount U was transferred from IRA X into an account set up and maintained in the name of Trust T. Company N, the financial institution which accomplished the transfer, correctly noted that an individual retirement account cannot be set up and maintained in the name of a trust, and appropriately issued a federal Form 1099 treating the Date 3, 2008 transfer as a taxable distribution.

The facts submitted in support of this ruling request indicate that Taxpayer A's financial advisor, acting on behalf of Taxpayer A, and on behalf of Trustee B, the trustee of Trust T, requested the IRA X distribution. The Service notes that although the financial advisor's instruction to Company N was based on a Court T order, a taxable event did occur as a result of the transfer and as a result of the actions of Taxpayer A's financial advisor.

Thus, under the facts outlined above, the Service, pursuant to Code section 408(d)(3)(I), waives the 60-day rollover period applicable to the Date 3, 2008 distribution from IRA X. Therefore, with respect to your ruling requests, the Service concludes as follows:

1. That, pursuant to section 408(d)(3)(I) of the Internal Revenue Code, the 60-day rollover period found at section 408(d)(3)(A) of the Code applicable to the distribution made on or about Date 3, 2008, from IRA X is waived; and

2. that Taxpayer A is granted a period not to exceed 60 days as measured from the date of this ruling letter to roll over an amount not to exceed Amount U into an IRA.

This ruling letter is based on the assumption that IRA X either has met, is meeting, or will meet the requirements of Code section 408(a) at all times relevant thereto.

No opinion is expressed as to the tax treatment of the transaction described herein under the provisions of any other section of either the Code or regulations, which may be applicable thereto.

This letter is directed only to the taxpayer who requested it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

The original of this letter has been sent to your authorized representatives in accordance with a power of attorney on file in this office.

If you wish to inquire about this ruling, please contact me XXXXXX

Sincerely yours,

Frances V. Sloan

Frances V. Sloan, Manager,
Employee Plans Technical Group 3

Enclosures:
Deleted copy of ruling letter
Notice of Intention to Disclose

VI. Internal Revenue Service Private Letter Ruling # 201116005

Internal Revenue Service

Number: **201116005**
Release Date: 4/22/2011

Index Number: 677.00-00, 691.01-00

Department of the Treasury
Washington, DC 20224

Third Party Communication: None
Date of Communication: Not Applicable

Person To Contact:
, ID No.

Telephone Number:

Refer Reply To:
CC:PSI:B01
PLR-129484-10

Date:
December 15, 2010

X =

A =

Trust =

D1 =

State =

Dear :

This letter responds to the letter dated April 5, 2010, and subsequent correspondence, submitted on behalf of X by X's authorized representative, requesting a ruling under the Internal Revenue Code.

FACTS

The information submitted states that X is disabled and eligible to receive public benefits. X's father, A, died D1. A owned two individual retirement accounts (IRAs) of which X and X's siblings are the designated beneficiaries. X proposes to transfer X's share of the IRAs to a newly established IRA benefitting Trust and the beneficiaries thereof.

Trust is intended to be a special needs trust. The terms of Trust provide that X is the sole beneficiary of Trust during X's lifetime. The trustee shall apply so much of the net income of Trust for the use of X as the trustee in its sole discretion shall determine is beneficial to X taking into consideration the best interest and welfare of X. If the income from Trust, together with any other income and resources possessed by X, including all governmental benefits, is insufficient to provide for the benefit of X, in the sole opinion of the trustee of Trust, the trustee is authorized to invade the principal for X's benefit. In general, however, the trustee may not invade the principal if such act will serve to deny, discontinue, reduce, or eliminate any government entitlement or payment which X would otherwise receive. The trustee shall accumulate and add to principal any net income not so paid or applied. Upon X's death, any remaining principal and undistributed income of Trust shall be distributed to State as reimbursement for assistance provided during X's lifetime. After reimbursement to the State, all remaining principal and undistributed income will be distributed to X's issue or, if there are no issue, to X's siblings, then to their issue by representation.

LAW AND ANALYSIS

Section 691(a)(1) of the Code provides that the amount of all items of gross income in respect of a decedent (IRD) which are not properly includible in respect of the taxable period in which falls the date of the decedent's death or a prior period (including the amount of all items of gross income in respect of a prior decedent, if the right to receive such amount was acquired by reason of the death of the prior decedent or by bequest, devise, or inheritance from the prior decedent) shall be included in the gross income, for the taxable year when received, of: (A) the estate of the decedent, if the right to receive the amount is acquired by the decedent's estate from the decedent; (B) the person who, by reason of the death of the decedent, acquires the right to receive the amount, if the right to receive the amount is not acquired by the decedent's estate from the decedent; or (C) the person who acquires from the decedent the right to receive the amount by bequest, devise, or inheritance, if the amount is received after a distribution by the decedent's estate of such right.

Section 691(a)(2) provides that if a right, described in § 691(a)(1), to receive an amount is transferred by the estate of the decedent or a person who received such right by reason of the death of the decedent or by bequest, devise, or inheritance from the decedent, there shall be included in the gross income of the estate or such person, as the case may be, for the taxable period in which the transfer occurs, the fair market value of such right at the time of such transfer plus the amount by which any consideration for the transfer exceeds such fair market value. For purposes of this paragraph, the term "transfer" includes sale, exchange, or other disposition, or the satisfaction of an installment obligation at other than face value, but does not include transmission at death to the estate of the decedent or a transfer to a person pursuant to the right of such person to receive such amount by reason of the death of the decedent or by bequest, devise, or inheritance from the decedent.

Section 1.691(a)-4(a) of the Income Tax Regulations provides that if a right described in § 691(a)(1) is disposed of by gift, the fair market value of the right at the time of the gift must be included in the gross income of the donor.

Rev. Rul. 92-47, 1992-1 C.B. 198, holds that a distribution to the beneficiary of a decedent's IRA that equals the amount of the balance in the IRA at the decedent's death, less any nondeductible contributions, is IRD under § 691(a)(1) that is includable in the gross income of the beneficiary for the taxable year the distribution is received.

Section 671 provides that where it is specified in subpart E of Part I of subchapter J that the grantor or another person shall be treated as the owner of any portion of a trust, there shall then be included in computing the taxable income and credits of the grantor or the other person those items of income, deductions, and credits against tax of the trust which are attributable to that portion of the trust to the extent that such items would be taken into account under chapter 1 in computing taxable income or credits against the tax of an individual.

Section 677(a) provides that the grantor shall be treated as the owner of any portion of a trust, whether or not he is treated as such owner under § 674, whose income without the approval or consent of any adverse party is, or, in the discretion of the grantor or a nonadverse party, or both, may be (1) distributed to the grantor or the grantor's spouse; (2) held or accumulated for future distribution to the grantor or the grantor's spouse; or (3) applied to the payment of premiums on policies of insurance on the life of the grantor or the grantor's spouse.

Rev. Rul. 85-13, 1985-1 C.B. 184, concludes that if a grantor is treated as the owner of a trust, the grantor is considered to be the owner of the trust assets for federal income tax purposes. A grantor's receipt of the corpus of a trust in exchange for an unsecured promissory note was treated as an unsecured borrowing of the trust corpus which caused the grantor to be treated as the owner of the trust under § 675(3). The transfer of the trust assets in exchange for the note was not recognized as a sale for federal income purposes.

CONCLUSIONS

Based solely on the facts and representations submitted, we conclude that Trust will be treated as owned by X under §§ 671 and 677(a). Therefore, assuming the transfer of X's share of the IRAs to the Trust is not a gift by X, such transfer will not be a sale or disposition for federal income tax purposes or a transfer for purposes of § 691(a)(2).

Except as specifically set forth above, we express or imply no opinion concerning the federal tax consequences of the facts described above under any other provision of the Code. Specifically, we express or imply no opinion under § 401(a)(9).

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

Pursuant to a power of attorney on file with this office, a copy of this letter is being sent to X's authorized representatives.

Sincerely,

Faith P. Colson
Faith P. Colson
Senior Counsel, Branch 1
Office of the Associate Chief Counsel
(Passthroughs & Special Industries)

Enclosures (2)
Copy of this letter
Copy for § 6110 purposes

cc:

VII.

26 U.S. Code § 199A - Qualified business income

(a) **In General** In the case of a taxpayer other than a corporation, there shall be allowed as a deduction for any taxable year an amount equal to the sum of—

(1) the lesser of—

(A) the combined qualified business income amount of the taxpayer, or

(B) an amount equal to 20 percent of the excess (if any) of—

(i) the taxable income of the taxpayer for the taxable year, over

(ii) the sum of any net capital gain (as defined in section 1(h)), plus the aggregate amount of the qualified cooperative dividends, of the taxpayer for the taxable year, plus

(2) the lesser of—

(A) 20 percent of the aggregate amount of the qualified cooperative dividends of the taxpayer for the taxable year, or

(B) taxable income (reduced by the net capital gain (as so defined)) of the taxpayer for the taxable year.

The amount determined under the preceding sentence shall not exceed the taxable income(reduced by the net capital gain (as so defined)) of the taxpayer for the taxable year.

(b) **Combined qualified business income amount** For purposes of this section—

(1) In general The term “combined qualified business income amount” means, with respect to any taxable year, an amount equal to—

(A) the sum of the amounts determined under paragraph (2) for each qualified trade or business carried on by the taxpayer, plus

(B) 20 percent of the aggregate amount of the qualified REIT dividends and qualified publicly traded partnership income of the taxpayer for the taxable year.

(2) **DETERMINATION OF DEDUCTIBLE AMOUNT FOR EACH TRADE OR BUSINESS** The amount determined under this paragraph with respect to any qualified trade or business is the lesser of—

(A) 20 percent of the taxpayer's qualified business income with respect to the qualified trade or business, or

(B) the greater of—

(i) 50 percent of the W–2 wages with respect to the qualified trade or business, or

(ii) the sum of 25 percent of the W–2 wages with respect to the qualified trade or business, plus 2.5 percent of the unadjusted basis immediately after acquisition of all qualified property.

(3) **MODIFICATIONS TO LIMIT BASED ON TAXABLE INCOME**

(A) Exception from limit

In the case of any taxpayer whose taxable income for the taxable year does not exceed the threshold amount, paragraph (2) shall be applied without regard to subparagraph (B).

(B) Phase-in of limit for certain taxpayers

(i) In general If—

(I) the taxable income of a taxpayer for any taxable year exceeds the threshold amount, but does not exceed the sum of the threshold amount plus $50,000 ($100,000 in the case of a joint return), and

(II) the amount determined under paragraph (2)(B) (determined without regard to this subparagraph) with respect to any qualified trade or business carried on by the taxpayer is less than the amount determined under paragraph (2)(A) with respect such trade or business,

then paragraph (2) shall be applied with respect to such trade or business without regard to subparagraph (B) thereof and by reducing the amount determined under subparagraph (A) thereof by the amount determined under clause (ii).

(ii)Amount of reduction The amount determined under this subparagraph is the amount which bears the same ratio to the excess amount as—

(I) the amount by which the taxpayer's taxable income for the taxable year exceeds the threshold amount, bears to

(II) $50,000 ($100,000 in the case of a joint return).

(iii)Excess amount For purposes of clause (ii), the excess amount is the excess of—

(I) the amount determined under paragraph (2)(A) (determined without regard to this paragraph), over

(II) the amount determined under paragraph (2)(B) (determined without regard to this paragraph).

(4)**WAGES, ETC**

(A)In general

The term "W–2 wages" means, with respect to any person for any taxable year of such person, the amounts described in paragraphs (3) and (8) of section 6051(a) paid by such person with respect to employment of employees by such person during the calendar year ending during such taxable year.

(B)Limitation to wages attributable to qualified business income
Such term shall not include any amount which is not properly allocable to qualified business income for purposes of subsection (c)(1).

(C)Return requirement
Such term shall not include any amount which is not properly included in a return filed with the Social Security Administration on or before the 60th day after the due date (including extensions) for such return.

(5) ACQUISITIONS, DISPOSITIONS, AND SHORT TAXABLE YEARS

The Secretary shall provide for the application of this subsection in cases of a short taxable year or where the taxpayer acquires, or disposes of, the major portion of a trade or business or the major portion of a separate unit of a trade or business during the taxable year.

(6) **QUALIFIED PROPERTY** For purposes of this section:

(A) **In general** The term “qualified property” means, with respect to any qualified trade or business for a taxable year, tangible property of a character subject to the allowance for depreciation under section 167—

(i) which is held by, and available for use in, the qualified trade or business at the close of the taxable year,

(ii) which is used at any point during the taxable year in the production of qualified business income, and

(iii) the depreciable period for which has not ended before the close of the taxable year.

(B) **Depreciable period** The term “depreciable period” means, with respect to qualified property of a taxpayer, the period beginning on the date the property was first placed in service by the taxpayer and ending on the later of—

(i) the date that is 10 years after such date, or

(ii) the last day of the last full year in the applicable recovery period that would apply to the property under section 168 (determined without regard to subsection (g) thereof).

(c) **QUALIFIED BUSINESS INCOME** For purposes of this section—

(1) **IN GENERAL**

The term “qualified business income” means, for any taxable year, the net amount of qualified items of income, gain, deduction, and loss with respect to any qualified trade or business of the taxpayer. Such term shall not include any qualified REIT dividends, qualified cooperative dividends, or qualified publicly traded partnership income.

(2) **CARRYOVER OF LOSSES**

If the net amount of qualified income, gain, deduction, and loss with respect to qualified trades or businesses of the taxpayer for any taxable year is less than zero, such amount shall be treated as a loss from a qualified trade or business in the succeeding taxable year.

(3) **QUALIFIED ITEMS OF INCOME, GAIN, DEDUCTION, AND LOSS** For purposes of this subsection—

(A) **In general** The term "qualified items of income, gain, deduction, and loss" means items of income, gain, deduction, and loss to the extent such items are—

(i) effectively connected with the conduct of a trade or business within the United States (within the meaning of section 864(c), determined by substituting "qualified trade or business (within the meaning of section 199A)" for "non-resident alien individual or a foreign corporation" or for "a foreign corporation" each place it appears), and

(ii) included or allowed in determining taxable income for the taxable year.

(B)Exceptions The following investment items shall not be taken into account as a qualified item of income, gain, deduction, or loss:

(i) Any item of short-term capital gain, short-term capital loss, long-term capital gain, or long-term capital loss.

(ii) Any dividend, income equivalent to a dividend, or payment in lieu of dividends described in section 954(c)(1)(G).

(iii) Any interest income other than interest income which is properly allocable to a trade or business.

(iv) Any item of gain or loss described in subparagraph (C) or (D) of section 954(c)(1)(applied by substituting "qualified trade or business" for "controlled foreign corporation").

(v) Any item of income, gain, deduction, or loss taken into account under section 954(c)(1)(F) (determined without regard to clause (ii) thereof and other than items attributable to notional principal contracts entered into in transactions qualifying under section 1221(a)(7)).

(vi) Any amount received from an annuity which is not received in connection with the trade or business.

(vii) Any item of deduction or loss properly allocable to an amount described in any of the preceding clauses.

(4) **Treatment of reasonable compensation and guaranteed payments** Qualified business income shall not include—

(A) reasonable compensation paid to the taxpayer by any qualified trade or business of the taxpayer for services rendered with respect to the trade or business,

(B) any guaranteed payment described in section 707(c) paid to a partner for services rendered with respect to the trade or business, and

(C) to the extent provided in regulations, any payment described in section 707(a) to a partner for services rendered with respect to the trade or business.

(d) **Qualified trade or business** For purposes of this section—

(1) **In general** The term “qualified trade or business” means any trade or business other than—

(A) a specified service trade or business, or

(B) the trade or business of performing services as an employee.

(2) **Specified service trade or business** The term “specified service trade or business” means any trade or business—

(A) which is described in section 1202(e)(3)(A) (applied without regard to the words “engineering, architecture,”) or which would be so described if the term “employees or owners” were substituted for “employees” therein, or

(B) which involves the performance of services that consist of investing and investment management, trading, or dealing in securities (as defined in section 475(c)(2)), partnership interests, or commodities (as defined in section 475(e)(2)).

(3) **EXCEPTION FOR SPECIFIED SERVICE BUSINESSES BASED ON TAXPAYER'S INCOME**

(A) **In general** If, for any taxable year, the taxable income of any taxpayer is less than the sum of the threshold amount plus $50,000 ($100,000 in the case of a joint return), then—

(i) any specified service trade or business of the taxpayer shall not fail to be treated as a qualified trade or business due to paragraph (1)(A), but

(ii) only the applicable percentage of qualified items of income, gain, deduction, or loss, and the W–2 wages and the unadjusted basis immediately after acquisition of qualified property, of the taxpayer allocable to such specified service trade or business shall be taken into account in computing the qualified business income, W–2 wages, and the unadjusted basis immediately after acquisition of qualified property of the taxpayer for the taxable year for purposes of applying this section.

(B) **Applicable percentage** For purposes of subparagraph (A), the term "applicable percentage" means, with respect to any taxable year, 100 percent reduced (not below zero) by the percentage equal to the ratio of—

(i) the taxable income of the taxpayer for the taxable year in excess of the threshold amount, bears to

(ii) $50,000 ($100,000 in the case of a joint return).

(e) **OTHER DEFINITIONS** For purposes of this section—

(1) **TAXABLE INCOME**

Taxable income shall be computed without regard to the deduction allowable under this section.

(2) **THRESHOLD AMOUNT**

(A) In general

The term "threshold amount" means $157,500 (200 percent of such amount in the case of a joint return).

(B) Inflation adjustment

In the case of any taxable year beginning after 2018, the dollar amount in subparagraph (A) shall be increased by an amount equal to—

(i) such dollar amount, multiplied by

(ii) the cost-of-living adjustment determined under section 1(f)(3) for the calendar year in which the taxable year begins, determined by substituting “calendar year 2017” for “calendar year 2016” in subparagraph (A)(ii) thereof.

The amount of any increase under the preceding sentence shall be rounded as provided in section 1(f)(7).

(3) **Qualified REIT dividend** The term “qualified REIT dividend” means any dividend from a real estate investment trust received during the taxable year which—

(A) is not a capital gain dividend, as defined in section 857(b)(3), and

(B) is not qualified dividend income, as defined in section 1(h)(11).

(4) **Qualified cooperative dividend** The term “qualified cooperative dividend” means any patronage dividend (as defined in section 1388(a)), any per-unit retain allocation (as defined in section 1388(f)), and any qualified written notice of allocation (as defined in section 1388(c)), or any similar amount received from an organization described in subparagraph (B)(ii), which—

(A) is includible in gross income, and

(B) is received from—

(i) an organization or corporation described in section 501(c)(12) or 1381(a), or

(ii) an organization which is governed under this title by the rules applicable to cooperatives under this title before the enactment of subchapter T.

(5) **Qualified publicly traded partnership income** The term “qualified publicly traded partnership income” means, with respect to any qualified trade or business of a taxpayer, the sum of—

(A) the net amount of such taxpayer's allocable share of each qualified item of income, gain, deduction, and loss (as defined in subsection (c)(3) and determined after the application of subsection (c)(4)) from a publicly traded partnership (as defined in section 7704(a)) [1] which is not treated as a corporation under section 7704(c), plus

(B) any gain recognized by such taxpayer upon disposition of its interest in such partnership to the extent such gain is treated as an amount realized from the sale or exchange of property other than a capital asset under section 751(a).

(f) **SPECIAL RULES**

(1) **APPLICATION TO PARTNERSHIPS AND S CORPORATIONS**

(A) In general In the case of a partnership or S corporation—

(i) this section shall be applied at the partner or shareholder level,

(ii) each partner or shareholder shall take into account such person's allocable share of each qualified item of income, gain, deduction, and loss, and

(iii) each partner or shareholder shall be treated for purposes of subsection (b) as having W–2 wages and unadjusted basis immediately after acquisition of qualified property for the taxable year in an amount equal to such person's allocable share of the W–2 wages and the unadjusted basis immediately after acquisition of qualified property of the partnership or S corporation for the taxable year (as determined under regulations prescribed by the Secretary).

For purposes of clause (iii), a partner's or shareholder's allocable share of W–2 wages shall be determined in the same manner as the partner's or shareholder's allocable share of wage expenses. For purposes of such clause, partner's or shareholder's allocable share of the unadjusted basis immediately after acquisition of qualified property shall be determined in the same manner as the partner's or shareholder's allocable share of depreciation. For purposes of this subparagraph, in the case of an S corporation, an allocable share shall be the shareholder's pro rata share of an item.

(B)Application to trusts and estates

Rules similar to the rules under section 199(d)(1)(B)(i) (as in effect on December 1, 2017) for the apportionment of W–2 wages shall apply to the apportionment of W–2 wages and the apportionment of unadjusted basis immediately after acquisition of qualified property under this section.

(C)Treatment of trades or business in Puerto Rico

(i)In general

In the case of any taxpayer with qualified business income from sources within the commonwealth of Puerto Rico, if all such income is taxable under section 1 for such taxable year, then for purposes of determining the qualified business income of such taxpayer for such taxable year, the term "United States" shall include the Commonwealth of Puerto Rico.

(ii)Special rule for applying limit

In the case of any taxpayer described in clause (i), the determination of W–2 wages of such taxpayer with respect to any qualified trade or business conducted in Puerto Rico shall be made without regard to any exclusion under section 3401(a)(8) for remuneration paid for services in Puerto Rico.

(2)**COORDINATION WITH MINIMUM TAX**

For purposes of determining alternative minimum taxable income under section 55, qualified business income shall be determined without regard to any adjustments under sections 56through 59.

(3)**DEDUCTION LIMITED TO INCOME TAXES**

The deduction under subsection (a) shall only be allowed for purposes of this chapter.

(4)**REGULATIONS** The Secretary shall prescribe such regulations as are necessary to carry out the purposes of this section, including regulations—

(A) for requiring or restricting the allocation of items and wages under this section and such reporting requirements as the Secretary determines appropriate, and

(B) for the application of this section in the case of tiered entities.

(g) **DEDUCTION ALLOWED TO SPECIFIED AGRICULTURAL OR HORTICULTURAL COOPERATIVES**

(1) **IN GENERAL** In the case of any taxable year of a specified agricultural or horticultural cooperative beginning after December 31, 2017, there shall be allowed a deduction in an amount equal to the lesser of—

(A) 20 percent of the excess (if any) of—

(i) the gross income of a specified agricultural or horticultural cooperative, over

(ii) the qualified cooperative dividends (as defined in subsection (e)(4)) paid during the taxable year for the taxable year, or

(B) the greater of—

(i) 50 percent of the W–2 wages of the cooperative with respect to its trade or business, or

(ii) the sum of 25 percent of the W–2 wages of the cooperative with respect to its trade or business, plus 2.5 percent of the unadjusted basis immediately after acquisition of all qualified property of the cooperative.

(2) **LIMITATION**

The amount determined under paragraph (1) shall not exceed the taxable income of the specified agricultural or horticultural for the taxable year.

(3) **SPECIFIED AGRICULTURAL OR HORTICULTURAL COOPERATIVE** For purposes of this subsection, the term "specified agricultural or horticultural cooperative" means an organization to which part I of subchapter T applies which is engaged in—

(A) the manufacturing, production, growth, or extraction in whole or significant part of any agricultural or horticultural product,

(B) the marketing of agricultural or horticultural products which its patrons have so manufactured, produced, grown, or extracted, or

(C) the provision of supplies, equipment, or services to farmers or to organizations described in subparagraph (A) or (B).

(h)**ANTI-ABUSE RULES** The Secretary shall—

(1) apply rules similar to the rules under section 179(d)(2) in order to prevent the manipulation of the depreciable period of qualified property using transactions between related parties, and

(2) prescribe rules for determining the unadjusted basis immediately after acquisition of qualified property acquired in like-kind exchanges or involuntary conversions.

(i)**TERMINATION**

This section shall not apply to taxable years beginning after December 31, 2025.

(Added Pub. L. 115–97, title I, § 11011(a), Dec. 22, 2017, 131 Stat. 2063.)

---

[1] So in original. Probably should be “7704(b))”.