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The Adviser's Guide to

Financial and Estate Planning

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The Adviser's Guide to Financial and Estate Planning

Volume 4 of 4

Use this guide and other PFP Section resources noted throughout these pages to help you stay current, communicate with your clients, and reinforce your role as trusted adviser during this time of uncertainty.

About the AICPA Personal Financial Planning Section

The AICPA's Personal Financial Planning (PFP) Section is the premier provider of content and tools to help you deliver the most valuable and competent advice to your clients in the areas of estate, tax, retirement, risk management, and investment planning. Visit our website for more information on many of the topics covered in this publication, such as the AICPA PFP Section homepage at aicpa.org/pfp, Proactive Planning Toolkit (includes updates for relevant proposed and final legislation and regulation), PFP technical guides written by top experts, PFP Learning Library with 24/7 on demand access to top experts via webcast replays (with slides) and podcasts, Broadridge Advisor (3,000+ client facing tools), Bob Veres Inside Information (cutting edge planning & practice ideas), and Advanced PFP Conference recordings.

Long-term trends in client demographics, needs, and expectations are now compounded with larger issues impacting financial plans like US and global debt being at an all-time high, the banking crisis, inflation, and geopolitical concerns. Clients need the professional, objective, and trusted advice of the CPA Personal Financial Specialist (CPA/PFS) more than ever to sort out the myriad questions and complexities and provide peace of mind. Learn more about the CPA/PFS credential.

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Sidney Kess, Esp., CPA, JD, LLM, sadly passed away during the creation of the 14th edition of volume 4 of The Adviser's Guide to Financial Planning. He was an extraordinary man that words cannot properly describe. You can learn more about the essence of Sid in these JoA highlights, Sidney Kess, a personal remembrance, Remembering the mentorship and impact of Sidney Kess, and Summing up Sid: The ultimate friend and CPA to all. It was due to Sid's generosity that the PFP Section membership has received this guide as part of their member benefits over the last decade. Sid also handpicked top expert Steve Siegel, JD, LLM to keep this guide refreshed on an annual basis so that members would have the best of the best content. Our hearts go out to Sid and his family.

Sidney Kess was the recipient of the AICPA's Gold Medal Award for Distinguished Service to the Accounting Profession. This award is the highest award granted to a CPA by the Institute. CPA Magazine selected him as "Most Influential Practitioner." He is author and co-author of hundreds of tax books on financial, tax, and estate planning. He is one of the nation's best-known lecturers in continuing professional education (CPE), having lectured to more than 1 million practitioners. Mr. Kess was consulting editor of CCH's *Financial and Estate Planning Reporter*. Mr. Kess was Chairman of the Advisory Board of the Tax Hotline and is was member of the PPC, Tax Action Panel. He has edited a column, "Tax Tips," for the *New York Law Journal* for the past 51 years.

Mr. Kess edited the AICPA's *CPA Client Bulletin* and *CPA Client Tax Letter*. He was Executive Editor Tax of *CPA Magazine*, was on the editorial board of the New York State Society of Certified Public Accountants' *The CPA Journal*, and was coeditor of that journal's financial planning section. He also wrote hundreds of AICPA tax and financial planning workshops, audio and video programs, and was the recipient of the AICPA Distinguished Lecturer Award. Mr. Kess was often quoted in *The Wall Street Journal*, *The New York Times*, and other national publications. He was included in *Accounting Today's* "100 Most Influential CPAs in the U.S." for several years. Mr. Kess was the National Director of Tax at KPMG Main Hurdman and a tax partner at KPMG Peat Marwick. Mr. Kess was the recipient of the AICPA's "Special Recognition Award" for his many years of contributions to the AICPA's CPE program and was elected to the Estate Planning Hall of Fame by the National Association of Estate Planners & Councils for his distinguished service to the field of estate planning. Mr. Kess was also a member of the AICPA's Personal Financial Planning Executive Committee. Mr. Kess was the recipient of the AICPA's 2015 Personal Financial Planning Distinguished Service Award. He was also recipient of the AICPA's 2022 Stanley H. Breitbard Personal Financial Planning Distinguished Service Award.

The AICPA established the Sidney Kess Award for Excellence in Continuing Education to recognize individual CPAs who have made significant and outstanding contributions in tax and financial planning and whose public service exemplifies the CPA profession's values and ethics. Sidney Kess was the first recipient of this award. Mr. Kess was selected as one of "125 People of Impact in Accounting" by the *Journal of Accountancy* in its June 2012 issue celebrating the AICPA's 125th anniversary. Mr. Kess was inducted into the New York State Society of CPA's Hall of Fame. He recently received the New York State Society's Outstanding CPA in Education Award.

He received his JD from Harvard University School of Law, LLM from New York University Graduate School of Law, and BBA from Baruch College.

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Steven G. Siegel, JD, LLM, is president of The Siegel Group, which provides consulting services to attorneys, accountants, business owners, family offices, and financial planners. Based in Morristown, New Jersey, The Siegel Group provides services throughout the United States.

Mr. Siegel is the author of many books, including *The Grantor Trust Answer Book* (2021, Leimberg Information Services, Inc.); *The Adviser's Guide to Financial and Estate Planning* (AICPA 2023, formerly *The CPA's Guide to Financial and Estate Planning*); co-author, *Income Taxation of Trusts and Estates* (Carolina Press 2020; 2nd Edition 2023); *Understanding the Federal Gift Tax* (2021, Leimberg Information Services, Inc.) *Federal Fiduciary Income Taxation* (Foxmoor 2020); and *Federal Estate and Gift Taxation* (Foxmoor 2016). His articles have appeared in *Estate Planning Magazine*, *NAEPC Journal of Tax & Estate Planning*, along with numerous other publications.

In conjunction with numerous tax planning lectures he has delivered for the National Law Foundation, Mr. Siegel has prepared extensive lecture materials on the following subjects: *Planning for An Aging Population; Business Entities: Start to Finish*; *Preparing the Audit-Proof Federal Estate Tax Return*; *Business Acquisitions: Representing Buyers and Sellers in the Sale of a Business*; *Dynasty Trusts*; *Planning with Intentionally Defective Grantor Trusts*; *Introduction to Estate Planning*; *Intermediate-Sized Estate Planning*; *Social Security, Medicare and Medicaid: Explanation and Planning Strategies*; *Subchapter S corporations: Using Trusts as Shareholders*; *Divorce and Separation: Important Tax Planning Issues*; *The Portability Election*; and many other titles.

Mr. Siegel has delivered hundreds of lectures to thousands of attendees in live venues and via webinars throughout the United States on tax, business, and estate planning topics on behalf of numerous organizations, including The Heckerling Institute on Tax Planning, The Notre Dame Tax Institute, CCH, National Law Foundation, AICPA, Investments and Wealth Institute, Yale School of Management, University of Chicago Booth Business School, The Kansas City Estate Planning Symposium, Western CPE, the National Society of Accountants, Cohn-Reznick, CPAmerica, CPA Academy, Foxmoor Education, many state accounting societies and estate planning councils, as well as in-house training on behalf of private companies.

He is presently serving as an adjunct professor of law in the Graduate Tax Program (LLM) of the University of Alabama and has served as an adjunct professor of law at Seton Hall and Rutgers University law schools.

Mr. Siegel holds a bachelor's degree from Georgetown University (magna cum laude, Phi Beta Kappa), JD from Harvard Law School, and LLM in taxation from New York University Law School.

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Chapter 36

Asset Protection: Problems, Issues, and Opportunities

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¶3601 Overview

Asset protection is a critical issue for financial planners to address with their clients. The current trend is to look for fault of another whenever a problem arises. The current environment in litigation has created more exposure to financial risk than ever before.

Historically, people have sought asset protection by turning to such traditional forms of protection as insurance, incorporation, trusts, and family transfers. Insurance has its limitations, such as policy exclusions and limits, the possibility that insurance policies may be allowed to lapse, and the possible insolvency of the insurance company. Corporate limited liability protection may be disturbed if activities are deemed sufficient to allow the corporate veil to be pierced. In a number of areas, it has become possible to sue and recover damages from corporate officers and directors, even if they appear to be protected by the corporate form.

Many clients are vulnerable to claims made by potential creditors and litigants. In particular, persons who are involved in professional practices, owners of real estate, fiduciaries of trusts and estates, and corporate officers and directors have a high degree of exposure to claims. Married couples, especially if there is an imbalance of wealth between the parties, have special concerns. Divorce is certainly a possibility. Last but not least is the average person who may become subject to claims based on negligence, contractual issues, or mistakes made in the workplace, such as discrimination, libel, or harassment.

¶3605 Types of Asset Protection

.01 Transfers to a Spouse

A traditional form of asset protection suggests that a person considered vulnerable to claims should make his or her spouse the owner of the family assets. This can be an effective way to insulate the transferor's assets from claims, assuming the transfer to a spouse does not constitute a fraudulent conveyance (discussed in ¶3610, later).

However, transfers to a spouse are not free from concerns. There must be a high level of trust between the spouses. Even in the best of cases, there is the potential for loss of control over the transferred

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property by the transferor spouse. There is always the possibility that the parties may divorce, which can make it difficult for the transferor to recover an appropriate share of the transferred assets. The transferee spouse may have his or her own creditor issues, possibly defeating the asset transfer plan. If the parties are married, and the transferee is a U.S. citizen, the unlimited gift tax marital deduction will eliminate any gift tax concerns. However, the gift tax marital deduction is not available if the parties are not married or if the transferee is not a U.S. citizen. In such cases, the parties will have to rely on the present interest exclusion from the gift tax ($17,000 in 2023 and indexed annually for inflation), and the special annual exclusion for transfers to a spouse who is not a U.S. citizen ($175,000 in 2023 and indexed annually for inflation).

.02 Transfers to a Corporation

As a general rule, a shareholder has limited liability when investing in a corporation and is not personally liable for the corporation's debts. Thus, the personal assets of the shareholder are protected from the claims of the corporation's creditors. However, when a corporation is closely held, the actions of the corporation and its owners may be difficult to distinguish, and creditor lawsuits may attempt to "pierce the corporate veil" and hold a shareholder, officer, or director personally liable for the violation of a statute, an environmental regulation, or some other action. In addition, many owners of corporations do not pay proper attention to corporate formalities, such as keeping annual minutes or adhering to various state law formal requirements (such as filing annual business reports). This failure could create an opening for a creditor to claim that the business is not being appropriately treated as a corporation and bring personal claims against the owners.

The corporate shareholder could also be sued in his or her personal capacity for personal misconduct, which has nothing to do with the person's interest in the corporation. Here, a judgment creditor could reach the shares of the corporation to satisfy a claim and possibly force a liquidation of the corporation or at least a costly settlement to satisfy a judgment. Accordingly, placing one's assets in a corporation is not a fail-safe solution to asset protection concerns.

.03 Using Limited Partnerships and Limited Liability Companies

The advantage sought by persons using limited partnerships (LPs) or limited liability companies (LLCs) is that creditor relief for successful claims is typically limited to what is called a "charging order." This grants the creditor a lien on the debtor's LP or LLC membership interest but does not allow the creditor to take control of such interest, become a substitute partner or member, exercise any voting or control rights, or enforce the lien against the underlying assets of the LP or the LLC.

A creditor with a charging order may receive distributions only from the LP or LLC when, and if, the distributions are made to the limited partner or member from whose interest the charging order was obtained. This may prove to be an illusory benefit, especially in a family situation in which distributions are controlled by other family members and may be withheld if a charging order is outstanding. Compounding the problem for the creditor is the possibility (but, by no means, the certainty) that the creditor's share of the LP or LLC may be charged with income based on the creditor's "rights" pursuant to the charging order. If this occurs, the creditor may have "phantom income," which would obviously not be to the creditor's advantage. This argument can be resisted by creditors on the grounds that the "true" owner of the partnership interest is the partner, not the creditor.

Creditors may be expected to resist a finding that the charging order is their exclusive remedy. They may argue for a court-ordered partition of the LP or LLC interest. They may claim that the entity is a sham without business purpose or a device to hold the personal assets of family members. If the entity

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has been handled casually by the family, this could enhance a creditor's argument. Even if the entity is able to resist these claims, handling the distributions to other limited partners or members in a manner differently than those to the creditor holding a charging order may be a problem. Either the other participants may be required to forgo distributions, or the entity will be forced to honor the holder of the charging order's claims at some point in time.

.04 Using Joint Ownership of Property and Tenancies by the Entirety

Joint ownership of property in its basic, general form does not provide protection from the claims of creditors. However, a special form of joint ownership, called a "tenancy by the entireties," may offer limited creditor protection. A tenancy by the entireties may exist only between spouses. Some states limit this form of ownership to real estate; others allow it for personal property as well. When property is held in a valid tenancy by the entireties arrangement, it may not be severed unilaterally by either spouse, thereby prohibiting the creditor of one spouse from executing on property held as a tenancy by the entireties.

This form of ownership, however, is not entirely protected from creditors' claims. If the spouses divorce, the tenancy is severed. If the non-debtor spouse dies, the tenancy is severed. If the real estate is sold, and personal property may not be held in a tenancy by the entireties under state law, the tenancy is severed. It is also possible that the creditor can establish a claim against both spouses, which will allow an action against the property to proceed.

Most states allow some form of creditor protection for an individual's personal residence, often called a "homestead exemption." In some states (Florida, Iowa, Kansas, Oklahoma, South Dakota, Texas, Arkansas and the District of Columbia), it is an unlimited protection, and virtually no judgment (except, perhaps, those involving issues of child support, alimony, or IRS claims) can require the home to be taken. Asset protection concerns may suggest relocating one's principal residence to one of these jurisdictions and spending as much money as one can afford to shelter (with home improvements and little mortgage debt) on a principal residence. New Jersey and Pennsylvania offer no homestead protection.

.05 Using Retirement Plans and IRAs

A "qualified" retirement plan meeting the rules of the Employee Retirement Security Act of 1974 (ERISA) is protected from the creditors of the plan participant, including creditors in bankruptcy.[1] Qualified plans are typically pension and profit-sharing plans, 401(k) plans, 403(b) plans, and 457 plans.

IRAs are not qualified plans under ERISA, so this rule does not apply to IRAs. The 2005 Bankruptcy Abuse Prevention and Consumer Protection Act provided an exemption from claims of creditors for monies in a fund or account exempt from taxation under IRC Sections 408 or 408A (Individual Retirement Accounts and Roth IRAs). The exemption is limited to a cap of $1 million, subject to inflation adjustments (the adjustment increased the protected amount to $1,512,350 through March 31, 2025). The limitation applies without regard to amounts attributable to rollover contributions from qualified plans and the earnings thereon. However, inherited IRAs may be treated differently because they do not represent the retirement savings of the holder of such an IRA, and the funds in an inherited

[1] *Patterson v. Shumate*, 504 U.S. 753 (1992).

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IRA may be withdrawn at any time without penalty. The Supreme Court has held in *Clark v. Rameker*, 134 S. Ct. 2242 (2014), that although the bankruptcy code is intended to protect the retirement accounts of debtors, it is not meant to protect the inherited IRAs that debtors may have been bequeathed by someone else who, by definition, will no longer be using it for his or her own retirement. Noting that inherited IRAs do not permit contributions, have ongoing distribution requirements regardless of age and retirement, and have no early withdrawal penalties associated with them, the unanimous Supreme Court decision acknowledged that inherited IRAs are effectively "freely consumable" by the beneficiary, and thus should be freely available to the creditors of the beneficiary as well. Some states have enacted laws that offer additional protection to IRA accounts and Roth IRA accounts that exceed whatever protection is provided by federal laws. Some states provide absolute protection, others are protective but allow certain claims — so-called "exception creditors" (child support, alimony, etc.). Some are protective, but not when assets are placed in a plan a short time before a creditor claim arises.

.06 Life Insurance

Life insurance is another asset that can be used to obtain protection from the claims of creditors. Federal bankruptcy rules offer limited protection for life insurance policies owned by the debtor. The more generous protections from creditors are typically found in state laws. Although state laws may differ in detail, many provide that a beneficiary's interest in a life insurance policy owned by another is protected from claims of the policy owner's creditors, notwithstanding the fact that the owner retains the power to change the policy beneficiaries. A note of caution: Be sure the policy owner does not name his or her estate as the policy beneficiary. If so, creditors may assert their claims against the deceased policy owner's estate.

In most states, if a policy owner insures the life of another person, the interest of the policy owner is protected from the creditors of the insured. Similarly, the interest of an owner or beneficiary of a life insurance policy is protected from the owner's or beneficiary's own creditors if the insured is the spouse of the policy owner. If a policy is purchased by the owner on another person's life and a third party is named the beneficiary, the beneficiary's interest in the policy is protected from the claims of the creditors of both the owner of the policy and the insured. Finally, the policy owner's interest in the cash surrender value of a life insurance policy on the owner's life is protected from the claims of the owner's own creditors.

¶3610 Fraudulent Transfers

When a transfer is considered a *fraudulent transfer*, asset protection to benefit a debtor will not be successful. All states and many foreign jurisdictions have fraudulent transfer (or fraudulent conveyance) laws. These laws provide that the transfer of assets in the face of or in anticipation of a creditor problem will be disregarded by the courts, and the creditor will be allowed to enforce its judgment against the transferee of the debtor's property.

These laws are typically strictly and broadly interpreted and enforced. A fraudulent transfer is one made with the intent to hinder, delay, or defraud either an existing creditor or a reasonably anticipated future creditor. They apply to transfers intended to defeat the claims of present creditors (that is, those who have already given notice of claims when the transfer is made). The laws also apply to claims of subsequent creditors (that is, those creditors the transferor anticipated might be making a claim when the transfer was made as the result of a fraudulent intent on the part of the transferor or reckless disregard of another's rights by the transferor). They may also apply to claims of future creditors (that is, those persons with legitimate claims against the transferor unknown to the transferor when the transfer was made).

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The issue of a fraudulent transfer often comes down to intent. What did the transferor know, and when was it known? How close in time to the transfer of property was the claim of the subsequent creditor? If the transferor has been named a defendant in a lawsuit, that fact alone may render all subsequent transfers fraudulent until the lawsuit is resolved, regardless of actual intent. Transfers made to render the transferor insolvent will automatically be held to be fraudulent transfers.

These rules make it imperative that the financial planner recognize clients that may be particularly vulnerable to the potential claims of creditors and address asset protection planning well in advance of any claims by creditors or actions by the client that might give rise to claims. The sooner asset protection transfers of property are made, the greater the opportunity will be to defeat any assertion of a fraudulent conveyance transfer.

¶3615 The Use of Asset Protection Trusts

.01 Spendthrift and Discretionary Trusts

Many planners make extensive use of *spendthrift trusts*. These are trusts in which a beneficiary is prohibited from assigning an interest in the trust and provide that a creditor may not reach the trust income or assets. A spendthrift trust refers to a trust that restrains voluntary and involuntary alienation of all or any of the beneficiaries' interests.[2] Attorneys drafting trusts typically include a spendthrift clause to take advantage of this rule.

.02 Perpetual Dynasty Trusts

The spendthrift concept is often combined with a discretionary trust concept. A *discretionary trust* is a trust in which distributions to the beneficiary are left wholly within the discretion of the trustee, generally without regard to any ascertainable standard.[3] A discretionary spendthrift trust can afford a beneficiary a significant amount of creditor protection.

The tax planning use of gifting may be combined with the creation of trusts to accomplish significant asset protection benefits. A gift to a trust will divest the grantor of the donated assets. Such gifts are an integral part of appropriate estate planning so that they will not be viewed exclusively as asset protection vehicles. Because the motivation for these trusts is proper estate planning and transfer tax savings, absent a clearly improper motive, they may be viewed as something other than fraudulent conveyances (that is, their motivation is something other than to hinder, delay, or defraud creditors).

A popular planning technique to accomplish these ends is the *dynasty trust*. This is a trust created by a grantor intended to benefit multiple generations of the grantor's family and take advantage of both the generous lifetime gift tax (or death) exemption ($12,920,000 per transferor in 2023, indexed annually for inflation) and the generation-skipping transfer (GST) tax exemption (also $12,920,000 per transferor in 2023 and indexed annually for inflation). A dynasty trust can be established to last for as long as the rule against perpetuities of the jurisdiction in which the trust is created allows a trust to last. Many states have abolished the rule against perpetuities, meaning that the duration of a dynasty trust created in such a state can last forever. Other states have extended their rule for hundreds of years. Among the states

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[2] *Restatement (Third) of Trusts*, Section 58, Vol. 2 at 355 (2003).

[3] *Restatement (Third) of Trusts*, Section 58, Vol. 2 at 355 (2003).

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that encourage dynasty trusts with repealed or substantially lengthened rules against perpetuities are those that do not impose a state income tax on trust income, including Alaska, Delaware (no income tax on Delaware nonresidents), Florida, Nevada, South Dakota, and Wyoming.

Creating and funding a dynasty trust during the grantor's lifetime can provide asset protection for the grantor and the grantor's heirs. Heirs can be protected by the use of a testamentary dynasty trust. The trust can take advantage of the transfer tax and GST tax exemptions available to the grantor. The trust can have as its beneficiaries the spouse and children of the grantor, as well as grandchildren and more remote descendants. The trust can contain a spendthrift clause and give the trustees discretion with respect to distributions of income and principal. The future trust beneficiaries will enjoy asset protection from creditors. They will own no part of the trust property. They will have no entitlement to any distributions. Judgment creditors, contract creditors, and matrimonial creditors will not have any access to the trust property to satisfy their claims. Because the future trust beneficiaries will not own the trust assets, they will have use of, and access to, the trust property without concern that future estate or generation-skipping taxes (at least as current law provides) will be imposed on that property.

If the dynasty trust is established on the death of the trust creator, it can take advantage of the decedent's 2023 federal estate tax exclusion of $12,920,000 and GST exclusion of $12,920,000, and provide asset protection and tax savings for the decedent's heirs. It is suggested that these exemptions should be addressed sooner rather than later, given the sunset of current law after 2025 and the political risk of changes sooner. The GST exclusion is not portable, so every potential donor needs to act. (See the discussion of the GST tax in chapter 27). Dynasty trusts can be established using real estate, publicly traded securities, and family business interests. When appropriate, if a trust is funded with a minority interest in an enterprise, discounts may be claimed for minority interest and lack of marketability. This will have the effect of leveraging the transferor's available gift or estate tax and GST tax exemptions and allow even more assets to be used to fund these trusts.

.03 Self-Settled Domestic Spendthrift Trusts

In recent years, a number of states have permitted the creation of domestic asset protection trusts (DAPTs) by enacting legislation extending spendthrift protections to a grantor-beneficiary of a self-settled discretionary trust (that is, the person who created the trust may receive distributions of trust property in the trustee's discretion and still avoid claims of creditors). As long as the funding of the trust is not a fraudulent transfer, these state laws permit a wider range of asset protection trust availability than had previously been possible.

The following states have adopted variations on the domestic asset protection trust provisions: Alaska, Connecticut, Delaware, Hawaii, Indiana, Michigan, Mississippi, Missouri, Nevada, New Hampshire, Ohio, Oklahoma, Rhode Island, South Dakota, Tennessee, Utah, Virginia, West Virginia, and Wyoming. The provisions of laws governing these trusts vary from state to state, with some trying to outdo others when making their jurisdiction the friendliest location for protection from the claims of creditors. Nevada appears to be the most favorable asset protection state at the present time. Issues still remain unsettled when a court in a state that does not have its own domestic asset protection trust statute is

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asked to enforce the terms of an asset protection trust organized under the laws of another state having such a statute against the home state's creditors.[4]

Planning Pointer.

A state ranking of DAPTs and a separate ranking of dynasty trusts is available from Steven Oshins, Esq., AEP (Distinguished). Use this chart to help your clients plan where to set up asset protection trusts and coordinate with their attorneys. Access these useful charts from Steve Oshins.

Such a trust may also be viewed as an acceptable estate planning vehicle. In IRS Private Letter Ruling 200944002, involving a self-settled spendthrift trust created under Alaska law, the IRS ruled that the discretionary authority of the trustee to distribute income or principal, or both, to the grantor does not, by itself, cause the principal of the trust to be includible in the grantor's gross estate under IRC Section 2036. If there was a prearrangement regarding distributions from the trustee to the grantor, or if the grantor retained the right to revoke or terminate the trust, or if it could be shown that the transfer of property to the trust was intended to defraud creditors, the result would be different. But this planning can be done in such a way to accomplish legitimate estate planning goals (that is, the reduction of one's taxable estate) while adhering to the guidelines of this private letter ruling and still achieve significant asset protection results.

Note that many states without DAPT statutes continue to view the assets of a self-settled trust as available to the claims of creditors.

.04 Foreign Asset Protection Trusts

For many years, people have sought asset protection by creating trusts in foreign jurisdictions to place assets out of reach of the courts of the United States and their creditors because many foreign jurisdictions do not honor U.S. judgments involving the rights and claims of creditors. These trusts are not intended to be secret or concealed. Instead, they create a situation in which the creditor, even if a U.S. judgment has been obtained, must litigate the claim and seek enforcement in a foreign jurisdiction, the laws and system of which are designed to be friendlier to debtors than to creditors. This presents the creditors with not only substantial legal barriers to overcome but financial, procedural, and logistical barriers as well. Some of the foreign jurisdictions where these trusts are created do not permit attorneys to handle matters on a contingent fee basis. Some provide that the losing party in a lawsuit must pay all the expenses of the victorious party, including legal fees. Some require a standard of proof beyond a reasonable doubt to be successful in a fraudulent conveyance case.

Foreign jurisdictions do have laws addressing fraudulent transfers. However, a key question to raise involves the limitations period within which a fraudulent transfer claim must be made. A number of foreign jurisdictions have changed the former practice of providing no limitations period within which a creditor must bring a fraudulent transfer claim or be thereafter barred from asserting its claim. Now,

[4] *See Toni 1 Trust v. Wacker*, 2018 WL 1125033; 413 P. 3d 1199 (Alaska, Mar. 2, 2018); *In Re Cleopatra Cameron Gift Trust*, 2019 SD 35.

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such claims must be made within several years of arising in a number of jurisdictions or be forever barred.

When considering a foreign jurisdiction as the possible situs to recommend for a trust, the financial planner must consider a number of important factors, including the political stability of the country being considered; the laws of that country regarding trust laws (particularly the duration of the statute of limitations on claims of fraudulent conveyances); the tax laws of the country under consideration; the complexity of the legal system; access to the system; language barrier issues, if any; and the presence of trusted institutions or individuals to serve as trustees, as well as whether the trust grantor can be a beneficiary of the trust or exert any administrative control or influence over the trust's activities, or both.

A number of foreign jurisdictions have enacted legislation that is considered favorable to asset protection issues and hold themselves out as havens for asset protection trust planning. Some have laws and procedures more favorable than others. If the financial planner is considering recommending a foreign jurisdiction trust, the planner must exercise considerable due diligence before any recommendation is made and is probably well advised to engage an expert in this area of legal practice. Among the jurisdictions that may be considered are Anguilla, Antigua, the Bahamas, Barbados, Belize, Bermuda, the Cayman Islands, the Cook Islands, Cyprus, Gibraltar, Guernsey, Isle of Man, Jersey, Labuan, Malta, the Marshall Islands, Mauritius, Nevis, Niue, Panama, St. Kitts, St. Vincent, St. Lucia, the Seychelles, Trinidad, and Turks and Caicos. Check this list carefully with an expert because it is certainly subject to change.

It is expected that concerns about asset protection will only increase in the context of a complex and litigious society. The federal government continues to enact laws making it more difficult for Americans to have foreign trusts and foreign bank accounts. Annual reporting of such accounts has become increasingly detailed and burdensome. With a number of states competing for asset protection business by making their laws more favorable for debtors and encouraging self-settled asset protection trusts, it seems that the financial planner may be more comfortable looking at U.S. jurisdictions for such asset protection answers. Of course, an unknown in all of this is whether the federal government may, at some point, decide to occupy the field and attempt to pass enforceable laws that override state provisions and either do or do not allow self-settled asset protection trusts in various states to achieve the protections that so many taxpayers are seeking.

The Cook Islands, Nevis, Panama, and Belize are often cited as among the preferred foreign asset protection jurisdictions.

However, U.S. courts may not be "sympathetic" to foreign jurisdiction trusts where the U.S. jurisdiction determines that its public policy for protection of creditors is jeopardized. In the case of *In re Rensin, Case No. 17-11834-EPK, Adv. Proc. No. 17-01281-EPK (May 3, 2019)*, the U.S. Bankruptcy Court for the Southern District of Florida held that assets in a Belize asset protection trust were governed by Florida law; could be attached by creditors; and were subject to administration in bankruptcy.

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Chapter 37

Portability: An Estate Planning Game-Changer — But Not as Simple as It Seems

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¶3705 Portability Application

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¶3701 What Is Portability, and What Does It Accomplish?

Portability allows the estate of a decedent who is survived by a spouse to make an election to permit the surviving spouse to apply the decedent's unused federal transfer tax exclusion (referred to as the *deceased spousal unused exclusion* or DSUE) to the surviving spouse's own transfers during life and at death. The 2023 basic exclusion amount is $12,920,000, indexed annually for inflation. It was originally $5 million in 2011.

The American Tax Relief Act of 2012 (ATRA) made permanent portability between spouses. The portability rules apply to deaths in 2011 and later. Nothing in the 2017 Tax Cuts and Jobs Act disturbed the portability opportunity.

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Example 37.1. Husband (H) died in 2011, leaving surviving Wife (W) an estate of $5 million outright. None of H's DSUE has been used to date. In 2023, W has H's $5 million DSUE plus her own inflation-adjusted $12.92 million basic exclusion amount (a total of $17.92 million) for gift and estate tax purposes.

Example 37.2. W died in 2011, leaving all her estate ($5 million) to her children from her first marriage. H survives W. In 2023, H has his own $12.92 million basic exclusion amount but received no DSUE from W.

Example 37.3. Assume in example 2, W left $2 million to her children, using $2 million of her basic exclusion amount, and her remaining $3 million to H using the unlimited marital deduction. Now, in 2023, H would have DSUE from W of the $3 million unused exclusion, plus his own $12.92 million exclusion, for a total gift and estate tax exclusion of $15.92 million.

Among the legislative purposes of portability is the effort to create fairness between those people who plan their estates and those who fail to do so. It preserves the unused portion of the deceased spouse's exclusion, which might otherwise have been lost through inadvertence or poor planning. It is designed to eliminate the need for many married couples to maintain assets in the separate names of each spouse and to not force, if not otherwise desired, the creation of complex trusts (referred to as *credit shelter trusts* or *bypass trusts*) at the death of the first spouse to be certain the federal transfer tax exclusion available to the first decedent is properly used.

This portability rule is effective for the unused exclusion amount of the deceased spouse who passed away after December 31, 2010. This amount is available to the surviving spouse in addition to the surviving spouse's own applicable exclusion amount.[1]

Certain observations must be made about portability, which will foreshadow some of the complications to be addressed later in this discussion. The following observations apply especially with respect to those estates that may be larger, rather than smaller:

- Although the basic exclusion amount for those persons living is indexed annually for inflation, once a death occurs, the DSUE is not further indexed for inflation.
- The unused GST tax exemption of a predeceased spouse is not portable.
- At least to date, state death tax exemptions (with the exception of Hawaii and Maryland) are not portable and will not be unless a state has adopted rules analogous to the federal rules for portability.
- If the current basic exclusion amount is reduced, the deceased spousal unused exclusion (DSUE) available from a predeceased spouse will not be reduced. Whether DSUE is used or unused, there will be no claw back.

[1] IRC Section 2010(c)(5).

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¶3705 Portability Application

In a situation in which a surviving spouse is predeceased by more than one spouse, the amount of the DSUE that is available to be used by the surviving spouse is limited to the lesser (for a death in 2023) of the basic exclusion amount of $12,920,000 or the unused exclusion amount of the last deceased spouse. If the last deceased spouse has no unused exclusion available, the surviving spouse gets no benefit from portability from that spouse, and the unused exclusion of an earlier deceased spouse cannot be used in such a case and is irrevocably lost. If none of the last deceased spouse's basic exclusion was used, the surviving spouse gets (for a death in 2023) the entire DSUE of $12.92 million from the last deceased spouse (but loses any unused DSUE from a previously deceased spouse) and may use his or her own basic exclusion amount as well.

A surviving spouse may use the last predeceased spouse's DSUE in addition to the surviving spouse's own 2023 $12,920,000 exclusion for transfers made by the surviving spouse either during lifetime or at death. A very favorable rule provides that for transfers made during lifetime, a donor is deemed to use the DSUE of the last deceased spouse **before** using his or her own transfer tax exclusion.

¶3710 Election Requirement for Portability to Apply

Portability is elective, rather than automatic.[2] In order for a surviving spouse to be allowed to use the DSUE amount of a predeceased spouse, an election must be made by timely filing a federal estate tax return (Form 706) (including extensions) for the estate of the predeceased spouse, regardless of the size of that person's gross estate (that is, regardless of whether the estate of the predeceased spouse is otherwise required to file an estate tax return).

Form 706 **must** be filed for a decedent whose gross estate exceeds the basic exclusion amount plus adjusted taxable gifts.[3]

There are no special boxes to check or statements to make on Form 706 in order to make the portability election. Form 706 is due 9 months after a decedent's date of death. Requests for an automatic 6-month extension of time to file must be made on Form 4768 filed before the due date of Form 706. Part 6 of Form 706 addresses the DSUE and requires calculations of the amount of DSUE portable to the surviving spouse and the amount of DSUE received from predeceased spouses. Part 6 also contains information about how to opt out of portability, and special considerations if there is a qualified domestic trust (QDOT) for a noncitizen surviving spouse.

Failure to timely file Form 706 will effectively prevent the portability election, absent obtaining the relief from non-filing discussed in the next section. Estates of decedents who passed away before January 1, 2011, are not entitled to make the portability election.

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[2] Regulation Section 20.2010-2(a).

[3] IRC Section 6018.

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.01 Relief for Missed and "Late" Portability Elections — Rev. Proc. 2017-34; Superseded by Rev. Proc. 2022-32

IRS Revenue Procedure 2014-18 stated that a late Form 706 could be filed to make the portability election as long as the form was filed by December 31, 2014. Once that date passed, the only relief allowed by the IRS was through an application for an extension of time to make the portability election by means of a private letter ruling, and payment of the required user fee, which in 2023 is $12,600.

Since the end of 2014, hundreds, if not more, private letter ruling requests were filed (and granted) under Reg. 301.9100-3 to extend the time to make a portability election where the decedent's estate was not otherwise required to file Form 706. Because the interests of the IRS would not be prejudiced by a late Form 706 filing and late portability election in such cases, relief was typically granted. Visit www.irs.gov for examples, including (LTR 202226005) (Jul. 5, 2022), and hundreds of others.

On June 12, 2017, the IRS issued Rev. Proc. 2017-34, Internal Revenue Bulletin (IRB) 2017-26, which provides a simplified method for estates of decedents that are not otherwise required to file Form 706 under IRC Section 6018(a) to obtain an extension of time to file Form 706 and elect portability, without a private letter ruling or user fee, assuming certain criteria are satisfied.

The taxpayer must be an executor of the estate of a decedent who was survived by a spouse who died after December 31, 2010, and a U.S. citizen or resident at the time of death. A complete and properly prepared Form 706 must then be filed on or before the *second anniversary* of the decedent's date of death. The words "FILED PURSUANT TO REV. PROC. 2017-34 TO ELECT PORTABILITY UNDER 2010(c)(5)(A)" must be written at the top of Form 706. Assuming these requirements are met, relief will be granted to extend the time to elect portability. On July 8, 2022, the IRS announced in Rev. Proc. 2022-32 that the two-year period from date of death to elect portability has now been extended to five years. The IRS has expressed that it is burdened by a large number of ruling requests to elect portability for which the two-year opportunity was not available; hence the extension to five years. The return (Form 706) must say at the top of page 1 "FILED PURSUANT TO REV. PROC. 2022-32 TO ELECT PORTABILITY UNDER § 2010(c)(5)(A)."

The IRS will close the file on any pending ruling requests from estates eligible for relief under Rev. Proc. 2022-32, and will refund the user fees.

If a taxpayer does not meet the requirements for relief, the estate can still request an extension of time to make a portability election by requesting a private letter ruling and paying the required user fee. If a taxpayer had a letter ruling request pending on June 9, 2017, and the estate was within the scope of the Revenue Procedure, the ruling request file was closed, and the user fee was refunded. However, if the Form 706 was required to be filed, even if no tax was due, and it was not timely filed, there is no relief available under a private letter ruling or otherwise that would allow a late portability election.

¶3711 The IRS Adopts Final Portability Regulations

The IRS issued T.D. 9725 (June 12, 2015) that includes more specific guidance on the requirements for electing portability of a deceased spouse's DSUE, and the rules for the surviving spouse's use of this DSUE amount.

The following sections review some of the significant revisions made by the final regulations.

No simplified Form 706. The recommendation for the IRS to issue a shorter version of Form 706 for portability election purposes was rejected.

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Filing extensions. The IRS clarified that when the value of a gross estate falls below the threshold amount in IRC Section 6018 for being required to file an estate tax return, that estate can potentially qualify for an extension of time to elect portability under Treasury Regulations 301.9100-3 (under which the IRS can grant a non-automatic extension for making certain regulatory elections if applicable requirements are met — as described in Rev. Proc. 2017-34, and now in Rev, Proc. 2022-32 as indicated earlier). Relief under that section may be granted to an estate that is not otherwise required to file an estate tax return.[4] However, the final regulations confirm that no late portability election will be allowed if an estate tax return is required under IRC Section 6018 (in other words, the general filing requirement for an estate tax return based on the value of the gross estate plus adjusted taxable gifts exceeding the basic exclusion amount in the year of death).

The portability election when the DSUE amount is not certain. Although the inclusion of a computation of the DSUE amount is an essential requirement of a complete and properly prepared estate tax return intended to make the portability election,[5] in the regulations the IRS acknowledges that there are situations in which subsequent adjustments are made to the return that would modify the amount of the unused exclusion of a decedent. In T.D. 9725, the IRS provided the example of an estate that, at the time of filing, has a DSUE amount equal to zero but also has pending claims against it that, when subsequently paid, result in an unused exclusion amount. In the example, the executor filed a contemporaneous protective claim for refund, and the IRS stated that the executor in the example properly elected portability and that the recomputed DSUE amount was available to the surviving spouse.

The final regulations clarify that the computation requirement in IRC Section 2010(c)(5)(A) will be satisfied if the estate tax return is prepared in accordance with the requirements of Treas. Reg. 20.2010-2(a)(7), which sets out the conditions that must be met for an estate tax return to be considered "complete and properly prepared" (and which are satisfied in the example described previously).[6]

The return must be complete and properly prepared. The regulations provide a "special rule" for estates that are otherwise not required to file an estate tax return under IRC Section 6018. This special rule effectively exempts the executor from reporting the value of certain property that qualifies for the marital or charitable deduction (and sets out exceptions to this rule). Listing the decedent's assets without indicating a specific value for each and estimating the total value is an approved filing method. See ¶3735 and ¶3740.

Who can make the portability election? The IRS declined to revise (expand) the definition of "executor" for purposes of the portability election or provide guidance on what state court actions may be needed to control or direct the actions of an executor, especially if the appointed executor declines to make a portability election and the surviving spouse or other beneficiaries object.

Qualified domestic trusts for non-U.S. citizens (QDOTs). The executor of a decedent's estate claiming a marital deduction for property passing to a noncitizen spouse via a QDOT should compute the decedent's DSUE amount on the estate tax return for the purpose of electing portability in the same

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[4] Treas. Reg. 20.2010-2(a)(1).

[5] IRC Section 2010(c)(5)(A).

[6] Treas. Reg. 20.2010-2(b).

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way the DSUE amount is computed for any other decedent. However, because estate tax payments or principal distributions made from the QDOT after the decedent's death may be part of the decedent's estate tax liability, the decedent's DSUE amount must be redetermined upon the final distribution or other taxable event on which estate tax under IRC Section 2056A is imposed. Accordingly, when determining the applicable exclusion amount available to the surviving spouse or the surviving spouse's estate, the earliest date such a decedent's DSUE amount may be computed is the date of the event that triggers the final estate tax liability of the decedent under IRC Section 2056A.

If the surviving spouse of the decedent becomes a citizen of the United States and the requirements under IRC Section 2056A(b)(12) and the corresponding regulations are satisfied, such that the tax on distributions from a QDOT imposed by IRC Section 2056A(b)(1) no longer applies, then the decedent's DSUE amount is no longer subject to adjustment. Consequently, it will become available for transfers by the surviving spouse as of the date the surviving spouse becomes a U.S. citizen.[7]

DSUE for surviving spouses who become U.S. citizens.[8] The final regulations include a rule allowing a surviving spouse who becomes a U.S. citizen after the death of the deceased spouse to take into account the DSUE amount of such deceased spouse, provided the deceased spouse's executor has made the portability election.

Allowable tax credits. T.D. 9725 provides that the amount of the allowable credits under IRC Sections 2012–2015 (for gift tax, estate tax on prior transfers, foreign death taxes, and death taxes on remainders, respectively) can be determined only after subtracting the applicable credit amount determined under IRC Section 2010 from the tax imposed by IRC Section 2001. Accordingly, to the extent the applicable credit amount is applied to reduce the tax imposed by IRC Section 2001 to zero, the credits in IRC Sections 2012–2015 are not available. The IRS further observed that the rule in IRC Section 2010(c)(4) for computing the DSUE amount does not take into account any unused credits arising under those sections. Therefore, eligibility for credits against the tax imposed by IRC Section 2001 does not factor into the computation of the DSUE amount.[9] The credits are essentially wasted.

Disregarded Qualified Terminable Interest Property (QTIP) elections. In Rev. Proc. 2016-49, IRB 2016-42 (September 27, 2016), the IRS addressed the issue of QTIP elections that are made when no estate tax is due and a portability election is made to use the decedent's DSUE. Here, the IRS announced that it would allow (and not disregard) QTIP elections even if the election was not necessary to eliminate estate tax liability. Such trusts are sometimes referred to as "portability QTIPs."

Effective date. The final regulations became effective on June 12, 2015, and are applicable to estates of decedents dying and gifts made on or after that date.

¶3715 Should Small Estates File Form 706 to Elect Portability?

There may be a tendency on the part of representatives of smaller estates to decide that making the portability election is not necessary because it may be assumed that it is unlikely that the estate of the

[7] Treas. Reg. 20.2010-2(c)(4); Treas. Reg. 20.2010-3(c)(3); Treas. Reg. 25.2505-2(d)(3).

[8] Treas. Reg. 20.2010-3; Treas. Reg. 25.2505-5.

[9] Treas. Reg. 20.2010-2(c)(3).

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surviving spouse would ever reach the level of the DSUE plus the surviving spouse's own basic exclusion amount. However, it is advised that even small estates should make this election.

What if the surviving spouse receives a windfall after the first spouse dies? This windfall could come in the form of an unexpected inheritance, a winning lottery ticket or profitable casino visit, or by being an injured plaintiff in a personal injury case. What if the surviving spouse remarries a wealthy person, making the DSUE more valuable? Had the representative of the first decedent simply elected portability, the additional exclusion would be available to the surviving spouse. Consider the portability election as an insurance policy against taxation of unexpected future wealth. If a windfall does occur, and no portability election was made, the representative of the estate of the first decedent may be sued for negligence by the heirs of the second spouse to die. If an election is not made at the insistence of the decedent's heirs, the executor should get a signed letter from the beneficiaries of the estate of the first decedent absolving the executor from any responsibility for failure to make the election. What if there is political change and the transfer tax exclusion is reduced, or extensions to elect portability are eliminated? The IRS has issued Treasury Regulation 20.2010-1, which states that even if the transfer tax exclusion is reduced in the future, any DSUE established prior to the change in the law will not be reduced and may still be used.

Note that the requirement to file Form 706 to make a portability election will require more filings of federal estate tax forms than would have previously been the case, especially with respect to relatively small estates well below the threshold required to pay taxes, but for which it is certainly advantageous and proper to make the portability election. The instructions for Form 706 have permitted a more simplified filing process if the form is being filed only to make the portability election. See ¶3725 and ¶3740 of this guide.

¶3720 Unlimited Statute of Limitations to Resolve a DSUE Claim

The IRS is given an unlimited statute of limitations (effective through the expiration of the statute of limitations on the death of the surviving spouse) to examine the return of the predeceased spouse in order to determine the correct DSUE amount available for use through portability by the surviving spouse. This suggests the requirement of record preservation by the executor for a potentially very long period of time — at least until several years after the death of the surviving spouse. The adequate disclosure rules do not apply to this situation.[10] The Tax Court has affirmed the unlimited statute of limitations in these circumstances.[11]

According to the regulations, the DSUE amount reported on Forms 706 can be adjusted or eliminated after the normal three-year limitations period, but additional tax on earlier Forms 706 can be assessed only within the normal statute of limitations period applicable to each deceased spouse's Form 706.

[10] Treas. Reg. 20.2010-3(d) and 25.2515-2(e).

[11] *Estate of Sower*, 149 T.C. No. 11 (Sept. 11, 2017).

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¶3725 Complete and Proper Preparation of Form 706, Special Rules for Estates Filing Only to Make the Portability Election

The regulations provide that an estate tax return prepared in accordance with all applicable requirements is considered to be a "complete and properly prepared" return. However, there is a special rule for smaller estates not otherwise required to file.[12]

In these situations, executors do not have to report the values of certain assets that qualify for the marital or charitable deduction. For those estates not otherwise subject to tax, the values of such assets are irrelevant for estate tax purposes; note, however, that such values are, nonetheless, relevant for determining basis for income tax purposes. Pursuant to Treas. Reg. 20.2010-2(a)(7)(ii)(A), estates need only report the property description, ownership, or beneficiary of such property and all other information necessary to establish entitlement to the marital or charitable deduction.

In addition, with such smaller estates, for purposes of Form 706, the executor must estimate the total value of the gross estate (including the values of assets not required to be specifically valued) based on a "determination made in good faith and with due diligence."

Instructions for Form 706 provide ranges of dollar values. The executor must identify the range for the executor's best estimate of the value of the gross estate. The executor will estimate the estate's total value, generally rounded to the nearest $250,000.

If a complete and properly prepared return is filed, the portability election is deemed made.[13] The regulations require the executor to make an affirmative statement on Form 706 to opt out of portability. A box is provided on Form 706 to opt out of portability. Failure to timely file Form 706 will also be considered such an affirmative statement opting out of portability.[14]

¶3730 Who Is Responsible for Making the Portability Election?

The regulations state that if an executor or administrator is appointed, then only such fiduciary (and not the surviving spouse) may file Form 706 to elect portability (or to opt out).[15]

If there is no appointed executor, any person in actual or constructive possession of any property of the decedent may file Form 706 to elect portability (or to opt out). Any portability election made by such a "non-appointed executor" cannot be superseded by a contrary election made by another non-appointed executor of that same decedent's estate. How does one resolve a potential conflict? Race to file? Should a surviving spouse always file in the absence of an appointed fiduciary?

Even if otherwise unnecessary, a surviving spouse may be well advised to commence a probate proceeding and obtain appointment of an executor or administrator (including herself or himself) to

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[12] Treas. Reg. 20.2010-2(a)(7)(ii).

[13] Treas. Reg. 20.2010-2(a)(1) and (2).

[14] Treas. Reg. 20.2010-2(a)(1) and (2).

[15] Treas. Reg. 20.2010-2(a)(6).

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control the process and ensure that the portability election is made in his or her favor. Note, however, that a surviving spouse may have great difficulty filing a return with sufficient information to constitute a "complete and properly prepared return" if others in control of the decedent's assets are hostile or uncooperative.

¶3735 The Angry or Vindictive Executor

Beware of the angry executor. If the executor of the first spouse to die is resentful of the surviving spouse, the executor may choose to ignore the portability opportunity to deny the additional tax savings in the future estate of the surviving spouse. Perhaps the executor is a stepchild of the surviving spouse, who resents the surviving spouse and does not want to allow a tax benefit to flow to the survivor's family. Consider adding a provision to the decedent's will or trust agreement requiring a portability election to be made to avoid any conflicts. Consider inserting language in a prenuptial agreement that requires the executor of each spouse, or at least of the spouse with the lesser amount of assets, to elect portability if that spouse is the first to die.

¶3740 Navigating Form 706 for Portability

Form 706 provides a step-by-step calculation (Part 6, Section C) to show the DSUE amount being portable from the deceased spouse to the surviving spouse.

The form and instructions reflect the more simplified reporting and permitted estimates of values (estimate the value of the assets and round up by generally $250,000) suggested by the regulations. The simplified reporting method does not require calculation or identification of marital and charitable deduction amounts. Section A of Part 6 states that a decedent with a surviving spouse elects portability of the DSUE by completing and timely filing Form 706. An estate can elect out of the portability election by checking a box in Section A. Section B inquires about any assets being transferred to a QDOT for a noncitizen surviving spouse, which would require the recomputation of the DSUE at the time of the final distribution of the QDOT property or other taxable event. Section C is used to calculate the DSUE transferred to the surviving spouse. In Section D, the estate of a surviving spouse with DSUE from a predeceased spouse computes the DSUE received from a predeceased spouse or spouses. There are also other revisions to Form 706 to reflect the portability changes in the computation sections.

Form 706 mandates the simplified approach when the estate is below the otherwise required filing threshold. This poses a problem: How, then, is the reverse QTIP election made when the estate of the first decedent is below the basic exclusion amount, but there is a desire to use the GST tax exclusion of the first spouse to die? (Recall that the GST exclusion is not portable.) To address this issue, the IRS says to use the standard rules for filing Form 706 when a reverse QTIP is desired (complete Schedule M and Schedule R as if the return was a required filing) and use the simplified approach for the balance of the return.

Solely for purposes of computing the DSUE amount, the amount of gifts on which gift taxes were previously paid by a decedent is excluded from the definition of adjusted taxable gifts.[16]

[16] Treas. Reg. 20.2010-2(c)(2).

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Many practitioners are concerned that use of the simplified Form 706 approach with its estimated values will not provide the decedent's heirs with accurate information as to the income tax basis of the decedent's property. It is suggested that a schedule of accurate values be attached to the filed return, or at least be given to the beneficiaries to create a record of income tax basis.

The completion of Form 8971 (see the discussion at Section 5050) that reports the basis of the decedent's assets (the "Consistent Basis Rules") is not required when Form 706 is filed only to elect portability. Form 8971 must be filed only when there is a required filing of Form 706.

¶3745 Navigating Form 709 for Portability

Form 709 addresses portability on Schedule C, DSUE Amount. Assuming the executor of the estate of the last deceased spouse of a surviving spouse elected portability, the surviving spouse can use the DSUE of that spouse as an additional gift tax exclusion. If a taxable gift is made, the DSUE amount received from the last deceased spouse is applied before the surviving spouse's basic exclusion amount.

Schedule C is completed by indicating the DSUE amounts received from the donor's last deceased spouse and any previously deceased spouses. Each line on Schedule C should reflect a different predeceased spouse. In Schedule C, Part 1, include information about the DSUE amount from the donor's most recently deceased spouse (after December 31, 2010). Indicate amounts of DSUE applied in prior years (beginning in 2011, if applicable) and for the current year.

In Schedule C, Part 2, include information about the DSUE amount from any spouses who passed away prior to the donor's most recently deceased spouse (but not before January 1, 2011). If DSUE was received from such spouse(s), indicate the amount of their DSUE applied against prior lifetime transfers. Note that any remaining DSUE from a predeceased spouse cannot be used if such spouse is not the most recently deceased spouse of the survivor on the date of the gift.

¶3750 How Is the DSUE Determined?

The regulations state that the DSUE is the lesser of the basic applicable exclusion amount, or the excess of the basic exclusion amount of the surviving spouse's last deceased spouse over the amount with respect to which the tentative tax was determined with respect to such deceased spouse's estate.

The regulations note that if the surviving spouse remarries, the DSUE will still be available to the surviving spouse as long as his or her new spouse is living. Therefore, a surviving spouse who remarries may want to use his or her DSUE quickly to protect against losing it upon the death of his or her new spouse. Patience in using one's DSUE is not a virtue here. However, if the surviving spouse remarries and divorces, the later death of the "new" (and divorced) spouse will not destroy the DSUE from the first deceased spouse because the second spouse, not being married to the surviving spouse at death, is not the last deceased spouse.

If a surviving spouse who has DSUE makes a taxable gift, the DSUE is applied first, before using the surviving spouse's own basic exclusion amount. This facilitates the use of the DSUE by a surviving spouse who remarries and risks losing it if the new spouse predeceases him or her. If a surviving spouse uses the DSUE of the first decedent-spouse, remarries, and then the new spouse dies with DSUE, the surviving spouse has a "new" last deceased spouse and can use that person's DSUE without concern for having previously used the DSUE of the first spouse to die.

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¶3755 Advantages and Disadvantages of Portability

.01 Simplification

An obvious advantage of portability is that it simplifies the estate planning process for many people. It will eliminate for many married people the need to divide their assets and hold them in the separate names of the spouses. Its use will provide a date-of-death value as the basis in the assets left to the surviving spouse. Portability may eliminate for many families the use of a bypass (credit shelter) trust. Such a trust may not be needed for federal estate tax reduction over two deaths (except perhaps in a state with a state death tax), so that it will not be used, especially if the property of the first decedent-spouse is not likely to appreciate substantially during the remaining lifetime of the surviving spouse.

.02 Retirement Plan Rollover Advantage

Portability can be a major advantage when the decedent has a large retirement plan. Before portability, there may have been a dilemma regarding whether to leave the plan to the surviving spouse to take advantage of the spousal rollover opportunity, favorable deferral, and favorable distribution rules or leave the plan to a bypass trust as perhaps the only family asset large enough to absorb the available applicable exclusion. This latter disposition may have saved estate taxes over two deaths but may have resulted in faster required minimum distributions and increased income tax liability for the surviving spouse. With the increased transfer tax exclusion and the portability option, married persons with large retirement plans will be more likely to leave them outright to their spouses and retain the spousal rollover as a viable planning option.

Planning Pointer.

Planning for Residents of States with Independent Death Taxes. States that have decoupled from the federal estate tax system must be taken into account when planning. What planning is appropriate in circumstances in which there may still be a state death tax, regardless of the fact that there may not be a federal estate tax as a result of the decedent's estate falling short of the federal exclusion but exceeding the state exclusion?

Be careful of planning that directs an entire estate to pass to a credit shelter trust. Although this may be a good idea under the federal system with the enhanced federal exclusion, it may result in a very substantial state estate tax. When the federal applicable exclusion is $12,920,000 (for 2023) and a credit shelter trust of that amount is funded, the state estate tax liability in many decoupled states may approach or exceed $1 million, depending on the state's exemption.

Similarly, be careful of ignoring the presence of an available state death tax exclusion at the first death of a married couple. If everything is left to the surviving spouse (taking advantage of the unlimited marital deduction and portability), there will be no state death tax at the first death, but no use of any exclusion for the deceased spouse. That will mean more assets will likely be subjected to state taxation at the second death, at least some of which tax liability could have been avoided if the state death tax exclusion was used at each death.

.03 Is the Simple Estate Plan the Better Plan?

The intentional rejection of a bypass trust can be viewed as either an advantage or a disadvantage. Without one, the surviving spouse has more control over property. In some families, this is viewed as an advantage and, in others, a disadvantage. Issues of asset protection, management, protection from future

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spouses of the surviving spouse and spouses of children, protection of blended family heirs of one spouse but not the other, and ultimate control of the disposition of the property by the first spouse to die must be considered as part of the portability discussion. Especially in situations in which there is a blended family or serious concerns about asset protection, remarriage, or management with respect to the surviving spouse, the simplicity of the portability election for an outright property distribution may be outweighed by the protection provided by the bypass trust or a QTIP marital trust at the first death.

For many families, the QTIP is the ideal planning solution — there is financial protection provided for the surviving spouse and availability of the decedent's DSUE, but with ultimate control of asset distribution remaining with the first spouse to die.

What happens if the assets left by the first decedent appreciate dramatically during the lifetime of the surviving spouse, who may survive the first decedent by many years? If portability is used, all the appreciated property will be taxable at the death of the surviving spouse. The DSUE amount is not indexed for inflation, so the DSUE of the first decedent is frozen and offers no help to address significant appreciation and inflation. Had the credit shelter bypass trust been used instead of portability at the first death, the appreciation would stay with the credit shelter trust, which would not be subjected to transfer tax at the second death.

.04 The Dilemma: Appreciation and Inflation Protection Versus Basis Step-Up Advantage

As indicated previously, portability is not indexed for inflation. Portability does not apply to the decedent's unused GST exemption. However, portability has the advantage of potentially providing a second step-up in basis of the assets of the first decedent-spouse. The first step-up occurs when the first spouse dies; the second occurs when the surviving spouse dies, having inherited the assets of the first spouse.[17] Higher income tax basis and potentially reduced capital gains are valuable planning opportunities, especially with the income tax rates for wealthy individuals and the net investment income tax effective in 2023.

Using the credit shelter bypass trust gets a basis step-up at the first death but not at the second death. Compare the advantage of the potential basis step-up over two deaths using portability, with the appreciation and inflation protection for the estate of the second spouse to die using the bypass trust. This comparison can possibly pose a very difficult case-by-case analysis, especially when the "unknown" of future political change and possible revision of the law is added to the discussion.

.05 Sophisticated Planning to Address the Appreciation Concern Without Losing the Basis Step-Up

The following sophisticated planning strategies address appreciation concerns:

1. To address the concern of appreciation without protection from future taxation, consider using portability with an outright transfer to the surviving spouse, and then have the surviving spouse take the assets with the greatest appreciation potential and use them in conjunction with a defective grantor trust to be created by the surviving spouse. The inherited assets are then sold to the trust in exchange for an installment note. This freezes the value of the ported assets in the hands of the survivor at the amount of the note and allows all future appreciation to inure to the benefit of the trust beneficiaries — typically, the children or grandchildren of the surviving spouse. That addresses the appreciation issue.

[17] IRC Section 1014.

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Loss of a potential basis step-up at the second death is also a concern. If the sale to the defective trust is accomplished, the basis of the property to the trust is the carryover basis from the trust grantor (the surviving spouse). Here, the power used by the surviving spouse to make the trust defective should be the power of substitution. The exercise of this power will enable the surviving spouse to substitute higher basis property from time to time for the property in the trust, thus managing the basis issue while the trust property appreciates outside of the survivor's estate. As long as the grantor trust rules are not changed, this combination of planning techniques should achieve the dual goals of using portability to gain the potential basis step-up of the property in the trust and avoiding tax on appreciation and inflation at the time of the second death.

If the surviving spouse exercises the power of substitution and reacquires property with a low basis, retaining that property until death will provide the heirs with a date-of-death fair market value basis.

To make this planning work, the first decedent-spouse must be comfortable that the survivor will follow through and accomplish everything envisioned by this plan. If there are any concerns, trusting the survivor with a full portability opportunity (with no protection of children by the first decedent), especially with a large estate or a blended family, may be a very big "leap of faith" and should not to be entered into without a great deal of reflection and assurance.

2. Another method used to address the desire for the double basis step-up issue is to use a credit shelter trust and plan it so that the "Delaware tax trap" can be triggered by the surviving spouse to cause the trust assets to be includable in the surviving spouse's gross estate.

   The credit shelter trust would be created at the death of the first spouse, thereby controlling the future appreciation issue. The trust would be drafted to give the surviving spouse a limited power of appointment that includes the power to grant new presently exercisable powers of appointment to appoint property in further trust, extending the duration of the original trust. This places the decision of whether to trigger estate inclusion in the surviving spouse's gross estate totally in the hands of the surviving spouse to be exercised in the future.

   If the surviving spouse wants to trigger estate inclusion, the spouse would exercise the original limited power to create a presently exercisable power of appointment in someone else to extend the term of the trust. That would "spring" the Delaware tax trap and cause estate inclusion in the surviving spouse's gross estate under IRC Section 2041(a)(3). Thus, the assets would receive a basis adjustment to date of death value. This plan could be particularly useful when the surviving spouse's estate (even including the appreciated value of the credit shelter trust) will not be subject to taxation, thanks to the inflation-adjusted increases in the survivor's own basic exclusion amount. In such a case, estate inclusion and basis increase will be a favored plan. This plan may not be available in states that have repealed the rule against perpetuities so that trusts have unlimited durations under law.

3. Another method to accomplish the basis step-up at the second death would be to have the first decedent create a credit shelter trust and appoint a trust protector authorized to grant the surviving spouse a general power of appointment over some or all of the trust property (resulting in an estate inclusion) if doing so would create a basis advantage without creating an estate tax problem for the surviving spouse's estate.

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¶3760 Portability Conclusions

Portability is, without question, a game-changer in estate planning for many clients. The opportunity to have a simpler plan and avoid unwanted trust arrangements will likely be used by many people over time.

The concern is that people may overlook some of the traditional “safe harbors” that trusts at the first death provide — to assure the inheritances for children and grandchildren, mitigate the effects of undue influence or elder abuse, assure fairness in the blended family, and provide appropriate management and asset protection to make certain that the assets left by the first decedent do, in fact, have the opportunity to last the lifetime of the surviving spouse.

Portability comes with another risk — that despite its benefits, it will be ignored or rejected by many of those it is designed to help most — if there is a refusal to authorize the filing of Form 706. With its simplified preparation requirements, completing this form does not have to be unduly expensive for the client. But that is no assurance it will not be made so by preparers, and even if the tax preparer is reasonable, any cost, however modest, may be rejected by the client as unnecessary.

For the large estates, and estates in states with their own death tax, the credit shelter bypass trust remains a worthwhile recommendation. Future tax liability on appreciated valuable assets can, and should, be avoided. If there is confidence that a surviving spouse will work with professional advisers and do the sophisticated planning suggested to freeze appreciation and still achieve basis adjustments, it should certainly be considered.

The bottom line is that portability is a case-by-case determination. It is a more complex issue than it first seems. Use it when appropriate and be sure to file Form 706 in a timely fashion. Avoid it or use appropriate trust planning safeguards when there are complicated family situations and individuals for which simple solutions are not really the right choice. The importance of knowing and understanding the clients for whom we plan has never been more important.

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Chapter 38

Planning for the Additional Medicare Tax and the Net Investment Income Tax

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¶3820 Understanding the Modified Adjusted Gross Income (MAGI) Requirement

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¶3801 Introduction

The additional Medicare tax and the net investment income tax were created by the Affordable Care Act (ACA), effective in 2013. A taxpayer may be subject to one or both of these taxes.

The net investment income tax is addressed in IRC Section 1411. A series of frequently asked questions is available on the IRS website at www.irs.gov. The IRS also issued final regulations (November 26, 2013) and an additional set of proposed regulations addressing the net investment income tax published in the *Federal Register* on December 5, 2013. The final regulations are 217 pages in length. The proposed regulations are an additional 89 pages.[1] The regulations are effective for 2016 and beyond. The tax was not changed by the 2017 Tax Cuts and Jobs Act.

[1] T.D. 9644, Reg. 130507-11; Reg. 130843-13.

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¶3805 Increased Medicare Tax on High Income Earners — The "Additional Medicare Tax"

In 2012, wages were subject to a 2.9% Medicare payroll tax. Workers and employers each paid half, or 1.45%. Self-employed persons paid the full 2.9%, but got an above-the-line income tax write-off for half of the amount paid. This Medicare tax was assessed on all earnings or wages without a cap.

Beginning in 2013, an additional 0.9% Medicare tax was imposed on wages and self-employment income over $200,000 for single filers and heads of households; $250,000 for married couples filing jointly and qualifying widows or widowers with dependent children; and $125,000 for married persons filing separately.[2] These thresholds are not indexed for inflation. This tax is in addition to the 2.9% Medicare payroll tax on all earnings and wages (with no cap) already in existence. That makes the marginal tax rate 2.35% for the employee's share. Self-employed persons will face a 3.8% rate on earnings over the preceding amounts. The 0.9% Medicare tax is not reduced by half for self-employed persons, making the effective tax rate 2.35% for self-employed persons as well. The additional Medicare tax is imposed only on the employee or self-employed person. There is no employer match for the additional Medicare tax.

To put this in perspective, taxpayers should bear in mind that the Medicare tax is *in addition* to the Old Age, Survivors, and Disability Insurance (OASDI) and Federal Insurance Contributions Act (FICA) taxes, which apply to employers and employees. The employers' rate is 6.2% on wages up to $160,200 for 2023.

Unlike the general 1.45% Medicare tax that is applied on an individual taxpayer basis, the additional 0.9% tax is on the combined wages of the employee and the employee's spouse (or on the self-employment income of self-employed persons), in the case of a joint return.

Employers must withhold the new 0.9% Medicare tax, but only if the employee receives wages in excess of $200,000. This requirement applies even if the employee is married and will not exceed the $250,000 threshold on a joint return. The employer may disregard the amount of wages received by the employee's spouse. If the Medicare tax is not withheld by the employer, the employee is required to pay the tax. Note that if each spouse earns under $200,000, each employer will not do the extra withholding. Accordingly, when the spouses file a joint return with liability for the extra tax, they may be under-withheld and possibly subject to a penalty. Asking employers to do some "extra" income tax withholding may be a good idea.

If a person has two jobs or is an employee at one job and self-employed at another, it is possible there will be no withholding of the tax — but the liability for the tax will still exist if the applicable threshold is passed. Either the payment of estimated taxes or a request for additional withholding should be addressed here.

If spouses are employed by the same employer, their wages are not to be combined for purposes of determining whether withholding of the additional Medicare tax is required.

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[2] IRC Section 3101(b)(2).

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If a person receives wages that are not paid in cash, such as taxable fringe benefits (for example, an employer's payment for group-term life insurance over $50,000), they are subject to the additional Medicare tax if the taxpayer's income exceeds the applicable threshold.[3]

Persons working for several subsidiaries of a company should have their wages combined only if the payer of the wages is a common paymaster.[4]

The IRS has issued Form 8959 to calculate the additional Medicare tax, which is attached to Form 1040. The IRS has also declared that employers may not begin withholding employee wages for this tax until the date the applicable threshold for liability for the additional Medicare tax has been reached. Withholding in advance of such time would be considered "knowingly over withholding," and the employer would be required to reimburse the employee and file Form 941-X and be subjected to penalties.

¶3810 The Net Investment Income Tax

.01 Overview — Taxation of Individuals

A 3.8% net investment income tax applies to a taxpayer's net investment income if MAGI (modified adjusted gross income, explained later in Section 3820) is over the $200,000 (single filer or head-of-household filer), $250,000 (joint return filer or qualifying widow or widower with dependent child), or $125,000 (married filing separately) threshold amounts.[5]

These amounts are not indexed for inflation. Over time, without adjustments, the tax will shift from applying to the wealthiest group of taxpayers to a much broader range of taxpayers, in the same way that the alternative minimum tax (AMT) coverage and taxation of social security payments has expanded over time.

The 3.8% net investment income tax will be based upon the lesser of the taxpayer's net investment income or the excess of the taxpayer's MAGI over the threshold amounts indicated earlier. Form 8960 is used to report this tax. The form is attached to Form 1040 for individuals and to Form 1041 for trusts and estates.

.02 Key Points to Understand

There can never be liability for the 3.8% net investment income tax unless MAGI exceeds the applicable threshold amount.

No matter how high the taxpayer's MAGI may be, there cannot be liability for the 3.8% net investment income tax without the presence of net investment income.

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[3] IRS FAQ No. 42 12/12/12.

[4] IRS FAQ No. 48-49 12/12/12.

[5] IRC Section 1411.

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.03 Components of Net Investment Income

Net investment income includes the following:[6]

- Gross income from interest, dividends, royalties, rents, and annuities, provided this income is not derived in the ordinary course of an active trade or business.

- Gross income from a business that is a passive activity. In the case of a trade or business, the tax applies if the trade or business is a passive activity with respect to the taxpayer. The tax does not apply to active trades or businesses conducted by a sole proprietor, partnership, LLC, or S corporation.

  Note: The inclusion of income from passive activities as subject to the net investment income tax represents a huge shift in tax planning thinking. To this point, some taxpayers have sought to classify income as passive to keep it free of employment taxes and to treat losses as nonpassive, so they can be used to offset other nonpassive income. Alternatively, taxpayers have been willing to classify income as passive when there are passive losses to offset it. The net investment income tax suggests a shift in planning, arguing that income should come from an active business, not a passive investment.

- Net gain from the disposition of property, other than property held in an active trade or business. Gain from an asset held in an active business is not considered investment income.

  If property sold was not held in a trade or business, any gain on the sale is net investment income.

  If property was held in a trade or business, but the taxpayer did not materially participate in that business, the gain is net investment income.

  Sale of S Corporation Stock or a Partnership Interest

  The 2013 proposed regulations provide that the amount of net gain from the sale of S corporation stock or a partnership interest is the *lesser* of

  a. the seller's overall gain or loss on the sale of the stock or membership interest determined under regular income tax (Chapter 1 of the IRC) principles or

  b. the seller's share of the hypothetical asset sale gain that would be included in net investment income because the assets were not used in a trade or business or the activity was passive to the seller (that is, include gain or loss in net investment income only to the extent of the gain or loss on the deemed sale of the entity's passive assets).

  The 2013 proposed regulations also offer an "optional simplified method" for qualifying taxpayers. There are two ways to qualify for this "simplified method," as follows:

[6] IRC Section 1411(c); Reg. 1.1411-4.

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a. Test 1. The taxpayer must pass both of the following:

i. The cumulative sum of net investment income from the entity allocated to the selling stockholder or member in the year of sale and the two preceding years must be less than 5% of the sum of all items of income, gain, loss and deduction allocated to the seller over that period (with any losses and deductions included as a positive number).

ii. The total amount of IRC Chapter 1 gain recognized on the sale of the stock or membership interest must be less than $5 million.

b. Test 2. The total amount of IRC Chapter 1 gain recognized on the sale of the stock or membership interest must be less than $250,000.

Accordingly, if a taxpayer sells stock or a membership interest in an S corporation or a partnership for less than a $250,000 gain, the shortcut is available. If the gain is more than $250,000 and less than $5 million, the 5% test described previously is available (see Prop. Reg. 1.1411-7). If the simplified method is available, multiply the gain allocated to the taxpayer upon disposition of the interest by a fraction, the numerator of which is the sum of the net investment income amounts allocated to the taxpayer, and the denominator of which is the total of all items allocated to the taxpayer in connection with the disposition.[7] These tests are not final — they are part of the proposed regulations for which further comment is sought.[8]

How is goodwill handled by the regulations? When an active business owner sells the assets of the business and the price includes an allocation to goodwill, will that gain be considered active income or net investment income? The regulations provide that goodwill is a business asset. Accordingly, if an active trade or business is sold and goodwill is part of the sale price, the gain will not be classified as net investment income.[9]

Capital loss carryovers from years prior to 2013 can be used to offset gains realized in 2013 and beyond for purposes of the net investment income tax. Capital losses may be carried forward for purposes of calculating net investment income.

Gross income from a trade or business trading in financial instruments or commodities (as defined in IRC Section 475(e)(2)) is categorized as a passive activity business for purposes of these rules.[10] The term *financial instruments* is described in the regulations to include stocks and other equity interests, evidences

[7] IRC Section 1411(c)(4).

[8] Reg. 1.1411-7(c).

[9] Reg. 1.1411-7(c)(5)(ii)(A).

[10] IRC Section 1411(c)(2)(B).

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of indebtedness, options, forward or future contracts, notional principal contracts, and any other derivatives.[11]

Substitute interest and dividend payments resulting from securities lending are net investment income.

Gains derived from marking to market IRC Section 1256 contracts are net investment income.

Certain payments under notional principal contracts, such as interest rate swaps and equity swaps, are deemed not to be net investment income, unless the income arises from a passive activity. However, gain on the disposition of a notional principal contract is net investment income.

.04 Calculation of Net Investment Income

Net investment income is determined by taking into account the gross income or net gain from the preceding income items reduced by allowable deductions that are "properly allocable" to the gross income or net gain. IRS guidance in the regulations has addressed this.[12]

Examples of properly allocable deductions include investment interest expense, expenses related to rent and royalty income, and state and local income taxes properly allocable to items included in net investment income.

This means that state and local income taxes allocated to salary would not be deductible in calculating net investment income because salary is not net investment income. The allocation of state and local taxes between net investment income and income that is not net investment income can be determined by taxpayers using "any reasonable method." The regulations provide a safe harbor by stating that allocating state and local income tax based on the ratio of net investment income to gross income would be considered a reasonable method.[13]

The limitation of the deduction of state and local taxes to $10,000 by the 2017 Tax Cuts and Jobs Act will also limit the offset of net investment income tax by these taxes.

Investment interest that is carried forward for regular income tax purposes will be carried forward for purposes of the net investment income tax, even if the interest was incurred prior to 2013.[14]

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[11] Reg. 1.1411-5(c)(1).

[12] Reg. 1.1411-4(f).

[13] Reg. 1.1411-4(f)(3)(i)(C).

[14] Reg. 1.1411-4(f)(3)(i)(A).

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The elimination of the deduction of miscellaneous itemized deductions (IRC Section 67) will also apply for purposes of the net investment income tax.[15] Items such as investment advisory fees and brokerage fees will not be deductible.

The IRS has indicated informally that the net number received by a taxpayer from a pass-through entity will be sufficient to report for purposes of the net investment income tax.

The IRS has indicated that foreign tax credits will not be permitted to offset the net investment income tax.

Net operating loss carryovers will not be permitted to be used against net investment income for purposes of this tax.

.05 Exclusions from Net Investment Income

Net investment income does not include the following:[16]

- Self-employment income for the tax year on which an individual pays FICA under IRC Section 1401(b).[17]
- Income derived from an active trade or business. One's status as an employee is considered being in the active trade or business of being an employee.
- Income derived from gains on the sale of an active interest in a partnership or an S corporation.
- Distributions from an IRA or qualified retirement plan. This category includes a wide variety of retirement plans (that is, IRC Section 401 plans — pension, profit-sharing, and stock bonus plans; 403(a) qualified annuity plans; 403(b) public school employee and tax-exempt organization plans; 408 and 408A traditional IRAs and Roth IRAs; and 457(b) plans for state and local governments).[18]
- The regulations make it clear that distributions paid to an employee under a nonqualified deferred compensation plan for such employees are not included in net investment income, regardless of whether such amounts are subject to FICA tax due to the earlier application of IRC Section 3121(v)(2).[19]
- Income realized by a charitable remainder annuity or unitrust exempt from tax under IRC Section 664. A taxpayer can contribute assets to a charitable remainder trust, which can then sell the assets without recognizing gain and without affecting the net investment income or MAGI of

[15] Reg. 1.1411-4(f)(3)(ii)(A) and (B).

[16] IRC Section 1411(c)(5).

[17] IRC Section 1411(c)(6) and Reg. 1.1411-9.

[18] IRC Section 1411(c)(5); Reg. 1.1411-8.

[19] Reg. 1.1411-8.

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the taxpayer. The taxpayer would only have net investment income as the annuity payments were received from the charitable trust.

With respect to the distribution of income from a charitable remainder trust, the "simplified method" addressed in the regulations takes the position that the net investment income realized by the charitable remainder trust will be considered the first income it distributes.[20]

The charitable remainder trust must keep track of the net investment income it receives on a cumulative basis. Distributions made to a beneficiary of the trust are then deemed to be allocated in accordance with the four-tier system found in IRC Section 664 to determine the net investment income payable to the non-charitable beneficiary. The alternative "simplified" method treats the lesser of all distributions or all of the trust's net investment income as the amount of net investment income distributable to a beneficiary of a charitable remainder trust.

If, prior to 2013, the charitable remainder trust realized income which is being carried forward, that income will not be treated as net investment income in subsequent years.

.06 Estimated Tax Payments and Penalties

The net investment income tax is subject to the individual estimated tax provisions, including the IRC Section 6654 failure to pay estimated tax penalties.[21] The tax is not deductible when computing any tax imposed by subtitle A of the IRC (relating to income taxes). The 3.8% tax applies to employees, self-employed persons, and persons who are not employed at all. Accordingly, there is no deduction for one-half of it for self-employed persons, as is the case for the 2.9% Medicare tax on self-employment income.

.07 Application to Nonresident Aliens and Charities

The net investment income tax does not apply to nonresident aliens or to a charitable trust whose unexpired interests are devoted to religious, charitable, scientific, literary, or educational purposes, nor does it apply to organizations created to foster national or international amateur sports competitions (provided no part of its activities involve the provision of athletic facilities or equipment) or to promote the prevention of cruelty to children or animals.[22]

> **Note:** What should be done if a U.S. citizen or resident who is subject to the net investment income tax is married to a nonresident alien who is not subject to the tax? In such a case, the spouses will be treated as married filing separately for purposes of the net investment income tax. This means that the U.S. citizen or resident spouse will be subject to the threshold for married persons filing separately ($125,000) and must calculate his or her own MAGI and net investment income. In that case, the nonresident alien spouse will not be subject to the net investment income tax.

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[20] Reg. 1.1411-3(c)(2).

[21] IRC Section 6654(a) and (f).

[22] IRC Section 1411(e).

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It is possible, however, to have the nonresident alien elect to be treated as a resident for federal income tax purposes, which would then allow a joint income tax return to be filed.[23] This would then allow the joint filer threshold of $250,000 to be used, and the MAGI and net investment income of both spouses would be taken into account.

¶3815 Application of the Net Investment Income Tax to Investment Income of Trusts and Estates

The net investment income tax will apply to the investment income of individuals, as well as to the investment income received by estates and trusts.[24] An estate or trust will pay the 3.8% net investment income tax on investment income based on the lesser of the estate or trust's undistributed net investment income or the excess of the estate or trust's adjusted gross income (AGI) as determined under IRC Section 67(e) over the dollar amount threshold at which the estate or trust is taxed at the highest marginal tax rate for the tax year.[25]

That threshold is $14,450 for 2023. The calculations for an estate and trust will be complicated by having to determine expenses that can offset investment income in light of the repeal of the deduction for miscellaneous itemized deductions. (The Supreme Court's decision in *Knight v. Commissioner* [128 S.Ct. 782 (2008)] has given the IRS ammunition to treat more expenses as miscellaneous itemized deductions). Will it become advantageous to distribute money more quickly from a larger estate or trust to the beneficiary to avoid the net investment income tax? If an estate or trust earns $25,000 of investment income, for example, it will face the net investment income tax. However, a beneficiary who is entitled to a distribution from the estate or who holds an interest in the trust may not have, even with the full distribution of his or her share of the estate or trust income, enough income above the individual's MAGI threshold to trigger the net investment income tax.

Will the fiduciary face a different analysis when determining whether to hold assets in the estate or trust, if doing so will increase the tax cost? Perhaps an executor is favoring delaying distributions to a later calendar year pending receipt of a state tax clearance letter or confirmation of the exact amount of a liability. Those decisions should be documented if the delay may trigger the additional tax. Instead, the fiduciary could distribute the funds prior to year-end, reducing the fiduciary income to a level below the threshold at which the net investment income tax will apply, and have the beneficiaries sign receipts, releases, and refunding bonds agreeing to refund the distribution to the estate if the funds are needed for the uncertain liability. This puts the fiduciary between the proverbial rock and the hard place. If the fiduciary distributes funds otherwise needed for covering the entity's expenses, the fiduciary might face personal liability. However, if the fiduciary does *not* make the distribution, the funds will be potentially taxed at a higher rate, and the fiduciary could face adverse claims from the beneficiaries.

Distribution of capital gains to beneficiaries may or may not be permitted by the governing instrument of the trust or estate. What does the governing instrument provide? Is there sufficient discretion to allow gains (principal) to be distributed? Is a unitrust distribution authorized? What does the state law

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[23] IRC Section 6013(g).

[24] IRC Section 1411(a)(2).

[25] Reg. 1.1411-3.

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principal and income act say? Does state law authorize a "power to adjust" that will allow capital gains to be more readily distributed?

Capital gains realized by a pass-through entity and allocated to a trust or estate by a Schedule K-1 may be passed to the beneficiaries. Such gains are not "owned" by the entity as part of its principal.[26]

Some trusts will be exempt from the net investment income tax. These include charitable trusts exempt from tax under IRC Section 501 and charitable remainder trusts exempt from tax under IRC Section 664.

The regulations provide that with respect to grantor trusts, the income, gain, deductions, and losses that are deemed to be the grantor's for purposes of calculating taxable income for regular tax purposes are also deemed to be the grantor's for purposes of calculating net investment income.[27]

¶3820 Understanding the Modified Adjusted Gross Income (MAGI) Requirement

.01 The Definition of MAGI

MAGI begins with AGI, which is the individual taxpayer's gross income reduced by the so-called "above-the-line" deductions that are reported on line 11 of Form 1040.[28]

Added to this number is the net amount excluded from the taxpayer's foreign earned income (if any) under IRC Section 911(a) to reach the definition of MAGI.

For practical purposes, the foreign earned income exclusion applies only to U.S. citizens or residents who live and work abroad, so that for most individual taxpayers, MAGI and AGI will be the same.[29]

Note that MAGI is not the same thing as taxable income. It is possible that a taxpayer with a significant amount of itemized deductions on Schedule A of Form 1040, allowing the reduction of taxable income below the amount of the MAGI threshold, will still be liable for the net investment income tax.

.02 Important Exclusions from MAGI

A number of items are not considered part of MAGI. Items that are totally excluded from gross income are excluded from both net investment income and MAGI, including

- tax-exempt bond and dividend income;
- distributions from Roth IRAs;
- payments for physical personal injury;

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[26] *Crisp v. United States* (Ct. Cl. 1995).

[27] Reg. 1.1411-3(b)(5).

[28] Reg. 1.1411-1(b).

[29] IRC Section 1411(d).

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- veteran's benefits; and
- the excluded gain on the sale of one's principal residence. (Reg. 1.1411-3(b)(5))

Example 38.1. In 2023, married taxpayers Adam and Betty sell their principal residence in a transaction that qualifies for the $500,000 IRC Section 121 exclusion. The net gain (sales price less adjusted basis) on the sale of the residence is $700,000. In 2023, Adam and Betty have MAGI of $310,000, all of which is salary income, before factoring in the gain on the sale of the residence. Adam and Betty's investment income is $200,000 ($700,000 gain − $500,000 IRC Section 121 exclusion). Apart from the residence, Adam and Betty have no other net investment income in 2023. They file a joint return for tax year 2023.

Their MAGI is computed by adding the $200,000 of gain not excluded under IRC Section 121 to their salary of $310,000; thus, their 2023 MAGI is $510,000. Their MAGI in excess of the $250,000 threshold amount is therefore $260,000 ($510,000 − $250,000). Because Adam and Betty's net investment income of $200,000 is less than their $260,000 MAGI in excess of the threshold amount, they will pay a 3.8% net investment income tax of $7,600 (.038 × $200,000) as a result of selling their residence at a $700,000 gain.

.03 Understanding the Applicable Threshold Amounts

The net investment income tax applies to the lesser of net investment income or MAGI exceeding the following thresholds:

- Single filers and heads of household: MAGI of $200,000
- Joint filers and qualifying widow or widower with dependent child: MAGI of $250,000
- Married persons filing separately: MAGI of $125,000

Note that these amounts are not indexed for inflation.

For trusts and estates, the threshold is set at the starting point for the highest tax bracket of a trust or estate, adjusted annually for inflation. In 2023, this amount is $14,450.

Note that these threshold amounts will not be reduced or prorated for a short tax year (such as by reason of the death of a taxpayer). However, the threshold is prorated if there is a change in the taxpayer's accounting year.[30]

Note also that the difference in thresholds for married and single taxpayers actually creates a marriage penalty because two single taxpayers, each with income under the AGI thresholds for the tax, will not be subject to the tax if they remain single, but will be subject to the tax if they marry and their combined income exceeds the AGI threshold for married taxpayers.

[30] Reg. 1.1411-2(d)(2).

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Example 38.2. T, a single filer, has $220,000 of salary income and no net investment income. $20,000 of the salary income will be subject to the 0.9% additional Medicare tax on earnings. The tax on net investment income will not be applicable.

Example 38.3. X, a single filer, has $180,000 of salary income and $40,000 of net investment income. X will not be subject to the 0.9% tax additional Medicare tax on earnings because X's earnings do not exceed $200,000. Because X's MAGI is $220,000, X is subject to the net investment income tax based on the *lesser* of X's net investment income ($40,000) or the excess of X's MAGI ($220,000) over the single filer threshold amount of $200,000 ($20,000). Accordingly, X will owe $760 (3.8% × 20,000) of net investment income tax in 2023.

Example 38.4. Sue and Sam, a married couple that files a joint return, collectively earn $270,000 in wages and have $80,000 of net investment income in 2023. Their MAGI is $350,000. For 2023, the couple will incur a 3.8% net investment income tax on the lesser of their (1) $80,000 of net investment income, or (2) $100,000 ($350,000 − $250,000) MAGI in excess of the $250,000 threshold for married taxpayers filing jointly. Thus, Sue and Sam will incur a $3,040 (.038 × $80,000) net investment income tax in 2023.

Example 38.5. In 2023, Rob, a single taxpayer, receives no wages or self-employment income. He does, however, earn $3.2 million in net investment income from a stock and bond portfolio that is not part of a qualified employee benefit plan. This is the total amount of Rob's MAGI for 2023. Rob will incur a 3.8% net investment income tax on the lesser of his (1) $3.2 million net investment income or (2) $3 million ($3,200,000 − $200,000) MAGI in excess of the $200,000 threshold amount for a single taxpayer. Thus, Rob will incur a $114,000 (.038 × 3,000,000) net investment income tax in 2023.

Example 38.6. A trust has undistributed net investment income of $18,000 and AGI of $35,000. The net investment income tax will apply to the lesser of $18,000 or $20,550 ($35,000 less the top bracket threshold of $14,450 = $20,550). Accordingly, in 2023 the net investment income tax is 3.8% of $18,000, or $684.00.

Even with careful planning, it is conceivable that unusual spikes in income could push taxpayers over the MAGI threshold. Items such as the sale of a large asset (such as the sale of a principal residence that yields a gain in excess of the principal residence exclusion amount, the sale of a vacation home, the sale of a business, the receipt of a taxable inheritance distribution from an estate, a retirement plan distribution, a Roth IRA conversion, and so on) could subject the taxpayer to the 3.8% net investment income tax.

.04 Active Versus Passive Business Activities — Individuals

The net investment income tax applies to income from a trade or business that is a passive activity with respect to the taxpayer.[31] The passive activity rules of IRC Section 469 are referenced as the authority for making the passive activity determination.[32] The rules to be considered in the context of the net investment income tax with respect to passive versus active participation, the material participation tests,

[31] IRC Section 1411(c)(2)(A).

[32] Reg. 1.1411-4 (c)(1); Reg. 1.1411-5(a) and (b).

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and the like are taken from and are essentially identical to the general rules that distinguish active and passive activities. These rules are addressed in detailed discussion in chapter 41 and should be consulted as they apply for purposes of distinguishing active and passive activities in general, as well as with specific application to the net investment income tax.

.05 Active Versus Passive Activities — Trusts and Estates

Because trusts and estates are subject to the tax on net investment income at low levels of income, it is likely that there will be significant efforts by the IRS to characterize as much trust and estate income as possible as passive.

Trusts and estates are generally covered by the passive activity loss rules under IRC Section 469(a)(2). However, there have not been any regulations issued to address how a trust or estate determines if its activities are active or passive.

Grantor trusts as defined in IRC Section 671 are excluded from the passive activity rules under Reg. 1.469-1T(b)(2). For grantor trusts, material participation is determined at the grantor level, rather than at the trust level. The IRS instructs its auditors that grantor trusts are not recognized as separate taxable entities and should be ignored entirely while looking to the activities of the grantor in determining whether the passive activity loss rules should apply.

As in the case of the preceding discussion of passive activities and the application of the net investment income tax to individuals, the application of IRC Section 469 and its application to trusts and estates is also addressed at length in chapter 41.

¶3825 Planning Considerations for the Additional Medicare Tax on Earnings and the Net Investment Income Tax

.01 General Planning Strategies

The general planning approach for addressing avoidance of these taxes includes the following:

- Reduce MAGI
- Reduce earnings or self-employment income
- Reduce net investment income

Broadly stated, these are not especially attractive planning alternatives.

¶3830 Suggested MAGI and Net Investment Income Reduction Planning

The level of a taxpayer's MAGI puts the taxpayer either above or below the threshold at which these taxes become applicable. If steps can be taken to keep MAGI below the thresholds, the taxes will not apply.

The following suggested planning techniques, designed to reduce MAGI and net investment income, are not intended to be one-time fixes, but rather a longer-term planning direction and behavior change. Planning techniques include the following:

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- Consider investing in tax-exempt bonds.

  — The interest from such bonds does not get added into MAGI.

  — Tax exempt interest is not considered net investment income.

  — If income tax rates increase, higher bracket taxpayers will find these bonds attractive.

  — There is concern that the federal government may suggest limiting the tax benefits of these bonds. If that should occur, the strategy may have to be reexamined. However, the action is likely to be prospective only — on newly issued bonds — so there may be an urgency to acquire qualified tax-exempt bonds sooner rather than later.

- Obviously, any investment in tax-exempt bonds should compare the yield on such bonds (possibly addressing AMT exposure to private activity bonds) with the net return on taxable investments. Consider moving investments from high-yielding dividend paying stocks to growth stocks that do not pay dividends or that pay lower dividends.

- **Harvest capital losses.** Try to balance capital gains and losses in 2023 and later. Of course, sensible investing decisions should come first. Keep in mind the wash sale rule is an issue when losses are realized. Reacquiring the stock sold at a loss before 31 days have elapsed will result in the loss deduction being suspended. Pay attention to possible tax law changes which may increase the tax rates on capital gains.

- **Favor installment sales.**[33] The idea here is to flatten out the spikes in gains and spread the gains over more tax years, keeping both MAGI and net investment income at a lower annual level. Be cautious when selling assets to related parties in an installment sale transaction. If the related purchaser sells the acquired property within two years after the acquisition, any gain on the sale will be attributed to the original seller. Installment sale treatment is not available for income arising from depreciation recapture or sales of publicly-traded securities.

- **Consider like-kind real estate exchanges.**[34] As the result of the 2017 Tax Cuts and Jobs Act, personal property is no longer eligible for like-kind exchange treatment. Be careful that the timing rules of IRC Section 1031 (to identify an exchange property and close the deal for a three-way exchange) are respected. Proposed tax law changes would limit IRC Section 1031 exchanges to a maximum deferred gain of $500,000.

- **Consider investing in tax-deferred annuities.** In years when the taxpayer is working and earning a strong income and also earning a return on investment, the likelihood of being subject to the 3.8% net investment income tax is fairly high. A strategy to consider here is to purchase a tax-deferred annuity that will delay payments for several years — perhaps until the taxpayer retires or at least until an age when the taxpayer expects less income to be earned. At that time,

[33] IRC Section 453.

[34] IRC Section 1031.

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MAGI may be lower, and the receipt of the deferred annuity payments will not push the MAGI above the threshold.

- **Consider purchasing a whole life (cash value) insurance policy.** The current payment of premiums will remove dollars that might otherwise produce current net investment income. The policy can build up. Its growth is not taxable. If desired in the future, withdrawal of policy earnings, even if adding to MAGI, can be timed to come in years when MAGI is otherwise low. However, it does appear that life insurance surrenders and sales will be subject to the net investment income tax, along with the realization (that is, cash out) of the inside build-up of the cash value in a policy in excess of the policyholder's basis.[35]

- **Try to increase the above-the-line deductions on Form 1040.** Consider contributions to qualified retirement plans and traditional IRAs. Certainly, when possible, maximize allowable contributions to these plans.

- **Consider a Qualified Charitable Deduction transferring IRA assets to a public charity.** The transfer (up to $100,000) will count as or toward the taxpayer's required minimum distribution and keep that amount out of the taxpayer's adjusted gross income. The $100,000 limit will be indexed for inflation beginning in 2024.

- **Determine if business deductions are available.** If the taxpayer is filing Schedule C as a sole proprietor or is a farmer filing Schedule F, or the taxpayer has permitted deductible expenses on Schedule E (rental properties, S corporations, or partnerships), these deductions and losses will also reduce MAGI.

Planning Pointer.

Proactive Planning Toolkit.

Recent legislation has added more complexity to financial planning. Technical content, tools, and other resources are available to PFP Section members in the Proactive Planning Toolkit to help you get up to speed on all of the intricacies so that you can educate your clients and proactively help them meet their life goals and give them peace of mind while navigating the complex financial landscape.

¶3835 Larger Planning Strategies to Reduce Net Investment Income

.01 Is the S Corporation Best Suited for Net Investment Income Tax Planning?

As a general statement, it is easier for a shareholder of an S corporation to satisfy one or more of the material participation tests of IRC Section 469(h)(2) (hours of participation, years of participation, significant participation, and so on) than it is for a limited partner to do so.

[35] Revenue Ruling 2009-13.

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If a person owns 100% of a business as an LLC, all the LLC income will be treated as self-employment income, and all will be subjected to the 0.9% additional Medicare tax on earnings if the MAGI threshold is exceeded.

If a person owns 100% of an S corporation, there is an opportunity to receive a salary as an employee of the corporation equal to less than all of the corporation's income. This may keep compensation income below the MAGI threshold. The IRS will insist that the shareholder's compensation be "reasonable" so as not to be so low as to allow avoidance of self-employment tax, as well as the 0.9% additional Medicare tax. This requirement should certainly be respected, but salary need not equal 100% of all the available return to the shareholder.

In cases in which the shareholder-employee took a salary of zero, the IRS has not had difficulty rejecting that position and allocating "reasonable" compensation. There are a number of decided cases standing for this proposition, including *Veterinary Surgical Consultants v. Commissioner,* TCM 2003-48 and *Water-Pure Systems, Inc. v. Commissioner,* TCM 2003-53.

In *Watson v. United States,* 668 F.3d 1008 (8th Cir. 2012), the court rejected a taxpayer's claimed compensation (a sole shareholder and only employee of an accounting firm took $24,000 compensation and $150,000 to $175,000 as S corporation distributions) and increased it to what they felt was a *"more* reasonable" level of compensation ($91,000 compensation) than that reported by the taxpayer. This was the first case decided on grounds of "more reasonable" compensation, rather than "reasonable" versus "unreasonable."

To the extent that funds are not paid out to the S corporation shareholder as compensation, but rather as an S corporation distribution because the owner is an active participant in the S corporation activities, the S corporation distribution will not be considered passive income, so that it will not be considered net investment income for purposes of the net investment income tax — even if it pushes MAGI above the threshold level for the shareholder's filing status.

It has been held that profits generated by non-owner employees must be classified as dividend income and cannot be reclassified as owner compensation. The test then becomes "who generated the profit?"[36] IRS does have the right to recharacterize dividends as wages.[37] There are several issues to address in consideration of the reasonable compensation battle. A threshold question is whether the payments are made purely for services.[38] At least one court has refuted the IRS position that profits from personal service S corporations are 100% wages.[39]

The next issue is whether the payments of compensation are reasonable. Here, many courts use the five factors established in *Elliots Inc. v. Commissioner,* 716 F.2d 1241 (9th Cir. 1983), which include the following:

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[36] *Pediatric Surgical Associates v. Commissioner*, TCM 2001-81.

[37] *Bramlette Building Corporation, Inc. v. Commissioner*, 424 F2d 751 (5th Cir. 1970); aff'g 52 TC 200 (1970).

[38] IRC Section 162(a); Reg. 1.162-7(a).

[39] *V.R. DeAngelis Md, PC v. Commissioner*, CA-2 2009-2 USTC para. 50,508, aff'g TCM 2007-360.

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1. *The employee's role in the company.* In S corporations, many shareholder-employees engage in the same activities as employee supervisors.

2. *External comparison with salaries of other companies.* This is difficult to measure in the context of a closely held S corporation.

3. *Character and condition of the company.* This factor may favor the S corporation because most small businesses use conservative financial practices, including limiting expenditures, such as payroll taxes, wherever possible.

4. *Potential conflicts of interest and hypothetical independent outside investors.* This factor favors the S corporation because a hypothetical independent investor would most likely approve of an S corporation's minimal compensation plan because lower employee salaries increase the shareholder's return on investment.

5. *Internal consistency in compensation.* This could favor the S corporation if there is a history of consistently low salaries.

Now take the S corporation possibility a step further — what if the shareholder wishes to gift some shares to family members as part of his or her estate planning considerations?

The shares can be voting or non-voting shares. Although S corporations may only have a single class of stock, there is a special rule permitting voting and non-voting shares to be used, as long as the only difference between them is the right to vote and there are no differences regarding dividend or liquidation preferences.[40]

Now consider to whom shares should be given. If they are given to persons who work for the S corporation, payment of an S corporation distribution to these persons will be active, not passive, income. If the shareholders receiving a distribution are not actively working for the corporation, the distribution will be net investment income to them, but to be tested at their own personal threshold for MAGI. Accordingly, spreading the S corporation distribution among several family members, all of whom may fall short of MAGI thresholds for the tax on net investment income, may serve to eliminate, or at least reduce, the imposition of this tax on the S corporation income.

What if the family members to whom shares are given are minors or other persons whose age or student status subjects them to the kiddie tax? Other concerns now arise. If distributions are made to such persons, the child's income will be taxed at rates applicable to his or her parents.

What of the net investment income issue related to the kiddie tax? Is the child's net investment income added to the parents' possibly pushing the parents' calculation over the threshold, or is it computed separately? IRC Sections 1411(a) and (b) say that each individual is viewed separately and independently for purposes of determining the net investment income threshold.

There is nothing in the statute to require the child to calculate his or her exposure to the net investment income tax based on the parents' calculation of this tax.

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[40] IRC Section 1361(c)(4).

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The child is entitled to address his or her own MAGI threshold before becoming liable for the net investment income tax. There may be no income tax savings here due to the kiddie tax rule, but at least there may be a savings of the net investment income tax.

Consider a situation in which an estate is an S corporation shareholder. There is a limited time (generally two years) that the estate can hold the S corporation shares. What if the ultimate beneficiary of the shares is a qualified subchapter S trust (QSST), the income of which must be distributed to the beneficiary?[41] The following conditions apply:

- The longer the estate holds the S corporation shares, the more income will be received by the estate with its very low threshold of MAGI ($14,450 in 2023) before the net investment income tax will be due.

- It is unlikely that the estate will be an active participant in the S corporation, so the income will likely be passive net investment income to the estate.

- Passing the shares and funding the QSST sooner, rather than later, will remove the income from the estate and move it to the individual beneficiary of the QSST, who may have a MAGI below the threshold and can avoid any liability for the net investment income tax.

- When the S corporation shareholder is an electing small business trust under IRC Section 1361(e), the regulations describe a complex set of required calculations to first address and separate the trust's share of S corporation income from the trust's share of non-S corporation income, then further allocate each portion of the trust's income between the regular tax and the net investment income tax.[42] This is all necessitated by the highly unfavorable required income tax treatment of electing small business trusts as provided by IRC Section 641(c).

In summary, the S corporation may be useful when planning to address minimizing both the 0.9% additional Medicare tax on earnings and the 3.8% tax on net investment income. Consider the following when making an S election:

- To become an S corporation, an individual or a proprietorship can do so on a tax-free incorporation basis.[43]

- A partnership or an LLC taxed as a partnership can generally incorporate without tax consequences.[44]

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[41] IRC Section 1361(d).

[42] Reg. 1.1411-3(c)(1).

[43] IRC Section 351.

[44] IRC Section 351.

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- An existing C corporation can convert to an S corporation but must be mindful of the application of the built-in gain tax on its C corporation history and attributes. In 2023, the look-back period for built-in gains is 5 years.[45]

- Any creation of, or conversion to, an S corporation must be mindful of a variety of special S corporation rules, including: limitations on who can be shareholders (individuals, but no nonresident alien individuals; certain trusts, but not all trusts; estates, but not C corporations or partnerships); filing Form 2553 to make the election; doing so in a timely manner; limiting the corporation to a single class of stock; etc.

- Be aware of the implications of the 20% qualified business income deduction (IRC 199A) introduced by the 2017 Tax Cuts and Jobs Act. The choice of entity may be dependent upon the nature of a business, the income of the owners, whether payment of wages (and how much) is advisable or not, etc., making these S corporation considerations more important than considerations relating only to the 3.8% net investment income tax.

.02 Trying to Reduce or Eliminate Net Investment Income by Converting Passive Activities to Active Activities

Address the various material participation tests under the passive activity regulations discussed in chapter 41.[46]

.03 Using the Grouping Election to Make Satisfying the Material Participation Tests More Likely

Grouping is possible when there is an "appropriate economic unit" to combine activities to avoid passive loss characterization.[47] This arises when there are one or more factors present among

- common control or ownership;

- similarity in types of trades or businesses;

- common geographical location; or

- interdependent activities.

The discussion of grouping may be found included in the broader discussion of active and passive activities in chapter 41 at Section 4145.

.04 Special Concerns Arising in Connection With Rental Activities

Be careful of asserting that rental activities may be grouped with trade or business activities. Although a taxpayer may elect to treat all interests in rental real estate as one activity per IRC Section 469(c)(7),

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[45] IRC Section 1374.

[46] Reg. 1.469-5T.

[47] Reg. 1.469-4(c)(2)(i).

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grouping rental real estate activities with other business activities is allowed only if the activities being grouped together constitute an appropriate economic unit and the rental activity is any of the following:

- Insubstantial in relation to the trade or business activity.
- The trade or business activity is insubstantial in relation to the rental activity.
- Each owner of the trade or business activity has the same proportionate ownership interest in the rental activity, in which case, the portion of the rental activity that involves the rental of items of property for use in the trade or business activity may be grouped with the trade or business activity.[48]
- The preamble to the regulations states that a proper grouping under Reg. 1.469-4(d)(1) (grouping rental activities with other trade or business activities) will not convert gross income from rents into other gross income derived from a trade or business described in Reg. 1.1411-5(a)(1) (that is, a business that constitutes a passive activity).

  Example 38.7. A taxpayer leased equipment to an S corporation of which the taxpayer was the majority owner. The Tax Court found that the taxpayer's leasing activity, a passive activity, could be grouped with the S corporation's business.[49]

  The taxpayer's rental activity was insubstantial in relation to the activities of the S corporation. The taxpayer created and operated the leasing activity solely for the benefit of the S corporation and spent little time conducting its affairs, as compared to the S corporation's activities. Additionally, the purpose of the leasing activity was to enhance the ability of the corporation to do business and did not provide an income stream to the taxpayer independently from the S corporation.

  Example 38.8. In another situation, the IRS concluded that an individual who owned a majority interest in a C corporation engaged in the retail sale of granite and marble was prohibited by the passive activity loss rules from offsetting passive rental losses from his solely-owned LLC against nonpassive wage income received from the C corporation. Reg. 1.469-4(d)(5)(ii) specifically limited the aggregation of the taxpayer's activities conducted through the C corporation with the activities he conducted through the LLC in determining whether he materially or significantly participated in the activities of the LLC. The taxpayer's contention that the limitation imposed by Reg. 1.469-4(d)(5)(ii) applies only when unrelated activities are grouped was rejected as contrary to its plain meaning. Because the taxpayer's rental activities in the LLC were *per se* passive, regardless of whether he materially participated in them and had no passive income, the losses were not deductible.[50]

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[48] Reg. 1.469-4(d).

[49] *Schumacher*, T.C. Summary Op. 2003-96.

[50] *Senra v. Commissioner*, T.C. Memo. 2009-79.

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The meaning of *insubstantial* is unclear because the IRS has refused to define the term in official guidance. The IRS received comments asking for clarification when it issued final regulations under Reg. 1.469-4 in T.D. 8565. The IRS determined the following:

> Because the regulations already adopt a facts and circumstances test that looks at all of the pertinent factors [for grouping], it is not necessary to specify that the term insubstantial refers to factors other than gross income. In addition, to avoid complex and mechanical rules, the final regulations do not adopt a bright-line or safe-harbor gross revenue test.

Courts, however, have attempted to define *insubstantial*. For example, in one case, the IRS conceded that a married couple's rental and management activities were an appropriate economic unit under Reg. 1.469-4. However, the IRS argued that facts that made the two activities an appropriate economic unit could not be used to sustain a finding that one activity was insubstantial in relation to the other.

The court rejected this argument, with the judge remarking, "We have difficulty imagining a scenario where two activities are so interdependent that they form an appropriate economic unit, yet are not 'essential' to each other in a way that the government's definition would allow them to be considered 'insubstantial.'"[51]

.05 Applying the Self-Rental Rule of Regulation 1.469-2(f)(6)

If a taxpayer rents property to a business in which said taxpayer materially participates (that is, self-rental), the net rental income is nonpassive. The final regulations under IRC Section 1411 provide that this rule also applies in the context of defining net investment income for purposes of the net investment income tax. Therefore, self-rental income, which is deemed active under the passive activities rules, is also deemed active for purposes of the net investment income tax.

The case of *Carlos v. Commissioner*, 123 TC 275, (2004) protected the active income aspect of self-rental when it held that grouping of activities does not preempt the self-rental regulation. The net rental income was held to constitute income not from a passive activity. Although this case was a victory for the government to maintain the classification of self-rental income as active so passive losses could not be used to offset it, it can now be used to assert an active income conclusion to avoid the net investment income tax.

Self-rental has also been addressed in the context of the IRC Section 199A Qualified Business Income deduction. The IRS determined that if the appropriate criteria were present, self-rental of property (to a 50% controlled entity taking the attribution rules into account) would qualify as a trade or business for purposes of Section 199A.

¶3840 Planning Considerations and Strategies for Trusts and Estates

.01 Distributing Income

It is fair to assume that most of the income realized by trusts and estates is net investment income.

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[51] *Glick v. United States*, 2000-1 USTC 50,372 (DC Ind.).

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Because the 3.8% tax on net investment income will affect trusts and estates at the lesser of undistributed net investment income or the excess of AGI over the threshold amount ($14,450 for 2023), distributing the net investment income seems like a logical plan. The rules for the net investment income tax with respect to distributed and undistributed income will follow the rules for trusts and estates addressing distributable net income (DNI). Allocations between the entity and beneficiaries may be required, and capital gains may be trapped in the entity.

It is very possible that many individual beneficiaries of trusts and estates will themselves have MAGI below the threshold for imposing the net investment income tax. Accordingly, there is likely to be increased pressure on fiduciaries to distribute the net investment income the entity receives when the discretion to do so exists.

The net investment income tax will follow the same rules as the "regular" tax on trusts and estates (that is, income will be taxed once — either to the entity if it retains the income or to the beneficiary to the extent it is distributed). The regulations adopt a multistep approach to determine whether net investment income has been either retained or distributed:

1. First, the estate or trust calculates its DNI under the usual income tax rules. The estate or trust must now also determine and keep track of whether each item of DNI does or does not constitute net investment income.

2. When distributions are made to a beneficiary that carry out DNI under the usual income tax rules, they are deemed to carry out a prorated portion of both net investment income that is included in DNI and income that is not net investment income but that is included in DNI.

3. To the extent the beneficiary receives a portion of a distribution characterized as net investment income, the beneficiary includes that portion in his or her own net investment income calculation.

4. The entity's share of undistributed net investment income will be the total net investment income received by the entity less the amount deemed distributed to its beneficiaries as determined previously. There cannot be a distribution of net investment income in excess of the DNI of the entity.

Such income distributions may not be possible based on the terms of a governing instrument, or not advisable, based on the fiduciary's view of appropriate discretion. Does state law permit discretionary distributions of capital gains? Is there a power to adjust authorized by the state's version of the Uniform Principal and Income Act? When distributions are limited, other strategies must be considered.

.02 Addressing Similar Investment Strategies for Trusts and Estates Previously Suggested for Individuals

Investment strategies for individuals include the following:

- Acquire tax-exempt securities and low or no dividend paying stocks.

- Net the gains and losses on sales.

- "Harvest" losses when gains are realized.

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Be aware that the fiduciary has obligations not only to minimize taxation but also to derive appropriate investment return for beneficiaries. There are obligations of fairness and general fiduciary obligation to income beneficiaries and remainder beneficiaries that go beyond tax planning, making the tax planning objectives not the only concern here.

.03 Taking Advantage of the "Discretionary Allocation of Expenses Rule"

Regulation 1.652(b)-3(b) provides that after the required allocation of direct expenses to the category of income associated with them, and the required allocation of a share of indirect expenses to tax-exempt income, if present, the fiduciary is then free to allocate expenses to any class of income desired and is not required to do so proportionately.

This can be especially helpful if the trust or estate has business income. If expenses for things such as fiduciary fees, accounting fees, and legal fees can be allocated to categories of income other than business, the other categories will constitute net investment income, whereas the business income (not net investment income) will bear no part of the expense allocation.

Because the law provides favorable characterization to qualified dividends, as opposed to other forms of ordinary income, using this regulation to keep expenses away from qualified dividends and focused on higher taxed categories of income, such as interest, can also be helpful.

¶3845 The Latest Proposed Regulations (Still Proposed) (December 5, 2013)

Numerous issues remain unanswered by the final regulations. An extensive set of proposed regulations addressing issues not resolved by the final regulations was issued in conjunction with the final regulations. The topics addressed in the latest proposed regulations include the following:

The proposed regulations exclude all IRC Section 707(c) guaranteed partnership payments received for services from net investment income, regardless of whether these payments are subject to self-employment tax, because payments for services are not included in net investment income.

However, the IRC Section 707(c) payments received for the use of capital are included in net investment income, per Proposed Regulation 1.1411-4(g)(10).

IRC Section 736(b) payments (for the liquidation of a retiring partner's share of partnership property) are taken into account as net investment income, per Proposed Regulation 1.1411-4(g)(11).

However, the proposed regulations also provide that IRC Section 1411(c)(4) applies to IRC Section 736(a)(2) and 736(b) payments. Accordingly, the inclusion of these payments as net investment income may be limited if the retiring partner materially participated in all or a portion of the partnership's trade or business.

Proposed Regulation 1.1411-4(d)(4)(iii) creates an annual adjustment to capital loss carryforwards to prevent capital losses excluded from the net investment income calculation in the year of recognition from becoming deductible losses in future years.

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Chapter 39

The Affordable Care Act: What Practitioners Need to Know and Do Now

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¶3940 Repeal of the Tax on "Cadillac Plans"

Author's Note: On June 17, 2021**,** in the case of California v. Texas, the U.S. Supreme Court dismissed the latest (and likely final) challenge to the Affordable Care Act ("ACA"). The Court concluded that Texas and other plaintiff states did not have standing to challenge the individual mandate of the ACA, as those states could not show a past or future injury related to the mandate provision. The Court's decision did not address the constitutionality question of the individual mandate. The 2017 Tax Cuts and Jobs Act contained a major change to the ACA. The penalty imposed on individuals for failure to have minimum essential health insurance for themselves and their dependents has been reduced to zero for months beginning after December 31, 2018. (IRC Section 5000A(c).) The employer mandate to provide minimum essential coverage as imposed by the ACA remains unaffected. The Court's opinion made no change to these rules.

Another important development involves the U.S. Department of Labor issuing new regulations in 2018. The new regulations allow small businesses and self-employed individuals to join together and obtain "association health plans" for themselves and their employees. The new rules allow the plans to offer coverage that excludes maternity care, prescription drugs, mental health services, and other items that the ACA requires to be included in coverage sold to individuals and small businesses. The objective of the new rules is to allow policies to be offered that are less expensive because they may omit some of the comprehensive benefits required by the ACA that make policies more expensive and unaffordable for many persons unable to obtain ACA subsidies.

Different states address the ACA requirements differently. Some states require individuals to have mandatory coverage or pay a penalty, despite the federal law. In this guide, we do not

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address the rules of each state or exchange, as these may change with new legislation. Beyond what has already been enacted and promulgated, we do not address possible revised federal guidelines or definitions of eligibility. If major changes are made, the AICPA will provide education to its members in the form of online learning and articles, etc.

A District Court in Texas had ruled that the ACA was unconstitutional after enactment of the 2017 Tax Cuts and Jobs Act because that act eliminated the penalty for an individual not having health insurance. The case was affirmed by the Fifth Circuit but was dismissed by the opinion of the Supreme Court.[1]

Note: The U.S. Supreme Court ruled in the case of *King v. Burwell*, 576 U.S. (2015) that the health insurance credit of IRC Section 36B is available to persons who enrolled in both federally facilitated and state-run exchanges. More broadly, the court defended the ACA, declaring, "Congress passed the Affordable Care Act to improve health insurance markets, not to destroy them."

¶3901 Introduction

The Patient Protection and Affordable Care Act, also known as the ACA (P.L. 111-148) and "Obamacare," is 2,409 pages long. The law is divided into 10 titles, each addressing a different part of the health care system. Many of the provisions of the law are found in IRC Section 5000A:

- Title I is "Quality, Affordable Health Care for All Americans" (374 pages). This is the part of the law that deals with health insurance. It is a complex body of law and the focus of most of this discussion.

- Title II is the "Role of Public Programs" (242 pages). It addresses Medicaid and Indian Health Services. It also focuses on how future medical care will be delivered.

- Title III is "Improving Quality and Efficiency of Health Care" (501 pages) and addresses primarily Medicare and guidelines for health care providers. The goal is to move from a fee-for-service system to a system that bases payments on quality of delivery.

- Title IV is "Prevention of Chronic Disease and Improving Health" (130 pages). It addresses efforts to prevent chronic illness or treat it in its early stages.

- Title V is "Health Care Workforce" (256 pages). It discusses the shortage of health care workers and how that affects care for the entire population and suggests bolstering primary care practice, implying that specialization has detracted from the delivery of health care services.

- Title VI is "Transparency and Program Integrity" (323 pages). It addresses the reduction of fraud and abuses in the medical service system.

[1] *Texas v. United States* (District Court12/14/18); Fifth Circuit -F3d- (December 18, 2019).

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- Title VII is “Improving Access to Innovative Therapy” (65 pages). It focuses on improving access to generic drugs.

- Title VIII is the “Community Living Assistance Services and Support Act.” It is 53 pages long. It was designed to create a federally run long-term care insurance program. After the U.S. Department of Health and Human Services (HHS) declared it too difficult to implement, it was repealed.

- Title IX is the section on “Revenue Provisions” (93 pages), which describes how this law will be paid for, including the 3.8% tax on net investment income. This tax is discussed separately in chapter 38, “Planning for the Additional Medicare Tax and Net Investment Income Tax.”

- Title X, “Strengthening Quality Affordable Health Care for All Americans” (372 pages), contains a laundry list of pilot programs for health care services, along with a number of concessions to special interests.

¶3905 Overview of What the ACA Requires

The law originally required most U.S. citizens and legal U.S. residents to have minimum health insurance coverage or pay a penalty.[2] The individual penalty remained in effect through 2018. Thereafter, it was reduced to zero. Note that some states have enacted their own laws requiring residents to have health insurance or face a state-imposed penalty.

It creates state-based American Health Benefit Exchanges and Small Business Health Options Program (SHOP) exchanges, through which individuals and small businesses with up to 100 employees can purchase qualified coverage, with premium and cost-sharing credits available to individuals and families with income between 138–400% of the federal poverty level (FPL).

The law requires large employers to pay penalties for employees who receive tax credits for health insurance acquired through an exchange when health care offered by a large employer is not adequate, with exceptions for small employers. It imposes regulations on health plans in the exchanges and in the individual and small group markets. The employer mandate has not been changed by the 2017 Tax Cuts and Jobs Act.

States must define small employers as those having up to 100 employees. States can choose to expand exchanges to larger businesses.

¶3910 Health Insurance Marketplaces (Exchanges)

.01 The Exchanges

Every state was intended to have a health insurance marketplace (exchange) where individuals, families, and small business owners could shop online for insurance. The exchanges will be administered by a

[2] IRC Section 5000A; Reg. 1.5000A-1.

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governmental agency or a not-for-profit organization. At least two multistate qualified health plans were to have been available in each state. All has not yet gone as planned.

There are states with state-based marketplaces, states with a state-based marketplace and a federal platform, states with a state-partnership marketplace, and states with a federally facilitated marketplace. These characterizations are described as follows and can change at any time if states decide to go in a different direction.

State-based marketplace: States running a state-based marketplace are responsible for performing all marketplace functions for both the individual market and the SHOP. Consumers as well as small employers and their employees in these states apply for and enroll in coverage through marketplace websites established and maintained by the states.

State-based marketplace — federal platform: States with this type of marketplace are considered to have a state-based marketplace and are responsible for performing all marketplace functions for the individual market and the SHOP, except that the state will rely on the federally facilitated marketplace IT platform. Consumers as well as small employers and their employees in these states apply for and enroll in coverage through healthcare.gov.

State-partnership marketplace: States entering into a partnership marketplace conduct plan management and may administer in-person consumer assistance; HHS performs the remaining marketplace functions. Consumers as well as small employers and their employees in states with a partnership marketplace apply for and enroll in coverage through healthcare.gov.

Federally facilitated marketplace: In a federally facilitated marketplace, HHS performs all marketplace functions. Consumers as well as small employers and their employees in states with a federally facilitated marketplace apply for and enroll in coverage through healthcare.gov.

The law requires the Office of Personnel Management to contract with insurers to offer at least two multistate plans in each exchange. At least one plan must be offered by a not-for-profit entity, and at least one plan must not provide coverage for abortions beyond those permitted by federal law. Each multistate plan must be licensed in each state and must meet the qualifications of a qualified health plan. These multistate plans will be offered separately from the Federal Employees Health Benefit Program and will have a separate risk pool. There are indications that many areas do not have two plans to offer for 2023 as the result of numerous insurance companies around the country suffering losses as the result of the ACA. Some areas will not have any plan available.

The law requires the exchanges to maintain a website and call center for customer service and establish procedures for enrolling individuals and businesses and determining eligibility for tax credits. It requires states to develop a single form for applying for state health subsidy programs that can be filed online, in person, by mail, or by phone. Exchanges are permitted to contract with state Medicaid agencies to determine eligibility for tax credits in the exchanges.

U.S. citizens and legal U.S. residents who are not incarcerated may purchase coverage through the exchange. The coverage will be subsidized for individuals in families with income not exceeding 400% of the FPL: $54,360 for an individual; $73,240 for a married couple with no children; and $111,000 for a family of four. These are 2023 numbers that are used to calculate eligibility for private health insurance plan subsidies for persons who are not eligible for Medicare, Medicaid, the Children’s Health Insurance Program, or affordable employer-sponsored insurance.

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In 32 states plus Washington, D.C., that expanded Medicaid (other states are free to expand Medicaid at any time — check with each state to determine the status), the minimum income to be eligible for the ACA subsidies is 138% of the FPL. In states that did not expand Medicaid, the minimum income is 100% of the FPL. If modified adjusted gross income exceeds the 400% of poverty level guideline by even $1, the entire subsidy is lost.

For purposes of determining eligibility for exchange subsidies, *affordable employer-sponsored insurance* is defined as requiring an employee contribution of less than 9.12% (for 2023) of household income for an employee-only plan that covers at least 60% of medical costs on average (minimum value). If self-only coverage costs less than 9.12% of household income, then both employees and their family members are ineligible for subsidies, regardless of whether family coverage is affordable for them.

Employers of all sizes may also continue to purchase coverage outside of the exchange.

The exchanges will have many responsibilities, including the following:

- Certifying for purposes of the individual responsibility penalty when there has been a failure to maintain minimum essential health coverage, if an individual is either exempt from the requirement or exempt from the penalty.

- Advising Treasury which individuals are exempt from the penalty for failing to carry health insurance (including the name and tax identification number of each individual).

- Providing each employer with the name of each of its employees who ceases coverage under a qualified health plan during a plan year and the date of such cessation.

.02 The Application Process

Various forms are available at healthcare.gov for online application. The online application can be used by any single adult who does not have any dependents and cannot be claimed as a dependent on someone else's return and whose employer does not offer health care coverage.

A different form will be needed for persons who are married or who have dependent children, or are in the foster care system and under age 26, or have items that can be deducted from income, or are American Indian or Alaska natives.

Among other information, the form requires a Social Security number or document number if the person is a legal immigrant, as well as employer and income information.

¶3915 Insurance Plan Opportunities

.01 Four Benefit Categories — Plus One

Each state will have its own set of plan options, broken down into four tiers or benefit categories, namely Bronze, Gold, Silver, and Platinum. In addition, a separate catastrophic plan will be offered through the exchange and in the individual and small group markets. The higher the level plan chosen, the higher the cost to the individual participants. Reports indicate declining costs for 2023 with increased subsidies. The cost of plans may differ from one state to another.

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The four levels are based on actuarial value; that is, how much of the total health care costs will be covered by the plan after deductibles, copays, coinsurance, and annual out-of-pocket caps.

- The Bronze plan represents minimum creditable coverage and provides the essential health benefits and covers 60% of the benefit costs of the plan, with an out-of-pocket limit equal to the ACA compliant plan health savings account (HSA) current law limit ($7,500 for individuals and $15,000 for families in 2023).

- The Silver plan provides the essential health benefits and covers 70% of the benefit costs of the plan, with the HSA out-of-pocket limits.

- The Gold plan provides the essential health benefits and covers 80% of the benefit costs of the plan, with the HSA out-of-pocket limits.

- The Platinum plan provides the essential health benefits and covers 90% of the benefit costs of the plan, with the HSA out-of-pocket limits.

- The Catastrophic plan will be available to those up to age 30 or those who are exempt from the mandate to purchase coverage and provides catastrophic coverage only with the coverage level set at the HSA current law levels, except that preventive care benefits and coverage for three primary care visits would be exempt from the deductible. This plan is available only in the individual market.

.02 Special Rules for Persons with Household Income Up to 400% of the FPL

For 2023, 400% of the FPL has been determined to be $58,320 for single individuals and $120,000 for a family of four. Persons with income at or below these levels will be entitled to receive a premium assistance credit. There is a sliding scale of required payments and subsidy, based on where the person falls, in the range of 100% to 400%.

The out-of-pocket limits will be reduced for those persons with incomes up to 400% of the FPL to the following levels:

- 100%–200% FPL: one-third of the HSA limits

- 200%–300% FPL: one-half of the HSA limits

- 300%–400% FPL: two-thirds of the HSA limits

The HSA limits for 2023 are $7,500 for individuals and $15,000 for families.

- The reduced out-of-pocket expenses at various income levels will apply to deductibles, co-payments, and total out-of-pocket spending limits. They are based on the standards of the lowest-cost Silver plan.

- Insurers are to be reimbursed for cost subsidies by the federal government.

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¶3920 The Individual Mandate

Through 2018, nonexempt individuals must either maintain "minimum essential health coverage" for themselves and their dependents or pay a "shared responsibility payment" (that is, a penalty). As the result of the 2017 Tax Cuts and Jobs Act, the individual mandate penalty has been abolished, beginning after 2018. Certain states do impose a penalty on individuals for failure to have health insurance coverage.

The discussion below addressing the individual mandate was applicable for years prior to 2019. It is preserved here in the event that the law changes again to require individuals to have health insurance or pay a penalty.

The rules apply to individuals of all ages, including senior citizens and children. Every child must have minimum essential coverage or qualify for an exemption for each month of the year. The person who claims the child as a dependent for federal income tax purposes is responsible for paying for the insurance if the dependent does not have coverage or an exemption.

There are several exemptions from the requirement to maintain minimum health coverage, including those for (Regulation 1.5000A-3)

- members of recognized religious sects,
- members of health care sharing ministries,
- persons who are not U.S. citizens or U.S. nationals, and
- incarcerated individuals.

Only an exchange may grant a religious sect conscience or hardship exemption certification. If received, the taxpayer must attach it to his or her federal income tax return.

Some persons will be subject to the requirement to maintain minimum essential health coverage, but exempt from the penalty for noncompliance.[3] These persons will be treated as having minimum essential coverage. Such persons include the following:

- Individuals unable to afford coverage because the health insurance premiums exceed 8% of their household income, subject to inflation adjustments. If the individual is eligible to purchase minimum essential health insurance coverage through an employer-sponsored plan, the annual premium is based on the self-only coverage under the plan. Otherwise, the required contribution is the annual Bronze plan premium, reduced by any premium assistance credit. When household income is being determined, a taxpayer's household includes all individuals for whom the taxpayer properly claims a personal expense deduction.[4]

[3] Reg. 1.5000A-3(j)(2)(ii).

[4] Reg. 1.5000A-3(e)(1) and (2).

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- Taxpayers with household income below the current year income tax filing threshold and not required to file a tax return for a year are automatically exempt from owing a penalty for that year and do not need to do anything else to secure an exemption.[5]

- Hardship cases in which the individual can show that a hardship made obtaining minimum essential coverage impossible.

- Native Americans are exempt from the penalty.

- Short lapses of coverage (less than three months) during the year.

- Persons residing outside the United States.

- Dependents, because the person claiming them as such is the responsible party.[6] Even if the dependent is not actually claimed by the eligible person, that person is liable for the penalty for that dependent, if applicable.[7] If the taxpayer's income is below the applicable filing threshold, all dependents of the taxpayer are also exempt. Note that the spouse is not considered a dependent for purposes of these rules.

- Medicaid recipients.

An individual is exempt from the requirement to have minimal essential health coverage if the coverage gap is a continuous period of less than three months.[8] A continuous gap in coverage of more than three months will cause the penalty to apply, absent other reasons to qualify for a penalty exemption.

.01 Minimum Coverage Requirements — The Essential Health Benefits Package

The following are the health benefits that insurance companies must provide in the policies offered:[9]

- Ambulatory patient services

- Emergency services

- Hospitalization

- Maternity and newborn care

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[5] IRS FAQ No. 22.

[6] Reg. 1.5000A-3(a)-(h).

[7] Reg. 1.5000A-1(c)(2)(i).

[8] Reg. 1.5000A-3(j)(2).

[9] T.D. 9493. Note that the Labor Department in 2018 has issued regulations allowing policies to be offered that do not include all of these benefits but will still qualify as "minimum essential health benefits" under the ACA.

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- Mental health and substance use disorder services
- Prescription drugs
- Rehabilitative services and devices
- Laboratory services
- Preventive and wellness services, including chronic disease management
- Pediatric services, including oral and vision care

In addition, the law imposes a series of coverage mandates, including the following:

- Elimination of lifetime limits.
- Elimination of annual limits.
- Restriction of policy rescission to cases involving fraud or intentional misrepresentation prohibited by the terms of the plan or coverage.
- First dollar coverage of certain preventive health services.
- Extension of dependent coverage until age 26.
- Elimination of preexisting condition exclusions.
- Restriction of waiting periods to no more than 90 days.
- Guaranteed enrollment and guaranteed renewal — disability, lifestyle, and so on may not be taken into account.
- Medical underwriting is prohibited. Restriction of premium differences based on age and tobacco use is limited to ratios of no more than 3 and 1.5, respectively, and elimination of any other such differences (except differences based on single or family coverage or geography).

This last provision (the insurance cost for an older person cannot be more than three times the cost of that for a younger person) is likely to have a significant impact on the relative costs of insurance coverage for older and younger people. It is suggested that the "cap" on the cost of insuring older citizens, combined with the relatively weak sign-ups of younger citizens who did not wish to pay health insurance premiums, may raise the cost of coverage for older persons, thereby raising the insurance cost for younger persons, forcing more to decline coverage, and leading to a cost of insurance spiral.

Minimum essential coverage does not include "specialized coverage," such as vision or dental care, workers' compensation insurance, automobile liability insurance, Medigap coverage, and so on.

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Minimum essential health coverage does include the following:[10]

- Government-sponsored health programs, such as Medicare (including Medicare advantage), Medicaid, Children's Health Insurance Program, various programs for veterans, military, and others.

- Eligible employer-sponsored plans, including group health plans, governmental plans, church plans, and grandfathered plans and grandfathered group health plans (that is, coverage in effect on March 23, 2010). Many plans thought to be "grandfathered" and acceptable under the ACA have been found to not qualify.

- Certain changes to plan design will nullify a plan's grandfathered status, such as elimination of benefits for certain conditions; any increase in coinsurance percentage; an increase in deductible or out-of-pocket limit by more than 15% plus medical inflation; an increase in copayment by more than $5, adjusted for medical inflation or 15% plus medical inflation, whichever is greater; an increase in an employee's share of premium by more than 5 percentage points; or certain increases in a plan's annual benefit limit. These limits are applied on a cumulative basis, not an annual basis. Changes to premiums, changes made to comply with federal or state laws, or a change of third-party administrator will not cause a plan to lose its grandfathered status. Employers that change insurers can maintain grandfathered status as long as the new plan has cost-sharing and benefits that are similar to the original plan. Many plans did not meet the requirements of the ACA, and participation in them had to be canceled, even if the participants wanted to continue the plan.

- Fully insured plans pursuant to a collective bargaining agreement (CBA) are grandfathered until the last expiration date of a CBA related to that coverage. Grandfathered status may be maintained upon the CBA expiration date if no changes were made since March 23, 2010, that would have otherwise caused the plan to lose its grandfathered status.

- Plans in the individual (that is, non-group) market and plans offered by an exchange.[11]

.02 Individuals without Employer Coverage or Eligible to Purchase Coverage Only on the Open Market

Individuals must pay for the lowest-cost Bronze plan available minus any credit from the exchange. An individual ineligible for coverage under an eligible employer-sponsored plan must pay the premium for the "applicable plan" less the maximum amount of the credit allowable under IRC Section 36B (discussed in the text that follows) for which the individual is eligible.[12]

The *applicable plan* refers to the single lowest-cost Bronze plan available in the individual market through the exchange serving the rating area in which the individual resides that would cover all individuals in the individual's nonexempt family. An individual's nonexempt family means the family

[10] IRC Section 5000A(f) and Reg. 1.5000A-2.

[11] Reg. 1.5000A-2(d).

[12] IRC Section 5000A(e)(1)(B)(ii) and Reg. 1.5000A-3(c)(4)(A)(ii).

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including the individual but excluding any exempt family members or family members eligible for coverage under an eligible employer-sponsored plan.[13]

.03 Individuals Eligible to be Covered by an Employer's Plan

If an employee or dependent of an employee is eligible for minimum essential health coverage under an employer-sponsored plan, only the cost of the employer's plan determines if the individual lacks affordable coverage. This rule also applies to individuals eligible to enroll in retiree coverage.

An employed spouse's eligibility for the credit is determined by testing the spouse's own employer's health plan for affordability.

Employees with no dependents must purchase at least the lowest-cost self-only coverage. Employees with dependents must purchase at least the lowest-cost family coverage.[14]

.04 The Health Insurance Premium Assistance Refundable Credit

The *premium assistance credit* is a refundable tax credit that is available to help subsidize the purchase of health insurance. The credit is available for an applicable taxpayer for any month that one or more members of the applicable taxpayer's family are enrolled in qualified health insurance through an exchange and not eligible for minimum essential health coverage from another source, such as an employer or government coverage.[15]

The credit is not available when minimum essential health coverage is available from an employer or government.

An employer-sponsored plan is not considered minimum essential coverage if the required employee's contribution exceeds 9.12% of household income, or the plan fails to meet the minimum value Bronze plan.

The following are required to qualify as an applicable taxpayer — for the subsidy:[16]

- The taxpayer's household income (MAGI) [adding back tax-exempt interest and excluded Social Security income] plus the MAGIs of all other individuals taken into account in determining the taxpayer's family size if such individuals must file a tax return) must be between 100% and 400% of the FPL for the taxpayer's family size (for 2023, $58,320 to $120,000 for a family of four).[17]

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[13] Reg. 1.5000A-3(e)(4)(ii)(B)(1).

[14] Reg. 1.5000A-3(e)(3)(ii)(A) and (B).

[15] Reg. 1.36B-2(a).

[16] IRC Section 36B(c)(2) and Reg. 1.36B-2(b).

[17] IRC Section 36B(d)(2).

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- If married at year-end, the taxpayers must file a joint return.
- The taxpayer must not be claimed as a dependent on another taxpayer's tax return.
- The taxpayer must be a U.S. citizen or U.S. national or an alien lawfully in the United States and (Reg. 1.5000A-3(e)(3)(ii)(A) and (B)) not incarcerated.
- The taxpayer must be enrolled in a qualified health plan that is certified as eligible to be offered by an exchange.

Determining the amount of the premium assistance credit requires a complex calculation. Eligible individuals report their household income to an exchange, which then calculates the taxpayer's required share of premiums for the health plan. That share is then subtracted from the premiums for the second lowest-cost Silver plan adjusted for age (referred to as the *applicable benchmark plan*) to determine the amount of the premium assistance credit. The exchanges will perform this computation for the taxpayer.

Initial eligibility for the premium assistance credit is based on the individual's income for the tax year ending two years prior to the enrollment period. Exchange participants applying for a premium assistance credit for 2023 must provide the exchange with their 2021 tax returns during the 2023 enrollment period (after October 1, 2023). Providing incorrect information to the exchange may subject the individual to civil penalties. Enrollment deadlines have often been extended by government action.

Once the premium assistance credit has been determined, individuals failing to pay all or part of the remaining premium amount are given a mandatory three-month grace period prior to an involuntary termination of their participation in the plan.

.05 Tax Penalty for Not Having Health Plan Coverage

Those persons without health plan coverage must pay a tax penalty to be included on their 2018 tax return if they did not have appropriate coverage for 2017. It appears that because the penalty was abolished for months after December 31, 2018, by the 2017 Tax Cuts and Jobs Act, it was still due for 2018 on 2019 tax returns; but there may not be efforts made to collect the penalty due for failure to have coverage for 2018, although that is not yet a certainty. Note that a number of states (for example, New Jersey, Massachusetts, and Rhode Island) have now enacted laws requiring a penalty to be paid to a state if an individual fails to have health insurance.

¶3925 The Employer Mandate

.01 Employer Obligations

A large employer subject to the ACA is only required to provide its full-time employees with the opportunity to enroll in a health care program — part-time employees, although counted when determining large employer status, are not required to be provided with health care.[18] This law was not affected by the 2017 Tax Cuts and Jobs Act.

[18] IRC Section 4980H.

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The noncompliance penalties described in the text that follows are levied upon a business only if a full-time employee receives subsidized health care through the exchange.

The ACA requires that all large employers provide their employees and their dependents the opportunity to enroll in a health care plan. Here, the focus is on whether a business is considered a large employer, and, if so, whether health insurance is provided. To be considered a large employer, a business must employ, at a minimum, 50 full-time equivalent employees. This includes counting all employees in a control group.[19] For example, for franchise owners who own more than one entity, all employees across the entities must be counted. This rule prohibits a company from splitting itself into two or more divisions to get the employee count below 50 employees.

Certain individuals are not treated as employees, including sole proprietors, partners in a partnership, 2% or more S corporation shareholders, and real estate agents and direct sellers under IRC Section 3508.

A *full-time employee* is one who works 30 or more hours a week or provides 130 hours a month service (including vacation, holidays, illness, and incapacity, including disability, layoff, jury duty, military duty, or leave of absence). After all full-time employees have been counted, a business must then determine how many full-time equivalents exist. A business determines its full-time equivalents by taking the total amount of hours worked by part-time employees during each month and dividing that number by 120. This number is then rounded down to the nearest whole number. This has the effect of converting the part-time workers to full-time equivalents for purposes of applying the large employer test.

Waiting periods of more than 90 calendar days (including weekends and holidays) are banned. This ban applies to all plans, including grandfathered plans and self-insured plans, and to all coverage offered, whether employee-only or family. This ban is applicable to all employees who would otherwise be eligible for coverage, including part-time workers who are offered coverage. Eligibility conditions may not be based solely on the lapse of a time period of more than 90 days, but substantive eligibility conditions, such as being in an eligible job classification or achieving job-related licensure requirements, are allowed. For new variable hour employees, coverage must begin less than 14 months from the employee's start date. Cumulative hours-of-service requirements are allowed if they do not exceed 1,200 hours. The 90-day waiting period may begin after the hours-of-service requirement is completed. Hours-of-service requirements must be one-time only and not applied to the same individual each year.

IRS Notice 2012-58 describes safe harbor methods that an employer may use to determine which employees are considered full-time employees for purposes of administering the ACA employer penalty provision. For newly hired employees who are designated as "variable hour" or seasonal employers that choose a long measurement period would have more than a year to determine these employees' full-time status and would not be subject to penalties during that time, under draft regulations. For newly hired employees who are reasonably expected to be full-time as of their start date, employers will be subject to penalties if they do not offer coverage by the end of the employee's initial three full calendar months of employment.

The safe harbor methods include a *measurement* or *look-back* period that allows an employer to measure how many hours an employee averaged per week during a defined period of not less than 3 and not more

[19] IRC Section 414.

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than 12 consecutive months. If an employee is determined to have worked full-time during the measurement period, an employer will then have the option of entering an *administrative period* during which the employee may be enrolled in a health plan. Following the administrative period, the employee would be treated as a full-time employee during a *stability period*. (The full-time classification would remain in place during the stability period as long as the worker remained an employee, regardless of how many hours are worked.) The IRS notice defines how the measurement, administrative, and stability periods are determined for three groups of workers (that is, ongoing employees; new employees reasonably expected to work full-time; and new employees with the safe harbor for variable hour and seasonal employees).

Businesses that employ a large number of seasonal employees (retail, farm, etc.) have an exception that they may use. Persons in positions for which the customary annual employment is 6 months or less generally will not be considered full-time employees, even if they work "full-time hours" during their period of employment. IRC Section 4980H(c)(2)(B) provides that any employer's workforce in excess of 50 employees who work for 120 days or less during the calendar year are seasonal workers. Their hours worked do not count. This includes extra workforce support during holiday periods in retail stores.

Hours contributed by bona fide volunteers for a government or tax-exempt entity, such as volunteer firefighters or emergency responders, will not cause them to be classified as full-time employees. Services performed by students under federal- or state-sponsored work-study programs will not be counted in determining whether they are full-time employees. Teachers and other educational employees will not be treated as part-time for the year simply because their school is closed or operating on a limited schedule during the summer.

The ACA definition of an employer is based on the common law standard, which states that an employment relationship exists if an employee is subject to the will and control of the employer not only about what shall be done but how it shall be done. In contrast, an independent contractor is an individual who controls what will be done and how it will be done, and the contract dictates the desired result of the work. The IRS provides further guidance on the distinction between an employee versus an independent contractor. In this context, a temporary worker is not an employee of the firm one is "leased" to; rather, the temporary worker is an employee of the temporary agency. The potential employer penalty applies to all common law employers, including an employer that is a government entity (such as federal, state, local, or Indian Tribal government entities) and one that is a not-for-profit organization that is exempt from federal income taxes.

Employers with more than 200 full-time employees must automatically enroll employees into a plan unless they opt out of coverage.

Employers do not have to pay 100% of the health insurance premiums for their employees. The premium cost may be shared by the employer and the employee. Employees pay a portion of their insurance as long as it is "affordable." Affordability is generally defined as not costing more than 9.61% of the employee's household income.

> **Example 39.1.** Acme Widget Co. has 20 full-time employees and 6 part-time employees who work 60 hours per month. Acme does not have to offer health insurance because it is not a "large employer." It is not close to 50 employees. It only issues only 26 W-2 Forms.
>
> **Example 39.2.** A business has 25 employees who work 80 hours a month and 30 employees who work full-time. First, an employer must calculate the total amount of part-time hours on a monthly basis (25 × 80 = 2,000). Then, the employer must divide by 120 to get the amount of

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full-time equivalents (2,000 ÷ 120 = 16.67 = 16 Full-Time Equivalents) + 30 Full-Time Employees = 46 Total Full-Time Employees and Full-Time Equivalents.

Although there is a total of 55 employees on the payroll, this business is not considered a large employer under ACA for the following year. Remember, however, that an employer needs to test this on an annual basis, with the prior year's results guiding the following year's applicability.

.02 Is the Health Care Affordable? Does It Provide Essential Minimum Coverage?

If a business is considered a large employer based on the preceding analysis, it must provide full-time employees the opportunity to enroll in health care plans that are both affordable and provide essential minimum coverage. Affordability and essential minimum coverage (sometimes referred to as *adequacy*) both have certain requirements. Employers who offer health insurance coverage that is inadequate or unaffordable will *not* be treated as meeting the employer requirements if at least one full-time employee declines their coverage and obtains a premium credit in an exchange plan.

For health care to be considered affordable, the cost of single coverage to the employee cannot exceed 9.12% for 2023 of the household's AGI for the taxable year. The coverage is based on the affordability of single coverage. Although large employers may be required to provide coverage to dependents, the coverage provided to these individuals need not meet the 9.12% affordability requirement. Affordable coverage means that the premium paid by the employee for the lowest-cost, self-only coverage does not exceed 9.12% of the employee's household income. There is no affordability percentage requirement with respect to coverage of the employee's spouse. The employee can be charged the full cost of such coverage.

.03 Revised Standards for Affordable Coverage

Under the terms of the ACA, large employers are required to provide affordable coverage limits based on employee income or potentially face penalties.

For plan years beginning in 2023, the limit is set at 9.12% of employee income.

The IRS must adjust the affordability percentage to reflect the excess of the rate of premium growth over the rate of income growth for the preceding calendar year, with each subsequent plan year being adjusted accordingly. It does serve as a reminder to employers that the definition of "affordable" can change. A key component of building a solid ACA compliance plan includes checking to see whether the various limits and percentages have changed prior to a plan year.

A major concern for large employers is knowing the AGI for the employee's household. The household's AGI not only includes the employee and the significant other but will include dependents that are required to file a tax return. There are, however, three safe harbors that large employers can rely on when determining affordable coverage with respect to the employee's household income:

1. The first of these safe harbors is known as the *W-2 safe harbor*. Here, the large employer will be deemed to have provided affordable coverage if the cost of the coverage does not exceed 9.61% of box 1 of the employee's W-2. Large employers must be careful when relying on this safe harbor. There are many factors that play into the amount reported on box 1 of an employee's W-2. For example, if an employee contributes to a traditional 401(k) plan, box 1 of the W-2 will

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report an amount less than the large employer may have considered when determining affordability.

2. The second safe harbor is known as the *rate-of-pay safe harbor*. Here, the large employer will be deemed to have provided affordable coverage if, as of the first date of the coverage period, the employee's out-of-pocket cost doesn't exceed 9.61% of the employee's monthly income. For salaried employees, this is a simple equation. For hourly employees, a large employer must take the employee's hourly rate and multiply it by 130 to project the employee's monthly income. Once this is calculated, the large employer can then calculate affordability. Under this safe harbor, a large employer can determine affordable coverage as of day one of the plan.

3. The third safe harbor is the *FPL safe harbor*. Here, a large employer uses the FPL for a single individual when determining what is affordable. This safe harbor, like the rate-of-pay safe harbor, allows large employers to determine affordability as of day one of the plan.

Essential minimum coverage requires that the plan cover 60% of the essential health benefits, which is also known as Bronze level status, as described previously. The essential minimum benefits include things such as emergency services, ambulatory services, hospitalization, lab services, prescription drug coverage, and maternity and newborn care, among others. What's not included is vision, dental, disability, and long-term care.

A Medicaid-eligible individual can always choose to leave the employer's coverage and enroll in Medicaid, and an employer is not required to pay a penalty for any employees enrolled in Medicaid.

.04 Penalty for Failing to Offer Health Care or Offering Insufficient Health Care Benefits

> **Note:** The standards as to coverage and penalties described later in this chapter are those prescribed by the ACA.

Penalty if Large Employer Does Not Offer Health Coverage. Large employers not offering coverage or offering coverage to less than 95% of full-time employees pay $2,880 (for 2023) multiplied by the total number of full-time employees minus 30. This penalty applies only if at least one full-time employee receives subsidies in the exchange. The $2,880 penalty also applies to employers that do not offer coverage to the children (under age 26) of full-time employees, regardless of whether the coverage offered to children is affordable.[20] The penalty is not deductible.

Large employers offering coverage to at least 95% of its full-time employees pay a penalty equal to the lesser of

- $4,320 × the number of those full-time employees actually receiving subsidies, and
- $2,880 × the total number of full-time employees − 30.

This penalty may occur because an employer did not offer coverage to a full-time employee or because the coverage offered was unaffordable or did not provide minimum value. The 95% threshold

[20] IRC Section 4980H(c)(5).

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requirement is satisfied if employees are *offered* coverage, regardless of whether they *accept* coverage. Related employers are not aggregated for purposes of this 95% test.

Note: If the employer's plan meets the minimum value requirement and its coverage is affordable, the employer is not liable for the $4,320 penalty, even if the employee receives a premium tax credit.

A large employer who fails to offer its full-time employees and their dependents the opportunity to enroll in minimum essential coverage under an employer-sponsored plan for any month is subject to a penalty if at least one of its full-time employees is certified to the employer as having enrolled in health insurance coverage purchased through a state exchange with respect to which a premium tax credit or cost-sharing reduction is allowed or paid to such employee or employees.

Note: Required coverage must be offered for the employee and the children of the employee, but not for the spouse of the employee.

The penalty for any month is an excise tax equal to

- the number of full-time employees over a 30-employee threshold during the applicable month (regardless of how many employees are receiving a premium tax credit or cost-sharing reduction) multiplied by one-twelfth of $2,880 ($240.00 per month per applicable employee).

The penalty is not deductible.

In the case of persons treated as single employers of controlled groups under the provision, the 30-employee reduction in full-time employees is made from the total number of full-time employees employed by such persons (that is, only one 30-person reduction is permitted per controlled group of employers) and is allocated among such persons in relation to the number of full-time employees employed by each such person.

.05 Large Employers Offering Health Coverage May Still Be Penalized if Any Employee Receives Premium Credits from State Exchange

An applicable large employer who offers, for any month, its full-time employees and their dependents the opportunity to enroll in minimum essential coverage under an employer-sponsored plan is subject to a "shared responsibility" penalty if any full-time employee is certified to the employer as having enrolled in health insurance coverage purchased through a state exchange with respect to which a premium tax credit or cost-sharing reduction is allowed or paid to such employee or employees.[21] This could arise if the employer's plan does not provide minimal essential coverage, or the employer does offer such coverage, but it is not affordable (based on the employee's household income), or it is not considered "adequate" if the plan's share of the total allowed cost of benefits is less than 60%. The employer plan must pay 60% or more of the employee's cost for covered services. The employee, through deductibles and copays, may be required to cover up to 40% of the employee's health care costs.

[21] IRC Section 4980H(b)(1).

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The annual nondeductible penalty is $4,320 per employee payable on a prorated monthly basis. The penalty is a nondeductible excise tax that is imposed for each employee who receives a premium tax credit or cost-sharing reduction for health insurance purchased through a state exchange. For each full-time employee receiving a premium tax credit or cost-sharing subsidy through a state exchange for any month, the employer is required to pay an amount equal to $4,320 ($360.00 per month per employee).

The penalty for each employer for any month is capped at an amount equal to the number of full-time employees during the month (regardless of how many employees are receiving a premium tax credit or cost-sharing reduction) in excess of 30, multiplied by one-twelfth of $2,880 .[22] ($240.00 per month)

Note that there is a major distinction between the penalties in that the non-coverage penalty applies to the entire full-time workforce (less the first 30) — even if only one person receives subsidized health care through the exchange. Alternatively, the penalty for inadequate coverage applies only to the employees who receive a subsidy through the exchange. Employers who fail to comply with both sections will not get hit with both penalties — just the greater of the two. If the $4,320 tax applies, it is capped at the total arising from the $2,880 tax.

.06 Part-Time Workers

Part-time workers are *not* included in the penalty calculations (even though they are included in the determination of a "large employer"). An employer will *not* pay a penalty for any part-time worker, even if that part-time worker receives a premium credit.

.07 The Penalties Are Inflation Adjusted

The initial penalty amounts of $3,000 and $2,000 have been increased by the percentage (if any) by which the average per capita premium for health insurance coverage in the United States for the preceding calendar year (as estimated by the Secretary of HHS no later than October 1 of the preceding calendar year) exceeds the average per capita premium for 2013 (as determined by the Secretary of HHS), rounded down to the nearest dollar. For 2023, the penalty amounts have been increased to $4,320 and $2,880, respectively.

According to the Congressional Budget Office, employers were projected to pay $130 billion in penalty payments over a 10-year period.

What are employers likely to do? Using a purely financial analysis, if the employee will not qualify for the premium tax credit, the employer may choose not to provide affordable health care coverage. If the employee will qualify for the premium tax credit, the employer may provide affordable coverage, as long as the cost of doing so is less than $4,320 per year.

> **Example:** Assume the employer plan's total annual premium for self-only coverage is $6,000 per year. Determine the employee compensation level in which the full premium paid by the employee would be considered affordable ($6,000 ÷ .0912 =$65,789). The employee with compensation at or above this level could be required to pay the full premium cost; the employer would pay $0, and the employer would not be liable for the $4,320 penalty.

[22] IRC Section 4980H(b)(2).

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Example: Assume the lowest paid employee was paid annual compensation of $11,310. To avoid the employer penalty, the employee's premium would be $11,310 × 9.12% = $1,031. The employer would cover the balance of the premium, $6,000 − $1,031 = $4,969 (unless the employee was covered by Medicaid, in which case there would be no penalty).

The employer should bear in mind that the cost of paying the employee's health insurance premium is deductible, but the excise tax payment is not deductible. If the net after-tax numbers are close, does the employer spend it on the employee or send it to the IRS?

To avoid the $4,320 penalty, the employer offering insurance could charge all employees a uniform percentage (9.12%) of compensation for their health insurance. This would minimize the employer's cost. Alternatively, all employees could be charged a uniform dollar amount. This amount could be calculated to cover the affordable premium for the lowest paid employee to avoid the $4,320 excise tax. This would most likely be easier for the employer to communicate and administer. Another alternative could be a blend of these suggestions, such as charging all employees a uniform percentage of compensation up to a maximum stated dollar amount.

.08 Procedures for Employers to Appeal

An employer must be notified if one of its employees is determined to be eligible for a premium assistance credit or a cost-sharing reduction. The notice must include information about the employer's potential liability for payments under IRC Section 4980H. The employer must also receive notification of the appeals process established for employers notified of potential liability for payments under IRC Section 4980H. An employer is generally not entitled to personal information about its employees who qualify for the premium assistance credit or cost-sharing reductions; however, the appeals process must provide an employer the opportunity to access the data used to make the determination of an employee's eligibility for a premium assistance credit or cost-sharing reduction, to the extent allowable by law. The Secretary of HHS is required to prescribe rules, regulations, or guidance for the repayment of any assessable payment (including interest) if the payment is based on the allowance or payment of a premium tax credit or cost-sharing reduction with respect to an employee that is subsequently disallowed and with respect to which the assessable payment would not have been required to have been made in the absence of the allowance or payment.

.09 Limited Subsidies Are Available for Small Employers

The small employer health insurance tax credit under Section 45R was enacted by the ACA to help small businesses and small 501(c) tax-exempt organizations afford the cost of providing health insurance coverage for their employees.

To be eligible, an employer must do the following:

- Pay premiums for employee health insurance under a qualifying arrangement. A qualifying arrangement, further described in the following paragraphs, generally is one in which the employer pays at least 50% of the premium cost for single (employee-only) coverage.
- Have fewer than 25 full-time-equivalent employees (FTEs) for the tax year.
- Pay average annual wages of less than $27,800 per FTE for 2022, and further adjusted for inflation thereafter..

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Qualifying arrangement. A qualifying arrangement generally requires the employer to pay at least 50% of the premium cost for single (employee-only) coverage for each employee enrolled in any health insurance coverage provided by the employer, even if the employer did not pay the same percentage of the premium for each employee. The health insurance provider must be either an insurance company or another entity licensed under state law to provide health insurance coverage.

For tax years 2014 and later, the maximum credit is 50% of the employer's contribution toward the employees' health insurance premiums (35% for nonprofits). The credit is available for a maximum of two years. In addition, employers must obtain the insurance through the SHOP, a feature of the health benefit exchanges, or marketplaces, that states and the federal government have established under ACA.

An employer's eligible premium contribution is limited to the average cost of health insurance for the small group market in the employer's state or an area of the state (see Proposed Regulations Section 1.45R-3(b)). The average premium for the small group market is determined by HHS. After HHS sets the rate for a state (or within a state), it is published on the IRS website and included in the instructions for Form 8941, "*Credit for Small Employer Health Insurance Premiums*."

The credit phases out as average annual wages increase above $56,000 for 2023 and further adjusted for inflation thereafter or average FTEs increase between 10 and 25. The credit is claimed using Form 8941. It is part of the general business credit, unused portions of which can be carried back 1 year and forward 20 years. The credit can be applied to both regular taxes and the AMT. The employer must reduce its health insurance premium expense deduction under IRC Section 162 by the amount of the credit.

For tax-exempt small employers, the credit is also calculated on Form 8941 and is attached to Form 990-T, *Exempt Organization Business Income Tax Return*. The credit is refundable and limited to the payroll taxes (federal income taxes withheld, Medicare taxes withheld, and employer Medicare taxes paid) for the tax year.

.10 Employer Reporting Requirements

Employers providing minimum essential coverage must report to the IRS annually with information about the coverage offered.

Large employers with at least 50 full-time equivalent employees have certain reporting requirements with respect to their full-time employees. As prescribed by the Secretary of Labor, they will have to provide a return that includes the following:

- Name, address, and employer identification number
- A certification about whether the employer offers its full-time employees (and dependents) the opportunity to enroll in minimum essential coverage under an eligible employer-sponsored plan
- The length of any waiting period
- The months that coverage was available
- The monthly premiums for the lowest-cost option
- The employer plan's share of covered health care expenses

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- The number of full-time employees
- The name, address, and tax identification number of each full-time employee

Additionally, an offering employer has to provide information about the plan for which the employer pays the largest portion of the costs (and the amount for each enrollment category). The employer must also provide each full-time employee with a written statement showing contact information for the person required to make the preceding return and the specific information included in the return for that individual. An employer may enter into an agreement with a health insurance issuer to provide necessary returns and statements.

Automatic enrollment programs will be required to include adequate notice and the opportunity for an employee to opt out.

¶3930 The Tax Forms for Employer Reporting

.01 Final ACA Forms: Introduction

The IRS has released final forms that large employers and health insurance issuers (as applicable) will use to report information regarding employees' full-time status and health coverage, as required under the ACA.

.02 Final ACA Forms: 1094B, 1095B, 1094C, and 1095C

i. Form 1094-B: *Transmittal of Health Coverage Information Returns* (that is, Form 1095-B)

ii. Form 1095-B: *Health Coverage*

iii. Instructions for Forms 1094-B and 1095-B

iv. Form 1094-C: *Transmittal of Employer-Provided Health Insurance Offer and Coverage Information Return* (that is, Form 1095-C)

v. Form 1095-C: *Employer-Provided Health Insurance Offer and Coverage*

vi. Instructions for Forms 1094-C and 1095-C

.03 Forms 1094-C to IRS and 1095-C to Employees

Applicable large employers — generally those with 50 or more full-time equivalent employees on average during the prior calendar year — will satisfy their reporting requirements by filing Form 1094-C (a transmittal to the IRS) and Form 1095-C (a statement to employees). Applicable large employers that sponsor self-insured plans will complete all parts of Form 1095-C (Part I, II and III), as necessary, to satisfy their obligation, whereas an employer sponsoring a fully insured plan will complete only the top half (Parts I and II) of Form 1095-C, and generally only for full-time employees.

.04. The IRS Uses Form 1095-C for Play-or-Pay Mandate

The IRS will use Form 1095-C to assess an employer's compliance with the play-or-pay mandate (i.e., provide health insurance or pay a penalty) as well as whether an employee is eligible for premium tax credits to purchase coverage through the health insurance marketplace. Employers must file Form 1094-

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C with the IRS by February 28 following the reporting year (March 31 if filing electronically) and must provide Form 1095-C to full-time employees by January 31 following the reporting year. Employers with self-insured plans provide Form 1095-C to all covered employees, as well as all full-time employees regardless of enrollment status (Part III is completed only for covered employees).

.05 The IRS Uses Forms 1095-B and 1095-C to Determine Minimum Essential Coverage

a. Health insurance issuers will satisfy their reporting obligations by filing Form 1094-B with the IRS and by providing Form 1095-B to covered employees, who will use the information to report compliance with the individual mandate on their federal income tax return. The IRS will use Form 1095-B (and Form 1095-C, when provided by a self-insured plan) to verify whether individuals have the minimum essential coverage necessary to comply with the ACA's individual mandate. Forms 1095-B and 1095-C will be used by providers of minimum essential coverage that are subject to IRC Section 6055, which requires health insurance issuers, certain employers, and others that provide minimum essential coverage to individuals to report information to the IRS about the type and period of coverage during the calendar year and furnish related statements to covered individuals. An employer may file only one Form 1095-C for each employee. If an employee works in multiple divisions for the employer, the information for such divisions must be combined onto a single form. Form 1095-C is to be furnished to employees on January 31. Forms 1094-C and 1095-C are due to be filed with the IRS on February 28, (or March 31, if filing electronically). Employers filing 250 or more Forms 1095-C must file Forms 1094-C and 1095-C electronically.

b. Forms 1094-B and 1094-C will be used by employers subject to the IRC Section 6056 information reporting requirements (generally, employers with at least 50 full-time employees, including full-time equivalent employees). IRC Section 6056 requires these employers to report to the IRS information on the health care coverage (if any) that they have offered to full-time employees during the calendar year, and to furnish related statements to their employees.

c. The forms require employers to calculate the lowest-cost plan available to each full-time employee on a month-to-month basis. This figure may vary as wages or working hours change. Every full-time worker's total monthly out-of-pocket cost for an employer health plan must be indicated.

.06 Government Reporting Requirements

a. The government will provide reports for person covered by Medicare, Medicaid, and CHIP programs on Form 1095-A. Insurance issuers and carriers are not required to provide forms for persons covered under these programs.

b. If a person is covered by insurance through an exchange, the exchange will provide that person with Form 1095-A. Insurance issuers and carriers do not file Forms 1094-B or 1095-B for persons covered by an exchange.

c. However, insurance issuers and carriers do file Forms 1094-B and 1095-B when reporting coverage for employees of small employers through the SHOP.

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¶3935 Problem: Does a Business Owner Reimburse Employees for Individual Policies?

A serious problem for business owners arose under Notice 2013-54 which provided that such a practice by a business owner created a serious problem for the owner. The Notice provided that reimbursement of employee costs constituted maintaining a "group health plan," and the ACA provides that any group health plan must not provide an annual limitation on benefits. The amount paid by the employer was deemed to be an annual limitation. Accordingly, the "plan" failed the requirement to be a "group health plan."

Although the premium reimbursement to the employee is still considered a tax-free receipt under Rev. Rul. 61-146, if the company involved has at least two employee participants, even if the plan is not considered discriminatory, it fails to meet the maximum lifetime benefit requirement, is deemed a disqualified group health plan, and was subject to a penalty under IRC Section 4980D of $100 per day, per participant! That amounts to $36,500 per employee, per year.

A sole owner of a small business can pay for his or her own health insurance, exclude other employees, and not be subject to the penalty. If, however, there are multiple employees, the business may not pay for all their insurance without a group health plan. According to Notice 2013-54, paying for the cost of an employee's policy falls short of the mandated group health plan, subjecting the employer to the penalty. This includes payments provided by the employer to reimburse the employee under a Section 105 medical reimbursement plan, under a Rev. Rul. 61-146 reimbursement plan, or through employee pretax contributions made through an IRC Section 125 cafeteria plan. Such plans are considered "improper" group health plans that fail to satisfy the "essential health benefits" requirements of the ACA.[23]

Employer reimbursements made on an after-tax basis may be used by an employee to purchase an individual market plan both inside and outside of the ACA exchanges.

Sole proprietors without employees are not subject to the penalty. Neither are sole Subchapter S shareholders without employees.

.01 The 21st Century Cures Act Addresses and Solves This Problem for Many Employers

Effective for tax years beginning after December 31, 2016, qualified small employer health reimbursement arrangements (QSEHRAs) are not treated as group health plans for purposes of the group health plan requirements (IRC Section 9831(d)(1), added by 21st Century Cures Act (P.L. 114-255)). Because the ACA market reforms are part of the group health plan requirements, the prohibitions against cost-sharing for preventive services and lifetime or annual dollar limits on benefits do not apply to QSEHRAs. As a result, small employers may offer stand-alone arrangements and reimburse their employees with pretax dollars for the cost of individual health coverage through the use of QSEHRAs without incurring a penalty.

[23] IRC Section 9815.

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To qualify as a QSEHRA, an arrangement must be provided on the same terms to all eligible employees of the eligible employer.[24] In addition, the arrangement must

- be funded solely by an eligible employer, with no salary reduction contributions under a cafeteria plan allowed;
- provide for the payment or reimbursement of medical care expenses (as that term is defined by IRC Section 213(d)) incurred by the eligible employee or the eligible employee's family members (as determined under the terms of the arrangement) after the employee provides proof of coverage to the employer; and
- provide that the total amount of payments and reimbursements for any year cannot exceed $5,850 ($11,800 for family coverage — 2023 numbers).[25]

The annual dollar limit will be adjusted for inflation. The limit is prorated for an individual who is not covered by an arrangement for the entire year based on the number of months for which the individual is covered.

As noted earlier, the arrangement must be provided on the same terms to all eligible employees of the eligible employer. However, an employee's permitted benefit may vary in accordance with the variation in the price of an insurance policy in the relevant individual health insurance market based on

- the age of the eligible employee (and, in the case of an arrangement which covers medical expenses of the eligible employee's family members, the ages of such family members); or
- the number of family members of the eligible employee the medical expenses of which are covered under such arrangement.

An "eligible employer" for purposes of a QSEHRA is any employer that

- is not an applicable large employer (generally, an employer with 50 or more full-time employees during the previous year) as defined in IRC Section 4980H(c)(2) for purposes of large employer shared responsibility payments and
- does not offer a group health plan to any of its employees.

An "eligible employee" means any employee of an eligible employer. However, an employer may exclude the following types of employees from the arrangement:

- Employees who have not completed 90 days of service
- Employees who have not attained age 25
- Part-time or seasonal employees
- Employees not included in the plan who are included in a unit of employees covered by a CBA, if accident and health benefits were the subject of good faith bargaining between such employee representatives and such employer or employers

[24] IRC Section 9831(d)(2)(A).

[25] IRC Section 9831(d)(2)(B).

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- Employees who are nonresident aliens and who receive no earned income (within the meaning of IRC Section 911(d)(2)) from the employer which constitutes income from sources within the United States

Notice requirements. An eligible employer funding a QSEHRA for any year must not be later than 90 days before the beginning of such year provide a written notice to each eligible employee, or not later than 90 days before the date on which such employee is first eligible. A failure to provide the required notice may result in a penalty unless the failure is due to reasonable cause and not willful neglect. The penalty amount is $50 per employee per incident with a maximum of $2,500 per calendar year.

Income exclusion for QSHERAs benefits conditioned on having minimum essential coverage. Coverage, payments, or reimbursements for medical expenses under an employer-provided accident or health care plan are generally excluded from gross income.[26] This rule continues to generally apply to payments or reimbursements from a QSEHRA. However, payments or reimbursements made under a QSEHRA are not excluded from gross income if for the month in which such medical care is provided the individual does not have minimum essential coverage.[27]

Premium tax credit is unavailable if coverage is affordable. The premium tax credit is available only with respect to an individual's coverage months for the tax year.[28] A coverage month is any month that, as of the first day of such month, the individual is enrolled in a qualified health plan through an ACA marketplace exchange.[29] A coverage month does not include any month with respect to an employee (or any spouse or dependent of such employee) if for such month the employee is provided a QSEHRA which constitutes affordable coverage.[30]

Coverage is treated as "affordable" for a month if

- the excess of: (i) the amount that would be paid by the employee as the premium for such month for self-only coverage under the second lowest-cost Silver plan offered in the relevant individual health insurance market, over (ii) $^1/_{12}$ (or in the case of a partial year, one over the number of months of coverage) of the employee's permitted benefit under such arrangement, does not exceed $^1/_{12}$ of 9.12% of the employee's household income;[31]
- in the event QSEHRA coverage is not affordable, an individual may obtain a premium tax credit, calculated on a cost that is reduced by $^1/_{12}$ of the employee's permitted benefit; and[32]
- an employee that obtains a reimbursement and applies for advance premium assistance must provide the Exchange with the amount of the permitted benefit.

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[26] IRC Sections 105(b) and 106.

[27] IRC Section 106(g).

[28] IRC Section 36B(b)(1).

[29] IRC Section 36B(c)(2).

[30] IRC Section 36B(c)(4)(A).

[31] IRC Sections 36B(c)(4)(C) and (D).

[32] IRC Section 36B(c)(4)(B).

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W-2 reporting. The total amount of permitted benefit for the year under a QSEHRA with respect to the employee must be reported on each employee's Form W-2.[33] Note that the "permitted benefit" is the maximum dollar amount of payments and reimbursements that may be made under the terms of the QSEHRA for the year with respect to that employee.[34] This reporting requirement applies to calendar years beginning after December 31, 2016.

Effective date. Except as otherwise provided, the amendments made by this provision apply to years beginning after December 31, 2016.

¶3940 Repeal of the Tax on "Cadillac Plans"

The ACA included IRC Section 4980I, which imposed an excise tax on high-cost employer-sponsored health coverage (so-called Cadillac plans). This ACA-created tax was to apply to tax years after December 31, 2017, but was postponed several times.

The tax is a 40% excise tax imposed on any "excess benefit" provided to an employee. An "excess benefit" refers to the excess, if any, of the aggregate cost of the applicable coverage of the employee for the month over the applicable dollar limit for the employee for the month. "Applicable coverage" is generally coverage under any group health plan. It includes the payments made by both employer and employee in testing the applicable dollar threshold.

The tax never became effective. After a series of postponements, the effective date of the tax was to have been 2022. The tax has now been repealed by bipartisan legislation adopted in December 2019.

[33] IRC Section 6051(a)(15).

[34] IRC Section 9831(d)(3)(C).

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Chapter 40

The Effects of the Supreme Court's Decisions on Same-Sex Marriage and the Defense of Marriage Act

¶4001 Overview: A Constitutional Right to Marry

¶4002 Impact of *Obergefell* for Same-Sex Married Couples

¶4005 Impact of the Post-DOMA Decisions

¶4010 Income Tax Benefits and Disadvantages

¶4015 Employee Benefits

¶4020 Estate and Gift Taxation

¶4025 Divorce Issues

¶4030 Social Security Benefits

¶4035 Affordable Care Act

¶4001 Overview: A Constitutional Right to Marry

On June 26, 2015, the U.S. Supreme Court issued its opinion in *Obergefell v. Hodges* 135 S. Ct. 2584 (2015) the name assigned to a series of consolidated cases on same-sex marriage rights. The court ruled five to four in favor of the petitioners, holding that same-sex married couples are entitled to equal protection under the laws and that their marriages must be recognized nationwide. State laws prohibiting same-sex marriages were declared invalid as unconstitutional. The *Obergefell* case followed *United States v. Windsor*, 570 U.S. 12 (2013) which held the federal Defense of Marriage Act unconstitutional, but left decisions on same-sex marriage to the individual states.

The *Obergefell* opinion resolved the following important issues:

- The 14th Amendment requires all states to issue marriage licenses to individuals of the same gender.
- The 14th Amendment requires states to formally recognize same-sex marriages of that state's residents, when those residents entered into a same-sex marriage in another state where the marriage was legally valid.
- *Obergefell* represents the last word on same-sex marriage, elevating these relationships to equal stature with other marriages. What is the status of civil unions and domestic partnerships in connection with federal laws in states recognizing these relationships? Revenue Ruling 2013-17

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(August 29, 2013) provides that these relationships will not be considered legally recognized marriages for purposes of federal law. Nothing in *Windsor* or *Obergefell* changes this result.

¶4002 Impact of *Obergefell* for Same-Sex Married Couples

State laws banning same-sex marriage are effectively invalidated. Same-sex spouses will now enjoy all state tax benefits and other spousal benefits afforded to other married couples.

¶4005 Impact of the Post-DOMA Decisions

Under federal income tax rules, same-sex married couples can now enjoy benefits that had been unavailable to them because of the overturned Defense of Marriage Act. On the other hand, certain strategic advantages previously enjoyed by same-sex married couples who filed as single individuals under the federal tax laws have likewise ended. Same-sex married couples should consider updating their estate plans based upon the estate and gift tax impact of *Obergefell*.

The right to receive information and access to a spouse's medical condition and visitation right as a family member under the Health Insurance Portability and Accountability Act of 1996 (HIPAA) is now enhanced. The ability to receive coverage under the federal Family and Medical Leave Act is now available.

For residents of community property states, federal law will now recognize the marriage, so the full basis step-up rule at death is now available.[1]

Persons of same-sex marriages will now be entitled to military and veterans' benefits that were not previously available.

¶4010 Income Tax Benefits and Disadvantages

.01 Filing Status

A taxpayer's filing status depends in large part — if not exclusively, in most cases — on the taxpayer's marital status. Taxpayers may be single, surviving spouse, head of household, married filing joint returns, or married filing separately. Filing status, in turn, determines the right to many tax benefits, both in terms of access and amount. Income tax rate bracket levels, the standard deduction, and the AGI amounts at which many tax benefits phase-out all hinge upon filing status.

Same-sex couples who currently are married under state law are now also barred, for federal and state tax purposes, from filing separate returns as unmarried (or as head of household, in most cases); they must file either jointly or as married filing separately. The general rule that has always applied to filing status now applies to same-sex married status as well: An individual's filing status is determined for the entire year based upon marital status on December 31 of that year.

Same-sex married couples who had been denied joint return status under federal tax laws now need to investigate the effect of joint return status. The benefits of filing a joint return may not always be greater than filing separately as unmarried individuals. Both the differences in tax rate bracket amounts and a

[1] IRC Section 1014(b)(6).

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variety of income floors and thresholds used to determine the right to certain tax breaks come into play when determining whether some same-sex couples were better off, income tax-wise, before the Supreme Court's decision and what they should do now.

Individuals in a relationship who are not married and who each realize approximately the same level of income and have similar tax deductions (at least in amount) have generally been better off from a tax standpoint filing as unmarried individuals. However, marriage and filing a joint return is favored if one partner earns or deducts the greater portion of any otherwise combined amounts.

If same-sex married couples want to keep their finances (and liabilities) separate for the purpose of filing separate returns, they will generally — but not always — pay more federal and state income tax. The rate brackets for married persons filing separately are higher than for persons who are unmarried; the brackets are also higher for a surviving spouse or a head of household.

Married taxpayers who file joint returns are jointly and severally responsible for the tax and any interest or penalty due on the joint return. In some cases, a spouse will be relieved of this shared liability for tax owed on a joint tax return. Three types of relief are available: general innocent spouse relief, separate liability relief, and equitable relief. Same-sex married partners cannot turn a blind eye to any item that is listed on a joint return. Therefore, a decision to file joint returns retroactively for prior tax years as the result of the Supreme Court's decisions should include consideration of the joint and several liability that would be triggered. Separate return status would eliminate the issue of joint liability entirely.

A surviving spouse computes tax using the same rate brackets as married couples filing joint returns. If a taxpayer is a surviving spouse, the year the spouse died is the last year for which the taxpayer can file a joint return with that spouse. A taxpayer can also qualify as surviving spouse for two tax years following the year in which his or her spouse dies if the taxpayer maintains a household for certain dependents (a child, adopted child, foster child, or stepchild), has not remarried, and filed or could have filed a joint return with the spouse for the year in which his or her spouse died.

.02 AGI Floors and Threshold Amounts

The amounts of income and deductions reported on a return are used by the IRS in determining whether certain threshold levels and floors are reached. Those amounts, in turn, determine access to a variety of tax benefits. Some of these floors or threshold amounts are applied to all filing statuses uniformly; others vary depending on filing status. Depending on AGI and other levels reported on a return, combining the income and deductions of each partner under a single joint return may or may not work to the advantage of the couple as a unit, in contrast to filing as unmarried or married filing separately.

Tax benefits dependent on floor levels of AGI or modified AGI (MAGI) set forth under the IRC include the medical expense deduction floor (7.5% of AGI for 2023 and beyond, as the 7.5% floor is now permanent). The net investment income tax and the cost of Medicare Part B and Part D premiums are also dependent on the taxpayer's AGI.

In the case of married individuals who file separate returns, if one spouse itemizes deductions on his or her return, the other spouse must also do so irrespective of whether his or her standard deduction would be larger. This rule does not apply to unmarried couples who file separate returns.

Use of excess capital losses to offset ordinary income is generally limited to $3,000 per return, whether on a joint return or an unmarried single return. Taxpayers who are married filing separately, however,

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are allowed only a $1,500 maximum capital loss deduction against ordinary income; the balance in all cases may be carried forward into the next tax year.

.03 Net Capital Gains and Net Investment Income

Taxable income thresholds are used in taxing investment-type income, including the following:

- Net capital gains begin to be taxed at the 20% maximum rate in 2023 at $553,850 of taxable income for married individuals filing joint returns and surviving spouses; $492,300 for single individuals; and $276,900 for married individuals filing separate returns). (The "regular" 15% capital gains rate is likewise reduced to 0% for taxpayers in the 10% bracket — a benefit that can be used by unmarried couples when one partner has very little income). These amounts are indexed for inflation.

- Net investment income, as defined under IRC Section 1411 is taxed in 2023 at 3.8%, keyed to a modified AGI threshold based on filing status ($250,000 for joint filers and widows or widowers with dependent children; $125,000 for married, filing separately; and $200,000 for other individual taxpayers). These thresholds are not indexed for inflation.

.04 Other Married Couple Income Tax Issues

Dependency exemptions. If both parents can otherwise claim a child as a dependent, the IRS will treat the child as the qualifying child of the parent with whom the child resides for the longer period of time. If the child resides with each parent for the same amount of time during the tax year, the IRS will treat the child as the qualifying child of the parent with the higher AGI.

Education benefits. Access to a number of education tax credits by same-sex couples was limited, both because of a student's status as a member or nonmember of the taxpayer's family and because lower phase-out levels apply to unmarried filers. That has been changed.

- *AOTC and Lifetime Learning Credit.* A taxpayer can claim the American Opportunity Tax Credit (AOTC) or the Lifetime Learning Credit for qualified expenses paid by the taxpayer for the education of the taxpayer, the taxpayer's spouse, or the taxpayer's claimed dependent for the tax year for which the credit is claimed. Prior to the Supreme Court decision, a taxpayer could not claim the AOTC or Lifetime Learning Credit for qualified expenses paid by his or her same-sex spouse.

- *Coverdell education savings accounts.* A Coverdell education savings account (ESA) is a savings vehicle similar to an IRA. If a Coverdell ESA is transferred to a surviving spouse as the result of the beneficiary's death, the Coverdell ESA retains its status, and the spouse may treat the account as his or her own and need not withdraw the assets as a result of the transfer. Prior to the Supreme Court decision, this treatment had been unavailable to the surviving spouse of a same-sex married couple.

- *IRA withdrawals for education.* Taxpayers who own IRAs (traditional, Roth, simplified employee pension (SEP) IRAs), and savings incentive match plan for employees (SIMPLE IRAs) can make penalty-free withdrawals to pay higher education expenses to the extent the distribution does not exceed the qualified higher education expenses of the taxpayer, the taxpayer's spouse, or the child or grandchild of the taxpayer or the taxpayer's spouse. Prior to the

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Supreme Court decisions, this treatment had been unavailable to the spouse of a same-sex married couple.

Post-death IRA payments. When a surviving spouse is the beneficiary of an IRA, there are certain options not granted to other beneficiaries, including the ability to roll over the decedent's IRA, tax-free, to another retirement plan. And, if the surviving spouse is the sole beneficiary, the spouse can elect to treat the IRA as if it were his or her own. These options may allow the survivor to delay the start of required minimum distributions from the account and stretch out the payment of required minimum distributions over one's life expectancy. A spouse is an eligible designated beneficiary under the Secure Act. The Supreme Court's decision opened up these distribution benefits to same-sex spouses.

Family stock attribution rules. IRC Section 267 contains attribution rules designed to prevent related taxpayers (including spouses under IRC Section 267(c)(4)) from recognizing losses in transactions between themselves and enjoying other tax benefits otherwise allowed in a variety of transactions. For example, an individual is treated under IRC Section 318(a)(1) as constructively owning stock owned directly or indirectly by a spouse (unless legally separated), children, grandchildren, or parents. Stock attribution rules under IRC Section 318 apply when determining whether a redemption of stock is treated as a sale or exchange or as a dividend. Likewise, prohibited transactions involving pension plans under IRC Section 4975 are defined, in part, upon dealing with certain persons, including spouses of those persons.

.05 Effects on State Income Taxes

The *Obergefell* case will make a difference in states that did not previously recognize same-sex marriage and where same-sex couples were thus not permitted to file as married for state law purposes. Joint federal returns and single state returns were required. That is no longer the case.

¶4015 Employee Benefits

.01 Benefits Generally

The Supreme Court's *Windsor* and *Obergefell* opinions have had a significant impact on employee benefit rules and taxation for married same-sex couples. A spouse is a permitted dependent for purposes of a health plan. Married couples may share the same benefits of health flexible spending accounts (FSAs), HSAs, and health reimbursement arrangements.

Domestic partners who are not married under state law are not treated as spouses for federal income tax purposes. Neither *Windsor* nor *Obergefell* changes this result. Accordingly, an employee must continue to pay taxes on the fair market value of the coverage for the employee's domestic partner (whether the domestic partner is a same-sex partner or an opposite-sex partner). However, domestic partner benefits are tax-free if the employee's partner qualifies as a dependent under IRC Section 152, so long as benefits are paid for a person who meets the following requirements:

- Receives more than half of his or her support from the taxpayer for the year
- Uses the taxpayer's home as the principal abode and is a member of the taxpayer's household during the entire tax year
- Is in a relationship with the taxpayer that is not a violation of local law

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Many employers require an employee to certify that a domestic partner qualifies as a dependent under IRC Section 152.

.02 Cafeteria Plans

Employer contributions to a cafeteria plan are usually made under a salary reduction agreement between the employer and the employee in which the employee agrees to contribute a portion of salary on a pretax basis to pay for the qualified benefits. Salary reduction contributions are not actually or constructively received by the participant. Therefore, those contributions are not considered wages for federal income tax purposes. In addition, those sums generally are not subject to FICA and Federal Unemployment Tax Act (FUTA) taxes. However, pretax dollars could not be used to pay for coverage of a same-sex spouse because of DOMA. This changed as a result of the Supreme Court's decisions.

.03 Health FSAs

A health FSA is a form of cafeteria plan benefit, funded by a voluntary salary reduction arrangement with pretax dollars. The benefits are subject to an annual maximum and an annual "use-or-lose" rule. Qualified medical expenses are those incurred by, among other individuals, the employee and his or her spouse. The Supreme Court's decision allows all married couples to use FSA dollars for qualified medical expenses of both spouses.

.04 HSAs

An HSA is a vehicle that eligible taxpayers can use to pay for or reimburse qualified medical expenses. Contributions to an HSA are tax-deductible (employer contributions are excluded from gross income), and distributions are tax-free if used to pay for qualified medical expenses. To be an eligible taxpayer, the individual, among other requirements, must be covered by a high-deductible health plan, not enrolled in Medicare, and not claimed as a dependent on another taxpayer's return. Qualified medical expenses are those incurred by, among others, the taxpayer and his or her spouse. All married couples may now use HSA dollars for qualified medical expenses of both spouses.

.05 Consolidated Omnibus Budget Reconciliation Act and Family and Medical Leave Act

Federal law requires that certain employers offer continuation of health care coverage to employees, their spouses, and families (Consolidated Omnibus Budget Reconciliation Act [COBRA] coverage). Before the Supreme Court cases, federal laws related to COBRA coverage did not apply to same-sex married couples. After the Supreme Court's decisions, these rights will now be available to all spouses.

.06 Qualified Retirement Plans

The IRC provides extensive protections for the spouse of an employee to share in the employee's retirement benefits payable through 401(k) plans and other qualified plans. A spouse must be the designated beneficiary of a participant's qualified retirement plan unless the spouse specifically relinquishes that right in writing. These protections will now apply to the same-sex spouse of an employee. Similarly, issues such as eligibility for hardship distributions and loans favor a spouse over other designated beneficiaries, and these opportunities will now be available.

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¶4020 Estate and Gift Taxation

.01 Generally

The *Windsor* case affirmed the availability to same-sex spouses of the estate and gift tax marital deduction. Previously, same-sex married couples could not take advantage of these deductions and other provisions, such as portability and gift-splitting.

.02 Marital Deduction

IRC Section 2056 provides an unlimited deduction from the gross estate for property passing from a decedent to a surviving spouse. To be eligible for the marital deduction, the decedent must be survived by his or her spouse who is a U.S. citizen at the time of the decedent's death; the property interest must have passed from the decedent to the spouse; and the property interest must be a deductible interest. Additionally, the property's value must be ascertainable. The $12.92 million estate tax exclusion for 2023 for all estates (indexed for inflation) makes the use of the marital deduction unnecessary in many situations for transfer tax purposes, but still useful for income tax (basis adjustment) advantages. However, as *Windsor* showed, it is a valuable tax benefit for larger estates. Many same-sex married couples should revisit their estate plans to make certain that, if desired, interests passing to the other spouse qualify for the marital deduction and other tax benefits.

With the recognition of marriage, one-half of jointly held property is included in the estate of the first spouse to die, regardless of contribution.[2] The entire property qualifies for the federal estate tax marital deduction.[3] There is a date-of-death basis adjustment for one-half of jointly held property. Spouses in community property states receive a full basis adjustment for all community property at the death of the first spouse.

.03 Portability

Portability allows the estate of a surviving spouse to use the unused portion of the estate tax applicable exclusion amount of his or her last deceased spouse. All married couples may now take advantage of portability as part of their estate planning.

.04 Gifts

All married couples can now use gift-splitting and make qualified transfers of assets between themselves with no concern for lifetime gift tax consequences.[5] When one spouse is not a U.S. citizen, the annual exclusion from gift taxes for gifts made to the noncitizen spouse is $175,000 for 2023, indexed annually for inflation.

.05 Grantor Retained Interest Trusts

IRC Section 2702 requires a strict set of rules with respect to transfers with retained interests and the gift tax. Family members receiving transfers must adhere to these rules and create retained interest

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[2] IRC Section 2040.

[3] IRC Section 2056.

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arrangements known as grantor retained annuity trusts, grantor retained unitrusts, and qualified personal residence trusts to avoid adverse gift tax consequences. Same-sex spouses were able to avoid these strict rules because they were not considered "family members" under federal law. Instead, same-sex spouses could use the technique known as the grantor retained interest trust (GRIT), which allowed a much more generous retained interest in the grantor and a more favorable gift tax calculation. The Supreme Court cases end the GRIT opportunity for same-sex marriages.

¶4025 Divorce Issues

.01 Property Settlements

Same-sex married couples will no longer have to pay federal income taxes on the transfer of appreciated property if they divorce and divide their assets. The no gain or loss and required carryover basis rules on matrimonial property transfers of IRC Section 1041 will now apply.

.02 Alimony

As a result of the 2017 Tax Cuts and Jobs Act, for any divorce or separation agreement executed after December 31, 2018, the Act provides that alimony and separate maintenance payments are no longer deductible by the payer spouse or included in the income of the payee spouse.

For divorces prior to 2019, the laws in effect through 2018 continue to apply, unless the parties agree to have the new 2019 laws apply.

The laws in effect prior to 2019 divorces allowed the payer spouse to deduct alimony payments assuming all the alimony definitional requirements of IRC Section 71 are satisfied and the payee spouse will be required to include the alimony payments in income.

.03 Qualified Domestic Relations Orders

All spouses will now be eligible to receive the retirement plan benefits of a divorced spouse per the rules allowing a spouse to be a recognized and permitted "alternate payee" of a qualified retirement plan.

.04 State Law Concerns

Prior to *Obergefell*, same-sex married couples who did not live in a state that recognized same-sex marriage had to seek a divorce in a state that did recognize it, and most states have a residency requirement for divorce. All states must now permit all married persons to divorce.

¶4030 Social Security Benefits

.01 Generally

Prior to the Supreme Court decisions, there were no survivor benefits for the surviving spouse of a same-sex married couple. The divorced spouse of a formerly married same-sex couple could not claim benefits based on the earnings of an ex-spouse. These limitations no longer exist.

Social Security retirement benefits contain bonuses for married couples. If there is just one earner, the non-earner gets a benefit equal to half the earner's benefit. Social Security has no marriage penalty. Non-earner spouses can also receive Medicare benefits based on the earner spouse's work history.

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.02 Survivor Benefits

When an individual dies the surviving spouse may be eligible for Social Security benefits if the surviving spouse is age 60 or older, age 50 or older and disabled, or any age if caring for the decedent's child who is younger than age 16 or disabled and entitled to Social Security benefits on the record of the deceased individual. Survivor benefits previously available only to opposite-sex married couples are now available to all married couples.

.03 Divorced Spouses

If an individual is divorced, an ex-spouse may qualify for Social Security benefits based on that individual's earnings. Generally, a divorced spouse must have been married to the individual for at least 10 years and have been divorced at least two years. Additionally, the divorced spouse must be at least age 62, unmarried, and ineligible for an equal or greater benefit based on his or her own earnings or the earnings of someone else. These benefits are now available to divorced individuals who were previously in a same-sex marriage.

.04 Death Benefits

The Social Security Administration (SSA) pays a one-time death benefit of $255 to the decedent's surviving spouse or to a minor dependent child. The SSA will now pay the one-time death benefit to all surviving spouses.

.05 Medicaid Eligibility

The resources of both spouses will now be pooled with respect to determining Medicaid eligibility. The healthy spouse will be recognized as the "community spouse" and subjected to all the allowances, limitations, and other provisions applicable for that status under the Medicaid rules.

¶4035 Affordable Care Act (ACA)

.01 Individual Mandate and Penalty

As the result of the 2017 Tax Cuts and Jobs Act, beginning in 2019, the ACA will no longer impose a penalty on individuals who do not carry minimum essential health coverage for one or more months, subject to certain exceptions (see chapter 39, "The Affordable Care Act: What Practitioners Need to Know and Do Now," for more information). Certain states do impose penalties on persons who do not have health insurance. Married taxpayers who file a joint return are jointly liable for any penalty that may be imposed on either spouse. The penalty does not apply in certain cases, such as in the case of individuals whose household incomes are less than certain filing and other thresholds. All married couples will be treated in the same manner for purposes of the individual mandate and its penalty, if any. The ACA prohibits the IRS from using liens or levies to collect any unpaid penalty. The IRS cannot levy on the property of one spouse to satisfy an unpaid penalty of the other spouse.

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.02 Premium Assistance Tax Credit

The IRC Section 36B premium assistance tax credit is available to those qualified individuals and families who are not offered minimum essential coverage and, as a result, obtain coverage through a health benefit exchange. The ACA provides for advance payment of the credit.

Taxpayers who are married at the end of the tax year must file a joint return to claim the credit.

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Chapter 41

Passive Activity Losses: Working With the Complex PAL Rules

¶4101 Overview

¶4105 Which Taxpayers Are Subject to These Rules?

¶4110 What Is a Passive Activity?

¶4115 Additional Exceptions to the Rental Activities Are Passive Activities Rule

¶4120 Material Participation

¶4125 Material Participation: Substantiating Material Participation

¶4130 Special Rules Address Real Estate Professionals

¶4135 Passive Activity Income and Losses

¶4140 Passive Activity Deductions

¶4145 Election to Group Passive Activities

¶4150 Dispositions of Interests in Passive Activities

¶4155 The Effect of the Passive Loss Rules on Proprietorships, S Corporations, and Partnerships

¶4160 Trust and Estate Issues

¶4165 Alternative Minimum Tax: Application of Passive Activity Rules to the AMT

¶4170 The Impact of the Passive Loss Rules on the 3.8% Tax on Net Investment Income

¶4101 Overview

Passive activity issues became a hot topic with the enactment of the 3.8% net investment income tax, which includes passive income as a component of "net investment income" that is subject to the tax.

Under the passive activity rules, losses and expenses attributable to passive activities may be deducted only from income attributable to passive activities.[1] The effect of these rules is to prohibit the use of

[1] IRC Section 469.

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passive losses to offset nonpassive income. Similarly, tax credits attributable to passive activities may be used only to offset taxes attributable to income from passive activities. Congress first enacted these rules in the Tax Reform Act of 1986 to prevent the growing abuse of taxpayers creating paper losses that were able to offset portfolio income, wages, and other "actively" produced income.

Part of the financial planner's frustration with these rules is the fact that many of the "answers" one seeks cannot be found in definitive guidance. The IRS has issued various proposed or temporary regulations — or none at all — in key areas of concern. There are a series of technical advice memoranda at odds with decided case law, as discussed later in this chapter, all adding to the confusion and complexity of these rules. The stakes were high enough to understand them when the "only" issue involved passive loss deductions. Now, as the passive income findings arising in connection with the net investment income tax are becoming controversial, the focus on passive activities has intensified.

Basically, the passive activity rules limit a taxpayer's ability to deduct losses otherwise allowed under IRC Section 162 or IRC Section 212 that are generated from activities in which the taxpayer does not materially participate. The rules limit loss deductions by allowing losses from passive activities to offset income only from the same passive activities. Under IRC Section 469(b), suspended losses must be carried over into subsequent tax years.

The passive activity rules restrict the use of losses from the conduct of a trade or business if the taxpayer does not participate in that activity. There are two types of participation, as follows:

a. Material participation, which generally applies to business activities

b. Active participation, applicable to certain rental real estate activities

As a general rule, active participation is a less stringent standard than material participation. For example, a taxpayer may be treated as actively participating if the taxpayer makes management decisions in a "significant and bona fide sense." Management decisions that count as active participation include approving new tenants, deciding on rental terms, and approving expenditures.

¶4105 Which Taxpayers Are Subject to These Rules?

Taxpayers subject to the passive loss limitation rules include individuals, trusts (other than grantor trusts), estates, personal service corporations, and certain closely held C corporations. The rules do not apply to S corporations and partnerships but do apply to their respective shareholders and partners and apply at the shareholder or partner level. The rules also apply to the grantors of grantor trusts. The rules apply to personal service corporations and closely held C corporations that file a consolidated return.[2] The passive loss rules generally do not apply to large C corporations unless they are closely held or personal service corporations.

A corporation is a closely held corporation if at any time during the last half of the tax year more than 50% in value of its outstanding stock is directly or indirectly owned by or for not more than five individuals, and the corporation is not a personal service corporation. Other C corporations are not subject to the passive activity rules.

[2] IRC Section 469(a)(2), IRC Section 469(j)(11), Temp. Reg. 1.469-1T(h).

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A closely held C corporation can offset net active income with its passive activity loss. It can also offset tax liability attributed to its active income with its passive activity credits. However, the closely held C corporation cannot use passive losses to offset its portfolio income (described later in this chapter). A closely held C corporation's net active income is equal to its taxable income determined without any income or loss from a passive activity or any portfolio income or loss.[3]

¶4110 What Is a Passive Activity?

A passive activity is any activity that involves the conduct of a trade or business in which the taxpayer does not "materially participate" during the year.[4] A trade or business activity is an activity that:

- involves the conduct of a trade or business which would allow deductions under IRC Section 162,
- is conducted in anticipation of starting a trade or business or involves research or experimental expenditures that are deductible under IRC Section 174, or
- does not include a rental activity or the rental of property that is incidental to an activity of holding the property for investment.

Rental activities are generally deemed to be passive activities, regardless of whether the taxpayer materially participates in the activity.[5] There is an exception to this rule for persons, described in ¶4130, who materially participate as real estate professionals.

Under IRC Section 469, Congress has carved out a special niche in the passive activity loss rules for rental activity. Losses from a rental activity are generally considered passive activity losses, regardless of a taxpayer's level of participation in the activity. Congress created this special treatment for rental activity for two reasons:

a. Income received from rental activities is not subject to the self-employment tax under IRC Section 1402(a)(1).

b. The material participation requirement would not be a sufficient indicator of whether taxpayers involved in rental activity deserved to receive the business expense deduction.

For the blanket passive activity rule to apply, the taxpayer must simply rent tangible property to others and, in return, receive income principally for use of that property. Nevertheless, there are six narrow exceptions to the *per se* passive rental income rule:

a. **Seven-day exception.** Rental activity is not a *per se* passive activity if the average period of use by the customer is fewer than seven days, an example being short-term use of a hotel room. The IRS calculates the average period of customer use by dividing the total number of days in all

[3] IRC Section 469(e)(2).

[4] IRC Section 469(c). Temp. Reg. 1.469-1T(e).

[5] IRC Section 469(c)(2). Temp. Reg. 1.469-1T(e)(3).

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rental periods by the number of rentals during the tax year (see IRS Publication 925). If the activity involves renting more than one class of property, multiply the average period of customer use of each class by a fraction. The numerator of the fraction is the gross rental income from that class of property, and the denominator is the activity's total gross rental income. The activity's average period of customer use will equal the sum of the amounts for each class.

b. **Thirty-day exception.** If customers use the property for an average period of 30 or fewer days and significant personal services are performed by or on behalf of the owner of the property in making the property available to the customer, the rental activity is not considered *per se* passive. An example of this exception would be a year-round vacation rental property.

i. Significant personal services include only services performed by individuals.

ii. Such personal services do not include services needed to permit the lawful use of the property; services to repair or improve property that would extend its useful life beyond the average rental period; and services commonly provided with long-term rentals of real estate, such as routine repairs and cleaning of common areas.

c. **Personal service exception.** Taxpayers who perform extraordinary personal services to make the property available to the customer — for example, hospitals and nursing homes — avoid *per se* passive activity classification regardless of the average rental period. Here, the use of the property is incidental to the performance and receipt of the services.

d. **Incidental exception.** In this case, the rental of the property is incidental to a non-rental activity. The property is held for investment, and the rental income is less than 2% of the lesser of the property's unadjusted basis or fair market value. Lodging provided to an employee or the employee's spouse or dependents is incidental to the activity in which the employee performs services if the lodging is furnished for the employer's convenience.

e. **Business hours exception.** Making property available during defined business hours for nonexclusive use by various customers avoids classification as a *per se* passive activity. To be considered nonexclusive use the taxpayer must not grant a particular customer exclusive use of the property during the time that the customer is using it, such as by renting a car or chartering an airplane.[6] For example, leasing a golf course to multiple customers, for different periods, yet all at the same time, is considered nonexclusive use. Other examples include health clubs and spas.

f. **Providing property exception.** A *per se* passive activity does not result if the taxpayer is compensated for providing property for use in a non-rental activity in an activity conducted by a partnership, S corporation, or joint venture in which the taxpayer owns an interest.

If a rental activity is not considered *per se* passive because of one of these six exceptions, the taxpayer still must prove "material participation" to avoid rental income being considered passive activity income.

As discussed in ¶4115, there is also a subset of special rules under the distinct rules for rental activity that offer relief from the passive activity rules for real estate professionals. Finally, there is a $25,000

[6] *Kenvill v. United States*, 97-2 USTC 50,936 (N.D. North Dakota 1997); Reg. 1.469-1T(3)(viii).

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exemption from the passive activity rules for rental income received by certain middle-income individual taxpayers.

¶4115 Additional Exceptions to the Rental Activities Are Passive Activities Rule

Aside from the six narrow exceptions to the *per se* rule that rental activities are deemed to be passive, there are three additional, broader exceptions to the general rule that rental income produces passive activity income that may be offset only by related (other passive) deductions and credits. These exceptions are as follows:

1. Rental income or losses in which a real estate worker materially participates as a real estate professional.

2. Incidental rental of a dwelling unit that is also used for personal purposes during the year for more than the greater of 14 days or 10% of the period that the home was rented at a fair rental.

3. Rental real estate losses up to $25,000 ($12,500 for married persons filing separately and living apart) may be deducted against nonpassive income by a natural person (it can be either spouse) whose modified adjusted gross income is less than $100,000 ($50,000 for married persons filing separately). The taxpayer must "actively participate" in the rental endeavor.

    a The $25,000 exception is phased out at the rate of $0.50 for every $1 of modified adjusted gross income above $100,000, effectively phasing out at $150,000 ($75,000 for married persons filing separately).[7] Married taxpayers filing separately who live together at any time during the tax year are not eligible for this special allowance.[8]

    b. To be entitled to this special *de minimis* treatment, the taxpayer also must have at least a 10% interest in the activity throughout the year and not have an interest as a limited partner. This rule may also be used to utilize credits from the activity against the tax on up to $25,000 of nonpassive income after taking into account any losses allowed under this exception.

    c. As mentioned previously, the active participation standard is less stringent than the material participation standard (described later). The active participation standard can be satisfied without regular, continuous, and substantial involvement in operations, as long as the taxpayer participates to some extent in the activity (see IRS Publication 925). For example, such participation includes the making of management decisions or arranging for others to provide services, in a "*significant and bona fide sense*." "Management decisions" that meet the active participation requirement include approving new tenants, deciding on rental terms, approving capital or repair expenditures and other similar decisions. This limit is complicated further when certain housing deductions and credits are taken into consideration.

[7] IRC Section 469(i).

[8] IRC Section 469(i)(5).

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d. In addition, under IRC Section 469(i)(6)(B), no active participation is required for:

i. The commercial revitalization deduction under IRC Section 1400I.

ii. The rehabilitation credit under IRC Section 47.

iii. The low-income housing credit under IRC Section 42.

¶4120 Material Participation

.01 Material Participation Rationale

A taxpayer must "materially participate" in a trade or business to avoid characterizing income from that business as passive activity income. This requirement poses the first and often the biggest hurdle to avoiding characterization of an activity as passive.

A taxpayer materially participates in an activity under IRC Section 469(h) if the taxpayer is involved in the operations of the activity on a regular, continuous, and substantial basis.[9] Any work done by an individual in connection with an activity in which the individual owns an interest at the time the work is done is deemed to be participation. Taxpayers with interests in closely held C corporations or personal service corporations materially participate in an activity if one or more of the shareholders who hold 50% of the outstanding stock of the corporation materially participate in the activity. Therefore, in this limited circumstance, it is possible for an individual taxpayer to meet the material participation requirement through the activity of others.

The participation of the taxpayer's spouse is taken into account in determining whether a taxpayer materially participates in certain activities. Material participation is determined separately for each tax year. Material participation in an activity depends generally on the facts and circumstances surrounding the taxpayer's involvement. Safe harbor provisions, however, automatically treat a taxpayer as materially participating if the taxpayer spends a minimum number of hours participating in an activity in a current year or a prior year, as described next.

.02 Material Participation: Seven Tests for Material Participation

A taxpayer is automatically treated as materially participating in an activity for a tax year if the taxpayer meets one of seven tests. The first four tests look to a set number of hours of participation in the tax year. The next two tests look to material participation in prior tax years. The final test looks to the facts and circumstances about the taxpayer's relationship with the activity.[10]

- **500 minimum hours test.** The individual participates in the activity for more than 500 hours during the year.

[9] Temp. Reg. 1.469-5T.

[10] Temp. Reg. 1.469-5T.

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- **Substantially all participation test.** The individual's participation in the activity for the tax year constitutes substantially all of the participation in such activity of all participating individuals (including individuals who are not owners of interests in the activity) for the year.

- **Equal participation test.** The individual participates in the activity for more than 100 hours during the tax year, and his or her participation in the activity for the tax year is not less than the participation in the activity of any other participating individual (including individuals who are not owners of interests in the activity) for such year.

- **Aggregated participation test.** The activity is a significant participation activity for the tax year, and the individual's aggregate participation in all significant participation activities during the year exceeds 500 hours. A *significant participation activity* is one in which the taxpayer participates for more than 100 hours during the year, the activity is a business, and the business must be otherwise considered a passive activity with respect to that individual under any of the seven tests. The business cannot be a rental or investment activity.

  Example: Sam, employed full-time as an accountant, also owns interests in a restaurant and a shoe store, each having several full-time employees. Sam works in the restaurant for 400 hours and in the shoe store for 150 hours during the tax year. Sam would fail all tests if he could not aggregate participation in the restaurant and shoe store activities. Because both are significant participation activities (more than 100 hours each), he can combine them and pass the 500 hours for presumed material participation.

- **Five-out-of-ten-years participation test.** The individual materially participated in the activity for any five tax years (whether or not consecutive) during the 10 tax years that immediately precede the taxable year.

  Example: Simon is considered to materially participate in a leasing business that he owns under the equal participation test, during 2014 through 2018. His ownership interest and this five-year stretch alone will entitle Simon to use any passive activity losses from his leasing business against any income he realizes during 2019 through 2023.

- **Three-year personal service activity test.** The activity is a personal service activity in which the individual is considered to have materially participated in any year if the individual materially participated in the activity for any three tax years preceding the tax year, regardless of whether they were consecutive. *Personal service activities* include the fields of health care, accounting, law, architecture, engineering, actuarial sciences, performing arts, consulting, or any other business in which capital is not a material income-producing factor.[11]

- **All facts and circumstances (catch-all) test.** As a last resort, the individual may argue that, based on all of the facts and circumstances, he or she has materially participated in the activity on a regular, continuous, and substantial basis for more than 100 hours during the tax year. Under this test, individuals are deemed to materially participate in the activity if all the facts and circumstances show such material participation on a regular, continuous, and substantial basis during such year. In connection with this test, an individual's participation in managing the

[11] Temp. Reg. 1.469-5T(d)(1) and (2).

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activity does not count toward the 100-hour requirement if any other person received compensation for managing the activity or any other person spent more time managing the activity.

.03 Material Participation: Management Activities

With regard to management activities, IRS regulations also require that:

- taxpayers participate in the activity for at least 100 hours over the course of a tax year,
- persons other than the taxpayers who manage the business do not receive any compensation, and
- hours of management conducted by other individuals do not exceed those hours of management conducted by the taxpayer.[12]

.04 Material Participation: Qualifying Participation

As a general rule, any work done by an individual with respect to an activity in which the individual owns an interest is treated as participation.[13] However, for "participation" to count toward material participation, the taxpayer's efforts must be directed toward the kind of work customarily performed by the owner of a similar trade or business, not purely "make work" performed to avoid the disallowance of losses under IRC Section 469.[14]

Work the taxpayer performs in the capacity of an investor does not count toward fulfilling the material participation requirement. Nonqualifying investor activity includes studying and reviewing financial statements, preparing or compiling financial analysis of the activity for the taxpayer's individual use, and monitoring the finances or operations of the activity but not acting as a manager.

Taxpayers are not allowed to consider commuting time used to travel to a trade or business site in the hourly requirements for material participation. According to the Tax Court, "Commuting is an inherently personal activity and as such does not constitute 'work' in connection with a trade or business."[15]

Travel time constitutes neither services nor participation in the activity and is not integral to the operations of an activity in most cases.

.05 Material Participation: Qualifying Participation by Limited Partners

In general, limited partners are not deemed to materially participate in partnership activities. As a result, a limited partner's share of partnership income is usually passive income. However, if the limited partner passes the 500 minimum hours test, five-out-of-ten years' participation test, or three-year

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[12] Temp. Reg. 1.469-5T(b)(2)(ii).

[13] Reg. 1.469-5(f)(1).

[14] Temp. Reg. 1-469-5T(f)(2)(i).

[15] *Truskowsky*, U.S.T.C. Summary Op. 2003-130.

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personal service activity test, that person's income from the limited partnership interest will no longer be considered passive activity income. In that case, losses arising from the limited partnership activity may avoid classification as passive losses. Caution, however—if a limited partner participates to this extent, will the partner's status continue to be recognized as "limited"?

In addition, general partners or acting general partners may hold limited partnership interests, yet still materially participate in the partnership under any one of the seven material participation tests described earlier. A general partner who also holds a limited partnership interest is not treated as a limited partner.[16]

.06 Material Participation: Qualifying Participation by LLC Members

The IRS Chief Counsel's Office has recommended that the IRS acquiesce, in result only, in *J.R. Thompson* (2009-2 USTC 50,501), in which the Court of Federal Claims issued a summary judgment opinion concluding that an interest in an LLC is not a limited partnership interest under the material participation test of Temporary Reg. 1.469-5T(e)(3)(i) for purposes of the passive activity loss rules.

In *Garnett v. Commissioner*, 132 T.C. 368 (2009), the Tax Court held that an interest in an Iowa LLC was not an "interest in a limited partnership as a limited partner" within the meaning of IRC Section 469(h)(2) or the regulations thereunder. In so doing, the court recognized that Congress enacted IRC Section 469(h)(2) to address the statutory constraints on a limited partner's ability to participate in the partnership's business, and that a member of an Iowa LLC was not similarly constrained. A member of an Iowa LLC, unlike a limited partner, was not prohibited by state law from participating in the partnership's business and more closely resembled a general partner. Therefore, the court concluded that a member of an Iowa LLC came within the general partner exception of Temporary Reg. 1.469-5T(e)(3)(ii). Consequently, the court held that the special rules of IRC Section 469(h)(2) did not apply to an interest in an Iowa LLC.

In another case, married taxpayers properly deducted the husband's distributive shares of losses from two businesses and were not restricted in their use of the losses by the passive activity loss rules. The husband satisfied the material participation test in Temporary Reg. Sec. 1.469-5T(a)(4) because his activity with respect to an LLC was a significant participation activity for the years at issue, and his aggregate participation in all significant participation activities exceeded 500 hours in each year. The special rule in IRC Section 469(h)(2) and Temporary Reg. Sec. 1.469-5T(e), which bars an interest in a limited partnership held as a limited partner from being treated as an interest in which the taxpayer materially participates, did not apply to the husband's interest in the LLC that he held as a managing member.[17]

The IRS eventually accepted the results of these cases and issued a proposed regulation restricting the "limited partner presumption" to situations in which the taxpayer is precluded by law or agreement from exercising any management rights. Prop. Reg. 1.469-5(e).

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[16] IRC Section 469(h)(2); Temp. Reg. 1.469-5T(e).

[17] *Newell v. Commissioner*, U.S. Tax Court, CCH Dec. 58,127(M); Dkt. No. 26844-06, TC Memo. 2010-23, 99 TCM 1107 (2010).

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.07 Material Participation: Qualifying Participation — Closely Held Corporations

Closely held C corporations and personal service corporations are treated as materially participating in an activity if shareholders owning 50% or more of the outstanding stock materially participate in the activity.[18] As a result, to avoid the *per se* passive activity rule on income from real estate rentals, IRC Section 469(c)(7)(D) allows closely held C corporations renting real property to show that 50% of their gross receipts were derived from real property trades or businesses in which the corporation materially participates. This is a significant improvement over the rule that applies to individuals claiming to materially participate in real estate activities.

Closely held C corporations can also satisfy the material participation standard under an alternative rule based on the participation of full-time employees in the activity under the "at-risk" rules.[19] A closely held C corporation (other than a personal service corporation) may offset passive losses by the "net active income" of a closely held C corporation under IRC Section 469(e)(2). The net active income of the corporation is the corporation's taxable income figured without any income or loss from a passive activity or any portfolio income or loss.

¶4125 Material Participation: Substantiating Material Participation

.01 Material Participation: Any Reasonable Means

Taxpayers may use *any reasonable means* to show that they materially participate in an activity. This includes, but is not limited to, identification of the performance of services over a period of time and the approximate number of hours spent performing such services through use of appointment books, calendars, or narrative summaries. Under Temporary Reg. 1.469-5T(f)(4), contemporaneous daily time reports and logs are not necessary if participation is established by other reasonable means. To identify taxpayers who do *not* materially participate in an activity, the IRS instructs its auditors to look for the following indicators:

- The taxpayer is not compensated for services.
- The taxpayer maintains a residence hundreds of miles from the activity.
- The taxpayer has a Form W-2 job requiring 40 plus hours a week for which the taxpayer receives material compensation.
- The taxpayer has numerous other investments, rentals, business activities, or hobbies that absorb significant amounts of time.
- There is a paid on-site manager, foreman, supervisor, or employees who provide day-to-day oversight and care of the operations.
- The taxpayer is elderly or has health issues.

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[18] IRC Section 469(h)(4).

[19] IRC Section 465(c)(7)(C).

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- The majority of hours claimed are for work that does not materially impact operations.
- Business operations would continue uninterrupted if the taxpayer did not perform the services claimed.

To prove material participation despite the presence of any of these indicators requires that the taxpayer prove participation for an adequate amount of time and that the character of that participation meets all the necessary requirements. Despite the regulation downplaying the importance of time records and logs, case law suggests that documentation, including contemporaneous time-and-activity logs, is critical for the taxpayer to carry the burden of proof when these indicators are present. Determination of these facts is the focus of a substantial amount of litigation.

.02 Material Participation: Rental Activities

Once a taxpayer overcomes the burden of proving that the rental activity is not a *per se* passive activity, the taxpayer must show material participation in the rental activity. If this requirement is met, the taxpayer may deduct the losses from rental activities against active and portfolio income or treat positive income as active. Even if a taxpayer overcomes the burden of the *per se* classification of rental activity for condominiums, vacation cottages, time-shares, hotels, motels, and bed and breakfasts, and proves material participation in the rental activity, the IRS may still disallow loss deductions under IRC Section 280A(d)(1) if the taxpayer uses the vacation residence as a personal residence for the greater of 14 days or 10% of the days during which it is rented.

Reg. 1.469-9(e)(1) treats each of a taxpayer's interests in real estate property as a separate real estate rental activity. Unless the taxpayer elects to group all of its real estate properties as a single real estate activity under Reg. 1.469-9(g), material participation must be shown for each individual property. *Grouping* of activities is discussed in ¶4145.

In one case, married taxpayers' losses from rental activities were passive activity losses rather than business losses, because the taxpayers did not perform more than 750 hours of services during the year in connection with their rental properties. They stipulated that they performed only 716 hours of services for one of the years at issue. A purported activity log that they presented for the second year was not believable because it was prepared after their examination began. It showed days in which the wife supposedly logged more than 24 hours of work, and it included activities related to their personal residence.[20] Case law requires that contemporaneous records be submitted, not those arising after an audit has been commenced.

¶4130 Special Rules Address Real Estate Professionals

As a general rule, rental activities are passive activities even if the taxpayer demonstrated some measure of material participation in them. However, Congress has created special rules to offer relief from these

[20] *Goolsby v. Commissioner*, U.S. Tax Court, CCH Dec. 58,171(M); Dkt. No. 1276-07, TC Memo. 2010-64, 99 TCM 1249, April 1, 2010.

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passive activity limitations for real estate professionals. Rental real estate activity is not considered a *per se* passive activity if conducted by a "real estate professional."[21]

To qualify as a *real estate professional*, the taxpayer must meet both of the following requirements:

1. The taxpayer must show that more than one-half of the personal services performed in all trades or business during the tax year were in the real estate business. Activities that fulfill this requirement include the following:

    a. Development or redevelopment of property

    b. Construction or reconstruction

    c. Acquisition or conversion

    d. Rental

    e. Management or operation

    f. Leasing

    g. Brokerage activities

2. Additionally, real estate professionals must have performed more than 750 hours of services during the tax year in that real property trade or business. Once deemed a real estate professional, the taxpayer must still show material participation in the activity to prove that the losses or the income were not the result of passive activity.

The IRS instructs its auditors to scrutinize returns carefully to ensure that they meet the time requirements for real estate professional status. In particular, the IRS will closely compare the time a taxpayer spends in his or her main occupation with the time claimed to have been spent on a real estate rental activity.

Activities by the taxpayer's spouse may assist the taxpayer in meeting the material participation requirement for passive activity loss deductions. An individual's participation includes the spouse's participation activities, even if the spouse does not own an interest in the activity and separate returns are filed.[22] However, the IRS will consider only whether *each* spouse filing a joint return *individually* meets the time requirements in determining whether a taxpayer is considered a real estate professional. Personal services performed as an employee are not taken into account under either of the two previously mentioned requirements unless the employee is the owner of more than 5% of the employer's outstanding voting stock or capital or profits interest.

A closely held corporation can qualify as a real estate professional if more than 50% of its gross receipts for the tax year are derived from real property trades or businesses in which it materially participated.

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[21] IRC Section 469(c)(7).

[22] Temp. Reg. 1.469-5T(f)(3).

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Numerous cases have addressed the real estate professional issue — many unfavorably to the taxpayers. In *Hudzik*, TC Summary Op 2013-4, the court rejected the taxpayer's claim of being a real estate professional when the taxpayer had another non-real estate full-time job, and no independent verification of records. In *Hoskins*, T.C. Memo 2013-36, a real estate agent and property manager was denied the opportunity to aggregate those activities with the management of his own real estate rental properties. The income and losses from his own properties were held to be passive. In *Ghilardi*, TC Summary Opinion 2013-15, a licensed real estate salesperson did not qualify as a real estate professional with respect to a rental property when the taxpayer performed substantial services in a non-real estate activity, and could not meet the 750 hours in real estate test. The court emphasized that rental real estate activity was a *per se* passive activity under IRC Section 469(c)(2). In *Merino, Jr.*, T.C. Memo 2013-167, the taxpayer ran a mortgage business and managed 7 rental properties but failed to substantiate the real estate professional claim. Hours of services were "reconstructed after the fact" and there were no contemporaneous records. Real estate professional status was denied. In *Ballesteros*, TC Summary Opinion 2013-108 logs were found unreliable, there was full-time employment in non-real estate fields, the losses were found to be passive and a substantial underpayment penalty was assessed. In *Adeyemo*, TC Memo 2014-1, real estate professional status was denied. Less than 35% of the taxpayer's activities and fewer than 750 hours were spent in the real estate business. Deductions were not substantiated, and the accuracy penalty was imposed. Proof of appropriate facts and circumstances is crucial in these cases.

¶4135 Passive Activity Income and Losses

.01 General Rules

1. Passive activity income includes all income from passive activities and gain from the disposition of an interest in a passive activity or property used in a passive activity.

2. A determination of passive activity income is important because losses, deductions, and credits generated on account of the activity responsible for generating passive activity income can offset only passive activity income.

3. To prevent taxpayers from using passive losses to offset unrelated income, the passive activity loss rules of IRC Section 469 restrict the deduction of passive activity losses to the amount of the individual taxpayer's passive activity income. This is reported on Form 8582, *Passive Activity Loss Limitations*.

4. Any net passive activity income (passive activity income minus passive activity loss) for an activity — as is the case of any amount of other income — however, may be offset by deductions or credits generally available to reduce any amount of ordinary income, regardless of whether it is "passive." Net deductions and credits from a taxpayer's passive activities are disallowed and are carried over to the following year. Like the at-risk rules, the passive loss limitations disallow excess deductions. Passive losses may offset passive income without limitation. Any losses suspended under the passive loss rules are allowable when the taxpayer disposes of his or her investment in the passive activity in a fully taxable transaction.

5. Passive activity deductions in excess of passive activity gross income (net passive activity losses) in a particular year are carried forward indefinitely and deducted from passive gross income in subsequent years.

6. The disallowed passive activity loss for a year is allocated among all of the taxpayer's activities that produced the loss. The allocation determines the treatment of disallowed losses when an

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activity ceases to be a passive activity to the taxpayer and the proper application of loss limitations under other IRC sections that may apply after the passive activity limitations.

7. Similarly, a taxpayer's passive activity tax credit is applied only against a taxpayer's tax liability allocable to the taxpayer's passive activities. If credits attributable to passive activities exceed the tax liabilities for those activities, the excess (disallowed) passive activity credit must be allocated to each of the taxpayer's credits arising from a passive activity for the tax year of the disallowance. Any disallowed credit is treated as a credit from the activity to which it is carried forward and allocated for the taxpayer's immediately succeeding tax year.

.02 Passive Activity Income: What Is Passive Activity Income?

Passive activity income stems from activities in which the taxpayer

a. does not materially participate,

b. receives rental income from property,

c. holds only a limited partnership interest, or

d. recognizes gain from the disposition of an interest in a passive activity or a property used in a passive activity.

There are a number of categories of activities listed in the IRC that are not subject to the passive activity loss rules at all (or in modified form). These are significant exceptions to the definition of passive activity income.[23] These special categories include the following:

a. Portfolio income (interest, dividends, royalties, and annuities not derived in the ordinary course of a trade or business). Portfolio income includes gain or loss from the disposition of property that produces these types of income or that is held for investment. Because portfolio income is not treated as income from a passive activity, it must be accounted for separately, and passive losses and credits generally may not be applied against it.

b. Personal service income. This includes salaries, wages, commissions, self-employment income from trade or business activities in which the taxpayer materially participates, taxable Social Security income, retirement benefits and payments from partnerships to partners for personal services.

c. Income from adjustments due to IRC Section 481 accounting method changes.

d. Income or gain from investments of working capital.[24]

e. Income from an oil or gas property.

[23] IRC Section 469(e)(1).

[24] IRC Section 469(e)(1).

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f. Trading personal property on behalf of others with an interest in the activity.

g. Income from intangible property significantly created by the taxpayer (patents; copyrights; literary, musical, and artistic compositions).

h. Cancelation of debt income, if the debt is not allocated to passive activities under interest expense allocation rules.

i. State, local, and foreign income tax refunds.

j. Gain from an interest in a publicly traded partnership.

.03 Portfolio-Type Income

Portfolio-type income derived in the ordinary course of a trade or business may be passive activity gross income if it is derived from a passive activity (such as an S corporation distribution paid to a passive shareholder).

.04 Rental Activity — the Self-Rental Rule

Under Reg. 1.469-2(f)(6), if a taxpayer rents property to a business in which the taxpayer materially participates, the net rental income is nonpassive. Rental income from self-rented property cannot be used to trigger the deduction of passive losses. This rule does not apply to the rental of property incidental to development activity under Reg. 1.469-2(f)(5). Under this rule, however, taxpayers who self-rent assets may not group the activity with rental of any other property, including other self-rented property. Taxpayers also cannot use gains derived from self-rental activity to offset losses recognized from unrelated passive activities.

Example 1: The Court of Appeals for the Ninth Circuit has held that preventing self-rental activity losses from offsetting unrelated passive activity income was in line with Congress's intention of "preventing the sheltering of positive income sources through the use of tax losses derived from passive business activities."[25]

This was true even though the taxpayer had a bona fide business purpose and did not structure any transaction for tax purposes.

Example 2: In another case, the IRS properly reconstructed an attorney's unreported income from her law practice and her real estate activities. The IRS's bank deposits analyses of the firm's accounts and the taxpayer's personal and business accounts were reasonable, as was its reconstruction of her real estate income and expenses. Her residential rental activities were passive, absent evidence that she materially participated in that aspect of her real estate trade or business. However, her rental of offices to her own law practice was self-rental; therefore, it did not produce passive income that could be offset by her residential rental losses.[26]

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[25] *Beecher*, CA-9, 2007-1 USTC 50, 379.

[26] Deanna Langille f.k.a. *Deanna Birdsong v. Commissioner*, U.S. Tax Court, CCH Dec. 58,156(M); Dkt. No. 17227-08, TC Memo. 2010-49, 99 TCM 1197, March 18, 2010.

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Example 3: In another case, a taxpayer owned two truck rental businesses. He rented trucks to his own trucking corporation, where he materially participated. One rental business was profitable; one was not. The Tax Court found that the loss from the non-profitable rental corporation was passive and could not be used to offset income from the profitable rental business because of the self-rental rule.[27]

.05 Disposition of an Interest in a Passive Activity

Passive activity income also includes gain from the disposition of an interest in a passive activity or property used in a passive activity. To ensure that the passive activity loss or passive activity gain connection remains, gain realized from the disposition of property used for both passive and nonpassive activities must be allocated between the two activities. This allocation must reasonably reflect the property's multiple uses during the 12 months immediately preceding the disposition.[28]

¶4140 Passive Activity Deductions

.01 Passive Activity Loss

A taxpayer has a passive activity loss for a year if the sum of the passive activity deductions for the year exceeds the sum of the passive activity gross income items for that year. Accordingly, a passive activity loss is determined by accumulating all of the items that constitute passive activity gross income and deductions. Passive activity gross income includes ordinary income attributable to passive activities, as well as gain from disposition of property used in a passive activity at time of disposition. It does not include portfolio income or personal services income, or any of the other categories of nonpassive income described in ¶4125.02.

.02 Deductions

A deduction is a passive activity deduction for a tax year if it (*a*) arises in the conduct of a passive activity for the current tax year, or (*b*) is carried over from a disallowed passive activity deduction for a prior tax year. Passive activity deductions also include losses from dispositions of property used in a passive activity at the time of the disposition and losses from a disposition of less than the taxpayer's entire interest in a passive activity.

.03 Taxpayers and Passive Activity Deductions

A taxpayer's passive activity losses in excess of passive activity income are suspended and carried forward to succeeding tax years until the taxpayer has passive activity income to offset them. The suspended passive activity loss for a year is allocated among all of the taxpayer's activities that produced the loss. The losses are generally treated as passive activity deductions from the activities in future tax years.

A taxpayer who disposes of his or her entire interest in a passive activity or former passive activity in a fully taxable transaction may deduct the suspended passive activity losses allocable to that activity,

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[27] *Veriha v. Commissioner*, 139 T.C. 45 (2012).

[28] Temp. Reg. 1.469-2T(c)(2)(ii).

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including losses recognized on the disposition of the interest, against nonpassive income. (Dispositions of passive activities are discussed in Section 4150).

Passive activity deductions do not include a wide variety of otherwise allowable income tax deductions, including the following:

- Deductions for expenses directly attributable to portfolio income
- Interest expenses, including qualified home mortgage interest
- Losses from dispositions of property that produce portfolio income or property held for investment
- State, local, and foreign income taxes
- Charitable contribution deductions
- Net operating loss deductions
- Capital loss carryovers
- Presidentially declared casualty losses
- Percentage depletion carryovers for oil and gas wells
- The deduction for the employer-equivalent portion of self-employment tax

.04 Compliance Requirements

Passive activity compliance must meet the following requirements:

1. Individuals, estates, and trusts who have losses from passive activities, including prior year disallowed losses, use Form 8582 *Passive Activity Loss Limitations*, to figure the amount of any passive activity loss.
2. Form 8582 generally must also be filed by a taxpayer who has an overall gain from business or rental passive activities for the year (even after including suspended passive losses from prior tax years).
3. Form 8582 does not need to be filed if the taxpayer actively participated in rental real estate activities.
4. The fact that income or deductions are passive does not change the Schedule on which the item is entered. For example, the income from a rental activity held by the taxpayer is entered on Schedule E, “Supplemental Income and Loss,” even though it is also passive and included on Form 8582.
5. Personal service corporations and closely held corporations use Form 8810, *Corporate Passive Activity Loss and Credit Limitations*, to figure any passive activity loss for the tax year.

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Partnerships and S corporations use Form 8825, *Rental Real Estate Income and Expenses of a Partnership or an S corporation*, to report income and deductible expenses from rental real estate activities.

¶4145 Election to Group Passive Activities

.01 Important Threshold Consideration

An important threshold consideration in dealing with the passive activity loss rules is the question of what constitutes a single activity of the taxpayer. In order to pass the material participation test, grouping several related activities may allow the taxpayer to address the time requirements to meet one of the seven material participation tests described earlier in this chapter.

.02 Identification of a Taxpayer's Activities

Identification of a taxpayer's activities is determined by its facts and circumstances. Being allowed to group activities can be pivotal in determining the amount of passive income available to offset passive losses, as well as in assessing the extent to which a taxpayer materially participates in an activity. Whether activities must be considered individually or may be combined into one activity depends on whether they constitute an appropriate economic unit for passive loss purposes.

.03 Grouping Activities

One or more trade or business activities, or rental activities, may be treated as a single activity if the activities constitute an appropriate economic unit for the measurement of gain or loss for purposes of the passive loss rules. Whether activities constitute an appropriate economic unit, and therefore may be treated as a single activity, depends upon "all the relevant facts and circumstances" (discussed later in this chapter). In addition, other grouping restrictions apply to the following situations:

a. Activities of pass-through entities and corporations

b. Business and rental activities

c. Tax-avoidance plans

.04 Rules and Enforcement Measures

As an enforcement measure for the grouping rules, a taxpayer who groups more than one business activity must notify the IRS of the grouping by attaching an election statement to the taxpayer's income tax return. This is known as a Reg. 1.469-9(g) election. No other notification is permitted.

The IRS has issued rules that require taxpayers to report, for purposes of the passive activity loss rules under IRC Section 469 and Reg. 1.469-4, their groupings and regroupings of activities, as well as the addition of specific activities within the current grouping of activities. Special disclosure rules apply to partnerships and S corporations. The failure to report whether activities have been grouped as a single

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activity will generally result in the unreported activities being treated as separate activities under a default rule. The rules are effective for all tax years beginning on or after January 25, 2010.[29]

.05 Election to Group Passive Activities: Late Elections

Prior to June 13, 2011, the election to group passive activities could not be made on an amended return or during an audit. However, on June 13, 2011, the IRS issued Rev. Proc. 2011-34, which provides special procedures for relief for late 1.469-9(g) elections. A taxpayer is eligible for an extension of time to file a 1.469-9(g) election if the taxpayer represents on a statement that it meets *all* of the following requirements:

a. The taxpayer failed to make the election solely because the taxpayer failed to timely meet the election requirements in 1.469-9(g).

b. The taxpayer filed consistently with having made an election under 1.469-9(g) on any return that would have been affected if the taxpayer had timely made the election. The taxpayer must have filed all required federal income tax returns consistent with the requested aggregation for all of the years, including and following the year the taxpayer intends the requested aggregation to be effective. Further, no tax returns containing positions inconsistent with the requested aggregation may have been filed by or with respect to the taxpayer during any of the tax years.

c. The taxpayer timely filed each return that would have been affected by the election if it had been timely made. The taxpayer will be treated as having timely filed a required tax or information return if the return is filed within six months after its due date, excluding extensions.

d. The taxpayer has reasonable cause for its failure to meet the requirements in 1.469-9(g).

e. The taxpayer must attach the required statement to an amended return for the most recent tax year. The statement must state at the top of the document "FILED PURSUANT TO REV. PROC. 2011-34."

.06 Election to Group Passive Activities: Relevant Facts and Circumstances

Reg. 1.469-4(c)(2) allows taxpayers to use "any reasonable method of applying the relevant facts and circumstances" in deciding whether to group activities. As guidance, the IRS provides that the following five factors are given the greatest weight in determining whether activities are from an appropriate economic unit (see Publication 925):

1. Similarities and differences between the types of trades or businesses
2. The extent of common control
3. The extent of common ownership
4. Geographical location

[29] Rev. Proc. 2010-13, I.R.B. 2010-4, January 6, 2010.

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5. Interdependencies between activities, that is, evidence of entities that buy or sell goods among themselves, provide products or services together, have the same customers, have the same employees, or use a single set of books and records to account for their activities.

Once a taxpayer has chosen a method of grouping the activities, the activities may not be regrouped in subsequent tax years unless a "material change in the facts and circumstances" has occurred.

> **Example:** Alberto owns a bakery and a movie theater in a mall in Baltimore and a bakery and movie theater in Philadelphia. Alberto does not materially participate in any of the businesses, which create both passive activity losses and income. Under the regulations, Alberto could combine gains and losses from the bakery and the movie theater in Baltimore as this grouping is based on geographical location.
>
> A similar group would be appropriate for the bakery and the movie theater in Philadelphia. He could also group gains and losses from the bakeries and form a separate group that combines gains and losses from both movie theaters.
>
> Alberto could also group gains and losses from all of the activities together, because all the activities have common ownership. Once Alberto decides on a grouping, he must maintain this grouping for all subsequent tax years unless a material change in the businesses' facts or circumstances requiring a change to the grouping occurs.

.07 Election to Group Passive Activities: Material Participation

Electing to group related activities into a single activity makes it easier for taxpayers to meet the tests for material participation. Meeting the requirements for grouping activities reduces the taxpayer's burden to show material participation because, rather than having to prove material participation for each individual activity, the taxpayer has only to prove material participation for all activities within the group as a whole.

.08 Election to Group Passive Activities: Rental Activities

A rental activity generally cannot be grouped with a trade or business. However, a rental activity may be grouped with a trade or business if either is insubstantial in relation to the other, or the owner has the same proportionate interest in the rental as in the business.

> **Example 1:** A taxpayer leased equipment to an S corporation of which he was the majority owner. The Tax Court found that taxpayer's leasing activity, a passive activity, could be grouped with the S corporation's business.[30] The taxpayer's rental activity was "insubstantial" in relation to the activities of the S corporation. The taxpayer created and operated the leasing activity solely for the benefit of the S corporation, and spent little time conducting its affairs, as compared to the S corporation's activities. Additionally, the purpose of the leasing activity was to enhance the ability of the corporation to do business and did not provide an income stream independently from the S corporation.

[30] *Schumacher*, T.C. Summary Op. 2003-96.

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> **Example 2:** In another situation, an individual owned a majority interest in a C corporation engaged in the retail sale of granite and marble. The IRS concluded that the individual was prohibited by the passive activity loss rules from offsetting passive rental losses from his solely-owned LLC against nonpassive wage income received from the C corporation. Reg. 1.469-4(d)(5)(ii) specifically limited the aggregation of the taxpayer's activities conducted through the C corporation with the activities he conducted through the LLC in determining whether he materially or significantly participated in the activities of the LLC. The taxpayer's contention that the limitation imposed by Reg. 1.469-4(d)(5)(ii) applies only when unrelated activities are grouped was rejected as contrary to its plain meaning. Because the taxpayer's rental activities in the LLC were *per se* passive, whether or not he materially participated in them and had no passive income, the losses were not deductible.[31]

The meaning of *insubstantial* is unclear because the IRS has refused to define the term in official guidance. The IRS received comments asking for clarification when it issued final regulations under Reg. 1.469-4 in T.D. 8565. The IRS determined:

> Because the regulations already adopt a facts and circumstances test that looks at all of the pertinent factors [for grouping], it is not necessary to specify that the term insubstantial refers to factors other than gross income. In addition, to avoid complex and mechanical rules, the final regulations do not adopt a bright-line or safe-harbor gross revenue test.

Courts, however, have attempted to define *insubstantial*. In one case, the IRS conceded that a married couple's rental and management activities were an appropriate economic unit under Reg. 1.469-4. However, the IRS argued that facts that made the two activities an appropriate economic unit could not be used to sustain a finding that one activity was "insubstantial" in relation to the other. The court rejected this argument. The judge remarked: "We have difficulty imagining a scenario where two activities are so interdependent that they form an appropriate economic unit yet are not 'essential' to each other in a way that the government's definition would allow them to be considered 'insubstantial.'"[32]

.09 Election to Group Passive Activities: Rental Real Estate

Each of a qualifying taxpayer's interests in rental real estate must be treated as a separate activity unless the taxpayer elects to treat all interests in rental real estate as a single activity. If activities are grouped, and one is disposed of, the disposition is only of a partial interest in the activity. If the activities are separate, and one is disposed of, then there is a disposition of the entire interest in that activity.

.10 Election to Group Passive Activities: Limited Partnership Interests

Taxpayers owning LPs may group the following activities with another activity only if it is in the same line of business:

- Holding, producing, or distributing motion picture films or videotapes

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[31] *Senra v. Commissioner*, T.C. Memo. 2009-79.

[32] *Glick v. United States*, DC Ind., 2000-1USTC ¶50,372.

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- Farming
- Leasing IRC Section 1245 property
- Exploring for, or exploiting, oil and gas resources
- Exploring for, or exploiting, geothermal deposits

.11 Election to Group Passive Activities: IRS Recharacterization

In addition to *denying* grouping for not being formed around an appropriate economic unit, the IRS, under Reg. 1.469-4(f), can *regroup* a taxpayer's passive activities if any of them do not form an appropriate economic unit, and the principal purpose of the taxpayer's grouping choice was to avoid the IRC Section 469 restriction on passive activity losses.

> **Example:** Five physicians form a partnership, in which none of them materially participates, to acquire several pieces of X-ray equipment. Although each individual owns a medical practice, the equipment is bought at a discount to be shared by all.
>
> The physicians pick a general partner and each physician receives a limited partnership interest in exchange for the equipment provided to the partnership. The physicians receive services from the partnership in proportion to their interests and pay for those services at fees set as though the physicians were dealing with a third party.
>
> The physicians do not group their limited partnership income with income from their individual medical practices. Some of them had passive losses from investing in a tax shelter, whereas others had passive real estate investment losses. Instead, they offset income from the partnership against these passive activity losses.
>
> This grouping is incorrect. The IRS will likely regroup the limited partnership gains and losses with those from the taxpayers' individual medical practices because the activities are interdependent and are in similar lines of business.
>
> Allowing the physicians to offset the income from the partnership with the passive losses from the tax shelter and real estate investments is against the purpose of IRC Section 469. The IRS could assert IRC Section 6662 accuracy penalties when appropriate.

.12 Special Regrouping Opportunity under the Tax on Net Investment Income

The final regulations under the net investment income tax allow a new election to be made to regroup passive activities. The regrouping will apply for both regular income tax purposes and for purposes of the net investment income tax. A one-time election will be permitted. It is required to be made on the tax return for the first year the taxpayer is subject to the net investment income tax.[33] However, the election to regroup may only be made if the taxpayer is subject to IRC Section 1411 and over the applicable

[33] Reg. 1.469-11(b)(3)(iv).

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threshold for purposes of the net investment income tax. Regrouping is not permitted until the threshold is reached.

A taxpayer may regroup on an amended return but only if the taxpayer was not subject to IRC Section 1411 on his or her original or previously amended return and if, because of a change in the original return, the taxpayer now owes tax under IRC Section 1411 for that tax year. The regrouping will be declared invalid if the taxpayer subsequently determines that the taxpayer is not subject to IRC Section 1411.

¶4150 Dispositions of Interests in Passive Activities

.01 Disposition-of-Interest Rule

The passive loss limitation is lifted when a taxpayer disposes of his or her entire interest in a passive activity in a fully taxable transaction.[34] At such time, any net passive loss from the activity must first be applied against income or gain from the taxpayer's other passive activities. Suspended passive activity losses attributable to the activity, and losses recognized on the disposition may then be deducted from active and portfolio income. Likewise, if the passive activity itself is terminated, all remaining net passive losses from that activity become deductible.[35] The following three requirements apply to the special disposition-of-interest rule:

1. The taxpayer must dispose of its entire interest in the activity.

2. The disposition must be in the form of a fully taxable transaction. It may not be in the form of a wash sale transaction.[36] Abandonment is a fully taxable disposition. An IRC Section 1031 like-kind exchange is not a fully taxable disposition.

3. The taxpayer must not be related to the party acquiring the interest under the rules of IRC Section 267(b), or as between a partner and partnership — a transaction that is addressed by IRC Section 707 (b)(1).

.02 Retention of Passive Activity Losses

Taxpayers who sell their interests to related parties retain the passive activity losses under IRC Section 469(g)(1)(B) until the related party sells the interest to an unrelated party. For purposes of this rule, sales between trusts or estates and their beneficiaries are considered to be sales between related parties. When taxpayers elect to group activities, all activities included in the group generally must be sold to recognize all losses from the disposition of an interest in a passive activity. Taxpayers seeking to take advantage of IRC Section 469(g) by deducting all current and suspended passive activity losses are best advised not to elect to group their activities. If they partially dispose of the properties, for example, by selling only one of 10 grouped properties, deduction of passive activity losses generally will be limited to the amount of passive activity gain they recognize from the disposition.

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[34] IRC Section 469(g).

[35] IRC Section 469(g)(1).

[36] IRC Section 469(g)(1)(A).

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Nevertheless, a taxpayer who disposes of a substantial part of an activity may treat that part as a separate activity for purposes of freeing passive losses, if it can be established with reasonable certainty the share of losses and credits that are allocable to the disposed portion.

.03 Installment Sale

A disposition by means of an installment sale results in only a portion of the suspended loss being deducted in the year of sale. The suspended losses are allowed in the year of sale and thereafter in the ratio that the gain recognized in the tax year bears to the total gross profit from the sale to be realized when payment is completed.[37]

.04 Nontaxable Exchange

The exchange of a taxpayer's interest in a passive activity in a nonrecognition transaction, such as a like-kind exchange, does not trigger the use of the suspended losses. However, if the taxpayer recognizes gain on the transaction to the extent of "boot" received, such gain is treated as passive income against which suspended passive losses may be deducted.

.05 Casualty or Theft Loss

A casualty or theft loss involving property used in a passive activity does not constitute a complete disposition of the taxpayer's interest in the activity unless the casualty or theft results in the loss of the entire property.

.06 Activity Changes from Passive to Active

If an activity ceases to be considered passive, the previously suspended losses from that activity may be claimed as deductions against the activity's net income.[38]

.07 Gift

A disposition of a passive activity by gift does not trigger the suspended losses. Rather, the basis of the transferred interest to the donee is increased by the amount of the donor's suspended passive losses.[39]

.08 Death

A transfer of an interest by reason of death causes the suspended losses to be allowed in the year of death only to the extent that they exceed the amount by which the basis to the heir is increased by the date-of-death basis rules of IRC Section 1014. That is, the basis increase is calculated first. If there are suspended losses that exceed the amount of any basis increase, such losses are then allowed to be

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[37] IRC Section 469(g)(3).

[38] IRC Section 469(f)(1).

[39] IRC Section 469(j)(6).

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deducted against the decedent's income in the year of death on the decedent's final income tax return. No suspended losses may be carried from a decedent to an heir.[40]

¶4155 The Effect of the Passive Loss Rules on Proprietorships, S corporations, and Partnerships

.01 Sole Proprietors

A sole proprietor's loss may be limited by the passive activity loss rules.[41] Generally, a proprietor can only deduct passive losses to the extent of passive income.[42] The passive activity loss rules apply if the proprietor does not materially participate in the proprietorship or if the proprietorship is involved in a rental activity (see IRC Section 469(c)). Real estate rental activities are generally considered passive activities by definition, even if the proprietor is actively involved in the activity.[43] A proprietor materially participates in an activity if the proprietor is involved in the activity on a regular, continuous, and substantial basis. The determination of whether a proprietor materially participates in the business is made annually. There is an exception to the limitation on rental activity losses for certain real estate professionals.[44] The exception also applies to individuals who own and actively participate in a rental activity and have an AGI of less than $150,000.[45]

If an individual's loss is limited as a passive activity loss, the loss carries over to subsequent years indefinitely until it can be used to offset passive activity income. The passive activity loss carryover can be claimed in the year the property giving rise to the loss is sold.

.02 S Corporation Shareholders

An S corporation shareholder's loss may be limited by the passive activity loss rules. A shareholder first applies basis limitations and the at-risk rules before determining loss limitations related to the passive activity loss rules. If a loss is prohibited under the basis limitation or at-risk rules, it is not a passive activity loss.[46] Generally, an individual shareholder can only deduct passive losses to the extent of passive income.[47] Passive activity loss rules apply if the shareholder does not materially participate in the corporation's business, or if the corporation is involved in rental activity.[48] A shareholder materially

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[40] IRC Section 469(g)(2).

[41] Temporary Reg. Sec. 1.469-2T(b)(4).

[42] IRC Section 469(d).

[43] IRC Section 469(c)(2).

[44] IRC Section 469(c)(7).

[45] IRC Section 469(i).

[46] Temporary Reg. Sec. 1.469-2T(b)(4).

[47] IRC Section 469(d)(1).

[48] IRC Section 469(c).

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participates in an activity if the shareholder is involved on a regular, continuous, and substantial basis.[49] The material participation determination is made on an annual basis. Real estate rental activities are, by definition, passive activities even if the shareholder is actively involved.[50] Exceptions to the limitation on rental activities losses are made for the following:

- Certain real estate professionals[51]
- Individuals who own and actively participate in a rental activity and have an AGI of less than $150,000[52]

If an individual's loss is limited as a passive activity loss, the loss carries over to subsequent years indefinitely until it can be used to offset passive activity income. The passive activity loss carryover can be claimed in the year the property giving rise to the loss is sold.[53]

.03 Partner's Loss

A partner's loss may be limited by the passive activity loss rules. The partner first applies basis limitations and the at-risk rules before determining loss limitations related to the passive activity loss. If a loss is prohibited under the basis limitation or at-risk rules, it is not a passive activity loss.[54] Generally, an individual partner can only deduct passive losses to the extent of passive income.[55] The partner is subject to the passive activity loss rules if the partner does not materially participate in the partnership's trade or business. The partner is also subject to the rules if the partnership is involved in a rental activity. A partner materially participates in an activity if the partner is involved in the operation of the activity on a regular, continuous, and substantial basis. The determination of whether a partner materially participates in the business is made on an annual basis. Real estate rental activities are generally considered passive activities by definition even if the partner is actively involved. There are exceptions to the limitation on rental activities losses for

- certain real estate professionals[56] and

[49] IRC Section 469(h)(1).

[50] IRC Section 469(c)(2).

[51] IRC Section 469(c)(7).

[52] IRC Section 469(i).

[53] IRC Section 469(g).

[54] Temp. Reg. 1.469-T(b)(4).

[55] IRC Section 469(d)(1).

[56] IRC Section 469(c)(7).

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- individuals who own and actively participate in a rental activity and have an AGI of less than $150,000.[57]

.04 Losses Limited as Passive Activity Losses

If a loss is limited as a passive activity loss, it carries over to subsequent years until usable to offset passive activity income. The passive activity loss carryover can be claimed in the year the property giving rise to the loss is sold.

.05 Passive or Nonpassive Character of an Item of Gross Income

The passive or nonpassive character of an item of gross income or deduction allocated to a taxpayer from a partnership or S corporation (pass-through entity) is determined by reference to the taxpayer's participation in the activity that generated the item. Participation is determined for the tax year of the pass-through entity and not the tax year of the taxpayer.

¶4160 Trust and Estate Issues

.01 Grantor Trusts

Trusts are generally covered by the passive activity loss rules under IRC Section 469(a)(2). However, grantor trusts as defined in IRC Section 671 are excluded from the passive activity rules under Reg. 1.469-1T(b)(2). For grantor trusts, material participation is determined at the grantor level, rather than at the trust level. The IRS instructs its auditors that grantor trusts are not recognized as separate taxable entities and should be ignored entirely; however, auditors are instructed to look to the activities of the grantor in determining whether the passive activity loss rules should apply.

.02 Non-Grantor Trusts

Unfortunately, little IRS guidance is available on how the passive activity rules affect prohibited losses claimed by non-grantor trusts. The IRS has reserved Reg. 1.469-8 for applying the passive activity loss rules to trusts, estates, and their beneficiaries and Reg. 1.469-5T(g) for defining material participation of trusts and estates.

.03 Trust and Estate Issues: Material Participation

A technical advice memorandum clarified the IRS's position on determining whether a testamentary trust has materially participated in a business activity. In the view of the IRS Chief Counsel, a testamentary trust is considered to have materially participated in an activity if its fiduciaries, but only the fiduciaries, meet the requirements for material participation.[58]

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[57] IRC Section 469(i).

[58] TAM 200733023.

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This memorandum was contrary to a 2003 U.S. District Court decision that deemed a trust to have materially participated in an activity.[59] The court confronted a situation involving a non-grantor trust holding a working cattle ranch that was also used for oil and gas interests. The district court allowed the loss deduction, because "common sense" dictated that the participation of the trust in the ranch operations involved looking to the activities of the employees working on the ranch to further its business. The court was persuaded by the taxpayer's argument that a trust, similar to a C corporation, had to have a living person act on its behalf. Further support of this pro-taxpayer position is found in the legislative history of IRC Section 469, Senate Committee Report to P.L. 99-514 (1986), S. Rep. No. 99-313. That report maintained that an estate or trust has materially participated in an activity if the executor or fiduciary has materially participated in the activity.

In many respects, a trust is very similar to a closely held C corporation. The trustee, like the board of directors of a C corporation, owes a fiduciary obligation to the trust beneficiaries to manage the trust for their benefit. Moreover, a trust, like a C corporation, is a separate legal entity, and is subject to entity-level income taxes (to the extent that income is not passed through to the beneficiaries). Most importantly, as a separate legal entity, a trust, like a C corporation, can act only through its fiduciaries, employees, and agents. Therefore, the trust is most arguably analogous to a closely held C corporation.

However, in TAM 200733023, the IRS rejected this interpretation. As a general rule, the IRS stated that the owner of a business cannot look to the owner's employees to satisfy the material participation requirement. Therefore, consistent with the treatment of other business owners, the IRS ruled that it is appropriate in the trust context to look only to the activities of the trustee. The IRS reaffirmed this position in PLR 201029014 (April 7, 2010) stating that a trust materially participates in an activity only if the trustee participates on a regular, continuous, and substantial basis. In TAM 201317010, the IRS found that a person serving as both company officer and trustee of a trust owning the company spent most of his time in the role of officer, not trustee, so that the trust was deemed not to be materially participating in the company activities.

The issue of material participation by trustees remains highly controversial. The latest word in this controversy comes from the reviewed opinion of the full U.S. Tax Court in the case of *The Frank Aragona Trust v. Commissioner*, 142 T.C. 165 (2014). The case is a victory for taxpayers on the issue of a trustee's ability to be considered actively involved in a business but does not resolve all of the controversial issues because several of the trustees were also employees of the business. The Tax Court did find that a trust is capable of performing personal services and therefore may qualify for the IRC Section 469(c)(7) real estate professional exception.

The court also held that a trust may materially participate in a real estate business. The activities of persons who are both trustees and employees of the business owned by the trust may be considered in determining what constitutes material participation. In this case, the losses sustained by the trust's real estate activities were deemed active, so that they could be used to offset other income of the trust.

> **Note:** The case did not address whether activities of non-trustee agents or employees should be counted or disregarded for purposes of determining material participation. It did not address issues relating to the number of hours of personal service that must be involved for a trust to satisfy the material participation standard. There remain unresolved issues here. The hope is that

[59] *The Mattie K. Carter Trust*, 2003-1 USTC 50,418 (ND Texas, 2003).

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the IRS will finally issue formal regulations addressing the application of IRC Section 469 to trusts and estates.

.04 Trust and Estate Issues: Rental Real Estate

Trusts may not take advantage of the $25,000 active participation allowance for real estate activities because they are not individuals, even if an individual acts on the trust's behalf. However, under IRC Section 469(i)(4), a decedent's estate may take advantage of the active participation allowance for two years if the decedent would have satisfied the active participation requirement for the activity for the year the decedent died. In addition, under IRC Section 645, a decedent's qualified revocable trust can also be treated as actively participating if both the trustee and the executor (if any) of the estate elect to treat the trust as part of the estate. Form 8855 is filed by the trustee and the executor to make this election. The election choice applies to tax years ending after the decedent's death and before the later of:

- two years after the decedent's death if no federal estate tax return is required, or
- six months after the federal estate tax liability is finally determined if a federal estate tax return is required.

.05 Trust and Estate Issues: Distributions

Under IRC Section 469(j)(12), if an interest in a passive activity is distributed to a beneficiary by a trust (or by an estate), a pro rata share of the activity's net losses, if any, are added to the basis of the asset immediately before the transfer. That adjustment will reduce the gain realized by the beneficiary on the asset's eventual sale. The losses — as losses — are not distributed to the beneficiary.

¶4165 Alternative Minimum Tax: Application of Passive Activity Rules to the AMT

The passive activity rules were enacted to combat specific tax-sheltered arrangements, but the AMT was established to combat tax abuse by broadly restricting the amount of special adjustments and preferences "wealthy" taxpayers could claim on their returns. The passive activity loss rules are applied in special ways to compute AMT liability, as compared to their usage for regular income tax liability.

In computing alternative minimum taxable income (AMTI), passive activity losses are disallowed for taxpayers to the extent they exceed passive activity income. This AMT treatment mirrors that under the regular tax. Outstanding aggregate passive activity losses must be carried forward into subsequent tax years. Such losses will be allowed as a deduction against future income from the passive activity and, to the extent that there are suspended losses, for the year in which the taxpayer disposes of the interest in the activity.

However, the passive activity rules for AMT change from regular tax treatment when one recomputes an individual's regular tax liability to reflect adjustments for tax preferences. For purposes of computing a taxpayer's AMTI, IRS Announcement 88-45 reminds taxpayers that adjustments related to a passive activity, such as the depreciation deduction, will often reduce the amount of passive activity loss the taxpayer would have been allowed to deduct for his or her regular tax liability.

> **Example:** Angela materially participates in a real estate rental activity and is allowed to deduct $15,000 worth of otherwise passive activity loss. Because the AMT applies, Angela is required to recompute her depreciation deductions for the leased property, thus decreasing her passive

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activity income loss deduction by $10,000. Her final allowable passive activity loss deduction under the AMT is $5,000.

Some calculations of AMTI may even turn a passive activity loss into a net gain.

Example: Aaron materially participates in a real estate rental activity and is allowed to deduct $5,000 worth of otherwise passive activity loss. Because the AMT applies, Aaron is required to recompute his depreciation deduction for the leased property, thus decreasing his passive activity loss deduction by $10,000. This creates a net gain of $5,000 for purposes of calculating Aaron's AMTI.

In IRS Announcement 88-45, the IRS stated that once taxpayers have made these adjustments to their passive activity losses for purposes of the AMTI, they do not have to again make them on Form 6251, *Alternative Minimum Tax — Individuals*; that would lead to duplicative adjustments.

¶4170 The Impact of the Passive Loss Rules on the 3.8% Tax on Net Investment Income

.01 The Tax on Net Investment Income

A tax of 3.8% is imposed on the net investment income of individuals, trusts, and estates. The tax applies to individuals who have AGI over $250,000 (married filing jointly), $200,000 (single filers), and $125,000 (married filing separately). The individual thresholds are not adjusted for inflation. It also applies to trusts and estates that have undistributed net investment income over the AGI threshold of $14,450 (the 2023 threshold for trusts and estates, which is adjusted annually for inflation).

The term *investment income* includes passive activity income, along with items such as interest, dividends, rent, annuities, and capital gains. It does not include income from an active trade or business, or interest, dividends, or capital gains derived from an active trade or business. This tax will serve as an incentive to the IRS to intensify its efforts to classify more activities as "passive" in order to increase the exposure of income to the tax. This tax will also increase efforts of taxpayers to avoid classification of activities as passive.

The final regulations issued by the IRS addressing the net investment income tax clarified some important issues and distinctions arising in connection with the relationship between the net investment income tax and the passive activity loss rules, as described next.

.02 The Real Estate Professional Safe Harbor Test

A real estate professional qualifies for a "safe harbor" (i.e., the income will not be treated as passive and will not be subject to the net investment income tax) if the real estate professional participates in a rental real estate activity more than 500 hours per year or participated more than 500 hours annually in the past 5 out of 10 years — then the rental income associated with that activity will presume to be derived in the ordinary course of a trade or business. Any election made under Reg. 1.469-9 to aggregate (group) all of a taxpayer's rental activities is respected for purposes of this 500-hour test. Moreover, gain or loss from

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the disposition of property used in such rental real estate activity is deemed to be derived from property used in the ordinary course of a trade or business.[60]

A real estate professional will not qualify for the rental real estate safe harbor if the taxpayer who satisfies the real estate professional test does so by virtue of non-rental real estate activities, such as construction or brokerage. If a real estate broker has two rental homes on the side, merely spending 100 hours on each property will be enough to materially participate in the activity assuming the broker is the only one devoting time to the activity. If the broker qualified as a real estate professional, the rental homes would not be considered passive activities. However, because the broker fails to spend 500 hours on the separate — or combined, if so elected — rental activities, the broker fails to satisfy the safe harbor and does not meet the "rental trade or business" requirement either.

.03 The Self-Rental Income Issue

The final regulations provide that if rental income is treated as nonpassive by reason of Reg. 1.469-2(f)(6) (which recharacterizes what otherwise would be passive rental income from a taxpayer's property as nonpassive when the taxpayer rents the property for use in an activity in which the taxpayer materially participates [within the material participation rules described in Reg.1. 469-5T], or when the activity is properly grouped with a nonpassive trade or business activity under Reg. 1.469-4(d)(1)), the gross rental income is deemed to be derived in the ordinary course of a trade or business and therefore not subject to the net investment income tax. Gain or loss from the sale of the property will also be treated as gain or loss from the disposition of property held in a nonpassive trade or business.[61]

.04 Self-Charged Interest

Under the final regulations, a taxpayer who loaned money to a pass-through entity in which the taxpayer materially participates is not subject to net investment income tax on the interest received for such loan. The final regulations provide that in the case of self-charged interest received from a nonpassive entity, the individual may exclude from net investment income an amount equal to the individual's allocable share of the flow-through entity's deduction.[62]

Planning might suggest, for example, increased use of an S corporation into which several activities are combined. Assuming the S corporation carries on sufficient activities to allow it to be characterized as an "active" trade or business, the passive income "taint" from isolated activities may be removed. If that is accomplished, the payment of an S corporation distribution from an "active" trade or business will also avoid the definition of "*investment income*." That, in turn, suggests that the lowest "reasonable compensation" be established for the S corporation owners (to avoid as much as possible the 0.9% Medicare tax on compensation and self-employment income) and have the largest justifiable S corporation distribution paid — thereby minimizing or avoiding the 0.9% additional Medicare tax, other self-employment taxes, and the net investment income tax.

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[60] Reg. 1.1411-4(g)(7).

[61] Reg. 1.1411-4(g)(6).

[62] Reg. 1.1411-4(g)(5).

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Chapter 42

Tax, Financial, and Estate Planning for the 99%

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¶4201 Overview

The financial planner has a new challenge. Under current law, the majority of our clients' estates will not be subject to the federal estate tax when death occurs. How are we to plan for them — and indeed, convince them that planning is still important and necessary? This chapter discusses this challenge in financial and estate planning, keeping in mind that if changes in the law are enacted, persons described as the "99%" may find themselves a much smaller group if income and estate and gift tax rates, brackets, and thresholds and rules are modified.

As of 2023, as the result of the 2017 Tax Cuts and Jobs Act, the applicable exclusion from the federal gift and estate tax is $12,920,000. This number is indexed annually for inflation. The 2023 applicable exclusion from the GST is $12,920,000, also indexed for inflation. These increased exclusion amounts sunset after 2025 and revert to the 2017 exclusion amounts ($5,490,000) as further indexed for inflation since 2017.[1] The coming "sunset," if it occurs, adds a troublesome complication for persons whose

[1] IRC 2010(c) and IRC 2631.

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assets are below the current exemption level of wealth, but above the 2026 projected threshold. Certainly, the possibility of "political risk" prior to the 2025 sunset suggests that the current exclusion amounts are not guaranteed to remain in place.

The American Tax Relief Act of 2012 (ATRA) also made permanent the concept of portability, which allows the surviving spouse to use the unused federal estate tax exclusion of a deceased spouse (the DSUE) who died after 2010. Depending on the year of death and the estate plan of the first deceased spouse, portability can give the surviving spouse an available applicable exclusion for lifetime gifting and use at death as much as $25,840,000 in 2023. The GST exclusion is not portable.

In 2001, 120,000 federal estate tax returns were filed, of which 60,000 were for taxable estates. In 2010, 15,000 returns were filed. In 2012, less than 4,000 taxable estate tax returns were filed. Estimates are that less than 0.1% of Americans — fewer than 2 out of every 1,000 people who die — will be subject to the federal estate tax with the current exclusion structure in place. The Tax Policy Center suggests that fewer than 1,800 estates in the United States (1 in every 1,400 people who die) will pay any estate tax in 2023.

¶4205 The New Normal in Estate Planning — Simplicity and Client Resistance?

If clients no longer fear the imposition of costly transfer taxes and the complex planning needed to avoid such taxes, will clients be willing to embrace complex planning and the professional fees often associated with such complexity?

The client may want to opt for the simplest (and least expensive) of plans, which may make complete sense when viewed solely as a tax planning decision, but which may be a serious mistake when other planning considerations are raised. The challenge for the planner will be to convince the client that simple from the tax standpoint does not always translate to simple or even correct from a wide range of other perspectives.

It is certainly likely that many persons will take a "do it yourself" approach to planning. Will, trust, and many other document forms are readily available on the internet (see, for example, www.nlfforms.com) and in bookstores. Moreover, many people are aware of the changes in the law and the absence of federal tax liability. Many will therefore decide to save the cost of professional planning fees, believing that there are no penalties for failure because no tax will be owed, regardless of what they sign or do. Such a decision can be a huge mistake for some families.

Sadly, many clients may put off planning completely because tax avoidance will not be a factor to motivate them to act. The tragic circumstances of the COVID-19 pandemic no doubt caught many people, young and old, without even the most basic planning documents in place, highlighting the importance of planning for all people, not only the wealthiest in our society.

Planning Pointer.

Proactive Planning Toolkit

Recent legislation has added more complexity to financial planning. Technical content, tools, and other resources are available to PFP Section members in the Proactive Planning Toolkit to help you get up to speed on all of the intricacies so that you can educate your clients, and proactively help them meet their life goals and give them peace of mind while navigating the complex financial landscape.

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¶4210 A New Emphasis in Planning

.01 Refocused Planning

The major focus for estate planning for married couples having assets under $25.84 million in 2023 will turn to core dispositive planning, income tax planning (such as achieving basis step-up at death), and the preservation and management of assets. However, attention must be paid to potential tax law changes, and the pre-emptive planning that can be done to prepare for possible changes

.02 Core Dispositive Planning

Planning should begin with a review of the clients' current personal and financial situation and an examination of the current estate plan and all associated documents. The planning should consist of several considerations, including (*a)* the desired beneficiaries to whom assets should be given or bequeathed, (*b)* coordination of beneficiary designations, which is still required to achieve the desired result, and (*c*) a review of the client's existing estate planning documents from a new perspective.

As you review the client's existing documents, do formula clauses that made sense in a different tax environment still work? Take great care if the client's documents still include formulas referring to the "maximum amount that can pass without tax consequences" to children and balance to spouse. Will there be any balance? Be careful of formulas leaving the surviving spouse only enough assets to reduce the federal estate tax to zero. The applicable exclusion may get a person's estate to zero long before a marital gift is needed. Are the formulas still needed if the client lives in a *decoupled state* (a state that still has an independent death tax with exclusions well below the federal level of tax exclusions)? Is there still a need for a credit shelter trust that no longer may generate federal estate tax savings?

What gifts has the client made? If they were made to trusts, how are the trusts structured and how are they operating? Are the trustees currently in place or those named as likely successors the right choices? If there has been a pattern of gifting to family members that was motivated by transfer tax concerns that no longer apply, what are the expectations of those family members? A discussion may be needed.

Look at beneficiary designations of items that pass outside of a will (life insurance policies, retirement plans). If trusts designed to achieve transfer tax savings are designated beneficiaries, perhaps they are no longer desired or necessary. Have the changes made by the 2019 SECURE Act limiting the stretch out of required minimum distributions to 10 years for most beneficiaries been taken into account in planning?

A real concern for the planner in this situation is the motivation of the client. In the pre-2017 TCJA world, taxes were a primary motivating factor. "I will plan your estate and save you taxes" was an acceptable way to overcome the client's reluctance to address planning. Now, estate tax savings has been largely or completely removed from that picture, at least temporarily. The challenge for the planner is to get the client to focus on the non-tax aspects of planning which remain of primary importance. The other challenge is making the client aware of the coming sunset of the 2017 Act after 2025 which will, absent additional legislation, dramatically change the available transfer tax exemption amounts.

.03 Areas Where Estate Planning Is Still Required

1. Planning for the disposition of the client's assets at his or her death

2. Asset protection planning (protection from creditors and predators)

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3. Planning for disability and incompetency

4. Business succession planning (with or without concerns that the estate tax will force a succession plan to be implemented)

5. Planning for possible divorce and other family relationship dissolutions

6. Charitable giving (for its own sake, not for death tax savings, and because income tax considerations will still be relevant; techniques such as lifetime charitable remainder trusts would not be adversely affected)

7. Life insurance planning (other than to provide funds to pay death taxes)

8. Fiduciary litigation (may become a greater problem because there is more to fight over as an inheritance with taxes out of the picture)

9. Retirement planning

10. Planning to pay state death taxes (in those states that have decoupled from the federal system and have their own death tax)

11. Planning to avoid or minimize gift taxes (if the client desires to give away more than the indexed applicable exclusion amount for gift tax purposes)

12. Planning for children with disabilities and special needs

13. Planning for spendthrift children (incentive and disincentive trusts)

14. Planning for clients who own real estate in more than one state, including ownership, asset protection, state income taxation, spousal rights, and probate issues (in addition to possible state estate taxes)

15. Planning for clients who are U.S. citizens or resident aliens who own property in other countries

16. Planning for nonresident aliens with assets in the United States or who plan to move to the United States

17. Planning for the possible future decrease in the estate, gift, and GST tax exemptions or increase in the transfer tax rates

18. Planning to pay education expenses, including contributing to IRC Section 529 plans

19. Identifying guardians for minor children, as necessary

20. Considerations arising with respect to eldercare planning

    a. Making certain that appropriate durable powers of attorney and health care directives are in place. (This planning consideration is appropriate not only for elderly clients, but for all clients).

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i. Consider more specific directives with respect to gifting to protect against possible elder abuse.

ii. Warn the power holder about not giving away assets that have substantially appreciated so that those assets will receive a basis step-up at death.

iii. Consider some directions about accessing digital assets in the event of incapacity or death.

b. With the demographic shift in the population and the aging of the baby boom generation, eldercare planning will take on a much greater significance. Planners should expect questions about when Social Security benefits should commence or be deferred and managing appropriate Social Security benefit strategies.

c. Long-term care insurance will be an eldercare concern of many clients, as will timely application for Medicare benefits and possible Medicaid eligibility.

21. Planning for persons living in the United States whose spouse is not a U.S. citizen.

22. Planning for clients who invest in cryptocurrency.

¶4215 Portability Must Be Addressed by Every Married Person

.01 Why Portability?

The primary motive for enacting portability of the federal estate tax exemption was simplifying estate planning for married couples. However, what often appears as simple may have a number of serious decisions associated with it. An issue all clients will face at all levels of wealth is whether to make the portability election at the death of the first spouse. Filing a federal estate tax return (Form 706) voluntarily to make the election will be preferable in most cases.[2] Form 706 must be filed only when a decedent's estate exceeds the applicable exclusion ($12,920,000 in 2023).

The assets of the decedent must be valued in any event for income tax basis purposes. The portability regulations allow a relaxed reporting procedure (when a return is not required but is filed for the purpose of taking advantage of portability) for filing the federal estate tax return (Form 706) to list assets and their estimated approximate values rather than listing and supporting (with appraisals, for example) the values of each of the assets. Completing Form 706 will not be overly onerous and should not be especially expensive for the average client. If an estate tax return is not filed to make the portability election, the planner will want to consider obtaining a waiver letter signed by the executor (and perhaps the beneficiaries).

If a federal estate tax return is required to be prepared in a decoupled state in connection with the filing of the state estate tax return, the incremental cost of filing the federal return will be even less onerous. ATRA made portability permanent, and the 2017 Tax Cuts and Jobs Act did not disturb portability. The law allows portability of any unused applicable exclusion amount for a surviving spouse of a decedent who dies after 2010 if the decedent's executor makes an appropriate election by filing a timely federal

[2] IRC Section 2010 (c)(5).

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estate tax return that computes the unused exclusion amount. The unused exclusion amount is referred to as the *deceased spouse's unused exclusion* or the "DSUE amount." The surviving spouse can use the DSUE amount either for lifetime gifts by the spouse or for estate tax purposes at the surviving spouse's subsequent death. An individual can only use the DSUE amount from his or her last deceased spouse.[3]

Example 1: A and B are married. A dies, leaving all of A's property to B. Form 706 is filed at A's death. B gets the DSUE as A's surviving spouse. Now B marries C (who had been married to D). B can still use the DSUE from A for gifting or at death, as well as B's own applicable exclusion. B and C can also utilize C's applicable exclusion, and possibly D's applicable exclusion, if C had received any DSUE from D.

Example 2: Assume in the previous example that C dies while B is still living. Now, C is B's last deceased spouse. Any remaining unused DSUE that B obtained from A is now lost because A is no longer B's last deceased spouse. If Form 706 is filed for C's estate, B may now obtain DSUE from C if any is available. If C has no DSUE (perhaps C left the exclusion amount to children of a prior marriage), B has no DSUE available from A or C, and is limited to B's own applicable exclusion.[4]

There is a "use it or risk losing it" point to be made here. By law, gifts made by a surviving spouse will first use the DSUE amount from the last deceased spouse before using the surviving spouse's own basic exclusion amount.[5] If there is a subsequent marriage, the DSUE from the first deceased spouse remains available as long as the most recent spouse remains alive. If the second spouse dies during the marriage, the unused DSUE of the first spouse is lost.

Every estate of a deceased married person should consider making a portability election. Even if the family assets are significantly below the federal estate tax filing threshold, it is possible that a windfall through good fortune or inheritance could occur in the future to increase a survivor's estate. The survivor could remarry a significantly wealthier and generous person willing to make gifts to the survivor's family, making the DSUE of the deceased spouse a valuable asset. The survivor could sustain an injury leading to an unanticipated but significant financial recovery. Note that the GST exclusion is not portable. It must be used by every transferor — or lost. Future political uncertainty suggests taking advantage of portability while it is still available. The IRS has issued regulations stating that if the transfer tax exclusion is reduced in the future, outstanding unused DSUE will be respected and previously utilized DSUE will not be "clawed back."[6]

The IRS announced in Rev. Proc. 2014-18 that a late Form 706 could have been filed to make the portability election for persons who died after December 31, 2010, as long as the form was filed by December 31, 2014. This late filing opportunity was not extended in the final portability regulations (Treasury Decision 9725, June 12, 2015). Instead, taxpayers who failed to make the election and now

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[3] Reg. 20.2010-3(a)(3).

[4] Reg. 20.2010-3(a)(3).

[5] Reg. 25.2505-3(b).

[6] Reg. 20-2010-1.

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wished to do so had to request a private letter ruling and pay a user fee to be granted an extension of time to file the election.

Since the end of 2014, hundreds, if not more, letter ruling requests were filed (and granted) under Reg. 301.9100-3 to extend the time to make a portability election where the decedent's estate was not otherwise required to file Form 706. Because the interests of the IRS would not be prejudiced by a late Form 706 filing and late portability election in such cases, relief was typically granted. See, for example, LTR 202204004, 202204005) (Jan. 31, 2022), and many others at www.irs.gov.

The IRS then issued Rev. Proc. 2017-34, IRB 2017-26 which provides a simplified method for estates of decedents that are not otherwise required to file Form 706 under IRC Section 6018(a) to obtain a two year extension of time to file Form 706 and elect portability, assuming certain criteria are satisfied.

The taxpayer must be an executor of the estate of a decedent who was survived by a spouse who died after December 31, 2010, and a U.S. citizen or resident at the time of death. A complete and properly prepared Form 706 must then be filed on or before the second anniversary of the decedent's date of death. The words, "FILED PURSUANT TO REV. PROC. 2017-34 TO ELECT PORTABILITY UNDER 2010(c)(5)(A)" must be written at the top of Form 706. Assuming these requirements are met, relief will be granted to extend the time to elect portability.

Still flooded with private ruling requests asking for extensions of time to elect portability after the two years had elapsed, the IRS extended the period to file Form 706 and gain portability without requiring a private letter ruling to five years in Rev. Proc 2022-32. With the issuance of Rev. Proc. 2022-32, the return (Form 706) must now say at the top of page 1 "FILED PURSUANT TO REV. PROC. 2022-32 TO ELECT PORTABILITY UNDER § 2010(c)(5)(A)."

If a taxpayer does not meet the above requirements for relief, the estate can still request an extension of time to make a portability election by requesting a private letter ruling from the IRS and paying the required user fee, now $12,600. However, if the Form 706 was *required* to be filed based on the size of the decedent's estate exceeding the applicable exclusion at the time of death, the only extension that is allowed is the six-month automatic extension if the Form cannot be filed within the required nine-month period. No further extension for portability is allowed when the return is a required filing. Portability is discussed at length in chapter 37.

.02 Simple Wills Are More Likely to Be Favored Now — Is That the Right Call?

With the portability provisions having been made permanent, married clients may be more inclined to proceed with fairly simple "all to spouse" will planning (the "I Love You" will), relying on portability to take advantage of both spouses' estate exemptions, rather than using more complicated bypass trust planning. Is that the correct decision from the planner's perspective? The lure of simplicity through portability and reduced planning costs may in some cases make the planning process more complicated to communicate fully to clients the advantages and disadvantages of planning alternatives. The advantages of simplicity and a stepped-up income tax basis at the surviving spouse's death may be a hard combination of perceived advantages to overcome.

.03 Why Still Consider Using a Bypass Trust at the First Spouse's Death in a Portable World?

The DSUE amount once established is not indexed for inflation. Is there concern about long-term appreciation between the first and second deaths? The bypass trust protects the surviving spouse's estate from being taxed on appreciation between the first and second death. If there has been appreciation that

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still leaves the survivor short of the federal estate tax threshold, consider using a trust and giving an independent person, such as the trustee or a trust protector, the right to grant the surviving spouse a general power of appointment over the assets in the bypass trust to force their inclusion in the spouse's estate, thereby gaining a basis increase with no estate tax liability.

Growth in the assets in a bypass trust is excluded from the estate of the survivor. Growth is not excluded from the gross estate of the surviving spouse where assets are received outright, or if they pass to a marital deduction QTIP trust. Consider this in light of possibly reduced exclusion amounts in the future.

There is no portability of the GST exclusion. A bypass trust at the first death passing ultimately to skip persons can secure the benefits of the first decedent's GST exclusion.

There is an unlimited statute of limitations on values for purposes of determining the DSUE that begins to run from the time the first deceased spouse's estate tax return is filed. Recordkeeping must be maintained until the second spouse dies and that spouse's estate tax issues are resolved. The unlimited statute of limitations applies only to the proper calculation of the decedent's DSUE amount. The federal estate tax liability of the decedent's estate cannot be reopened once the standard three-year statute of limitations has run out. The statute of limitations does run on values if a bypass trust is funded at the first spouse's death.

The DSUE of the first spouse is lost if the surviving spouse remarries and the new spouse predeceases the surviving spouse. If the second deceased spouse leaves behind little or no unused exclusion, the surviving spouse has missed a potentially valuable opportunity. The surviving spouse can use the decedent's DSUE for lifetime gifting, and the ordering rules provide that the DSUE is used by the survivor before the survivor's own exclusion.

The state exemption amount is not portable (except, to date, in Hawaii and Maryland, which have made their state estate tax exclusions portable). In a decoupled state, the client may, as a minimum, want to fund a bypass trust with the amount of the state death tax exclusion.

A bypass trust could be funded with discounted hard to value assets when there may be a low audit risk at the first spouse's death where there is no federal tax liability.

The use of a bypass trust can avoid unequal treatment that might otherwise occur in a blended family situation (where at least one spouse has children by a prior marriage). The presence of a blended family situation may be one of the more compelling reasons to advise a client to consider planning that is somewhat more complex, but essentially more protective of family members. Many clients are in blended family situations. According to statistics,[7] more than 29 million parents (13%) are also stepparents to other children, and 40% of married couples with children in the United States are step-couples. In such cases, at least one partner has a child from a previous relationship; this includes full and part-time residential stepfamilies and those with children under or over the age of 18. The share of children living in a two-parent household is at the lowest point in more than half a century.

In a blended family situation, substantial inequities may result if the credit shelter approach is not used. Potential problems can arise if there is hostility between the executor (perhaps a child by the decedent's prior marriage) and the surviving spouse's family. The executor may try to extort consideration for

[7] www.pewsocialtrends.org/2015/12/17/1-the-american-family-today/

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making the portability election, or simply refuse to make it. The executor may be unwilling to bear the expense of filing an estate tax return to make the election. (Where this may be a concern, consider drafting the will to provide that the executor would not be required to make the portability election unless the surviving spouse pays the expenses of filing the estate tax return.)

If assets are left outright to the surviving spouse, the spouse may give or bequeath the assets to persons other than the first decedent-spouse's descendants (or may favor some over others of those descendants in ways that the decedent-spouse would not have wanted). If the survivor has children of his or her own, they become the more likely beneficiaries where the spouse is entirely free to act. If the survivor remarries, there is the risk that the new spouse will benefit from the decedent-spouse's property.

The first decedent may use a QTIP trust to control the ultimate disposition of the property. However, even if a QTIP trust is used, the surviving spouse may be able to take steps that would significantly disadvantage the decedent-spouse's descendants. For example, that spouse could request and receive principal distributions from the trust, or make large lifetime gifts using the DSUE amount of the first spouse to die, leaving no exclusion amount to apply against the marginal tax generated by the QTIP, or could gift the income interest, resulting in a deemed gift of the entire QTIP property per IRC Section 2519.

Consider using a premarital or postnuptial agreement in which the parties agree that the surviving spouse will make certain that the decedent's executor makes the portability election. Trusts provide a variety of important benefits, including asset protection, management, and restricting transfers of assets by the surviving spouse (although those benefits can also be utilized with portability by using a QTIP trust rather than a bypass trust). The client should consider carefully whether the surviving spouse is capable of managing assets. Is there fear of the spouse's remarriage or a concern about undue influence? Spendthrift provisions, providing that trust beneficiaries cannot sell, pledge, or encumber their beneficial interests in the trust, should be included as a protection against creditors. The possible future incapacity of a spouse or descendant can be addressed through a trust. If appropriate, special-needs provisions can be inserted to guard against the trust assets being used for payments that could otherwise come from public assistance.

.04 Some Planning Situations Favor the Use of Outright Transfers to the Spouse and Reliance on Portability

There are several instances in which the use of outright transfers to the spouse may be favored, including the following:

- The client insists on a strong desire for simplicity and wants nothing to do with any trusts.
- The spouse is an entirely competent individual who can manage assets capably.
- The spouses are in a first and only marriage, or it is not a first marriage but there are no children existing by a prior marriage of either spouse.
- The clients indicate much more interest in securing a basis step-up than getting future appreciation out of their estates, especially if they believe that any such appreciation will still leave them well short of the applicable exclusion amount.
- The clients own a residence or other assets that would be difficult to administer in a trust.

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- The additional administrative and income tax costs of having assets in trust, such as the additional income tax and net investment income tax that may apply to undistributed trust income, outweigh the potential tax and non-tax advantages of trusts. In 2023, trusts with income in excess of $14,450 have that income taxed at the highest tax rates — a threshold substantially below the threshold that individuals, whether single or married, must address.

¶4220 Income Tax Planning — The New Essential Planning Focus

.01 Income Tax Planning Will Replace Transfer Tax Planning as a Primary Focus

Income tax issues will overtake transfer taxes as the primary area of planning concern for persons of moderate wealth in an effort to minimize current income taxes and maximize the basis step-up available on death. For those clients domiciled in non-estate tax states, which are states that are not decoupled from the federal estate tax, income tax considerations may totally replace estate taxes as the tax planning focus of estate planning.

A key issue for these clients will be preserving a step-up in basis at the death of each spouse. For many clients, a potentially higher capital gains tax in the future, resulting from loss of a second basis step-up for assets that might be held inside a bypass trust, may be an unacceptable choice. The potential 20% federal capital gains tax, supplemented perhaps by a 3.8% net investment income tax, and possibly state income taxes, could result in some clients facing a capital gains rate approaching or exceeding 30%.

A simple will or revocable trust leaving all of the assets outright to the surviving spouse will achieve a basis adjustment at the deaths of both spouses.

If a trust is desired for blended family protection or for management or asset protection purposes, using a QTIP trust or giving the surviving spouse a testamentary general power of appointment will allow a fair market value basis adjustment to take place at the surviving spouse's death.

Lifetime gifting of appreciating assets may no longer be recommended as a planning technique. For persons of moderate wealth, it will be more advantageous to retain appreciating assets and leave them to heirs, thereby passing on the highest tax basis at death.[8] Had the assets been given away during one's lifetime, the basis to the donees would be the carryover basis of the donor,[9] most likely leading to more capital gain and net investment income tax liability for the donees.

[8] IRC Section 1014.

[9] IRC Section 1015.

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Planning Pointer.

Consider the planning suggestion of *upstream planning*. This involves transferring low basis assets to an elderly family member (E) with the expectation that E will die, have the assets included in E's estate (be sure E will not have a taxable estate), and the assets will return to the donor with a basis equal to the fair market value of the assets at the date of the E's death. If E lives more than one year from the date of the transfer, the donor will receive the returned property with the fair market value basis as of E's date of death. If E fails to live one year, the property returns to the donor with no basis adjustment from the donor's basis.[10] To guard against E's death within one year, consider having E leave the property to the donor if E survives more than one year from the transfer, and to the donor's children (or others) if E does not live beyond one year. Only the donor is affected by the *return of basis rule*; E's passing the property to others, even if there is a death within one year, will give the recipient a basis equal to the fair market value of the property at E's date of death.

.02 New Planning Considerations Will Focus on Income Tax Issues

A very significant part of the value of the moderate wealth client's estate presently consists of appreciated assets. Because these assets will not be subjected to income or transfer tax (under current law), the avoidance of both capital gain taxes and net investment income taxes and passing assets with a stepped-up basis becomes a primary concern. Traditional estate planning techniques used to reduce the value of assets on death, such as family limited partnerships and LLCs formed to create valuation discounts for estate tax savings, may be counterproductive to planning in the current planning environment.

In a sense, estate planning is upside down from what has been traditionally favored. For persons of moderate wealth below the federal estate tax exclusion, the goal of planning is to now include everything possible in an estate at maximum value. This is quite a change from the traditional notion of exclude as much as possible, and minimize the value of whatever must be included.

This change in thinking must be embraced not only by the client, but also by the planner who must guide the client. It is an essential consideration in much of what must be done to plan estates effectively in the post-TCJA world. Practitioners have fought for many years to maximize valuation discounts for lifetime gift transfers and for the value of interests in any assets included in a client's estate. A key component of the documentation of many gift plans, and estate tax returns, has been the formal appraisal of the discount applicable to the non-controlling interest in an asset or entity involved. The IRS has resisted these discounts and often challenged them as excessive. With the majority of clients no longer facing a federal estate tax, claiming valuation discounts will provide no estate tax benefit whatsoever, but will reduce the value of the basis step-up and thereby increase the future capital gains costs the client's heirs will face.

Accordingly, creating asset transfers that generate significant discounts may no longer be desirable. Claiming discounts on transfers at death for minority interest or lack of marketability will only serve to reduce the value of property inherited by heirs from a decedent, and the basis of that property to the

[10] IRC Section 1014(e).

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heirs. Where there will not be any federal estate tax at the decedent's death, such discount claims are counterproductive.

It is possible that the practitioner and the IRS will reverse roles in these situations, with the practitioner arguing for lower (or no) discounts. This issue actually may favor the taxpayer because if an estate is well below the taxable threshold for federal estate tax, it may not be reviewed carefully (if at all) by the IRS. When that is the case, the IRS will not be in a position to challenge the taxpayer's value as too high and argue that a discount should be claimed.

Consider whether there are provisions in the governing documents of an entity (such as a partnership agreement for a partnership, shareholders' agreement for a corporation or operating agreement for an LLC) that were crafted to allow or encourage discounting (such as minority interests, preferred issues, or below fair market value puts and calls). Where these are present, consider amending the governing document to minimize or eliminate the discounting opportunity.

This planning fix may not be as simple as it appears because such a suggested revision may not be agreeable to other members of the entity involved if their estates are large enough to face a federal estate tax. It is possible that some, but not all of the members of the entity reside in a decoupled state where the discounting opportunity would be favorable. In making any changes to the governing document, consideration should also be given to not reducing asset protection benefits or taking away important non-tax considerations, such as a right of first refusal to keep a family asset in the family.

The current planning environment for persons of moderate wealth will give rise to a new approach to appraisals of property owned by a decedent. Nothing will change for persons whose estates are over the federal estate tax exemption — they will continue to seek appraisals to minimize values that will have the effect of minimizing federal estate tax (and state estate tax, if applicable). For those persons whose estates are under the federal estate tax exemption and who are domiciled in a state that does not have a state estate or other death tax, maximizing the valuations of all estate assets so long as the person's estate remains under the federal exemption will provide the decedent's heirs with the most favorable income tax basis or capital gains result at no estate tax cost. For those persons whose estates fall under the federal estate tax exemption and under their decoupled state's estate tax exemption, it makes sense to maximize the valuations of all estate assets so long as the person's estate remains under the state estate tax exemption. This will provide the decedent's heirs with the most favorable tax basis or capital gains result at no estate tax cost.

The most difficult issues will arise for those persons whose estates fall under the federal estate tax exemption but over their state estate tax exemption. What will be the marginal tax impact of the state estate tax compared to the possible capital gains tax savings that high values (and high-income tax basis) will result to the decedent's heirs? The heirs may be in the 20% or 23.8% capital gains tax bracket (including the net investment income tax). The highest estate tax bracket for most states with a decoupled estate tax is presently 16% — except Washington and Hawaii, which have a top bracket of 20%. It may be intuitive to do everything possible (lifetime transfers or discounting) to reduce the impact of the immediate estate tax; however, the counterintuitive planning of maximizing values at death — especially looking at the likely state estate tax bracket compared to the federal and state income tax impact — may be the better long-term plan.

This latter consideration involves the planner in further issues, such as the likely disposition by the heirs of the assets owned by the decedent. Will they be immediately sold by the heirs, suggesting the capital gain saving is a primary consideration? Instead, will they likely be held long-term by the heirs, possibly for the duration of their own lifetimes, suggesting that saving transfer tax at the first death should be the

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primary consideration? Considerations of marginal tax rates, anticipated holding periods, whether tax-free conversion options exist (such as an IRC Section 1031 tax-deferred like-kind exchange of real estate assets) will all have to be factored into the planning process.

Deciding to disregard discounts on transferred property will be a more difficult issue in decoupled states, where the value of property at death will have a transfer tax impact. Focus on transferring possibly discountable property such as minority interests in S corporations, LLCs, and family partnerships to family members in lower income tax brackets so that the ongoing income can be earned there. Where the kiddie tax is not a factor, this planning can have an immediate benefit, and where the kiddie tax is applicable, the law now forces the child's income tax liability to be taxed at the marginal rates applicable to the parents of the child. Persons outside of the kiddie tax range may be in the 0%–15% tax bracket for qualified dividends and capital gains on the sale of property.

However, this suggestion may introduce complication and possible objection into the discussion. Is the transferred property income producing so that it makes sense to transfer the income-producing potential to persons in lower income tax brackets? Conversely, is the property not especially income producing but of low basis to the donor, so that the donor's transfer of the property will deliver a low carryover basis to the donee with little income potential but a possibility of a substantial future capital gain? The latter is not the ideal plan in the current planning environment.

Another planning tool to consider in the quest for higher income tax basis adjustments is the IRC Section 754 election. This election is available for partnerships and LLCs taxed as partnerships. When a partner or LLC member dies, his or her heirs receive the partnership or LLC interest of the decedent with a basis equal to the date-of-death value of such interest, according to IRC Section 1014. That is the *outside* basis of the partnership interest. The basis of the partnership or LLC in its own assets (the *inside* basis) is not affected by the death of the partner or member. Accordingly, sales of low basis partnership or LLC assets will be taxable to the new heir partner — even though that person may have a high outside basis.

That is where the IRC Section 754 election comes in. If the entity makes an election to have Section 754 apply, the inside basis of the decedent partner or member's share of the entity's assets is also adjusted to equal the outside basis. This allows the heirs to apply the higher basis to the realization of the entity's income, and very possibly avoid income taxation. The partnership or operating agreement may provide for the 754 election to be made. If it is silent and planning suggests making it would be helpful to the heirs of any partner or member who dies, amend the appropriate agreement as soon as possible. This may be preferable to awaiting a death, then possibly having to negotiate making the election. Taking action before anyone dies may be the best strategy.

.03 Special Planning Concerns Where Trusts Are Used

Even where trusts are favored for all of the reasons discussed (management, asset protection, and blended family concerns), retaining income within a trust is not a favorable planning decision. Due to the highly compressed income tax rates for trusts (trust income in excess of only $14,450 in 2023 is taxed at the highest marginal rate of 37%, the 20% marginal rate on long-term capital gains and qualified dividends is reached at $14,650, and $14,450 is the 2023 threshold for application of the net investment income tax). This suggests that distributing trust income currently can be tax advantageous.

Compare the compressed rate threshold for trust distributions to the thresholds for individual taxpayers — single persons reach the net investment income tax threshold at $200,000 of AGI and the 37% rate threshold at $578,125 of taxable income in 2023, and married persons filing jointly reach the

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net investment income tax threshold at $250,000 of AGI and the 37% rate threshold at $693,750 of taxable income in 2023. The 20% rate threshold for long-term capital gains and qualified dividends is reached in 2023 at taxable income of $492,300 for single filers and $553,850 for married persons filing jointly.

Although distributing trust income is a favored planning alternative, it may not always be an available option. What does the governing instrument require with respect to distributions? What about state law? What does the governing instrument or state law say about the distribution of capital gains to any current income beneficiary? As a general rule, capital gains are defined as and allocated to trust accounting principal and not readily distributable to income beneficiaries.

In preparing new trusts, it is suggested that the trustee be at least given discretion to distribute capital gains to the income beneficiaries. For existing trusts, look carefully at state laws. Is there a "power to adjust" provision allowing a trustee to distribute capital gains if not strictly prohibited by the governing instrument? Is there authority granted to a trust protector or other fiduciary to modify the document to allow such distributions? If not, consider decanting the trust to a new trust with broader provisions that would permit inclusion of capital gains in trust income. With all of that said, however, planning should not lose sight of why a trust was created in the first place. Appropriate consideration must be given to any relevant non-tax factors that weigh against making a distribution, prior to distributing trust income solely to save income taxes.

.04 Consider a Sprinkling Trust to Maximize Income-Shifting Opportunities

A marital deduction qualified trust (QTIP or general power of appointment) must, of course, limit income distributions exclusively to the surviving spouse. Where a trust is created that is not a marital deduction trust (a bypass trust or any other trust desired by the grantor), consider including a broad list of current or permitted beneficiaries — possibly all of the descendants of the creator of the trust. This may provide trustees who are given the appropriate discretion to make distributions a larger pool of potential distributees in lower income tax brackets.

There may be opportunities here with separate non-grantor trust interests for different beneficiaries to create opportunities for multiple state and local tax deductions and trusts with income below the trust threshold of $182,100 in 2023 to take advantage of the IRC Section 199A qualified business income deduction.

Where appropriate, think of each permitted beneficiary as a bucket to be filled from the trust without exceeding the thresholds of the lower tax brackets of these beneficiaries, with the goal of minimizing the overall impact on the family's income taxes. Tax planning is not the only issue here. Are current distributions by the trustees to selected beneficiaries appropriate? Will the beneficiaries be honest in reporting their other income situation to the trustees? How will the beneficiaries behave if some receive more generous distributions from the trust than others? View the income distribution opportunity as just that — an opportunity, not an absolute requirement created by otherwise adverse tax laws.

.05 Take Advantage of the 65-Day Rule for Complex Trusts and Estates

An election is available under IRC Section 663(b) to have an amount paid or credited to a beneficiary within the first 65 days of a tax year to be treated as if paid or credited during the estate or trust's prior tax year. This election gives the fiduciary the opportunity to use information as to the income status of all beneficiaries for the prior year in planning a distribution to minimize overall family tax burdens.

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This election can be used in a number of helpful planning situations, such as shifting income to a lower bracket taxpayer, shifting income to avoid an underpayment of estimated taxes by the trust, or moving income to a beneficiary to take advantage of a beneficiary's net operating loss or excess capital loss.

Most, if not all, of the income of a trust will be net investment income subject to the 3.8% tax when the 2023 threshold of $14,450 is passed. Therefore, the trustee may consider taking advantage of the election to make income distributions in order to reduce the trust's exposure to the net investment income tax.

The 65-day election is made by checking the required box on page 3, "Other Information," line 6 of Form 1041 for the trust (or estate, if applicable).

.06 Take Advantage of a Section 529 College Savings Plan

The advance funding of five years of IRC Section 529 plan contributions — that is, the permissible making of five years of annual exclusion gifts to a Section 529 plan in the current calendar year with no detriment for gift tax purposes — has long been used as part of a gift strategy to shift assets out of the donor's taxable estate. If the donor dies within the five-year period, there is a recapture and inclusion in the donor's estate of all or a portion of the gifts made for transfer tax purposes, representing the "unused" years of the gift tax present interest exclusion. Otherwise, the Section 529 plan holder is not subject to estate tax inclusion. For those persons who will not face a federal estate tax, the potential recapture is of no consequence. However, with the gifted assets earning tax-deferred or excluded income within the Section 529 plan, there are many years of potential income tax savings available here. This makes the Section 529 contribution all the more appealing in the current planning environment.

The 2017 TCJA allows funds in an IRC Section 529 plan to be also used for K-12 expenses for public and private school students (up to $10,000 per student per year). The TCJA also permits funds in an IRC Section 529 plan to be transferred to an ABLE Act plan if the beneficiary is disabled. See chapter 44 for discussion of the ABLE Act.

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The SECURE Act expanded the definition of qualified higher education expenses to include student loan payments and apprenticeship programs, leaving more options for families to use these Section 529 plan savings tax-free. These new 529 rules are retroactive for distributions made after December 31, 2018. With the SECURE Act, Section 529 plan holders can now withdraw any remaining savings to put toward their own student loan debt, or that of their children, grandchildren, or spouses. The law includes an aggregate lifetime limit of $10,000 in qualified student loan repayments per Section 529 plan beneficiary and $10,000 for each of the beneficiary's siblings. Siblings may include a brother, sister, stepbrother, or stepsister. This means a family with two children can withdraw from the Section 529 plan a maximum of $20,000 to pay down student loans. Education planning requires CPAs to be knowledgeable about tax planning, financial aid planning, and cash flow planning, and more importantly, to be aware of how each of these planning areas interact with one another so families can receive holistic guidance. Secure Act 2.0 permits beneficiaries of Section 529 college savings accounts to make direct trustee-to -trustee rollovers from a Section 529 account to a Roth IRA for the same beneficiary without tax or penalty. The Section 529 account must have been in existence for more than 15 years at the time of the rollover, and aggregate rollovers cannot exceed $35,000. Rollovers are also subject to the Roth IRA annual contribution limits. The change is effective for distributions made after December 31, 2023.

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Planning Pointer (continued)

The Secure Act 2.0 increases the age limit before which an individual's disability or blindness must have occurred from 26 to 46 in order for the individual to be eligible to establish and become the designated beneficiary of an achieving a better life experience (ABLE) account. The change is effective for tax years beginning after December 31, 2025.

Access more in-depth content in The Adviser's Guide to Education Planning.

¶4225 What Should Be Done with Life Insurance?

.01 Why Was Life Insurance Acquired?

Persons of moderate wealth will no longer need life insurance to fund the federal estate tax. If that was the only reason life insurance was acquired, and if the client sees no other benefit in retaining it, the client may opt to cancel the policy.

If life insurance was acquired for more traditional planning reasons, such as payment of death-related expenses or financial security for heirs or education funding, and its central focus was not just to be a source of death tax payment, then it remains a viable asset for the purposes acquired. Of course, if the traditional reasons have changed, the planner should explore the continued viability of life insurance with the client.

.02 The Role of Life Insurance in Any Estate Plan

Life insurance is an asset possessed by virtually all clients to some extent. Assume that there is no need to retain life insurance to pay federal estate tax liabilities. What should be discussed with the client as to the ongoing role of life insurance in an estate plan?

The core reasons that most persons acquire life insurance never included using it as a source of tax payment. Tax payment was always a secondary objective, and one more appropriate for high net worth families, not families of moderate wealth. The current planning world has not changed the reasons most people acquire life insurance, which include the following:

- To create an estate for the financial support and security of a family in the event of premature death
- To provide financial support for a surviving spouse and educational funding for young children
- To provide a readily available source of liquidity to pay debts, address funeral and administration expenses, fund bequests, and, where necessary, fund buyout agreements and other possible contractual obligations

There may be a need to preserve permanent life insurance to pay for state estate tax liabilities for those clients domiciled in decoupled states. This may not be a strong motivating factor for clients who may argue that a surviving spouse may move to a non-decoupled state, or that the state of current domicile may eliminate its estate tax. Some clients may decide that life insurance is the easy way to pay for state estate tax liabilities without doing other more complex planning and maintain a policy for this purpose. Others will embrace the concept of comprehensive planning to avoid state estate taxes and decide that life insurance protection for this purpose is not necessary.

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Despite the client's best efforts to engage in comprehensive planning, it is possible that not all assets owned by a decedent will achieve the optimal basis step-up. In such a situation, life insurance policies benefiting the client's children may be used to help pay for the income tax cost the children will bear when the low basis assets are acquired by them and subsequently sold. Perhaps ordinary income assets representing income in respect of a decedent will be inherited. It may be advantageous for non-tax reasons to gift some low basis assets during lifetime and accept the carryover basis result. The life insurance payable to the heirs at death can provide a source of income tax payment if these assets are liquidated. Planning may have favored a bypass credit shelter trust for a surviving spouse that resulted in a basis step-up at the first death, but not at the second death when the children inherit property still bearing the first decedent's date-of-death basis. The sale of the trust assets by the children may result in capital gains to them.

Life insurance can be used to provide direct bequests to children from a prior marriage. This may satisfy the client's desire to provide for children without having to address the blended family concerns of trusts or dividing assets between the current spouse and the children of an earlier marriage. Insurance left to the children so that the balance of the insured's estate can be left outright to the surviving spouse may be advisable both to maintain simplicity and achieve a full basis step-up for the assets passing to the spouse.

Consider recommending the acquisition of additional life insurance as an excellent income tax shelter. Permanent life insurance has significant income tax advantages as the result of the possibly higher income tax rates and the 3.8% tax on net investment income. The build-up of cash value within a permanent life insurance policy is not considered net investment income and is not taxable to the policy owner. For the client in a high-income tax bracket unconcerned about federal estate taxes, the favorable income tax treatment of life insurance (the tax-free build-up of cash values and the ability to access that cash value in a tax-advantaged manner through policy loans) may become an attractive planning option.

Access to cash values within a life insurance policy is possible even if the policy is held in an irrevocable trust, assuming the trust is properly drafted. Language can be included in an irrevocable trust authorizing an independent trustee to borrow the cash value and distribute it to the trust beneficiaries. Such distribution will be income tax free to the recipients. If one spouse is the insured who creates the trust and the other spouse is the primary trust beneficiary, the borrowing and distribution by the trustee can be for the benefit of the beneficiary spouse — with the insured spouse having no adverse tax effect from the availability of funds to the marital relationship. So long as the withdrawals do not exceed the income tax basis in the policy based on the premiums paid by the insured, withdrawals to the extent of the income tax basis are not subject to income tax. If additional cash is needed beyond the income tax basis, such cash should be withdrawn as policy loans to avoid income tax implications. For these income tax rules to apply, the policy must not be characterized as a modified endowment contract and should not be surrendered. Should the insured die with the policy in force, any cash value above the income tax basis not previously withdrawn is also not subject to income tax, even if the policy is then characterized as a modified endowment contract.

With the concern about the federal estate tax alleviated for the moderate wealth taxpayer, there is less reason to feel compelled to transfer a life insurance policy to an irrevocable trust. Retaining ownership of the policy allows the policy owner to access policy features such as long-term care riders or other benefits, and to withdraw cash values as needed without having to look to trustees or strain the language of a trust to secure a withdrawal from the policy.

As many life insurance sales persons are quick to point out, compare the return generated by a permanent life insurance policy with other investment returns realized by a client through his or her

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portfolio. The insurance policy return has exceeded interest rate returns on bank and money market funds, is often favorably compared with average dividend yields, and, depending on investment performance, may be favorably compared with the client's portfolio growth. Certainly, acquiring or retaining some life insurance as part of a person's investment profile is both a good hedge against the volatility of other investments and now, more than ever, a tax-favored investment in the post-TCJA world.

.03 Use Life Insurance More Aggressively in Planning

Consider the situation of a moderately wealthy client who created and owns a successful business. Planning prior to the 2017 TCJA may have suggested giving away pieces of the business during lifetime to avoid federal estate tax on appreciation and to secure minority interest and other discounts as the gifts are made. Now, consider leaving the business in the hands of the owner to assure a stepped-up basis on death, especially if it is likely to be retained by the surviving family members. To protect against any possible state estate tax, have the client acquire a life insurance policy that could be used, if necessary, to cover the state estate tax liability, allowing the business interest to pass untaxed to the intended beneficiaries.

Similar considerations favoring life insurance ownership would apply if the asset owned by the senior family member was appreciated real estate, rather than a business interest. Where family business succession planning is a potentially difficult issue if one family member is an appropriate successor to the business interest and other family members are loved equally but not seen as appropriate business successors, using life insurance to equalize benefits among heirs becomes an even more attractive option when the life insurance proceeds left to heirs will avoid estate tax. The business interest can be held until death, thus assuring a date-of-death basis to the heir and be specifically bequeathed to the intended beneficiary. If other children are residuary beneficiaries of the estate and named beneficiaries of life insurance policies, there is a greater likelihood that equalization among beneficiaries can be achieved absent concerns about whose share of the estate will be reduced through tax payments.

.04 What Should Be Done With Life Insurance Trusts?

If the client's estate is approaching the level where state or federal estate tax liability is becoming a possibility, an irrevocable trust to hold life insurance policies and remove them from the taxable estate remains a viable and recommended planning option. If the traditional non-tax reasons for using a trust are present, an irrevocable trust to hold life insurance policies remains an excellent planning tool. Life insurance is typically an easy asset to persuade clients to gift because they do not see themselves enjoying the benefits of the proceeds of the policy, and absent a cash need, generally do not plan to withdraw the cash value. There is no carryover basis or basis step-up issue for a life insurance policy, so there is no detriment in giving it away during the client's lifetime.

In smaller estates, consider whether there is appropriate justification for a life insurance trust. There are legal, administrative, and tax preparation costs associated with a trust that may not be necessary. Absent the need for the protective benefits of a trust, consider just giving the life insurance policies to heirs while the insured is alive. The insured can keep making premium payments as an annual gift, but the policy will be removed from the insured's estate along with any issues of probate, potential claims of the creditors of the decedent's estate, and the costs and administrative burdens of dealing with the policy after the insured's death.

The clients may have purchased survivorship life insurance and placed the policy into a trust. The purpose of the insurance was specifically to have a fund to pay federal estate taxes at the second death of

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a married couple. In light of the increased applicable exclusion and portability, the insurance may no longer be needed for that purpose. What should be done with the policy and the trust that holds it?

One answer would be to cancel the policy and have the trustee receive the cash value and administer it in accordance with the terms of the trust. That is an easy solution to suggest — but attention must be paid to the terms of the trust and the responsibilities of the trustee.

Other options might be to consider a tax-free exchange of the policy under IRC 1035 for a qualified annuity or another insurance policy that could offer more attractive terms (such as faster cash value build-up that can be withdrawn) than the second-to-die policy offers. Alternatively, keep the existing policy but stop paying additional premiums and make the policy a paid-up policy based on the premiums paid to date.

Consider the status of the life insurance policy in the context of the annual administrative ritual of the trustee's receiving the premium notice, receiving a check from the insured, and addressing the annual Crummey notice issues. Assuming the client followed the correct Crummey notice procedures, is it necessary to continue to do so? In the worst case, an insurance trust will omit all references to rights of withdrawal and Crummey powers. Here, the premium payments by the insured will be viewed as future interest gifts, and a gift tax return will be required to be filed. Given the current applicable exclusion and portability, the typical client will never have to pay gift tax or other federal transfer tax, so dispensing with the "Crummey dance" may be administratively favored with no adverse tax consequence.

If there is a desire to respect the Crummey withdrawal opportunity and avoid the gift tax return filing, consider a written waiver of all future withdrawal rights. Alternatively, it has been suggested that the client sign a one-time waiver stating that all Crummey rights in the future need be only given verbally. If this is done, be sure the trust document permits notices to be given verbally. Although these alternatives may not have the blessing of established law or IRS guidance, it can be argued that these suggestions are reasonable compliance with the Crummey procedures — and perhaps most importantly, if there will not be any transfer tax issues, no one will ever have to address any of these issues. Another suggestion could be to fund the trust with enough cash or securities to pay the annual premiums for a number of years and ignore the present interest gift tax concerns that the Crummey power is intended to address. If transfer tax will not be an issue for the client, the excess gift to fund the trust will not prove to be a problem.

Include provisions in a life insurance trust to have it classified as a grantor trust. If the trust will own assets other than cash and life insurance, being deemed a grantor trust will allow the tax-free substitution of properties. Even if the trust will hold only life insurance, grantor trust status is still desirable as the trust will not be subject to the transfer for value rule if there is any transfer of the life insurance policies between the grantor and the trust, even if the transfer is made for consideration. See Rev. Rul. 2011-28. A substitution power may allow the grantor to remove the policy from the trust in exchange for its then fair market value in cash and re-designate beneficiaries in a new trust to remove the benefit of the future policy proceeds from a beneficiary who may have fallen out of favor.

¶4230 What Should Be Done with Retirement Plan Benefits?

The surviving spouse has always been the favored beneficiary of a decedent's retirement plans. A roll over of the decedent's qualified plan or IRA to a surviving spouse enjoys the marital deduction to avoid the estate tax and special rules to defer the income tax on the roll over. Where possible, spouses have typically favored a distribution of a retirement plan to the surviving spouse to take advantage of these tax benefits.

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A problem has sometimes arisen in the larger taxable estates where the decedent's retirement plan is one of the major assets of the decedent's estate. In these situations, the only way to fund a bypass trust reasonably is to use the decedent's plan. When this is done, the applicable exclusion protects the plan from estate tax, but the inability to accomplish a spousal rollover results in immediate commencement of income taxation of the plan benefits based on the minimum distribution requirements if the spouse is not the sole trust beneficiary.

A spouse remains an eligible designated beneficiary under the SECURE Act, still able to use his or her life expectancy for required minimum distributions. Adult children and any grandchildren are now subject to the SECURE Act requirement that all plan benefits must be withdrawn by the end of the 10th year following the year of death of the plan participant. This is a major change from prior law. Many clients have beneficiary designations that may no longer be appropriate. Financial advisers should discuss with clients how this law will affect their planning.

Where the decedent's estate will not be subject to taxation, and portability will allow the bypass trust to be avoided, the recommended planning strategy would be to leave the retirement and IRA benefits directly to the surviving spouse to gain the advantages of income and estate tax deferral at the first death, and then to rely on portability to be able to utilize the deceased spouse's unused estate tax exclusion amount at the surviving spouse's subsequent death.

The IRS has eased the concerns about making certain that the rollover to the spouse occurred within 60 days of receiving the distributed funds with the issuance of Rev. Proc. 2016-47 (August 24, 2016). If the 60-day rollover is not completed in a timely fashion, it may no longer be necessary to apply for a private letter ruling and pay a user fee to "fix" the problem. A person may self-certify that the 60-day period may be waived, and the IRS has issued a form letter to use in the process.

Three conditions must be satisfied for self-certification, namely, (1) there can be no prior denial by the IRS for a waiver, (2) the reason for the late rollover must be one of 11 reasons listed in the form letter, and (3) the funds must be redeposited in an IRA account as soon as practicable after receipt — 30 days is indicated as a "safe harbor" here. The 11 reasons to allow self-certification include: financial institution error; misplaced check that was never cashed; deposit of the check mistakenly in an account believed to be an IRA account; damage to principal residence; death in the family; serious family illness; incarceration; restrictions imposed by a foreign country; postal error; distribution was made due to an IRS levy, now recovered; the distributing company did not provide information to the receiving company.

The IRS can audit a return and decide the self-certification is not appropriate, leading to the reminder that the safest way to accomplish a rollover is through a direct trustee-to-trustee transfer.

As in any recommendation of an outright transfer to a spouse, the issues addressed earlier regarding management, creditors, or blended families should also be considered in the context of a retirement plan distribution. Where the protection of a trust is desired, the retirement plan assets could be left to a QTIP trust, but such a designation involves a fair amount of administrative and drafting complexity[11] and will

[11] Rev. Rul. 2006-26.

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most likely result in a faster required withdrawal of plan assets that will accelerate the income tax liability.

Distributions from a retirement plan are income in respect of a decedent, so there is no basis step-up when the decedent dies. The distributions are not considered net investment income, so they are not subjected to the 3.8% net investment income tax. However, the withdrawal of funds from a traditional IRA or qualified retirement plan account is taken into account in determining if the AGI and taxable income thresholds have been reached. Consider converting a qualified plan or traditional IRA to a Roth IRA to both avoid having withdrawals be included in AGI (beyond the year of the actual conversion) and to avoid required minimum distributions if not needed.

¶4235 Changes in the Way Title to Property Should Be Designated

Before the enactment of portability, and the increases in the amount of lifetime transfer tax exclusions, planning for a married couple (especially in a common law state that does not enjoy the automatic split of marital property, which is the law in community property states) always involved an uncomfortable discussion about how assets should be titled — ideally an amount of assets in the name of each spouse up to the amount of the applicable exclusion. This was recommended so that the estate of the first spouse to die could take full advantage of the funding of a bypass trust. If this was not done, and the spouse with less property died first, there would be a shortfall in the available exclusions over two deaths because an insufficient amount of property was owned by the poorer spouse who had the bad fortune of being the first to die.

As the transfer tax exclusions grew in size, it became increasingly difficult (as well as burdensome and expensive) for many couples to retitle assets, such as real estate holdings or businesses. The spouse with the larger share of assets often was reluctant to retitle his or her holdings to the name of the less propertied spouse. Assets in joint names were recommended to be retitled as tenancies in common — a recommendation not always embraced by skeptical spouses. Even if there was willingness to make transfers, some assets could not be retitled, such as a business involving professional licenses or a family business with prohibitions on transferring interests outside the lineal family members.

Portability has made a great change here. Regardless of the title of assets at the first death, portability will grant the surviving spouse the DSUE from the first spouse to die, even if all of the family assets were titled in the name of the surviving spouse. There is no longer a federal estate tax-driven need to retitle assets to divide them between the spouses. That said, retitling at least to some extent may be useful and helpful to meet the state estate tax exclusion in a decoupled state to be sure the state exclusion is used at the death of each spouse, or to make it easier to fund a credit shelter trust, if desired.

Title to property can now be used to address other important goals free of the tax-driven need to fund the bypass trust. Is one spouse an asset protection risk? Is a spouse involved in an activity where there is a possibility of malpractice or other liability claims? Where this may be the case, titling assets in the name of the lower risk spouse does not pose a tax problem where portability will preserve the DSUE of the first decedent, regardless of who is the property owner.

Controversy often arose about retitling assets that one spouse was gifted or inherited from his or her own family or brought to the marriage having earned or acquired them prior to the marriage. Where these assets were arguably safe from matrimonial claims of equitable distribution before retitling, changing the title suggested a gift and a withdrawal of the protection from separate property or equitable distribution claims. Portability makes these transfers unnecessary to gain a tax advantage. The advantage exists without the need for retitling.

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Title to a person's home raises several issues that may be more easily addressed in the current planning environment. Property held jointly between spouses as tenants by the entirety generally is given preferential asset protection treatment under most state laws. The creditors of one spouse cannot reach the property while the other spouse is alive. The choice of retitling this property to gain the benefit of the bypass trust versus losing the asset protection benefit was often difficult. The current combination of the increased applicable exclusion and portability allows the client to avoid making any change in the form of ownership here. What if the clients took the advice of the planner several years ago and removed a home from tenancy by the entirety status and conveyed it to separate tenancy in common ownership? It is suggested that the clients reconvey the tenancy in common property to joint names and reestablish the tenancy by the entirety asset protection if permitted by state law. Transfers between spouses bear no gift tax liability here.

Where a state offers special property tax and other benefits if a homestead exemption can be claimed, not disturbing the title to property qualifying for such an exemption is generally a good idea.

Some states (notably New York and California) have become especially aggressive in trying to extend the reach of their income taxes to persons who work in and maintain an abode in those states, even if the persons are clearly domiciled elsewhere. Not having to be concerned about preserving a piece of title to property to qualify for federal tax benefits will allow persons to concentrate on issues such as domicile designations to make certain that they do not run afoul of aggressive state income tax rules.

Title considerations in jurisdictions outside of a person's true domicile may also trigger ancillary probate concerns. To avoid the cost and inconvenience of ancillary probate, consider owning such properties in a revocable living trust. That will avoid probate, but still gain the trust beneficiaries a date-of-death value as the basis when the trust grantor dies, because the property will be included in the deceased grantor's estate.[12]

Did the client create a qualified personal residence trust (QPRT) that still has years to run? If the client has an ultra-high net worth and is likely to be a federal estate taxpayer, leave the QPRT alone. For the client of moderate wealth, however, having a QPRT may no longer generate any needed tax benefit. Instead, if the client successfully outlives the QPRT document's terms, there will not be any estate inclusion, and the heirs will take a carryover basis from the decedent. This may now be viewed as a detriment to family tax planning.

Consider having the client continue to live in or use the residence without paying any rent, asserting a retained interest despite the QPRT document's terms once the term of use has expired. That will place the QPRT property in the decedent's estate under IRC Section 2036. Have the QPRT beneficiaries acknowledge the retained interest. Alternatively, have the grantor purchase the residence from the trust. Or, have the beneficiaries exercise a prohibited commutation that will void the QPRT qualification. With no concerns about federal transfer tax liability, suggestions such as these to gain the potential basis step-up from estate inclusion are worthy of consideration.

Several caveats should be raised here. First, if the client resides in a decoupled state, be careful about suggesting more assets to be included in the client's taxable estate. Balance the impact of state estate tax imposition versus capital gains (and possibly state income tax) savings. It may be relevant for tax

[12] IRC Section 2038.

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planning if the QPRT involves a residence that will be sold by the beneficiaries as soon as possible after the grantor's death (basis is then important), or a residence such as a treasured vacation home that is not likely to be ever sold (basis is then irrelevant). If a residence will qualify as the principal residence of someone — the gain exclusion of IRC Section 121 may be available (if the criteria are satisfied) to avoid income tax concerns here. Consider the requirements of the trust, the obligations of the trustees, and the possible concerns of the beneficiaries. If the trustee is willing to act to break up the QPRT, be sure all beneficiaries of the trust are in accord, preferably by receiving an acknowledgment in the form of a written consent.

¶4240 Address the Status of LLCs, Family Limited Partnerships (FLPs), and Sales to Defective Grantor Trusts

In many cases, these entities (LLCs and FLPs) were formed to remove assets from the transferor's estate and obtain a valuation discount in doing so. In the current upside-down planning world for the client of moderate wealth, the estate exclusion and the discount are both negatives.

The lifetime removal of the asset from the estate eliminates the basis step-up and may require a very low carryover basis from the donor. The discounted value used in transferring the lifetime interest arguably also reduces the value of the asset at death — another limitation of the basis step-up. Over the last 20 years, there have been numerous cases litigated in the United States Tax Court addressing issues of whether retained rights and interests in family businesses should force inclusion in a decedent's estate. Perhaps taxpayers should look to the arguments raised by the government in these cases and concede that the government position is correct — and embrace it. File an estate tax return (if nontaxable in the current world of portability and large exclusions) and concede the inclusion of the value of the enterprise in the decedent's estate.

Should the entity be dissolved? Possibly, but there may be appropriate non-tax asset protection, management and business identity reasons to continue the entity. Be careful with a dissolution, however. Bear in mind the rule in partnership transactions that the distribution to one partner of appreciated property contributed by another partner within seven years preceding the distribution will cause the contributing partner to recognize the post-contribution appreciation, as if the partnership had sold the property at its fair market value on the date of distribution.[13]

Does the operating agreement or partnership agreement contain provisions that suggest discounting would be appropriate or required? If so, consider amending the agreement to remove those provisions so that the value on death will be fair market value, not a discounted value.

Consider if the operating or partnership agreement can be modified to assure inclusion of the value of the entire entity in the decedent's estate. Perhaps a retained right to income or controlling management powers can be used to force IRC Section 2036 or IRC Section 2038 to become applicable to the decedent's retained powers.[14] In *Estate of Trombetta,* T.C. Memo 2013-234, the court found an implied agreement where the decedent, having transferred property to an irrevocable trust, made all decisions with respect to the property, led negotiations in refinancing the property, and retained sole signatory

[13] IRC Section 704(c).

[14] Estate of Powell, 148 T.C. 392 (2017).

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authority in connection with disposing of the property. The court found the trust property was includible in the decedent's estate despite the transfer to the irrevocable trust. Continued use of property despite its transfer may be sufficient to require estate inclusion.[15] Evidence of continued exclusive use or enjoyment of property can suggest an implied agreement to retain an interest in the property despite its transfer to an irrevocable trust, and force an estate inclusion.[16]

Consider accepting an argument sometimes raised by the IRS when a controlling interest is present to add a control premium to the price of a decedent's asset to increase the value (and the basis to heirs) when the decedent's estate falls below the applicable exclusion threshold.[17]

If the client utilized the planning technique of the sale to the intentionally defective grantor trust, consider the client's federal estate tax status. If the client is expected to be a federal estate taxpayer, leave the grantor trust in place and have the client continue to pay the income tax and burn off potential estate taxable assets by doing so. If the client utilized the technique but is not likely to be a federal estate taxpayer, consider toggling off grantor trust status (relinquishing the powers that classified the trust as a grantor trust), especially if the income tax liability will then fall on persons in lower tax brackets, possibly below the thresholds for the highest income tax rates and the 3.8% tax on net investment income.

In either event, in the case of the intentionally defective grantor trust, whether or not the federal estate tax will be an issue, pay attention to the basis of the property the client used to sell to the trust. Absent further planning, the basis to the trust and to the trust beneficiaries is the carryover basis of the grantor, presumably a low-income tax basis. If the grantor retained the power of substitution under IRC Section 675(4) as the power to make the trust a grantor trust, have the grantor produce cash or acquire property of equivalent value to what is in the trust, have an independent trustee so certify, and use this power of substitution to exchange the properties. The trust and its beneficiaries will now have property with a current fair market value basis and the grantor will get back the property with the low basis. If the grantor holds the property until death and leaves it to the persons who are the trust beneficiaries, they will obtain a stepped-up basis in that property as well.[18] Income tax on the appreciation will not be paid.

¶4245 Planning for Persons in Decoupled States

.01 More Difficult Considerations to Address

The family with moderate wealth may still have to address estate tax considerations if their state of residence is decoupled from the federal estate tax system and maintains its own estate or inheritance tax. Typically, the state exclusion is less than the federal exclusion, and the states other than Hawaii and Maryland do not offer portability of their exclusions. Such a situation will require more complex planning if the family wants to take advantage of the available state exclusion.

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[15] *Estate of Linderme*, 52 T.C. 305 (1969); Rev. Rul. 70-155, 1970-1 C.B. 189.

[16] *Estate of Thompson*, 382 F.2d 367 (3rd Cir. 2004).

[17] *Estate of Salisbury*, T.C. Memo 1975-333.

[18] IRC Section 1014.

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Planning complexities may be compounded by the fact that some states will change their laws to either reduce or eliminate the taxes, and others may go in the opposite direction and institute a tax or reduce an existing exemption. Another complexity is the domicile of the survivor. If the survivor relocates to a state that does not have an estate tax, planning that was done may not have been necessary, or planning that was never done may be rewarded. Uncertainty rules here!

Planning in decoupled states suggests using a bypass trust at the first death to capture the amount of the available state exclusion so that it avoids taxation at both deaths. The advantage of this choice is the absence of state death taxation on the excluded property. Be careful of formulas here. If the formula used ties the amount of funding of the bypass trust to the full federal estate tax exclusion, the state estate tax liability at the first death could now approach or exceed $1 million under current law. If the formula is tied to and limited to the state estate tax exclusion, the state estate tax liability at the first death will be zero. The disadvantage of this choice to use the bypass trust at the first death is the lack of a stepped-up basis for the bypass trust property at the death of the surviving spouse and the possibility of future capital gain taxation at a rate higher than the state death tax rate.

The mathematics of all of this can become quite complex if time value of money issues are added to the analysis. When will the survivor die? When will property be sold? How much estate tax will be deferred? How much capital gain tax will be paid? What if the tax laws are changed? These are all issues to be addressed in these situations. Some clients are likely to reject planning for these complexities and opt for the more simplified and less costly planning suggested by the federal estate tax rules. Their attitude may be that if state taxes are due at the second death of a married couple, both spouses will be dead at the time, and let the children worry about it. They may say that if the surviving spouse lives long enough after the first death, state and federal laws may change dramatically or the survivor may relocate — so why spend a lot of money and planning anguish now when so much is unknown. Can it be said that they are wrong?

Other clients will object to paying any tax that is not absolutely unavoidable, so they will embrace the bypass trust concept. For these clients, all of the issues of gifting or discounting that can be largely dismissed in addressing the federal exclusion and portability come back into focus and need to be addressed if the state estate tax becomes a matter of concern. Lifetime gifting in decoupled states is a favored planning technique. The suggestion would be to pay attention to basis where possible to avoid giving donees the lowest basis assets that will result in future capital gains tax.

Some states permit a state-only QTIP election to be made to take advantage of the marital deduction for state estate tax purposes, even if no such election has been made for federal purposes. Others prohibit such an independent election. Still others require the federal choices to be followed, but if no federal return is filed, a state QTIP election is allowed. Where permitted, consider use of the state-only QTIP to address the decedent’s excess assets over the state excluded amount — especially if an outright transfer to the surviving spouse is not favored. The IRS eased some concerns at the federal level when it issued Rev. Proc. 2016-49, IRB 2016-42 (September 27, 2016). Here, the IRS declared that it would allow QTIP elections to be deemed valid even if the election was not necessary to eliminate estate tax liability, (sometimes referred to as the “portability QTIP”) setting aside Rev. Proc. 2001-38, which had suggested unnecessary QTIP elections could be held invalid under federal law.

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¶4250 Summary: Key Estate Planning Techniques in the Current Environment for Estates of Moderate Wealth

Where trusts are used, consider giving the beneficiary a lifetime or testamentary general power of appointment to achieve a basis step-up at the beneficiary's death. If the beneficiary is likely to be a federal estate taxpayer, suggest to the beneficiary that disclaiming such a power may be advisable. Alternatively, give the trustee or a trust protector the right to convey a general power of appointment on a beneficiary in an appropriate case.

As another alternative, consider use of the more complex and sophisticated approach of using the "Delaware tax trap."[19] This involves providing in a trust that the beneficiary is given a limited power of appointment that includes the power for the beneficiary to grant a presently exercisable power of appointment to another person (even a limited power to appoint property in further trust) that can further postpone the vesting of the appointed property. Where this power is exercised by the trust beneficiary, the appointed property will be included in the beneficiary's gross estate — exactly the result desired when the estate will not be subjected to the federal estate tax but seeks a stepped-up basis for the trust assets, and a result easily avoided when the estate is too large (that is, taxable) by having the beneficiary take no action to "spring" the Delaware tax trap. The beneficiary controls this decision. If this technique is to be used, the beneficiary should seek sophisticated tax advice before proceeding.

For spouses, be sure to address the portability election. Do not fail to file Form 706 to make the necessary election. Take advantage of the extended time to file the portability election as outlined in Rev. Proc. 2017-34, and the recently issued Rev. Proc. 2022-32, extending the relief period from two years to five years, discussed in this chapter in Section 4215 and in chapter 37 as well.

Where maximizing gifts to grandchildren is desired, remember that the GST exclusion is not portable. Have the first decedent-spouse be a transferor to the grandchildren. This can be done either directly, or by creating a QTIP trust for the benefit of the surviving spouse and making the reverse QTIP election on the Form 706 filed for the first deceased spouse. That will make that spouse the transferor to the grandchildren and the surviving spouse will enjoy the lifetime benefits of the QTIP trust and will still have his or her full GST transfer opportunity available.[20] A further advantage of this reverse QTIP trust planning is that the assets will receive a potentially stepped-up basis at the deaths of each spouse. If it is desired to assure that the surviving spouse will also be a transferor to grandchildren, consider creating a lifetime QTIP for the benefit of the surviving spouse with remainder to grandchildren.[21] Such a trust will be included in the estate of the beneficiary spouse, who will be the transferor of the property for GST purposes, and the trust assets will obtain a potentially stepped-up basis at the death of the spouse for whose benefit the lifetime QTIP was created.

Consider flexible planning that gives the surviving spouse the option of what planning to select at the first death. This is a useful suggestion for both the federal estate tax standing alone and for spouses who may live in decoupled states with their own state estate tax. Use an outright transfer to the surviving

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[19] IRC Sections 2041(a)(3) and 2514(d).

[20] IRC Section 2652(a)(3)(b).

[21] IRC Section 2523(f).

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spouse with a disclaimer provision (by the surviving spouse) leading to a bypass trust where the spouse is a primary (or sole) lifetime beneficiary. This may seem to be an apparently simple choice; however, concern is often expressed as to whether the surviving spouse will actually proceed with a disclaimer. A qualified disclaimer must be made within nine months of the decedent's date of death. No extension of time to make a qualified disclaimer is available. Where a disclaimer plan is used and the surviving spouse is the beneficiary of the bypass trust to be funded by the disclaimer, the spouse may not be given a limited power of appointment over any trust which can be affected by the spouse's disclaimer — unless such a power is limited by an ascertainable standard.[22]

Alternatively, leave assets in a manner such that the executor of the estate of the decedent can elect QTIP treatment to the extent desired, with the balance of property possibly passing to a bypass trust or to some other beneficiaries — a so-called partial QTIP or Clayton QTIP provision.[23] This option takes the planning choice away from the surviving spouse and puts it in the hands of the deceased spouse's executor, who may be more objective, especially if there are blended family considerations that could cause a conflict for the surviving spouse. The regulations permit partial QTIP elections.[24] Such a provision could also be helpful in a decoupled state estate tax situation. If an automatic extension of time to file Form 706 is obtained, the executor has 15 months from the decedent's date of death to decide to make the QTIP decision.

If desired, trusts created in this manner could give the surviving spouse a limited power of appointment.[25] The choices to be made in a flexible plan that would involve the funding of a bypass trust could include allowing discretionary trust beneficiaries other than the spouse so that the possibility of distributing income to persons in low tax brackets will be available. The trust could also encourage the trustee to distribute appreciated assets to the surviving spouse so that they will enjoy a stepped-up basis upon the surviving spouse's death.

Where trusts are used, bear in mind the highly compressed income tax rates imposed on trusts. Wherever possible and appropriate, allow discretion in distributing income and principal to the trust beneficiaries.

If a bypass trust is utilized, bear in mind that the trust assets may be highly appreciated at the death of the surviving spouse with no basis step-up to the trust beneficiaries at the second death. Pay careful attention to the assets used to fund such a trust. For the family with moderate wealth, allocation of appreciating assets at the first death should be favored in places other than the bypass trust.

The moderate wealth client whose assets may be approaching the threshold where the federal estate tax could apply must continue to pay attention to asset values in relation to the law. The client could utilize a program of annual gifting to stay below the threshold if that will be sufficient, or consider more involved planning (such as GRATs, for example) to restrict appreciation from overtaking the federal estate tax threshold.

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[22] Reg. 25.2518-2(e)(2).

[23] Reg. 20.2056(b)-7(d)(3) and 7(h) Example 6; Clayton v. Commissioner, 976 F. 2d 1486 (5th Cir. 1992)

[24] Reg. 20.2056(b)-7(b)(2)(i).

[25] IRC Section 2056(b)(7)(B)(ii)(II).

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For persons living in decoupled states, be sure to address the issue of how the state exclusion will be addressed, if at all. If there is state death tax paid at the death of either spouse, be sure it was an anticipated consequence of the estate plan selected, and that this consequence was communicated to interested family members before anyone has died. Be warned of surprised and angry heirs who thought they were told there would be no death tax when their loved one died. Their surprised reaction may accurately describe the federal estate tax, but not necessarily the state death tax.

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Chapter 43

Statement on Standards in Personal Financial Planning Services

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¶4301 Pathway to Standards

More than 30 years ago, a group of passionate AICPA member volunteers came together with staff, council members, and the board of directors to form the PFP Division for the purpose of representing and giving voice to CPAs providing personal financial planning services. Soon after, the board of directors created the PFP Executive Committee (PFP EC) to serve as the senior committee responsible for supporting the AICPA by providing its members with information, advocacy, and leadership. This committee determines the Institute's technical policies and serves as the Institute's official voice on those matters.

Between 1992 and 1996, the PFP EC issued five statements of substantive guidance for members providing PFP services. These statements were named the *Statements on Responsibilities in Personal Financial Planning Practice* (SORs). The primary objective of the SORs was to provide CPAs with best practices in the delivery of what was then an emerging practice area. The SORs provided CPAs with a roadmap for delivering these services in a manner consistent with the responsibilities of a long-established profession.

Over the past three decades, a growing number of CPAs have expanded into providing personal financial planning services to individuals and families. The increased demand and projected growth of PFP services in areas such as estate, retirement, risk management, and investments have brought the

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accounting profession to an important crossroads. To adapt to an evolving profession and regulatory landscape, in addition to the existing regulatory framework[1] for CPAs, the AICPA is promulgating the *Statement on Standards in Personal Financial Planning Services No. 1*[2] (the standard), which was unanimously adopted by the PFP EC in December 2013 and published in January 2014. The standard became effective on July 1, 2014. Frequently asked questions are continually updated.

.01 Pathway to Standards

CPAs need to prepare for the increased societal demand for PFP services. If a member's client base includes individuals and families, it is inevitable that questions such as the following will arise:

- What should I be doing about college funding for my kids?
- How will I ever be able to retire? How much should I be saving?
- Should I have life insurance? How much? Where should the cash come from to pay the premiums? Who should own it? Should it be in a trust?
- How do I balance our family charitable giving goals with my retirement objectives?
- Beyond the potential tax cost of exercising my company stock options, how should I incorporate them into my long-term personal planning?

These questions must be addressed intelligently and with prudent care.

¶4305 Why Should Members Care About the Standard?

"Standards," to quote Lawrence Busch,[3] "are recipes for reality." They provide order. Standards are the ways in which a professional seeks to express the values held most important for professional conduct. Standards are intended to answer the questions that every professional should ask: (*a*) "What is this profession about?" and (*b*) "How should I conduct myself in my relationships with clients?"

Standards play a consequential role in nearly every aspect of life. They introduce predictability. The standard defines the expectations of minimum required behavior in the CPA-client relationship.

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[1] CPAs are licensed and regulated by their state boards of accountancy. Additionally, all AICPA members are required to follow a rigorous Code of Professional Conduct, which requires that they act with integrity, objectivity, due care, and competence; fully disclose any conflicts of interest (and obtain client consent if a conflict exists); maintain client confidentiality; disclose to the client any commission or referral fees; and serve the public interest when providing financial services. The vast majority of state boards of accountancy have adopted the AICPA Code of Professional Conduct within their state accountancy laws or have created their own.

[2] To supersede the *Statement on Responsibilities in Personal Financial Planning Practice* (AICPA, *Professional Standards*, PFP sec. 100).

[3] Lawrence Busch is a University Distinguished Professor of Sociology in the Center for the Study of Standards in Society at Michigan State University and Professor of Standards and Society in the Centre for Economic and Social Aspects of Genomics at Lancaster University, U.K., and author of *Standards: Recipes for Reality*, (Cambridge, MA: MIT Press, 2011).

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Standards can and should hold that relationship together. The standard provides a framework within which professional judgments and relationships can be conducted.

Standards, and the *Statement on Standards in PFP Services* in particular, provide a common lens through which proper professional conduct can be examined. Taken together, the standard provides essential guidelines for one appropriate broad avenue of action. Use professional judgment and experience to proceed along that road, but stay within the guidelines of the standard. Do so and professional integrity will be protected and enhanced.

The standard is designed to generate predictable outcomes. The outcome sought by the standard is a desirable and proper professional relationship between CPA and client. The standard provides a recipe for performance and is intimately connected with ethical behavior. Adherence creates a strong presumption of trustworthiness in the CPA-client relationship. The value of such a presumption cannot be overstated. Without standards, there is an unlimited universe of possible acceptable behaviors. Market yourself as someone who adheres to the standard. Affirmatively inform clients that standards exist and that they are an integral part of your practice. Follow that route and proper ethical behavior and trust become presumptions in your favor.

Compliance with the standard will culminate in a professional and public perception of real differences between those who follow the standard and those who do not.

Adhering to the standard helps to protect your clients and your business. Federal and state monitoring and regulation of financial activities is increasing. In this very litigious society, any misstep can result in a lawsuit. In many instances, it is both necessary and appropriate to engage in a *defensive practice*, in which you take steps to protect yourself, while at the same time advancing the interests of your clients. Lawyers litigating conflicting claims of parties in many adversarial contexts often cite what is known as the "best evidence" rule. Clear documentation communicated to and acknowledged by both parties to a dispute always trumps either party's undocumented recollection regarding what was or was not said.

It is essential that professional standards and responsibilities be clearly stated and meticulously observed to ensure that members subject to the standards continue to earn the trust and respect of clients. With the growing importance of standards and the increased demand and growth in PFP services comes the need to formalize the CPA's responsibilities in the conduct of his or her practice. That is the genesis of the standard described next.

¶4310 Foundation of the Standard

The standard has been developed to assist all AICPA members in delivering personal financial planning services with competence, consistency, and confidence. Seasoned, experienced practitioners and those new to the service area will benefit from having a framework to guide their work with clients in the development of their personal financial plan. The framework of the standard covers the following topics:

- General professional responsibilities
- Responsibilities of members in PFP engagements
- Planning the PFP engagement
- Obtaining and analyzing information

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- Developing and communicating recommendations
- Implementation engagements
- Monitoring and updating engagements
- Working with other service providers
- Using advice provided by other service providers

In thinking about the activities covered by the standard, it is helpful to consider the foundation upon which the standard is built. The cornerstone of the standard is the AICPA Code of Professional Conduct (the code), which all members are required to follow. The code lays out a high level of professional responsibility centered on the core values of the CPA profession — in the performance of any professional service, a member must maintain objectivity and integrity, shall be free of undisclosed conflicts of interest, and shall not knowingly misrepresent facts.

Furthermore, courts will likely hold members to the fiduciary standard of conduct when performing personal financial planning services. Generally, if the following three elements are present in a client relationship, a member may be deemed to be a fiduciary to his or her client: (*a*) the member holds himself or herself out as an expert in an aspect of business, (*b*) the client places a high degree of trust and confidence in the member, and (*c*) the client is heavily dependent upon the member's advice. The code embodies standards of conduct that are analogous to the fiduciary standard of behavior.

¶4315 Scope of the Standard

With this as a backdrop, the standard captures the essence and spirit of the code and other considerations in defining appropriate minimum behavior for members providing PFP services. The intention of the standard is to provide CPAs with a framework of what would be reflective of good and competent practice. The standard is *not* in any way designed or intended to instruct a member how to undertake a financial plan or perform a financial analysis. There is *no* suggestion in the standard that "one size fits all" in the personal financial planning services arena. The standard is not saying that there is only one set way to undertake a financial plan. Instead, it establishes a process of how to maintain an appropriately ethical and competent personal financial planning services practice. It presents a model of how a practice should be conducted to preserve the respect of clients and the public and avoid claims of impropriety.

The fundamental aspects of interacting and communicating with a client are delineated in the standard to provide a roadmap for members in performing these services with appropriate professional behavior. *Appropriate* PFP approaches and methods are those that serve the best interest of the client, taking into consideration financial and non-financial factors of both the environment (market) and the individual situation of the client, and require professional judgment.

¶4320 Objective of the Standard

The standard is intended to provide authoritative guidance and establish enforceable standards for members. The objective of the standard is to ensure the appropriate delivery of personal financial planning services. It addresses the key areas of communication, disclosures, and documentation as they relate to the basics of planning the engagement, developing recommendations, and working with and recommending other professionals and service providers. It ensures that the client receives the

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information needed to make sound financial decisions. It ensures that the member is meeting minimum standards of behavior expected of a trusted adviser in the delivery of PFP services. And it sets forth a clear path for the member to deliver the level of PFP services that clients need in today's dynamic environment.

¶4325 What Are Personal Financial Planning Services?

The term *personal financial planning services* refers to the process of identifying an individual client's personal financial planning goals, evaluating the individual's existing resources, designing appropriate financial strategies, and making personalized recommendations (both written and oral) that, when implemented, will assist in the client achieving the desired goals. This process may include not only providing the recommendations, but also implementing, monitoring, or updating the original personal financial planning services engagement.

Representing to the public or a client takes place when a member (rather than a firm) takes an action that a client or the public could reasonably rely on to conclude that you provide PFP services. Examples would include the following:

- Advertisement that you provide PFP services or in which you solicit PFP engagements
- Reference on your business card to PFP services
- Placement of brochures or other client educational materials in the office describing your PFP services
- Inclusion in an engagement letter of a description of PFP services
- Classification in telephone book yellow pages or in an online advertisement under personal financial planning categories using your name
- Oral representation to a client or prospective client that you personally provide PFP services
- Solicitation of PFP engagements in any marketing materials that you use
- Indication of providing PFP services in client proposals that you execute
- Inclusion of skills listed in social media, such as LinkedIn

¶4330 When Does the Standard Apply to a Member?

The first test to determine whether the standard is applicable to a member is to see if the member makes personalized recommendations in one or more of a broad list of planning activities, broadly grouped under the description of personal financial planning services. This list of activities includes the following areas:

- Cash flow planning
- Risk management and insurance planning
- Retirement planning

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- Investment planning
- Estate, gift, and wealth transfer planning
- Elder planning
- Charitable planning
- Education planning
- Tax planning

The term *personalized recommendations* refers to financial advice directing a client to take action based on the personal financial information of the client known to the member.

If the member makes personalized recommendations in one or more of the above activities, the next inquiry is whether the member represents to the public or to clients that the member provides personal financial planning services. Note that this representation may come under other pseudonyms such as *personal financial consulting*, *personal financial services*, *comprehensive personal advisory services*, *holistic financial advisory services*, *investment advisory services*, *trusted personal adviser*, *wealth management adviser*, *personal financial adviser*, *fee only financial adviser*, *private client services*, *private wealth management*, or other similar terms. If the member makes such representations, the standard applies.

If the member does not represent that personal financial planning services are provided but engages in activities that would require the member to register as an investment adviser under federal or state security laws, the standard applies.

If the member does not represent to the public or to clients that personal financial planning services are provided and does not engage in activities that would require registration as an investment adviser under federal or state security laws, but might sell a product (such as a life insurance policy) as a result of a personal financial planning engagement, the standard applies.

If the member does not make personalized recommendations in one or more of the nine categories of activities listed earlier, and does not represent to the public or to clients that personal financial planning services are provided, does not engage in activities that would require federal or state registration as an investment adviser, and does not sell a product as the result of a personal financial planning engagement, then the standard does *not* apply. Nevertheless, the code does apply to the member's activities.

Planning Pointer.

Refer to the FAQs for answers to commonly asked questions about determining applicability of and compliance with the standard.

If the aforementioned applicability test leads you to determine that you are not covered by the standard, then there is absolutely nothing that should deter you from being aware of, understanding, and to the extent appropriate, adhering to the requirements of the standard if you engage in any of the nine activities listed previously, because it is truly reflective of appropriate personal financial planning practice and serves to protect your clients and your practice.

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The member should also be aware of the possibility that he or she may be required to register with the SEC as an investment adviser under the Investment Advisers Act of 1940. Release No. IA-1092 defines when the accountant's exemption from the act does not apply. It provides that the act applies to financial planners, pension consultants, and other persons who provide investment advisory services as a component of other financial services. The statute defines an investment adviser as any person who, "for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities."

Whether a person providing financially related services of the type requiring registration as an investment adviser within the meaning of the act must register depends upon all the relevant facts and circumstances. As a general matter, if the activities of any person providing integrated advisory services satisfy the elements of the definition, then the person would be an investment adviser within the meaning of the act, unless entitled to rely on one of the exclusions from the definition of investment adviser. There is an exclusion from the act for any accountant whose performance of such advisory services is solely incidental to the practice of his or her profession. However, this exclusion will not apply if the accountant holds himself or herself out to the public as providing financial planning, pension consulting, or other financial advisory services.

The majority of states have adopted rules similar to the federal rule requiring registration as an investment adviser.

Planning Pointer.

For guidance on understanding when you are deemed to be providing investment advice such that registration as an investment adviser is required, reference *The CPA's Guide to Investment Advisory Business Models*, published by the AICPA. In addition, use this decision chart that will walk you through a series of questions to help you understand whether or not you qualify for the accountant's exclusion and, if you do not, whether or not you meet the definition of an "investment adviser" per the SEC. Also, this case study is an example of what a common CPA financial planning firm offering financial planning advice might look like and the outcome of determining that registration as an investment adviser was not required.

To understand the specifics of when the standard is applicable, reference the standard in conjunction with the flowchart and list of frequently asked questions provided as part of the compliance toolkit.

When Does the AICPA *Statement on Standards in Personal Financial Planning Services No. 1* Apply to a Member?

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Note that the standards apply to a non-CPA AICPA member when the applicability requirements set forth in paragraphs 3–4 of the standard are met. Members, associate members, and international associates of the AICPA — both CPAs and non-CPAs — are bound by the AICPA bylaws and Code of Professional Conduct. The "Compliance With Standards Rule" (AICPA, *Professional Standards*, ET secs. 1.310 and 2.310) requires members to comply with AICPA standards promulgated by bodies designated by council.

If a person is not a member of the AICPA but is a licensed CPA in his or her state, the member must consult the state board for an authoritative answer regarding how the state board might apply any particular AICPA standard. State boards of accountancy have broad authority over licensees who provide professional services to the public, and these boards determine whether a licensee has followed applicable professional standards under state laws and regulations. State boards may look to AICPA standards, including the *Statement on Standards in Personal Financial Planning Services No. 1*, when they evaluate whether a licensee has complied with applicable professional standards. Many states have adopted the AICPA Code of Professional Conduct as part of their ethics requirements and other states call out specific standards.

¶4335 Documentation and Disclosure

Paragraph 22 of the standard requires that a member disclose in writing all compensation the member and the member's firm or affiliates will receive for services rendered or products sold, including the method, amount, time period over which the compensation will be received, and compensation for referrals. Providing a client with the exact dollar amount or with adequate information that allows that client to reasonably calculate the compensation amount is sufficient in meeting the requirements of the standard.

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Planning Pointer.

There are a number of scenarios when it is not possible to determine the exact dollar amount or to reasonably estimate the amount of compensation to be earned prior to beginning the engagement. Generally, the member should disclose how compensation is determined, that it is not reasonably determinable at this time, and that further written disclosures will be made once the amount can be reasonably estimated. Refer to the FAQs for answers to commonly asked questions practitioners may have with regard to documentation and disclosure requirements for various scenarios and different types of compensation models.

¶4340 Enforcement

Members may well raise the question: How will the standard be enforced? The AICPA Professional Ethics Division investigates potential disciplinary matters involving members of the AICPA and state CPA societies participating in the Joint Ethics Enforcement Program. A member who fails to comply with the standard may be subject to discipline by the AICPA or his or her state board of accountancy (or both) under the "Compliance with Standards Rule" of the AICPA Code of Professional Conduct.

¶4345 Compliance Toolkit

Understand the depth of the Statement on Standards in Personal Financial Planning Services (SSPFPS) and put it into practice using the SSPFPS Toolkit.

The toolkit includes the following:

- Checklists to assist in compliance with SSPFPS and improve workflow
- Customizable engagement letters for use in PFP engagements and to assist with compliance with SSPFPS
- Frequently asked questions regarding applicability and compliance with SSPFPS
- *The CPA's Guide to Investment Advisory Business Models* to gain an understanding of when a member is deemed to be providing investment advice such that registration as an investment adviser is required, an important aspect in determining whether SSPFPS applies to the services provided

These resources are provided to assist you in compliance with the standard but are not required. The sample engagement letters and checklists are intended to be customized for use in any practice format to meet the needs of your practice and individual engagements. Members should review language used in the sample engagement letters and checklists in conjunction with reviewing requirements of the standard, and then add, delete, or otherwise revise as deemed appropriate.

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¶4350 Conclusion

In the final analysis, the standard is about behavior. It is aimed at ensuring that members conduct themselves at the highest level of professionalism when performing personal financial planning services. If members adhere to the requirements of the standard, then individual members and the profession will be protected on many levels. Having standards in place can accomplish many highly desirable goals. They can be cited by litigants in a judicial setting as a benchmark measure of proper conduct — follow them, you win; ignore them, you lose. They can be used by professional groups such as the AICPA and state boards of accountancy as a way to make certain that members and licensees are maintaining the highest professional standards as conditions for ongoing membership and licensure.

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Chapter 44

The Achieving a Better Life Experience Act of 2014: Tax-Favored Savings Plans for Disabled Beneficiaries

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¶4401 Overview

The Achieving a Better Life Experience (ABLE) Act of 2014 (P.L. 113-295) added a new section to the Internal Revenue Code. IRC Section 529A allows a state (or agency or instrumentality of the state) to create tax-advantaged savings plans — an ABLE program — on behalf of disabled beneficiaries.

The ABLE program was developed to encourage individuals and families to establish a tax-favored savings account to assist and support individuals with disabilities, thereby allowing them to maintain an independent lifestyle and meaningful employment through the use of private funds. A key element of the act is that an ABLE account (described next) shelters assets from federal means-testing for the purposes of either qualifying for or determining the level of benefits from other federal welfare benefit programs.

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The structure for establishment, contributions, distributions, and tax treatment of this type of tax-favored account follows the design of the rules created for qualified tuition programs under IRC Section 529.

¶4405 ABLE Accounts and Their Designated Beneficiaries

An ABLE account is an account that is established by or for an eligible individual, owned by that individual, and maintained under a qualified ABLE program.[1] The designated beneficiary of an ABLE account is the owner of the account.[2] In the event of a change of beneficiary in a rollover from one eligible individual to another eligible individual,[3] the individual named must be a family member of the designated beneficiary.[4] Family members include any eligible individual who is also a brother, sister, stepbrother, or stepsister, including legally adopted siblings of the designated beneficiary.[5]

¶4410 Who Is an Eligible Individual for an ABLE Account?

An eligible individual is a person who is disabled or blind, and the onset of the disability or blindness must have occurred before the individual attained age 26. The person must either be entitled to benefits based on blindness or disability under Title II of the Social Security Act. A previous requirement that there be a disability certificate on file with the IRS for the tax year in which the ABLE account is created was amended by the IRS. A certification of disability under penalty of perjury is required, but an advance written diagnosis is not required to be filed, and the IRS will not be required to evaluate detailed medical records unless the disability claim is challenged (see Notice 2015-81, IR-2015-130, Nov. 20, 2015).[6]

.01 Disability Certificate

If requested by the IRS to establish proof of disability (but no longer required as a precondition to establishing an ABLE account), a disability certificate can be submitted by either the individual or by the parent or guardian of the individual. It must certify that the individual has a medically determinable physical or mental impairment resulting in marked and severe functional limitations that either can be expected to result in death or have lasted or are expected to last for a continuous period of not less than 12 months. Alternatively, it must certify that the individual is blind within the meaning of Section 1614(a)(2) of the Social Security Act. When filing the disability certificate, a copy of the individual's diagnosis related to his or her relevant impairment or impairments must be signed by a physician meeting the requirements under Section 1861(r)(1) of the Social Security Act.[7] No inference may be

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[1] IRC Section 529A(e)(6).

[2] IRC Section 529A(e)(3)(A).

[3] IRC Section 529A(c)(1)(C)(ii).

[4] IRC Section 529A(c)(1)(C)(i).

[5] IRC Section 152(d)(2)(B); IRC Section 529A(e)(4).

[6] IRC Section 529A(e)(1).

[7] IRC Section 529A(e)(2).

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drawn from a disability certificate for the purpose of establishing the individual's eligibility for benefits under Title II, XVI, or XIX of the Social Security Act.[8]

.02 Enhanced Opportunity to Use the ABLE Act.

The Secure Act 2.0 increases the age limit before which an individual's disability or blindness must have occurred from 26 to 46 in order for the individual to be eligible to establish and become the designated beneficiary of an achieving a better life experience (ABLE) account. The change is effective for tax years beginning after December 31, 2025.

¶4415 Contributions to an ABLE Account

A person may make nondeductible contributions to an ABLE account for the benefit of an eligible individual.[9] Contributions must be made in cash, and the aggregate annual contribution amount by any donor cannot exceed the annual gift tax exclusion amount ($17,000 for 2023, indexed annually for inflation).[10]

This contribution limitation has been increased by the 2017 Tax Cuts and Jobs Act. The general contribution limit remains the same (i.e., the amount of the annual gift tax exclusion), but now it may be increased by contributions made by the designated beneficiary before the sunset of the law on January 1, 2026.[11] Once the general contribution limit is reached, the ABLE account designated beneficiary may make additional contributions equal to the lesser of (*a*) his or her compensation includable in gross income for the tax year or (*b*) the federal poverty line for a one-person household, currently $14,580 for 2023. For an employee or self-employed person to take advantage of this additional contribution, no contribution may be made for the tax year to any qualified retirement plan. The reference to the "federal poverty line" is the official poverty line set by the Office of Management and Budget.[12]

.01 Excess Contributions

In the event a person makes an excess contribution to an ABLE account, a 6% excise tax applies to such contributions.[13] An excess contribution subject to tax does not include timely made corrective distributions when excess contributions are returned.[14]

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[8] IRC Section 529A(e)(3).

[9] IRC Section 529A(b)(1).

[10] IRC Section 529A(b)(2).

[11] IRC Section 529A (b)(2)(B)

[12] IRC Section 529A (b)(7)(B). HHS Poverty Guidelines January 19, 2023

[13] IRC Section 4973(a)(6).

[14] IRC Section 4973(h).

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.02 Corrective Distributions

A corrective distribution to the account contributor must be made on or before the day prescribed by law (including extensions of time) for filing the individual's return for that tax year. The corrective distribution must include any net income attributable to the contribution (which will be deemed to have been earned and received in the tax year in which such contribution is made).[15]

The concept of a "corrective distribution" follows the model of an IRA corrective distribution,[16] where contributions returned before the due date of the return are not considered excessive. Of course, in the IRA context, there may be recognition of the excess contribution in income if a deduction was allowed. In the case of the ABLE account, because the contributions are not deductible, there is no issue of income inclusion if a corrective distribution is made.

.03 Rollovers to ABLE Accounts from Section 529 Accounts

The 2017 Tax Cuts and Jobs Act has added a new provision allowing amounts from qualified tuition plans (Section 529 plans) to be rolled over to an ABLE account without penalty before January 1, 2026, if the ABLE account is owned by the designated beneficiary of that Section 529 account or is a member of the family of the designated beneficiary. Any amounts rolled over count toward the overall limitation that can be contributed to an ABLE account within a tax year.[17]

¶4420 Distributions to Beneficiaries

Distributions from an ABLE account for a tax year are not included in the gross income of the recipient unless they exceed the amount of qualified disability expenses incurred by the recipient during the tax year.[18] If the distribution to the beneficiary is in excess of qualified disability expenses, the amount includible in gross income is the excess amount reduced by an amount in the same ratio as the expenses bear to the distributions.[19]

Distribution amounts that are not excluded from income taxation are taxed similarly to annuity payments under IRC Section 72.[20] When applying IRC Section 72, all distributions during a tax year are treated as a single distribution, and the value of the contract, income on the contract, and investment on the contract are computed as of the close of the *calendar* year in which the tax year begins.[21] In addition, when a designated beneficiary receives a distribution from an ABLE account in a qualified ABLE program that is includible in gross income, that beneficiary is subject to an additional 10% tax on the

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[15] IRC Section 529A(b)(2)(B).

[16] IRC Section 408(d)(4).

[17] IRC Section 529(c)(3)(C)(i)(III); IRC Section 529A(c)(6).

[18] IRC Section 529A(c)(1)(B)(i).

[19] IRC Section 529A(c)(1)(B)(ii).

[20] IRC Section 529A(c)(1)(A).

[21] IRC Section 529A(c)(1)(D).

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includible income.[22] This 10% addition to tax does not apply if the payment or distribution is made to the designated beneficiary or to the estate of the designated beneficiary, as a result of the death of the designated beneficiary.[23]

¶4425 What Is Meant by Qualified Disability Expenses?

The term "qualified disability expenses" includes any expenses related to the eligible individual's blindness or disability paid for the benefit of that individual who is the designated beneficiary of an ABLE account in a qualified ABLE program.[24] These expenses include, but are not limited to, the following:

- Education
- Housing
- Transportation
- Employment training and support
- Assistive technology and personal support services
- Health, prevention, and wellness
- Financial management and administrative services
- Legal fees
- Expenses for oversight and monitoring
- Funeral and burial expenses

The IRS is authorized to approve other expenses that fall within this term.

¶4430 ABLE Account Rollovers

Amounts in an ABLE account can be rolled over for the purpose of either changing the designated beneficiary or changing the ABLE program.[25]

To avoid tax being imposed, the amount withdrawn from one ABLE account must be paid into another ABLE account in a qualified ABLE program not later than the 60th day after the date of payment or distribution. The ABLE account accepting the payment must be established for the same designated

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[22] IRC Section 529A(c)(3)(A).

[23] IRC Section 529A(c)(3)(B).

[24] IRC Section 529A(e)(5).

[25] IRC Section 529A(c)(1)(C)(i).

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beneficiary or for an eligible individual who is a family member of the designated beneficiary. In the event of a change of designated beneficiary, taxation of the payment or distribution is avoided if the new beneficiary is an eligible individual for the tax year and a member of the family of the former designated beneficiary.[26]

An ABLE account can be rolled over to another ABLE account owned by or for the same beneficiary, and it can be rolled over for the benefit of a family member of the designated beneficiary who has also been disabled or blind since turning age 26. If any assets are left over from paying qualified disability expenses for the eligible individual, generally they will be transferred to the state. ABLE accounts are not estate planning devices; they are meant primarily to shelter assets from means-testing for purposes of government benefits.

Once an ABLE account in a qualified ABLE program is established, no account subsequently established for the same eligible designated beneficiary can be treated as an ABLE account.[27] There is, however, an exception for an ABLE account opened to facilitate the rollover from another such account, either for the same beneficiary or to change a beneficiary, as long as the first ABLE account is terminated no later than the end of the 60th day after the date of the distribution. Rollovers for purposes of changing programs or changing the designated beneficiary are limited to one such transfer within a 12-month period. This time period commences on the date of the last transfer of an ABLE account from any qualified ABLE program for the benefit of the designated beneficiary.[28]

¶4435 ABLE Accounts and Transfer Taxes

For purposes of gift and GST taxes, any contribution to an ABLE account in a qualified ABLE program on behalf of a designated beneficiary is treated as a completed gift and not as a future interest in property.[29] Contributions are not considered transfers under IRC Section 2503(e) for direct payment of qualified educational and medical expenses.[30] Distributions from an ABLE account to the designated beneficiary are not treated as a taxable gift.[31] Transfers made by reason of changing the beneficiary or the ABLE program are not subject to gift or GST taxes.[32] However, a qualified ABLE program is subject to taxes imposed by IRC Section 511 on unrelated business income.[33]

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[26] IRC Section 529A(c)(1)(C)(ii).

[27] IRC Section 529A(c)(4).

[28] IRC Section 529A(c)(1)(C)(iii).

[29] IRC Section 529A(c)(2)(A)(i).

[30] IRC Section 529A(c)(2)(A)(ii).

[31] IRC Section 529A(c)(2)(B).

[32] IRC Section 529A(c)(2)(C).

[33] IRC Section 529A(a).

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¶4440 What Is a Qualified ABLE Program?

A qualified ABLE program is one established by a state, or an agency or instrumentality of the state, under which an individual may make contributions to an ABLE account established for the benefit of an eligible individual, where the purpose of the account is meeting the qualified disability expenses of the designated beneficiary.[34] The law requires each state to enact enabling legislation to accept the ABLE program. To date, all 50 states and the District of Columbia have enacted the legislation. Some of the states that have enacted legislation to authorize the program have yet to establish the details of the program. Some states allow account contributions from persons in any state, others limit the program to persons in their own state of residence. The program must limit a designated beneficiary to one ABLE account and allow for the establishment of an ABLE account only for a beneficiary who is a resident either of the state or of a contracting state.[35] A qualified ABLE program must also satisfy the following requirements:

- All contributions must be in cash, and the aggregate of all annual contributions cannot exceed the annual gift tax exclusion amount under IRC Section 2503(b) ($17,000 for 2023, indexed annually for inflation).[36]
- The program must provide for separate accounting for each designated beneficiary.[37]
- Any designated beneficiary may directly or indirectly control the investment of any contribution or earnings no more than twice a year.[38]
- No interest in, or portion of, an ABLE account can be pledged as security for a loan.[39]
- Safeguards must be in place to prevent aggregate total contributions (including contributions from any prior ABLE program) on behalf of a designated beneficiary from exceeding the limits established by the state for its qualified tuition program[40]with respect to the amount necessary to provide for a beneficiary's qualified higher education expenses.[41]

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[34] IRC Section 529A(b)(1).

[35] IRC Section 529A(b)(1)(B) and (C).

[36] IRC Section 529A(b)(2).

[37] IRC Section 529A(b)(3).

[38] IRC Section 529A(b)(4).

[39] IRC Section 529A(b)(5).

[40] IRC Section 529(b)(6).

[41] IRC Section 529A(b)(6).

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A qualified ABLE program is allowed to provide services to residents of other contracting states. A contracting state is one without a qualified ABLE program that enters into a contract with a state that does have a qualified program to provide their residents access to such a program.[42]

¶4445 Reporting Requirements for ABLE Accounts

A qualified ABLE program must submit a notice to the IRS upon the establishment of an ABLE account. The notice must include the name and state of residence of the designated beneficiary and any other information the IRS requires.[43] Additionally, reports regarding contributions, distributions, and return of excess contributions must be made to designated beneficiaries and to the IRS.[44] The IRS is required, for research purposes, to make available to the public reports containing aggregate information on contributions and distributions categorized by diagnosis or other relevant characteristics.[45] These reports will be filed at the time and in the manner required by the IRS.[46] In addition, states are required to submit information electronically on a monthly basis to the Commissioner of Social Security on relevant distributions and account balances, to coordinate with other federal welfare benefit programs.[47] Failure to submit any report will result in a penalty of $50 for each failure.[48] Any state or its agency or instrumentality that establishes and maintains a qualified ABLE program must file Form 5498-QA, *ABLE Account Contribution Information*, with the IRS, for each ABLE account.

¶4450 The Effect of an ABLE Account on Other Means-Tested Federal Programs

The amount in any ABLE account — including earnings held for any individual, any contributions to the ABLE account, and any distributions for qualified disability expenses — is disregarded with respect to determining one's eligibility for or the benefit amount from any other federal welfare assistance programs.[49] There are, however, two exceptions:

- Any distribution for housing expenses will not be disregarded.
- Any amount in an ABLE account, including earnings, in excess of $100,000 will be considered a resource of the designated beneficiary.

Additionally, any supplemental security income program benefits available to the eligible beneficiary under title IX of the Social Security Act will not be terminated due to excess resources of the

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[42] IRC Section 529A(e)(7).

[43] IRC Section 529A(d)(3).

[44] IRC Section 529A(d)(1).

[45] IRC Section 529A(d)(2).

[46] IRC Section 529A(d)(5).

[47] IRC Section 529A(d)(4).

[48] IRC Section 6693(a)(2).

[49] Division B, Act Sec. 103(a) of the ABLE Act of 2014.

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individual,[50] but will be suspended instead.[51] This suspension of supplemental security income benefits will not, however, impact the individual's Medicaid eligibility.[52]

¶4455 The Relationship Between ABLE Accounts and the Bankruptcy Laws

The ABLE Act amends the bankruptcy code to exclude funds placed in an ABLE account from a bankruptcy estate under specific circumstances. Under Section 541(b) of *Bankruptcy*, U.S. Code (USC) 11, any amounts in an ABLE account in a qualified program are excludable from the property of the bankruptcy estate if the contributions to the ABLE account are made no later than 365 days prior to the filing date of the bankruptcy petition. The following requirements must also be met:[53]

- Contributions must be for a designated beneficiary, that is, a child, stepchild, grandchild, or step-grandchild of the debtor.
- The funds must not be pledged or promised to an entity in connection with any extension of credit and may not be an excess contribution as described in IRC Section 4973(h).
- The funds must not exceed $7,575 and must be contributed to all ABLE accounts of the same beneficiary no earlier than 720 days nor later than 365 days before the filing of the petition for purposes of property exclusion.

For the purposes of determining the debtor's monthly expenses under 11 USC 707(b)(2)(A)(ii)(II), these may include contributions to an ABLE account in a qualified ABLE program. However, they may be included only to the extent that these contributions are not excess contributions under IRC Section 4973(H), and the designated beneficiary of the ABLE account must be a child, stepchild, grandchild, or step-grandchild of the debtor.[54]

The debtor under 11 USC 521(c) must declare any interest in an ABLE account in a qualified ABLE program upon filing a bankruptcy petition.[55] These amendments to title 11 of the United State Code apply to any bankruptcy cases commenced on or after the enactment date of the ABLE Act of 2014.

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[50] Division B, Act Sec. 103(a) of the ABLE Act of 2014.

[51] Division B, Act Sec. 103(b)(1) of the ABLE Act of 2014.

[52] Division B, Act Sec. 103(b)(2) of the ABLE Act of 2014.

[53] Division B, Act Sec. 104(a) of the ABLE Act of 2014.

[54] Division B, Act Sec. 104(b) of the ABLE Act of 2014.

[55] Division B, Act Sec. 104(c) of the ABLE Act of 2014.

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¶4460 Effective Date

The amendments to the IRC made by the ABLE Act apply to tax years beginning after its enactment date, December 31, 2014. The IRS will issue regulations or other guidance required under IRC Section 529A(g).[56]

¶4465 Final IRS Regulations

The IRS issued final regulations with respect to the ABLE Act on November 19, 2020.[57] The regulations are effective January 1, 2021.

.01 Designated Beneficiary

The regulations confirm that the owner of the ABLE account is the designated beneficiary of the account. Additionally, the person with signature authority over the account, if not the designated beneficiary, may neither have nor acquire any beneficial interest in the ABLE account and must administer such account for the benefit of the designated beneficiary of that account.

.02 Requirements for a Qualified ABLE Account

The regulations restate a number of the requirements outlined in the statute and discussed previously, namely that in order to be qualified, the ABLE program must

- be established by a state or state agency or instrumentality,
- permit the establishment of an ABLE account only for a designated beneficiary who is an eligible individual,
- limit a designated beneficiary to only one ABLE account,
- permit contributions to an ABLE account established to meet the qualified disability expenses of the account's designated beneficiary, and
- limit the nature and amount of contributions that can be made to an ABLE account.

The IRS acknowledged that in some cases, eligible individuals may be unable to establish accounts themselves. If that is the case, either the eligible individual's agent under a power of attorney or the person's parent or legal guardian may establish an ABLE account for the eligible individual.

.03 Eligible Individual

The regulations confirm that a person is an eligible individual for a tax year if, during that tax year, either

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[56] Division B, Act Sec. 102(f) of the Achieve a Better Living Experience Act of 2014 (P.L. 113-XXX).

[57] 85 FR 74010-74047, November 19, 2020.

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- the individual is entitled to benefits based on blindness or disability under Title II or Title XVI of the Social Security Act, and the blindness or disability occurred before the date on which the individual attained age 26; (subject to the extension of the age to 46 after 12-31-25) or

- a disability certification meeting specified requirements is filed with the IRS. This IRS filing requirement was later eliminated. See paragraph .07 of section 4465.

.04 Contributions

Contributions to a qualified ABLE program are to be "cash contributions," which includes cash, checks, money orders, credit card payments, or similar methods of payment. The total contributions to an ABLE account in each calendar year may not exceed the amount of the annual gift tax exclusion. If contributions exceed the amount of the annual gift tax exclusion, the failure to return the excess contribution to the donor will result in the imposition of a 6% excise tax, subject to the allowance for increased contributions permitted by the 2017 Tax Cuts and Jobs Act and discussed previously in section 4415.

.05 Distributions

Distributions from an ABLE account will not be included in the gross income of the beneficiary, as long as the distributions do not exceed the qualified disability expenses of the beneficiary. If the distributions exceed the allowable amount, the distribution may be subjected to income tax as well as an additional 10% tax, as described previously in section 4420.

Qualified disability expenses. The regulations broadly interpret the term "qualified disability expenses" as expenses that relate to the designated beneficiary's blindness or disability and address maintaining or improving health, independence, or quality of life. Expenses for education, housing, transportation, employment training, and personal support services are all within the scope of qualified disability expenses.

.06 Reporting Requirements

New reporting forms will be required as the result of the ABLE Act. A qualified ABLE program must report the establishment of each ABLE account on Form 5498-QA, *ABLE Account Contribution Information*. Information regarding distributions will be reported on Form 1099-QA, *Distributions from ABLE Accounts*.

.07 New IRS Guidance to Simplify ABLE Program Administration

The IRS announced three changes to the rules for ABLE accounts for eligible disabled individuals that are included in the final regulations. These changes will make it easier for states to offer and administer ABLE programs. States, program administrators, and other interested commenters identified the three areas for change, and Notice 2015-81, IR-2015-130 (Nov. 20, 2015), describes these changes. They include the following:

- *Categorization of distributions not required.* ABLE programs need not include safeguards to determine which distributions are for qualified disability expenses, nor are they required to specifically identify those used for housing expenses. Commenters noted that such a requirement would be unduly burdensome and that, in any case, the eventual use of a distribution may not be

known at the time it is made. Designated beneficiaries will still need to categorize distributions when determining their federal income tax obligations.

- *Contributors' taxpayer identification numbers (TINs) not required.* ABLE programs will not be required to request the TINs of contributors to the ABLE account at the time when the contributions are made if the program has a system in place to reject contributions that exceed the annual limits. However, if an excess contribution is deposited into a designated beneficiary's ABLE account, the program will need to request the contributor's TIN. For most people, the TIN is their Social Security number.

- *Disability diagnosis certification permitted.* Designated beneficiaries can open an ABLE account by certifying, under penalties of perjury, that they meet the qualification standards, including their receipt of a signed physician's diagnosis if necessary, and that they will retain that diagnosis and provide it to the program or the IRS upon request. This means that eligible individuals with disabilities will not need to provide the written diagnosis when opening the ABLE account, and ABLE programs will not need to receive, retain, or evaluate detailed medical records.

.08 Mistakes to Avoid When Using the ABLE Act

1. **Leaving a Lump Sum of Money or Physical Assets to an ABLE Account.** The ABLE account rules only allow maximum contributions of the federal gift tax exclusion amount each year, currently $17,000, as supplemented by the beneficiary contributing the lesser of earnings or additional contributions up to the federal poverty line per the 2017 Act. Lump sum transfers for the benefit of a disabled beneficiary should use another vehicle, such as a third-party special-needs trust. In addition, ABLE accounts are not considered entities so they cannot own physical assets such as a car or a house or other real estate.

2. **Exceeding a $100,000 balance in an ABLE Account.** If the ABLE account value grows to $100,000 or higher, SSI (Supplemental Security Income) will be suspended and the beneficiary will no longer receive the SSI income. If the beneficiary relies or will rely on monthly SSI income to help support the beneficiary's lifestyle, be sure that the ABLE account does not exceed the $100,000 limit.

3. **Using ABLE Act Money for Other Family Members.** An ABLE Act account does not work the same way as a third-party special-needs trust. If the disabled beneficiary dies, do not expect the remaining funds in the account to be available for distribution to other children or grandchildren. The ABLE Act was written with a Medicaid payback provision so that the government has the right to repayment of any remaining proceeds in the decedent's ABLE account to the extent of the cost of the benefits that were provided to the beneficiary by Medicaid while alive.

4. **Avoid Withdrawing Funds for Nonqualified Expenses.** Although contributions to an ABLE account are made on an after-tax basis, the assets in the account grow income tax-free and are protected from income taxation as long as they are used to pay for qualified expenses exclusively. Withdrawals must be made for qualified expenses only, or else the earnings portion would be subject to regular income tax and a 10% penalty. Depending on state income tax laws, there could also be a potential state income tax imposed on disqualified expenses as well.

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Appendix

¶5001 Federal Income Tax Rates, Deductions, Exemptions, and FICA and FUTA Taxes

¶5005 Annual Cost-of-Living Adjustments and Dollar Limitations for Employee Trusts

¶5010 Unified Federal Estate and Gift Tax Rates for Tax Years 2010–2023

¶5015 Valuation of Annuities, Life Estates, and Remainders

¶5020 Key Documents and Lists to Request from the Client

¶5025 125 (and More) Reasons Why Clients Should Seek Planning Assistance Now

¶5030 Business Succession Planning Checklist

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¶5045 Major Law Changes Enacted in the PATH Act that Remain in Effect

¶5050 Basis Reporting and Duty of Consistency — Form 8971

¶5055 IRC Section 199A and the Qualified Business Income Deduction

¶5060 IRC Section 1400Z — Qualified Opportunity Zone Provisions

¶5065 The SECURE ACT of 2019

¶5070 The CARES Act of 2020

¶5075 The Consolidated Appropriations Act of 2021

¶5080 The American Rescue Plan Act of 2021

¶5085 The Secure Act 2.0 (2022)

¶5090 The Inflation Reduction Act of 2022 (2022 IRA)

¶5095 The Corporate Transparency Act

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¶5001 Federal Income Tax Rates, Deductions, Exemptions, and FICA and FUTA Taxes

.01 2023 Federal Income Tax Rate Schedules (Individuals, Trusts, and Estates)

Unmarried Taxpayers

If taxable income is	*Your tax is*
Not over $11,000	10% of taxable income
Over $11,000 to $44,725	$1,100.00 + 12% of the excess over $11,000
Over $44,725 to $95,375	$5,147.00 + 22% of the excess over $44,725
Over $95,375 to $182,100	$16,290.00 + 24% of the excess over $95,375
Over $182,100 to $231,250	$37,104.00 + 32% of the excess over $182,100
Over $231,250 to $578,125	$52,832.00 + 35% of the excess over $231,250
Over $578,125	$174,238.25 + 37% of the excess over $578,125

Married Filing Jointly and Surviving Spouses

If taxable income is	*Your tax is*
Not over $22,000	10% of taxable income
Over $22,000 to $89,450	$2,200 + 12% of the excess over $22,000
Over $89,450 to $190,750	$10,294 + 22% of the excess over $89,450
Over $190,750 to $364,200	$32,580 + 24% of the excess over $190,750
Over $364,200 to $462,500	$74,208 + 32% of the excess over $364,200
Over $462,500 to $693,750	$105,664 + 35% of the excess over $462,500
Over $693,750	$186,601.50 + 37 % of the excess over $693,750

Married Individuals Filing Separately

If taxable income is	*Your tax is*
Not over $11,000	10% of taxable income
Over $11,000 to $44,725	$1,100.00 + 12% of the excess over $11,000
Over $44,725 to $95,375	$5.147.00 + 22% of the excess over $44,725
Over $95,375 to $182,100	$16,290.00 + 24% of the excess over $95,375.00

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If taxable income is	*Your tax is*
Over $182,100 to $231,250	$37,104.00 + 32% of the excess over $182,100
Over $231,250 to $346,875	$52,832.00 + 35% of the excess over $231,250
Over $346,875	$93,300.75 + 37% of the excess over $346,875

Heads of Household

If taxable income is	*Your tax is*
Not over $15,700	10% of taxable income
Over $15,700 to $59,850	$1,570.00 + 12% of the excess over $15,700
Over $59,850 to $95,350	$6,868 + 22% of the excess over $59,850
Over $95,350 to $182,100	$14,678 + 24% of the excess over $95,350
Over $182,100 to $231,250	$35,498 + 32% of the excess over $182,100
Over $231,250 to $578,100	$51,226 + 35% of the excess over $231,250
Over $578,100	$172,623.50 + 37 % of the excess over $578,100

Trusts and Estates

If taxable income is	*Your tax is*
Not over $2,900	10% of taxable income
Over $2,900 to $10,550	$290 + 24% of the excess over $2,900
Over $10,550 to $14,450	$2,126 + 35% of the excess over $10,550
Over $14,450	$33,491 + 37% of the excess over $14,450

.02 Standard Deduction

Tax Years Beginning in 2023	
Joint return or surviving spouse	$27,700
Single (other than head of household or surviving spouse)	$13,850
Head of household	$20,800
Married filing separate returns	$13,850

For an individual who can be claimed as a dependent on another taxpayer's return, the basic standard deduction in 2023 cannot exceed the greater of $1,250 or the sum of $400 plus the individual's earned income. The additional standard deduction amount for the aged over 65 and blind is $1,500 in 2023.

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These amounts are increased to $1,850 in 2023 if the individual is also unmarried and not a surviving spouse.

.03 Personal Exemption

The personal exemption has been suspended for 2018 through 2025 by the 2017 Tax Cuts and Jobs Act.

.04 Itemized Deductions

An individual may not deduct personal interest.[1] An individual may deduct qualified residence interest on acquisition indebtedness up to $1 million for acquisition indebtedness incurred on or before December 15, 2017, and up to $750,000 for acquisition indebtedness incurred after December 15, 2017. Interest on a home equity loan may only be deducted in 2023 and later if it is incurred for the acquisition, refinancing, and improvement on a taxpayer's principal residence and one other residence.[2]

A taxpayer's otherwise allowable itemized deductions will no longer be subject to a phase-out rule through 2025, called the "Pease limitation," which was suspended by the 2017 Tax Cuts and Jobs Act.

.05 Corporate Tax Rates for 2023

For years beginning after December 31, 2017, the graduated corporate tax rate structure is eliminated, and corporate taxable income is taxed at a 21% flat rate.[3]

Personal service corporations are also taxed at a flat 21% rate.[3]

.06 Self-Employment Tax

A self-employed individual must pay self-employment tax in addition to income tax. The self-employment tax rate is 15.30% — 12.40% for the OASDI part[4] and 2.9% for the hospital insurance (HI) (Medicare) part.[5] The self-employment income is subject to a ceiling for the OASDI part that may change annually.[6] The ceiling is $160,200 for 2023. The HI part is not subject to a ceiling. A self-employed taxpayer may deduct the product of the net earnings from self-employment and one-half of the 15.3% self-employment tax rate when computing the tentative base for the self-employment tax.[7] Schedule SE simplifies this calculation by multiplying the unadjusted net earnings from self-employment by 92.35%. Any FICA wages the taxpayer earned during the year reduce the ceiling for the

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[1] IRC Section 163(h).

[2] IRC Section 163(h)(3)(F)(i)(II).

[3] IRC Section 11(b)(2).

[4] IRC Section 1401(a).

[5] IRC Section 1402(b).

[6] IRC Section 1402(b).

[7] IRC Section 1402(a)(12).

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OASDI part.[8] After subjecting the 92.35% of self-employment income to the OASDI ceiling, the taxpayer computes the self-employment tax by multiplying the base by 12.4% for the OASDI part and by 2.9% for the HI part. The self-employment tax is the sum of the OASDI part and the HI part. One-half of the self-employment tax liability is deductible when computing AGI on Form 1040.[9] One-half of the self-employment tax is also subtracted from earned income to arrive at the net earned income base against which the Keogh and SEPs contributions rate is applied.

Self-employed persons (as well as employees) are also subject to an additional Medicare tax of 0.9%. Because the tax is imposed only on the worker, self-employed persons may not deduct this tax when computing AGI. The tax applies when a person filing as married filing jointly or as a qualifying widow or widower has modified AGI over $250,000, a single person or head of household has modified AGI over $200,000, and a married person filing separately has modified AGI over $125,000. These thresholds are not adjusted for inflation.

.07 Social Security and Unemployment Taxes

Deferral of Employer's Share of Social Security. The CARES Act permitted employers and self-employed individuals to delay payment of the 6.2% employer share of the Social Security tax (but not the employer's share of FUTA or the 1.45% employer share of the Medicare tax) from March 27, 2020, through December 31, 2020. The tax is payable over the following two years with half due by December 31, 2021, and the other half due by December 31, 2022. These provisions are available to everyone, regardless of income. An employer that receives a Paycheck Protection Program loan is eligible for the Social Security tax deferral. This was not extended beyond the period allowed by the Cares Act.

The tax rate, the maximum wage base for the OASDI portion, and the maximum tax for OASDI are as follows:

Calendar Year	*Tax Rate*	*Maximum Wage Base**	*Maximum Tax for OASDI*
2023	6.2% on the employer's share	$160,200	$9,932.40
*As adjusted by the Secretary of Health and Human Services.			

Unemployment Insurance. The FUTA rate is imposed on the employer but not on the employee. Persons who are self-employed do not pay it. The tax rate is 6% for 2023, but there is a credit of 5.4% available for taxes paid to a state, making the effective FUTA tax rate 0.6%.[10] The employer's net federal tax for the year is 0.6% from, and after, July 1, 2023, because of credits granted for state unemployment tax.[11] The tax is on the first $7,000 of wages paid to an employee during the calendar

[8] IRC Section 1402(b).

[9] IRC Section 164(f).

[10] IRC Section 3101.

[11] IRC Section 3302.

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year.[12] The FUTA tax also applies to persons who paid cash wages of $1,000 or more to a household employee during any calendar quarter in the current or preceding calendar year. Accordingly, employers should not pay more than $420 per employee.

General test: A taxpayer is subject to FUTA tax in 2023 on the wages paid to employees who are not farmworkers or household workers (special rules apply to these categories) if

- the employer paid wages of $1,500 or more in any calendar quarter in 2023 or 2022, or
- the employer had one or more employees for at least some part of a day in 20 or more different weeks in 2023 or 20 or more different weeks in 2022.

¶5005 Annual Cost-of-Living Adjustments and Dollar Limitations for Employee Trusts

Reproduced later in this appendix are the cost-of-living adjustments that apply for various qualified retirement plan purposes for calendar year 2023.

IRC Section 415 provides for dollar limitations on benefits and contributions under qualified defined benefit pension plans. It also requires that the IRS Commissioner annually adjust these limits for cost-of-living increases. In 2023, the maximum limitation for the annual benefit under IRC Section 415(b)(1)(A) for defined benefit plans is $265,000.

The contribution limitation for defined contribution plans under IRC Section 415(c)(1)(A) is $66,000 for 2023.

The IRC provides that various other dollar amounts are to be adjusted at the same time and in the same manner as the dollar limitation of IRC Section 415(b)(1)(A) is adjusted. These dollar amounts and the adjusted amounts are discussed in the text that follows.

The special limitation for qualified police or firefighters under IRC Section 415(b)(2)(G) is not reduced when the benefit begins before the Social Security retirement age.

The limitation on the exclusion for elective deferrals under IRC Section 402(g)(1) is $22,500 for 2023. The $22,500 limit is indexed for inflation. Taxpayers who are age 50 or older may contribute an additional $7,500 for 2023 and later years. (The reference covers employee contributions to 401(k) plans and salary reduction SEPs under IRC Section 408(k).)

The dollar amount under IRC Section 409(o)(1)(C)(ii) for determining the maximum account balance in an employee stock ownership plan subject to a five-year distribution period is $1,330,000 for 2023. The dollar amount for lengthening the five-year distribution period of that section for tax credit employee stock ownership plans is $265,000 for 2023.

The limitation used in the definition of a highly compensated employee under IRC Section 414(q)(1)(B) is $150,000 for 2023.

[12] IRC Section 3306(b).

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The annual compensation limit under IRC Sections 401(a)(17) and 404(l) is $330,000 for 2023 and is indexed for inflation.

The minimum compensation amount under IRC Section 408(k)(2)(C) regarding SEPs is $750 for 2023. The maximum SEP compensation amount under IRC Section 408(k)(3)(C) is $330,000 for 2023.

The maximum contribution amount under IRC Section 408(p)(2)(A) for savings incentive match plans for employees of small employers (SIMPLE) retirement accounts is $15,500 for 2023. The amount is indexed for inflation. Taxpayers who are age 50 or older may contribute an additional $3,500 for 2023.

¶5010 Unified Federal Estate and Gift Tax Rates for Tax Years 2010–2023

For 2023, the maximum estate, gift, and generation-skipping tax rate is 40%.

There is an exemption from tax for estate tax, gift tax, and generation-skipping tax of $12.92 million. The $12.92 million exemption is to be indexed annually for inflation. The $12.92 million exemption can also be expressed as a unified credit against transfer tax liability of $5,113,800.

If the Amount Subject to Tax Is

Over (1)	*But not over (2)*	*Tax on (1)*	*Rate on excess (1)*
$0	$10,000	$0	18
10,000	20,000	1,800	20
20,000	40,000	3,800	22
40,000	60,000	8,200	24
60,000	80,000	13,000	26
80,000	100,000	18,200	28
100,000	150,000	23,800	30
150,000	250,000	38,800	32
250,000	500,000	70,800	34
500,000	750,000	155,800	37
750,000	1,000,000	248,300	39
1,000,000	—	345,800	40

.01 Unified Credit Against Federal Estate and Gift Taxes and Filing Requirements

Applicable credit amount. IRC Section 2010 shows an applicable credit amount for the unified credit against federal estate and gift taxes. The amount of this credit is the amount of the tentative tax computed on the applicable exclusion amount (formerly called the "exemption equivalent"). The applicable exclusion amount for estate tax purposes is as follows:

Year	*Applicable Exclusion Amount*
2006, 2007, and 2008	2,000,000
2009	3,500,000

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Year	*Applicable Exclusion Amount*
2010-2011	5,000,000
2012	5,120,000
2013	5,250,000
2014	5,340,000
2015	5,430,000
2016	5,450,000
2017	5,490,000
2018	11,180,000
2019	11,400,000
2020	11,580,000
2021	11,700,000
2022	12,060,000
2023	12,920,000

For gifts made in 2023, the applicable exclusion amount for gift tax purposes is $12,920,000.

Filing requirements. A federal estate tax return (Form 706) must be filed if a decedent's gross estate, increased by post-1976 taxable gifts, exceeds the applicable exclusion amount for the year of the decedent's death. For deaths in 2011 and later, if the decedent was survived by a spouse, a federal estate tax return should be filed, even if not otherwise required, to make the portability election. Failure to file a federal estate tax return will deny the decedent's surviving spouse the opportunity to use the decedent's unused federal exemption amount. Filing the return is a deemed election of portability of whatever amount of the exemption is unused by the decedent. Portability is discussed in chapter 37, "Portability: An Estate Planning Game-Changer — But Not as Simple as It Seems."

.02 Estate Tax Worksheet

The following is an estate tax worksheet that can be used for estimating potential federal estate taxes.

Computation of Tentative Tax Base			
1.	Client's separate and joint property interests		
2.	Transfers with retained interests		
3.	Annuities, retirement plan assets, and life insurance proceeds		
4.	General powers of appointment over property		
5.	Property that qualified for a qualified terminable interest property marital deduction in the prior decedent's spouse's estate		
6.	Gift taxes paid on gifts within three years of death		
7.	Equals: Gross estate		
8.	Less: expenses, indebtedness, taxes, and losses and state death tax paid		
9.	Adjusted gross estate		

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10.	Less: (a) Marital deduction		
	(b) Charitable deduction		
11.	Equals: Taxable estate		
12.	Add: Adjusted taxable gifts		
13.	Equals: Tentative tax base		
14.	Compute: Tentative tax		
15.	Less: gift taxes paid		
16.	Equals: Tentative estate tax before credits		
17.	Less: unified credit and prior DSUE		
18.	Equals: Gross estate tax before other credits		
19.	Less: other credits		
20.	Net estate tax due		

Line 1. Include interests in property owned, as well as all, or a share of, jointly-owned property in accordance with IRC Sections 2033, 2040, and other rules. For community property, exclude the community spouse's share. For jointly-owned property by spouses, include only one-half of the value of the property. Watch for the special value rule for certain real property under IRC Section 2032A.

Line 8. These are the deductions allowed under IRC Sections 2053 and 2054 and should include funeral and estate administration expenses (estimate if necessary). State death taxes paid are a deduction for estates of decedents.

Line 9. The concept of adjusted gross estate is important for purposes of determining qualifications for the IRC Section 6166 14-year deferral of tax attributable to a business interest.

Line 10(a). The marital deduction for property passing to or for the benefit of a U.S. citizen surviving spouse is unlimited. The marital deduction is not available for transfers to a noncitizen spouse absent special planning considerations.[13]

Line 12. Adjusted taxable gifts means the total amount of taxable gifts (that is, those gifts made in excess of the annual gift tax exclusion) made after 1976, other than gifts that are includible in the gross estate under other rules, such as those included at line 2 of the worksheet shown previously.

Line 14. The rate schedule at IRC Section 2001(c) is applied to the amount at preceding line 13.

Line 15. The gift taxes to be subtracted are those paid on gifts made by the client after 1976 that are not includible in the gross estate.

[13] IRC Section 2056(a); 2056A.

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Line 19. Other credits are those for any tax paid on prior transfers[14] and foreign death taxes.[15]

¶5015 Valuation of Annuities, Life Estates, and Remainders

The value of annuities, unitrust interests, life estates, remainders, and reversions is determined under tables (Publications 1457 and 1458) issued by the IRS under IRC Section 7520. Taxpayers use one set of tables based on the 2020 Census to determine the value of an interest that has a valuation date after April 30, 2020. Another set of tables, based on the 2010 Census, is used for valuation dates after April 30, 2010, and before May 1, 2020. The tables have two components: a mortality component and an interest component.

Under the tables, the interest rates are adjusted monthly. The mortality component is based on the latest mortality tables, which are to be revised at least once every 10 years. The interest component is revised monthly, geared to 120% of the applicable federal mid-term rate on Treasuries compounded annually (rounded to the nearest two-tenths of 1%). For charitable transfers, the interest rate for the month of the transfer or either of the two preceding months may be used.

IRC Section 7520 tables are contained in IRS Publications 1457, *Actuarial Values, Book Aleph;* 1458 *Actuarial Values, Book Beth*; and 1459 *Actuarial Values, Book Gimel*. Book Aleph contains tables of valuation factors and examples that show how to compute other valuation factors for determining the present value of annuities, life estates, terms of years, remainders, and reversions, measured by one or two lives. Taxpayers may also use these factors in the valuation of interests in a charitable remainder annuity trust and a pooled income fund. Book Beth contains certain tables of one and two life valuation factors for computing the present value of remainder interests in a charitable remainder unitrust. Book Gimel has tables for calculating depreciation adjustment factors.

Planning Pointer.

As noted previously, the interest factor under the valuation tables changes monthly. As a result, the value of a gift or the amount of a charitable deduction could be higher or lower in an earlier or later month, depending on the type of interest being valued and the direction of interest rates. For transfers, any part of which qualify for an income, estate, or gift tax charitable deduction, a client may use the interest rate for the month of the transfer or for either of the two preceding months. No such flexibility is afforded for purely personal transfers. However, financial planners and their clients who can reasonably predict which direction interest rates are headed from one month to the next may be able to reduce transfer tax costs. They can accelerate or defer a transfer to obtain the advantage of a higher or lower rate, as the case may be. A change in interest rates affects various interests, as shown in the table that follows.

[14] IRC Section 2013.

[15] IRC Section 2014.

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Type of Interest	*Effect of Increase in Rate on Value*	*Effect of Decrease in Rate on Value*
Life income	Increases	Decreases
Remainder after life income	Decreases	Increases
Reversion after life income	Decreases	Increases
Term income	Increases	Decreases
Remainder after term income	Decreases	Increases
Reversion after term income	Decreases	Increases
Life annuity	Decreases	Increases
Remainder after life annuity	Increases	Decreases
Reversion after life annuity	Increases	Decreases
Term annuity	Decreases	Increases
Remainder after term annuity	Increases	Decreases
Reversion after term annuity	Increases	Decreases
Unitrust interest	Unaffected	Unaffected
Remainder after unitrust interest	Unaffected	Unaffected

¶5020 Key Documents and Lists to Request from the Client

With all the excellent services the financial planner is able to provide, if the client does not communicate a significant amount of information effectively to the planner or to his or her family members, it is possible that the benefit of many of the financial planner's services will go unappreciated, or even worse, unused. The following material is intended to enumerate those items that every client should be sure to document and make readily available to family members or heirs in the event of the client's incapacity or death. Having the client make certain that these items exist and are well-organized and available may prove to be one of the most valuable services the financial planner can provide.

- The will. Be sure there is a will and that the location of the original is identified.
- Trust documents. Is there a living trust that becomes operative at death? Is there a separate life insurance trust? Again, be sure to identify the location of the originals.
- Letter of instructions. Provide the contact information for the client's financial planner, attorney, and CPA. Indicate whether there are any special requests or directions for funeral arrangements.
- Proof of ownership of various items of property. Be sure to identify where the original deeds to real estate holdings are located, as well as any cemetery plots, stock certificates, savings bonds, and titles to vehicles.
- List all brokerage accounts and contact information for them.
- If the client is involved in any partnerships, LLCs, or corporations, indicate the location and provide copies of partnership agreements, operating agreements, and buy-sell agreements.
- If a lender, provide proof of loans made. If a borrower, indicate proof of debts outstanding.

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- Provide at least three years of federal and, if applicable, state income tax returns.
- Provide at least the most recent gift tax returns, preferably all that have been filed.
- List all bank accounts.
- List all safe deposit boxes and provide the location of the access key.
- List all life insurance policies and annuity contracts.
- List all IRAs (Roth and traditional), as well as all 401(k) accounts, pension and profit-sharing plans, and stock options.
- Indicate if there is expectation of special employee benefits, such as a death benefit.
- Maintain all marriage documents, including a marriage license, divorce decrees and settlement agreements, and qualified domestic relations orders. If alimony or child support are addressed, indicate proof that all obligations have been satisfied.
- Address issues of health care and incapacity. Indicate the identity of treating physicians and the location of medical history records.
- Have a durable power of attorney and make certain it can be located.
- Have a living will that addresses the appointment of a health care representative and discusses wishes regarding end-of-life care and, if desired, a "do not resuscitate" order.
- Make certain that any health care directive appointing an individual to act for the ill person includes authority to release health care information to such appointed person.
- If the client wishes to be considered for organ donation, make certain that fact has been communicated and is documented in a readily accessible manner.
- Provide information addressing all digital assets, including user names and passwords.

¶5025 125 (and More) Reasons Why Clients Should Seek Planning Assistance Now

A concern common to all financial planners is "How do I get my clients to realize how important it is to plan?" Regardless of how knowledgeable and skillful the planner may be, getting in front of a client and motivating that client to take positive actions is an ongoing challenge. Clients do not have to be especially wealthy or old or ill to make plans. The pandemic has provided a harsh lesson that one can never be certain when planning will be needed. Many planning issues are best addressed when assets are modest, and youth and good health are present. We have compiled a list of suggested reasons to plan and issues to be addressed, thanks to the contributions of a number of talented people working as financial planners, accountants, attorneys, trust officers, and insurance agents, and we gratefully acknowledge their contributions. They were instrumental in our efforts to share our collective best ideas to motivate both clients and their planners to get the planning process underway.

The suggestions that follow are not intended to be listed in any order of particular importance. Their inclusion in one category does not suggest that they are, in any way, exclusive to that category. To the

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contrary — financial, estate, tax, retirement, and insurance planning is a collaborative process. Integrated financial planning is a goal we all seek to attain. Many skills and talents are needed to be brought together to best serve the interests of our clients.

.01 Financial Planning Considerations

1. Consider the client's basic asset and liability position. What is the plan for the short- and long-term?

2. Develop a family balance sheet listing assets, liabilities, values, and forms of property ownership. Focus on the income tax basis of a client's assets.

3. Develop a family tree with birth dates, residences, and contact information, so that family members, heirs, and fiduciaries can be located in the event of an emergency or a death.

4. Create a master list of passwords and user IDs for all computer-stored information.

5. Address asset allocation and diversification.

6. Reevaluate risk tolerance issues.

7. Rebalance an investment portfolio.

8. Address issues of the client's domicile — has everything been done to establish domicile in one state clearly, and are all documents in place to reflect that domicile?

9. Discuss Social Security and Medicare benefits and the choices available about timing eligibility claims and obtaining supplemental plans.

10. Address, in general, education planning, including college savings plans (529 plans) and the use of trusts and direct tuition payments for education planning.

11. Determine the combination of college savings vehicles (529 plans, custodial account, trust, Coverdell Plan, Roth IRA) most appropriate for the client's family.

12. Examine the investment mix of assets in a college savings plan relative to a child's age.

13. Evaluate the family's expected family contribution for college costs. Undertake planning to better address this.

14. Exercise income-shifting strategies between parents and children to lower the overall cost of college expenses — or at least obtain additional financial aid.

15. Discuss, in general, a range of beneficiary designation issues, including those required for life insurance policies, retirement plans, IRAs, stock options, and deferred compensation plans.

16. Review issues involving titling to assets, such as in individual name, joint names, community property, tenancy by the entireties, and tenancy in common.

17. Facilitate coordination of the planning team — financial adviser, accountant, attorney, insurance professional, and trust officer.

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18. Review federal and state income tax returns to look for planning ideas and avoid possible problems.

19. Discuss issues of family governance and how to prepare children for an inheritance.

20. Consider issues relating to a business start-up venture, including form of organization, financing options, and financial projections for the business.

21. Evaluate the requirements of a suggested franchise venture.

22. Consider a client's charitable objectives and evaluate alternative methods of fulfilling those objectives. The objectives and alternatives include outright cash gifts, gifts of appreciated property, IRA transfers to charity, use of donor-advised funds, charitable gift annuities, or private foundations, recommendations of split-interest charitable trusts.

23. Counsel clients following the death of a spouse, especially addressing income resources and liquidity requirements.

24. Determine if an inheritance will be available and counsel how it should be managed.

25. Discuss flexible planning alternatives (disclaimers, general and limited powers of appointment) in view of the sunset of current law death tax exclusions and the importance of tax basis planning.

26. Discuss how to avoid potential family disharmony after the death of a family member.

27. Discuss the tax planning aspects of a pending divorce.

28. Discuss the advisability and use of prenuptial and postnuptial agreements.

29. Discuss tax issues that may arise in a foreclosure, short sale, or bankruptcy.

30. Discuss the most efficient use of capital loss carryovers, charitable contribution carryovers, and suspended passive activity losses and credits.

31. Examine the client's income tax return issues to determine if any planning can reduce AMT exposure.

32. Review and assess a severance package.

33. Address the exercise of stock options and other compensation awards. Changes to the AMT rules may expose fewer stock options to tax. Consider "harvesting" gains to balance against losses.

34. Address the tax planning aspects of the sale of a primary residence or vacation home.

35. Reassess financial plans following a dramatic change in circumstances (such as a natural disaster or long-term unemployment).

36. Discuss issues involving possible emigration and expatriation planning.

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37. Discuss concepts of valuation discounts for clients with ownership interests in businesses or properties — especially because the law allows discounting.

38. Discuss incorporating alternative asset classes (such as commodities or currencies) into a financial plan that are not typically correlated to stock market performance to possibly reduce volatility.

39. Discuss the management of an award or settlement from a lawsuit.

40. Look at entity choices and organizations in light of IRC Section 199A's 20% pass-through deduction, the 21% C corporation tax rate, and what can be done to best address these planning alternatives.

41. Be certain that information with respect to digital assets is available to be located and used in the event of disability or death.

.02 Estate Planning Considerations

1. Review and update the estate plan and the client's planning objectives in general.

2. Recognize that the federal tax laws have changed in recent years and that existing planning documents may no longer be effective or desirable.

3. Review existing estate planning documents to understand how they will work.

4. Discuss appropriate fiduciaries — executors (personal representatives), trustees, and guardians.

5. Address successors — beneficiaries and fiduciaries — in case they are needed.

6. Discuss the special planning opportunities and possible pitfalls of the federal gift, estate, and GST tax changes effective for 2023. Be aware of suggested law changes on the horizon. Access the audio learning in the Proactive Planning Toolkit for more information on these proposals.

7. Point out the scheduled changes in the federal gift, estate, and GST tax laws for 2023 that may be advantageous. Be sure the client understands portability of the transfer tax exclusion at the death of a spouse.

8. Address possible state estate or inheritance tax issues, especially where the federal and state tax laws diverge. The estate plan should address both federal and state issues.

9. Discuss and recommend gifting programs for children and grandchildren and recommend various techniques as appropriate (custodial accounts, payable on death accounts, outright gifts, loans, trusts, or more sophisticated leveraged gifting techniques). Pay attention to the income tax basis of transferred assets.

10. Discuss planning for a special-needs child and the use of a special-needs trust. Consider the applicability of an ABLE account, and available government assistance programs (SSI, Affordable Care Act, etc.)

11. Consider the possibility that a parent being assisted by a child will survive the child and what trusts should be created to address this.

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12. Prepare a trust for financial management in the case of disability.

13. Discuss using a living trust for titling real estate owned by the client in multiple jurisdictions to avoid ancillary probate issues, as well as home state probate and privacy concerns.

14. Address the need for a buy-sell agreement for a business to put into effect a business succession plan.

15. Look specifically at a client's will following changes in the law, changes in family circumstances, or relocation to a new state.

16. Look specifically at a client's revocable trust following changes in the law, changes in family circumstances, or relocation to a new state.

17. Put into effect a charitable giving plan, especially if it involves the creation of charitable trusts or private foundations.

18. Determine the proper disposition of the tangible assets of the family — artwork, jewelry, antiques, collectibles, and so on.

19. Consider planning for "special" family situations — such as "blended" families, adoption, or stepchildren.

20. Make certain that the client's documents address an appropriate "pathway" for a disclaimed interest in property if the disclaimer technique is being used.

21. Make certain that beneficiary elections are being properly handled in spousal and marital trusts.

22. Modify existing documents and plans (beneficiaries of life insurance policies and retirement plans) in the event of a divorce.

23. Consider planning loans to family members while the published federal interest rates are still at low levels.

24. Bring to the attention of the client (in appropriate situations) some of the more sophisticated estate planning techniques that remain available in 2023, which may possibly be limited or eliminated by future tax laws (including GRATs, QPRTs, SCINs, SLATs, defective grantor trusts, and dynasty trusts).

25. Evaluate the different state laws regarding asset protection, income taxation, and estate and inheritance taxation, and recommend the best location(s) for the situs of a trust.

26. Determine generally the estate planning effect of a birth, death, marriage, or divorce on estate planning documents, IRAs and qualified retirement plan benefits, life insurance, and annuities. Revise the estate plan and beneficiary designation forms accordingly and coordinate the other issues with the appropriate professionals.

27. Explain the impact of the portability rules of the estate tax exemption and point out the advantages and disadvantages of these rules.

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28. Coordinate the assets a person has that pass under a will with those assets passing outside of a will, with special attention to the interests of beneficiaries and the allocation of state and federal transfer tax burdens, if applicable.

29. Consider, when allowed and appropriate, "decanting" (that is, modifying) an existing irrevocable trust to comply with the intentions of the trust grantor or to address unanticipated changes in family circumstances.

30. Address general creditor protection issues, such as homestead protection from claims of creditors or the use of a domestic asset protection trust. Consider states with favorable laws providing protection from creditors.

.03 Retirement Planning Considerations

1. Address what the plan is and how it has changed if asset values or family relationships have changed.

2. Review all the client's beneficiary designations. Are they still applicable? Has naming one's estate been avoided?

3. Determine if annual plan contributions have been made and if contribution opportunities have been maximized.

4. Discuss the benefits of IRA and Roth IRA contributions.

5. Consider the merits of converting an IRA to a Roth IRA, especially in times of a declining stock market.

6. Consider the loss of the opportunity after the 2017 TCJA to recharacterize a converted Roth IRA to a traditional IRA.

7. Ascertain that the client's retirement plan and actions are in compliance with the current required minimum distribution rules, especially in light of the SECURE Act of 2019 and the Secure Act 2.0 of 2022.

8. Recommend exceptions to the 10% penalty for early withdrawal of retirement plan assets when the client has a need for the cash.

9. Determine the impact of the SECURE Act and the ten-year required distribution rule on the client's planning, particularly if the client was anticipating a lifetime stretch out of distributions for someone who is not an eligible designated beneficiary. Revisit any conduit trusts.

10. Advise a client turning age 72 about minimum distributions. Consider a gift at age 70½ from an IRA to a charity of up to $100,000 to take advantage of the special qualified charitable distribution rule.

11. Advise a noncompany owner-client, who is turning 72 and still employed, that minimum distributions from a qualified plan (but not from an IRA) can be delayed until retirement.

12. Discuss annuities, including the option of partial annuitization.

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13. Explain the advantages and disadvantages of a spousal rollover to an IRA.

14. Explain how the inherited IRA can be accomplished and the procedures needed to make it work.

15. Discuss the special rules for employer stock in a retirement plan, and how net unrealized appreciation is treated for income tax purposes.

16. Discuss how minimum required distributions can be reduced by investing in a Qualified Longevity Annuity Contract.

17. Consider cautioning against gifts of low basis property by elderly donees.

18. Consider "upstream" planning: gifting low basis assets to elderly family members with the expectation that their eventual death will return assets to the donor with an enhanced basis.

.04 Insurance Planning Considerations

1. Consider planning for possible disability — short-term and long-term disability insurance.

2. Determine if life insurance will be included in the client's taxable estate and possibly subject to unnecessary estate tax.

3. Review the insured's health situation to see if premiums can be reduced.

4. Review the beneficiary designation forms. Are all decisions still appropriate?

5. Determine if the amount of life insurance on hand is sufficient for income replacement if the breadwinner of the family dies.

6. Review the entire list of necessary liability insurance policies — home ownership and contents, automobile, professional liability, and umbrella liability.

7. Determine the correct ownership and beneficiary designations of existing policies among the insured, spouse, children, and irrevocable life insurance trust.

8. Examine if a Crummey power is part of the life insurance plan and if all notice requirements have been satisfied.

9. Review recent premium projections to determine if current premium levels are adequate and attainable to maintain the policy for the rest of the client's life.

10. Check out the financial strength rating of your insurer to make sure it is among the top performing of all insurance companies.

11. Analyze the advantages of the cash value of life insurance as both an asset protection vehicle and as a category of asset exempt from the 3.8% net investment income tax.

12. Evaluate the liquidity needs that can be provided by different life insurance products, such as whole life insurance, term life insurance, universal life insurance, variable life insurance, private placement life insurance, premium funded life insurance, and life insurance with a connection to long-term care insurance and survivorship (second-to-die) life insurance.

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13. Address all relevant tax rules, including the grandfathered benefits of pre-1986 policies.

14. Determine if insurance is needed in a buy-sell program and evaluate the merits of a cross-ownership situation versus an entity buyout situation, especially in light of the repeal of the corporate AMT by the 2017 TCJA.

15. Determine if any business planning with life insurance will raise issues under the transfer for value rules. Where appropriate, recommend using an irrevocable grantor trust to own life insurance policies.

16. Determine if life insurance in place is owned by a C corporation that will no longer cause problems with the now repealed corporate AMT.

17. Determine if all existing life insurance policies remain necessary and what to do with those no longer needed or desired. Does the client have only term life insurance, which is likely to become exceptionally costly as the client ages?

18. Advise clients in financial difficulty what can be done to preserve their life insurance coverage.

19. Advise a client desiring to gift a life insurance policy of the three-year "look-back" rule for transfers of existing policies.

20. Advise a client acquiring a new life insurance policy to have it owned from the outset in an irrevocable trust to avoid the three-year "look-back" rule.

21. Consider if some form of split-dollar life insurance arrangement would be appropriate.

.05 Long-Term Care Planning Considerations

1. Discuss long-term care insurance and state programs for long-term care.

2. Address Medicaid eligibility planning and availability of other government benefits.

3. Prepare or revise a medical directive, health care proxy, or living will.

4. Make certain a current durable power of attorney has been considered and prepared, especially in light of the law changes affecting powers of attorney made in some states.

5. Explain the difference between a standard durable power of attorney and a springing durable power of attorney.

6. Discuss annuities as protected family assets in Medicaid planning.

7. Discuss issues arising in the care or support of a disabled parent, including trust planning if the child predeceases the parent.

8. Consider long-term planning for a disabled child if the parent dies, including special-needs trusts.

9. Explore care issues related to Alzheimer's disease and other possible long-term illnesses.

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10. Make certain that Medicare is applied for in a timely manner to avoid future penalties.

11. Consider if an HSA is an appropriate investment.

.06 Year-End Tax Planning Considerations

1. Consider the standard planning of accelerating deductions and deferring income, unless the taxpayer is trying to fill up tax brackets for multi-year planning purposes. Will the 2017 TCJA changes that reduce or eliminate many deductions have an impact here? See chapter 33, "Year-End and New Year Tax Planning," for further discussion of this planning technique.

2. Consider the income tax rates and the 3.8% tax on net investment income for 2023. See the discussion in chapter 33, about how year-end planning considerations have become more complex.

3. Coordinate, if possible, regular income tax and AMT liability issues.

4. Be careful of the prepayment of expenses, such as estimated state income taxes and property taxes in light of the $10,000 per year deduction limitation, keeping in mind the effect of such strategies on AMT issues.

5. Address estimated tax situations. If gains were accelerated in 2022, estimates might be overpaid if a safe harbor was used for 2023. Estimates may be underpaid if the repeal of many itemized deductions, the additional 0.9% Medicare tax, net investment income tax, and the 2023 tax rates have not been addressed, and a fail-safe safe harbor was not used.

6. Be aware of the various tax law planning opportunities that were repealed or created for 2023 and beyond, as well as those that may be expiring or sun setting after 2025 without further extension provided. Be aware of the numerous proposals in 2023 to change tax laws and the strategies available to address them.

7. Assess what to do about mutual funds that have declined in value but will still pay out capital gains.

8. Address capital gains and losses and try to balance them if possible. Try to minimize the client's exposure to the 20% tax rate and the 3.8% tax on net investment income by harvesting losses. Alternatively, in some circumstances, harvesting gains may be more preferable than losses in order to fill up tax brackets without exceeding them. See chapter 33, for further discussion of this planning technique. Consider using donor-advised funds and charitable remainder trusts to bunch deductions and manage gains and smooth out income within a multi-year or multi-scenario, customized individual plan.

9. Consider the use of a like-kind exchange (of real estate only after the 2017 TCJA) to defer reporting of a gain on the sale of investment property. Be aware of suggestions to eliminate this planning opportunity, or limit it to gains not greater than $500,000.

10. Consider installment sales — either elect out of the installment method for a 2023 sale and pay all the tax on the gain at the 2023 rates, or utilize installment sale treatment to stretch out reporting of a gain.

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11. Consider a conversion of a traditional IRA plan to a Roth IRA before year-end. The 2023 federal tax rate on the conversion could be as high as 37%, depending on the size of the conversion. However, there will not be required distributions by the participant from the Roth IRA in future years. IRA withdrawals are required once the client reaches age 72 and possibly needed sooner. Although they are not considered net investment income, they will still increase the client's AGI and may help push the client over the net investment income tax AGI threshold. Address this in the context of the 2023 tax rates, the stock market performance, and possibly higher tax rates in the future.

12. Consider voluntary withdrawals from IRAs and qualified retirement plans, as long as they will not be subject to the 10% excise tax.

13. Take advantage of the 2023 "perfect storm" of estate planning opportunity while it is still available. Interest rates are rising, values may be depressed, discounts are still available, exemptions are generous, and tax rates are low. All of this may cease to be available in the future if wealthy taxpayers and the planning techniques they favor are targeted for change.

14. Pay attention to clients with trusts. Income in trusts will be taxed at the 37% bracket and subject to the net investment income tax when $14,450 (for 2023) of undistributed trust income is reached. When possible and appropriate, encourage distributions to individual beneficiaries with higher tax rate thresholds.

¶5030 Business Succession Planning Checklist

Many businesses are family-owned. With the aging of the baby boomer generation, many business owners are contemplating the disposition of their business. Too few owners have a succession plan in place. Statistics indicate that fewer than 30% of family businesses transition successfully from the first to the second generation, and fewer than 15% successfully transition from the second to the third generation.

The financial planner can make an important difference by assisting the client in the development of a business succession plan. Some issues to consider are as follows:

- **Goals and Objectives**

  — Identify the need for a succession plan

  — Develop vision, goals, and objectives

  — Establish personal retirement goals

  — Identify family goals or employee or other owner's goals

  — Establish a team of professional advisers

  — Make certain there is, and will be, sufficient personal and family liquidity

  — Try to minimize conflicts among family members that may arise from the succession plan

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- **Decision-Making**
  - — Involve family members in the decision-making process
  - — Establish methods for dispute resolution
  - — Communicate wishes to family members or employees or other owners
- **Successors**
  - — Identify successors
  - — Determine the ownership structure
  - — Determine the management structure
  - — Identify the required training for successors
  - — Provide training to build a vision for the future of the business
  - — Provide support for successors
- **Estate Planning**
  - — Address implications of taxation to the owner and business upon sale or transfer of ownership
  - — Develop an estate and personal financial plan for the owner, spouse, and the succeeding generation
  - — Detail retirement income needs
  - — Provide for active and nonactive family members
- **Contingency Planning**
  - — Identify potential problem areas
  - — Develop “what if” scenarios
  - — Include action plans
- **Business Structure and Transfer Methods**
  - — Will the business be transferred to family members or sold?
  - — Define roles for family members and key employees
  - — Fill key management positions
  - — Identify role(s) for the retiring owner, if any

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- — Restructure the business, if necessary (create non-voting interests to make gifting easier, for example)
- — Consult with the team of professionals (financial planner, accountant, attorney, broker, and banker)

- **Business Valuation**
  - — Obtain professional advice to determine a fair market value for the business
  - — Determine what is to be sold
  - — Consider issues of profitability, business location, inventory level, and financing of the buyout
  - — Obtain a bona fide appraisal to satisfy adequate disclosure rules
- **Exit Strategy**
  - — Determine the method of transfer (gift, asset sale, stock sale)
  - — Establish a timeline for implementation of the succession plan
  - — Make all affected persons aware of the plan
  - — Communicate regularly with all affected parties
- **Family Issues and Concerns**
  - — Will heirs be forced to liquidate or sell the business to outsiders?
  - — Will the deferred payment of estate tax rules be needed and available?
  - — What incentives are needed to retain key people?
  - — If the business is gifted only to children active in the business, will there be an unequal estate distribution between those children and those not active in the business?
  - — What will be the source of income for the surviving spouse?
  - — Will the financial security of the surviving spouse be compromised by the children's ability to continue payments after the principal's death?
  - — If the owner dies prematurely, will the business interest be retained by the surviving spouse or children?
  - — If the company has bought out the principal business owner, will the required installment payments compromise the company's ability to operate and grow the business?
  - — Will conflicts arise between the children and senior generations?

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- **Continued Planning**

  — Review and discuss the plan on a regular basis.

  — Revise and update the plan as necessary.

  — Involve the next generation in the planning discussion process.

¶5035 Checklist of Estate Administration Issues and Responsibilities

I. To Be Done as Soon as Possible After a Death	
A. Consider Immediate Family Needs	
	1. Review sources of cash for family maintenance before probate.
	a. Joint bank accounts. Surviving joint tenant may be able to withdraw some or all bank balances upon presentation of a death certificate and before probate.
	b. Pension and profit-sharing benefits payable to an individual beneficiary.
	c. Social Security and Veterans' survivor benefits (spouse and minor children).
	d. Life insurance proceeds payable to an individual beneficiary may be payable upon presentation of death certificate and completed claim form.
	2. Consider custody of children, if orphans.
	3. Explain to the immediate family what is involved in probate and administration.
	4. Order sufficient number of death certificates. 5. Ascertain the decedent's wishes for disposition of remains.
B. Income Tax and Gift Tax Returns	
	1. Are returns due? Are returns overdue?
	2. Are payments due? Are payments overdue? (Note that quarterly estimates of personal income taxes are suspended by death for the decedent, but not for the surviving spouse.)
	3. Have extensions been requested? 4. Has a new employer identification number (EIN) been obtained for the estate?
C. Secure the Property	
	1. Secure the decedent's residence and private offices. Remove valuables for safekeeping.
	2. Secure the decedent's computer, if appropriate, and determine who has passwords and access to business and financial records. Also, consider the value of proprietary domain names.
	3. Consider care and protection of pets and perishable assets.
	4. Have tangible personal property inventoried and appraised. Consider multiple appraisals of rare or valuable articles.
	5. Review insurance coverage for real estate, automobile, tangible property, and liability exposure. Check ownership, payment of premiums, and expiration dates of policies.
	6. Take possession of bank and brokerage statements, checkbooks, and passbooks for three prior years plus year of death. Cancel credit cards. Locate safe deposit boxes.
	7. Get control of mail.
	8. Check maturity dates for investments, such as bonds, certificates of deposit, and time deposits. Check deadlines for corporate tender offers.
	9. Review outstanding leases, including real property, vehicles and equipment, including rights to cancel or renew or extend the terms, or to assign or sublet.
	10. Review other outstanding contractual obligations.

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	11. Notify SSA and Veterans' Administration if the decedent was receiving benefits or if the estate or family is entitled to benefits.
D. Commence Probate or Administration Proceedings	
	1. Locate the will. If the original will is in the decedent's safe deposit box, obtain an order to open the box if required.
	2. Review the will for its dispositive scheme and for information as to assets, beneficiaries and witnesses.
	3. Identify any potential probate or construction problems, such as duplicate wills, interlineations, or mutilations.
	4. Resolve issues of the decedent's domicile if there was more than one residence.
	5. Identify distributees and other persons required to be cited in probate proceedings; contact witnesses if there is no self-proving affidavit or if a will contest is contemplated; and prepare and file necessary papers.
	6. Review any prenuptial or postnuptial agreements affecting the rights of the surviving spouse. Determine whether there is a potential right-of-election by the surviving spouse, especially where "elective share" has been put into a trust or where a QTIP trust has been established for most of the estate.
	7. Consider whether the state Attorney General must be notified of probate because of the existence of a bequest in trust to charity or a residuary bequest to charity.
	8. Consider whether the state Attorney General must be notified because there is no distributee or beneficiary or the facts are unknown.
	9. Where an attorney is also named as executor, look for an attorney disclosure statement if local practice requires this.
	10. Apply for letters testamentary.
	11. Consider use of small estates provisions as an alternative to probate, if applicable under local rules. Present the will for probate.
	12. Determine whether ancillary probate is required in another jurisdiction for tangible personal property or real estate.
II. Within 30 Days	
A. Marshall the Assets	
	1. Locate assets.
	a. Confer with the family.
	b. Check the decedent's attorney's records.
	c. Open the decedent's safe deposit box
	d. Prepare an inventory and have valuables appraised.
	e. Write to the decedent's banks inquiring as to other accounts or safe deposit boxes.
	f. Review checkbooks and income tax returns for information about assets.
	g. Search the residence(s) and office.
	h. Search the computer files.
	i. Determine employer-provided retirement and death benefits and locate IRAs.
	j. Are there assets in foreign countries? Has the income been reported?
	2. Gain control of assets.
	a. Register bank accounts and securities in the estate name, not in the fiduciary's name.
	b. Collect proceeds of life insurance payable to the estate. Ask for IRS Forms 712 and assist with the collection of life insurance proceeds payable to named beneficiaries.

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	c. Make private medical insurance, major medical and Medicare claims, and applications for refunds on cancelation of any health or property insurance or prepaid services.
	d. Determine whether there are any decedent-held employee stock options that must be exercised within a specific time after death.
	e. Are there claims of the decedent or the decedent's family, such as wrongful death claims or pending contract claims? f. Determine status of outstanding leases, including real estate, auto, equipment, etc. Can any be canceled if desired?
	3. Value the assets.
	a. Have real property appraised. Use a formal real estate appraisal rather than a letter from a realtor, especially if there will be any estate tax to pay.
	b. Obtain valuations of securities. (Note that the value of securities is the mean between high and low on the date of death, not the closing price.)
	c. Obtain date-of-death values on bank accounts from the banks.
	d. Is there a marital trust from a predeceased spouse? Was portability involved?
	e. Is there income due from a marital or non-marital trust from a predeceased spouse or a parent or other relative?
	B. Begin Estate Administration
	1. Determine estate cash requirements, and circulate to executors and, if appropriate, to residuary beneficiaries.
	a. Determine funeral expenses and obtain a receipted funeral bill.
	b. Determine balances due at death on mortgages and loans.
	c. Review mail for current bills.
	d. Estimate administration expenses, including attorney's fees and commissions.
	e. Make a preliminary determination of estate taxes owed and proper apportionment of estate tax liability under the will.
	(i) Determine state estate taxes in state of domicile.
	(ii) Determine estate taxes in any other state or in any foreign country.
	f. Are available assets subject to capital gains taxes on sale, despite the general rule of step-up in basis? Are there assets classified as income in respect of a decedent for which there is no basis adjustment?
	(i) Are there any assets inherited from a spouse or other testator who died in 2010, which is when carryover basis applied, if elected?
	(ii) Are there any assets held in trust with historic basis?
	g. Are there lawsuits pending or other claims against the decedent or potentially against the estate?
	h. Determine total dollar amount of cash bequests under the Will.
	i. Review whether the beneficiaries will need access to the assets of the residuary estate during the period of estate administration, for their support or any business use.
	j. Does the will or living trust set up a disclaimer option for the surviving spouse? Make preliminary calculations of the optimum disclaimer. Note the nine-month filing deadline. Arrange for counseling of surviving spouse and children. k. Determine if the estate plan includes any directed trusts. If so, contact the persons named as having directing authority.
	C. Business Needs and Estate Liquidity
	1. Business needs: Review the will as to the fiduciary's powers and duties.
	a. Does the executor have authority to continue the decedent's business?

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	b. Will the executor retain assets or sell them and reinvest?
	c. Who is managing the investments?
	d. Who is the responsible accountant?
	e. Apply to the court if required to continue the decedent's business if the decedent was the sole owner and the will does not authorize continuation.
	2. Determine the estate liquidity.
	a. Consider sales of assets, including common stocks and non-income-producing assets.
	b. Withdraw funds from time deposits without penalty for early withdrawal and make certain that a penalty is not imposed.
	c. Consider the possibility of an IRC Section 303 redemption of the decedent's stock in a closely held business.
	d. Consider provisions for deferring the payment of estate taxes.[16]
	e. Consider valuing farm or closely held business real property in accordance with the qualified use value under IRC Section 2032A.
	f. Consider the desires of residuary beneficiaries for the retention of assets.
	(i) Liquidate assets that beneficiaries do not want to receive in kind.
	(ii) Consider obtaining an indemnification from beneficiaries to protect the fiduciary from a loss in value before distribution.
	g. Consider appropriate short-term reinvestments.
D. Tax Filings	
	1. Apply for an estate identification number from the IRS, using Form SS-4 or on the IRS website.
	2. File a notice of fiduciary relationship (IRS Form 56).
	3. Apply for federal and state releases of liens on real estate before their sales, using IRS Form 4422 and the appropriate state form.
	4. Review gift tax filings, especially filings for large gifts. File any missing gift tax returns.
	5. Is the decedent liable for gift taxes, employer taxes, or other lifetime taxes?
	6. Are there any pending audits of previously filed income tax or gift tax returns?
	7. For a decedent with more than one home, is any state challenging the decedent's claimed residence? Is there a pending audit relating to the residence?
	8. Regarding S corporations, does the will or trust affect the Subchapter S election?
	9. If S corporation shares are left to a QSST or ESBT Trust, file the required elections within 2½ months.
III. Within Three Months	
A. Raise Cash Requirements	
	1. Sell marketable securities.
	2. List real estate with a broker.
	3. Deliver works of art to be sold to a dealer or auction house.
	4. Reinvest the sale proceeds in income-producing assets.

[16] See IRC Section 6166 regarding closely held business and IRC Section 6161 regarding reasonable cause or undue hardship.

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	B. Develop Post-Mortem Tax Plans
	1. Income Taxes
	a. Determine whether to use the calendar year or a fiscal year.
	(i) For revocable trusts, use of the calendar year is mandatory, but combined temporary filing of the trust as a qualified revocable trust (IRC Section 645) with executor as an estate may permit use of a fiscal year.[17]
	(ii) For estates, use of a fiscal year or the calendar year is permitted. Use of a short fiscal year is also permitted.
	b. Determine the timing of deductions and distributions.
	(i) With the new, larger U.S. estate tax exemption, it may become common to elect to take deductions for income tax purposes, rather than for estate tax purposes.
	(ii) Income tax deductions are generally available *only* in the year the expenses are incurred.
	(iii) Timing of deductions may become a significant element of estate administration. For example, it may be wise to consider advance payment of executors' commissions rather than paying all commissions in one year at the end of the administration of the estate. Determine if deductions will be denied as miscellaneous itemized deductions.
	(iv) Consider the timing of distributions to beneficiaries and income-splitting between the estate and residuary beneficiaries. Determine if capital gains are distributable.
	(v) Fiduciary income tax rates on Form 1041 may be higher than the beneficiaries' personal income tax rates on Form 1040.
	(vi) Consider the impact of the 3.8% tax on net investment income.
	c. Assess whether to deduct the decedent's medical expenses on the decedent's final income tax return or on the estate tax return. Those paid within one year of death can be claimed on the final income tax return.
	d. Assess whether to report accrued interest on U.S. savings bonds on the decedent's final income tax return.
	2. Pensions and IRAs.
	a. Consult with the family and the family accountant.
	b. Review methods of payment from qualified plans and IRAs:
	(i) Income taxes
	(ii) Estate taxes
	c. Consider the different tax needs of different beneficiaries. d. Consider outright distributions, inherited IRAs, spousal rollover opportunities. e. Was the decedent's planning updated in response to the SECURE Acts? f. Determine the beneficiaries and the duration of distributions for them g. If the decedent was subject to RMDs, was one taken in the year of death, or must the beneficiary take it?
	3. Payment of debts and legacies.
	a. Pay undisputed debts. Pay legacies if the estate is solvent.

[17] IRC Section 645.

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	b. If the estate may not be solvent, review the priority of payment of debts.
	c. Pay special attention to an estate fully disposed of by specific bequests and devises.
	d. Consider whether an informal (non-judicial) accounting is permitted by local rules and whether it would be acceptable to beneficiaries. e. Be sure to reserve ample funds for taxes before making distributions to beneficiaries. Determine the beneficiaries and the duration of required distributions to them. f. If the decedent was subject to RMDs, was one taken in the year of death, or must the beneficiaries take it?
	4. Begin to prepare the final accounting for eventual presentation to beneficiaries and/or the court.
	a. Are all beneficiaries also executors? Are they taking equal responsibility?
	b. Will the attorney, accountant, or executor prepare an accounting if required? Will accountings be required in more than one court?
	c. Use official forms of the local court.
	d. Begin to enter data. List assets already received, list income as it is received, and list disbursements as they are made.
IV. Within Six Months	
	A. Estate Tax Returns
	1. Prepare draft IRS Form 706 and state return, if applicable.
	a. Assemble additional papers to be filed with returns.
	(i) Forms 712 from life insurance companies for policies owned by the decedent or policies on the life of the decedent or payable to the estate.
	(ii) Balance sheets for the previous five years for closely held businesses in which the decedent had an interest, including family partnerships, S Corporations or LLCs.
	(iii) Appraisals of real and personal property.
	(iv) Is there unified credit available from a predeceased spouse: "portability"? (DSUE)
	b. Assemble an "audit file" for papers an IRS agent may wish to examine on audit.
	(i) Collect pre-death checkbook records, bank and brokerage statements, and income tax returns for year of death and three years prior to death.
	(ii) Collect verification for debts claimed as deductions.
	(iii) Collect gift tax returns.
	2. Plan to obtain alternate valuations of estate assets if the estate will be taxable. Determine if electing the alternate valuation date is available and advantageous. (Note that the estate tax value will become the basis of the decedent's assets for determining future capital gain or loss on sales.)
	3. Does the will take advantage of the decedent's unified credit and/or generation-skipping tax exemption? Consider the U.S. tax implications in contrast to the state tax implications and reach a final decision as to a possible disclaimer by the surviving spouse. Is a reverse QTIP election called for?
V. Within Nine Months	
	A. File U.S. Estate Tax Return and State Death Tax Return, and Pay the Tax
	1. Complete and file Form 706 and any applicable state returns.

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	a. Many estates are no longer taxable and will not require the filing of an IRS Form 706. Nevertheless, consider filing Form 706 to take advantage of portability. Alternate valuation may be elected only on a timely filed return and only if the election reduces the values of the estate assets and the estate tax, not merely for the purpose of increasing the basis of assets.
	b. If necessary, file a six-month automatic extension of time to file.[18]
	2. Pay any estate taxes due, regardless of whether the returns are filed. If necessary, apply for an extension of time to pay the tax.[19]
	3. Consider an application for discharge of the fiduciary from personal liability for the estate tax, to take effect nine months after the return is filed.[20]
	4. Review and refine the post-mortem tax plan.
	5. Advise the executor with respect to how much of the residuary estate to distribute and how much to hold as a reserve against the possibility of an estate tax audit or other contingencies.
	a. Have discounts been taken with respect to any interests in property owned by the decedent?
	b. Did the decedent own real estate, art works, or other assets that are inherently hard to value? c. Consider a request for a prompt assessment of taxes. File IRS Form 4810. d. Consider the availability of the credit for prior transfers.
B. Advise Beneficiaries With Regard to Disclaimer	
	1. Consider disclaimers by beneficiaries other than the surviving spouse, including wealthy children or children exposed to claims, such as doctors. Review alternative will provisions that would apply to disclaimed property.
	2. A "qualified" disclaimer must be made within nine months of death, to avoid federal gift tax consequences.[21] (Note that an extension of time to file estate tax returns does not extend the time for filing a disclaimer. For U.S. gift tax purposes, a beneficiary who is under age 21 is allowed nine months after his or her 21st birthday to make a qualified disclaimer.)
	3. Fiduciaries may waive commissions.
	a. If the fiduciaries are beneficiaries or family members and if there is no U.S. estate tax, the acceptance of commissions may create an income tax obligation for the fiduciary without a corresponding estate tax deduction. (Note that there will be many more estates with no U.S. estate tax.)
	b. A waiver should be in writing and signed on a timely basis before estate tax returns are filed; otherwise, the fiduciary risks constructive receipt of the commissions for income tax purposes.
VI. Within Other Periods	
A. File the Decedent's Final Income Tax Returns	
	1. These are due by April 15 of the year after death unless an extension is granted.
	2. No estimated payments need to be made after death for the decedent, but for joint returns, the surviving spouse must continue to make estimated tax payments.

[18] IRS Form 4768.

[19] IRC Section 6161 et seq.

[20] IRC Section 2204.

[21] IRC Section 2518.

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	3. If the decedent had a revocable trust, consider making a Section 645 Qualified Revocable Trust election to have the trust taxed as an estate for income tax purposes for at least two years. File Form 8855.
B. File the Decedent's Final Gift Tax Returns	
	These are due no later than the earlier of the due date (with extensions) for filing the Form 706, or by April 15 of the year after death or the extended due date granted for filing the donor's gift tax return.
C. File the Estate Income Tax Returns. (Form 1041)	
	These are due within three and one-half months after the close of the fiscal year chosen by the executor, unless an extension is granted. Use Form 7004, *Application for Automatic Extension of Time*. (Note that the extension for fiduciary income tax returns is now limited to 5½ months.)
D. Consider Other Tax Filings	
	1. Apply for a refund of overpayment of U.S. estate tax within three years after a required return was filed or within two years after the tax was paid, whichever period expires later.[22] Consider filing protective refund claims as part of Form 706, Schedule PC.
	2. Report to the IRS any asset discovered within three years after the U.S. estate tax return was filed or within six years after the return was filed if the omitted asset exceeds 25% of the reported gross estate.
	3. The estate tax credit for foreign death taxes under IRC Section 2014 is normally allowed only if such taxes are paid and the credit is claimed within four years after filing a required U.S. estate tax return. Proof of payment of the foreign taxes is required.
	4. Apply for a refund of any overpayment of state inheritance or estate tax.
	5. If an estate tax return is required to be filed, prepare and file Form 8971 to satisfy the consistent basis reporting obligation. Monitor required amendments to this reporting for subsequent estate administration developments.
	6. Consider requesting a closing letter from the IRS because such letters will now be issued only upon request. Determine if the IRS has instituted a user fee requirement.
E. Complete the Final Accounting Proceedings	
	1. Complete the accounting after the completion of estate tax proceedings. This should be done as soon as possible and should be done within two or three years after the issuance of permanent letters testamentary to the executors. (Note that there will be many more estates for which a U.S. estate tax return is not required.)
	2. Obtain receipts and releases from the beneficiaries or commence a formal court proceeding for settlement of the executors' accounting.

¶5040 Penalty Issues for Taxpayers

The number of accuracy-related penalties assessed each year against individual taxpayers has continued to increase.[23] According to Chief Counsel Notice 2004-36, revenue agents should consider, develop, and impose penalties where appropriate. The chief counsel indicated that IRS attorneys must evaluate the hazards of litigation with respect to penalties separately from the hazards with respect to the underlying tax adjustment. The IRS has issued Rev. Proc. 2019-9 (December 20, 2018) describing what is considered "adequate disclosure" to avoid an accuracy-related penalty.

[22] Form 843.

[23] From the IRS *Data Book*, https://www.irs.gov/pub/irs-soi/16databk.pdf.

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The mere fact that a taxpayer obtained professional advice does not, in itself, constitute a defense to penalties. An Appeals Memorandum dated June 21, 2004, states that appeals will no longer trade penalty issues. Penalties still should be settled, but the settlement should be based on the merits and hazards surrounding each individual penalty issue.

The following outline identifies potential penalty issues for taxpayers. The IRS is becoming more aggressive in pursuing these infractions, and financial planners should pay close attention to them.

1. Procedure for assessing penalties: IRM 20.1.5.1(2) (7/1/2008)

    - Penalties must be considered in every case.
    - Penalties must be developed as the audit progresses.
    - Appropriate application of penalties can be determined only after all the facts and circumstances have been developed.
    - IRC Section 6751(b) requires written supervisory approval of the initial determination of a penalty by the immediate manager or higher-level official of the IRS employee initially proposing the penalty.
    - According to IRM 20.1.1.5.1.6(3) (7/1/2008), the IRS also requires a managerial review on the non-assertion of penalties when there is a substantial understatement of tax under IRC 6662(d).

2. Three main types of penalties

    - Delinquency penalties
    - Accuracy-related penalties
    - Civil and criminal fraud penalties

3. Delinquency penalties

    There are three different delinquency penalties:

    - 6651(a)(1), Failure to File
    - 6651(a)(2), Failure to Pay Tax Shown on Return
    - 6651(a)(3), Failure to Pay Tax Not Shown on Return

4. Failure to file penalty

    - Failure to file a return on the due date, including extensions, incurs a penalty of
        — 5% of the tax due per month or part thereof, and
        — a 25% maximum.

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— If a return is more than 60 days late, a minimum penalty applies. For 2023 the minimum amount is $450 for returns due after January 1, 2023.

- Penalties apply *unless* the failure is due to reasonable cause and not willful neglect.
- Fraudulent failure to file incurs penalties of 15% of the tax due per month, with a 75% maximum.

5. Failure to pay tax shown on return
    - Failure to pay on the date prescribed for such a payment. As a general rule, there are no extensions of time to pay.
    - The penalty charged is 0.5% per month or part thereof with a 25% maximum.
    - The penalty is assessed unless the failure to pay is due to reasonable cause and not willful neglect.
    - Some examples of what is deemed "reasonable cause" include the following:
        — There is a valid extension of time to file.
        — 90% of the tax due has been paid.
        — The return is filed by the extended due date.
        — The remaining amount due is paid with the return.
6. Failure to pay tax not shown on the return
    - Failure to pay within 21 days from the date of notice and demand for payment or within 10 days if the amount is $100,000 or more incurs a penalty of
        — 0.5% per month or part thereof, and
        — a 25% maximum.
    - Penalties apply *unless* the failure is due to reasonable cause and not willful neglect.
7. Defenses
    - All of the delinquency penalties are subject to a defense if the delinquency was caused by "reasonable cause" and not "willful neglect."
    - To claim reasonable cause, the taxpayer must have exercised ordinary business care and prudence but nevertheless was unable to file or pay on time without suffering undue hardship.
    - Consider all of the facts and circumstances, including the following:
        — Lavish or extravagant business expenses

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- — Speculative or illiquid investments
- — Anticipated income

8. Reliance on professionals

   Take the example of *United States v. Boyle*, 469 U.S. 241 (1985):

   - The executor of estate hired a lawyer to handle the estate, including filing Form 706.
   - The executor had no experience with estate taxes.
   - The executor called the lawyer several times to determine whether the return was filed.
   - Despite assuring the executor that it would be taken care of, the lawyer failed to file on time.

   The Supreme Court held that this case did not involve reliance on erroneous advice of counsel regarding a question of law:

   > When an accountant or an attorney advises a taxpayer on a matter of law, such as whether a liability exists, it is reasonable for the taxpayer to rely on that advice.... By contrast, one does not have to be a tax expert to know that returns have fixed filing deadlines and that taxes must be paid when they are due. In short, tax returns imply deadlines. Reliance by a lay person on a lawyer is of course common but that reliance cannot function as a substitute for compliance with an unambiguous statute...such reliance is not reasonable cause for avoiding a late filing penalty under IRC Section 6651(a)(1).

9. IRC Section 6662: Accuracy-related penalty on underpayments

   - This penalty addresses the accuracy of positions taken on the tax return.
   - It defines how sure a taxpayer has to be before taking a position on the return.
   - A 20% penalty is imposed for
     - — negligence or disregard of rules or regulations,
     - — substantial understatement of income tax,
     - — substantial valuation misstatement,
     - — substantial overstatement of pension liabilities,
     - — substantial estate or gift tax valuation misstatement, and
     - — when the transaction lacks economic substance or fails to meet requirements of any similar rule of law.

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- A 40% penalty is imposed for

  — gross valuation misstatement of valuation, pension liabilities, or estate and gift tax liability (see the previous bullet); undisclosed transactions that lack economic substance or fail to meet requirements of any similar rule of law; and

  — undisclosed foreign financial asset understatements.

10. Definition of "negligence"

    - Negligence is any failure to make a reasonable attempt to comply with the provisions of the IRC or to exercise ordinary and reasonable care in the preparation of a tax return.[24]

    - Negligence also includes the failure to do what a reasonable and ordinarily prudent person would do under the same circumstances.[25]

    - There is no negligence if the return position has a reasonable basis.

11. Disregard of rules or regulations

    - "Disregard" includes any careless, reckless, or intentional disregard of rules or regulations.

    - The penalty is not imposed if there is

      — adequate disclosure on a properly completed Form 8275, *Disclosure Statement*; or Form 8275-R, *Regulation Disclosure Statement*, and

      — in the case of a position contrary to a regulation, the position represents a good faith challenge to the validity of a regulation.

      There is a $500 penalty contained in the 2017 Tax Cuts and Jobs Act for failure by a tax return preparer to use due diligence to confirm that a taxpayer is eligible for head-of-household status.[26] Other due diligence requirements apply to claims for the earned income credit and the various education and tuition credits.

12. Substantial understatement of income tax penalty

    Substantial understatement is defined as the following for individuals and corporations, respectively:

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[24] IRC Section 6662(c) and Treas. Reg. Section 1.6662-3(b).

[25] See *Marcello v. Commissioner*, 380 F.2d 499, 506 (5th Cir. 1967).

[26] IRC Section 6695(g).

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- **Individuals:** Understatement exceeds the greater of 10% of the tax required to be shown on the return or $5,000.

- **Corporations:** Understatement exceeds the lesser of 10% of the tax required to be shown on the return (or, if greater, $10,000) or $10 million.

13. Reduction of understatement for substantial authority or disclosure

- A "substantial understatement" of tax is reduced by any portion of the understatement that is supported by "substantial authority," or any portion that is both supported by a "reasonable basis" *and* "adequately disclosed."

- "Substantial authority" means that the weight of authority in support of the position is substantial in relation to the weight of authority contrary to the position.

- Only enumerated recognized authorities can be considered (not counsel opinions).

- The possibility of an audit cannot be considered.

- There is a reasonable basis if the position is supported by some authority higher than one that is merely arguable or "not frivolous."

- To comply with the adequate disclosure requirement, attach Form 8275 or Form 8275-R (*Disclosure Statements*), and attach Form 1120, Schedule UTP (*Uncertain Tax Position Statement*).

- This reduction does not apply to negligence or tax shelter items.

14. Substantial or gross valuation misstatement penalty

- The underpayment must exceed $5,000 for an individual.

- The underpayment must exceed $10,000 in the case of a corporation, but not an S corporation.

- A substantial valuation misstatement equals 50% or more of the correct valuation. If this is the case, a 20% penalty is imposed.

- A gross valuation misstatement equals 200% or more of the correct valuation. If this is the case, a 40% penalty is imposed.

15. Substantial estate or gift tax valuation misstatement penalty

- The underpayment must exceed $5,000.

- A substantial valuation misstatement equals 65% or less than the correct valuation. If this is the case, a 20% penalty is imposed.

- A gross valuation misstatement equals 40% or less than the correct valuation. If this is the case, a 40% penalty is imposed.

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16. The economic substance penalty

- In 2010, the Health Care and Education Reconciliation Act codified the Economic Substance Doctrine in IRC Section 7701(o).
- It added a strict liability penalty on any underpayment attributable to a non-economic substance transaction in IRC Section 6662(b)(6) (as defined in Section 7701(o)) or underpayment attributable to the failure to meet the requirements of any similar rule of law. It also amended IRC Sections 6664(c) and (d)(2) to remove the reasonable cause exception for any portion of an underpayment or reportable transaction understatement attributable to a non-economic substance transaction described in IRC Section 6662(b)(6).
- The amendments were generally effective for transactions entered into after March 30, 2010.
- The economic substance penalty is a 20% penalty on an underpayment described in IRC Sections 6662(a) and 6662 (b)(6).
- There is a 40% penalty on an underpayment if relevant facts affecting the tax treatment are not adequately disclosed in the return or a statement attached to the return.[27]

17. Tax fraud penalties

- "Willfulness" means there is "intentional violation of a known legal duty."
- Civil Fraud — IRC Section 6663 imposes a 75% penalty. It must be proven by "clear and convincing evidence."
- Criminal Fraud — IRC Section 7201, et seq. The penalty for this type of fraud is jail. It must be proven "beyond a reasonable doubt."
- Avoidance of taxes is not a criminal offense.
- Any attempt to reduce, avoid, minimize, or alleviate taxes by legitimate means is permissible.[28]
- The distinction between tax avoidance and fraud is fine yet definite.
- Tax avoidance: One who avoids taxes by legitimate means does not conceal or misrepresent. This person shapes events to reduce or eliminate tax liability and, upon the happening of the events, makes a complete disclosure.

[27] IRC Sections 6662(i)(1) and 6662(i)(2).

[28] *Gregory v. Helvering*, 293 U.S. 465(1935).

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- Tax evasion: This has badges of fraud. Evasion involves some affirmative acts to evade or defeat tax or payment of tax.

  — Examples of affirmative acts are deceit, subterfuge, camouflage, concealment, and attempts to color or obscure events or make things seem other than they are.[29]

  — Common evasion schemes include intentional understatement or omission of income, claiming fictitious or improper deductions, false allocation of income, improper claims, credits, or exemptions, and/or concealment of assets.[30]

18. Tax Evasion Penalties

- Tax evasion is a willful attempt to evade or defeat any tax. It can result in up to 5 years in prison and a $100,000 fine ($500,000 for a corporation).

- Other criminal tax penalties include the following:

  1. Up to 3 years in jail and $100,000 in fines for filing a fraudulent tax return

  2. One year in jail and $25,000 in fines for willfully failing to pay estimated taxes

  3. One year in jail and $25,000 for the fraudulent failure to file a tax return

     – A taxpayer can also face both civil and criminal penalties for the same actions.

¶5045 Major Law Changes Enacted in the PATH Act that Remain in Effect

The PATH Act was signed into law in December of 2015. The law included a tax extender package, addressing tax provisions that previously expired during the end of 2014. The PATH Act was followed by the even more extensive 2017 Tax Cuts and Jobs Act. The 2017 act eliminated some things that the PATH Act made permanent and left other areas undisturbed. Additional changes were made in the SECURE Act of 2019, the CARES Act of 2020, the Consolidated Appropriations Act of 2021 and the American Rescue Plan Act of 2021. The following material addresses the laws included in the PATH Act that were not affected by the 2017 and subsequent acts and remain in effect.

.01 Individual

Permanent Changes. The permanent changes in the "individual" category are as follows:

- Tax-free IRA contributions to charity after a person turns age 70½ permits tax-free distributions to charity from an IRA held by someone age 70½ or older of up to $100,000 per taxpayer, per taxable year. These distributions will qualify as part or all, as the case may be, of the taxpayer's annual required minimum distribution. Amounts in excess of $100,000 must be included in income but may be taken as an itemized charitable deduction, subject to the AGI annual caps for

[29] IRM, pt. 25.1.1.2.4(2) (Dec. 16, 2011).

[30] IRM, pt. 25.1.1.2.4(3) (Dec. 16, 2011).

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contributions. Despite the change made by the SECURE Act of 2019, which deferred required minimum distributions until age 72, and the SECURE Act 2.0 which deferred required minimum distributions until age 73, the age 70½ opportunity for these qualified charitable distributions remains in effect. The $100,000 limit will be indexed for inflation after 2023.

- Teachers' Classroom Expense Deduction — the act permanently extends the above-the-line deduction for elementary and secondary school teacher's classroom expenses. It is now limited to an annual deduction of $300 for those teachers who work at least 900 hours in the year at a school..

- Basis adjustment to stock of S corporations making charitable contributions of appreciated property. The basis reduction to the taxpayer is the taxpayer's cost basis. Not the fair market value of the contributed property.

There are also some new restrictions, detailed next.

Toughened earned income tax credit (EITC) rules. Effective for returns and any amendment or supplement to a return, filed after December 18, 2015, an individual is prohibited from retroactively claiming the EITC by amending a return (or filing an original return if the individual failed to file) for any prior year in which the individual or a student for whom the credit is claimed did not have a valid Social Security number.[31] However, the preceding change does *not* apply to any tax return (other than an amendment or supplement to a return) for any tax year that included December 18, 2015, if the return is filed on or before its due date.[32] Other changes to the EITC were made in the American Rescue Plan Act of 2021, and are described below.

New anti-abuse measures for the American Opportunity Tax Credit (AOTC). The following toughened compliance rules apply to taxpayers claiming the AOTC. They all apply for tax years beginning after December 31, 2015, except as otherwise noted:

- Effective for returns, and any amendment or supplement to a return, filed after December 18, 2015, an individual is prohibited from retroactively claiming the AOTC by amending a return (or filing an original return if the person failed to file) for any prior year in which the individual or a student for whom the credit is claimed did not have an individual tax identification number (ITIN).[33] However, the preceding change does *not* apply to any tax return (other than an amendment or supplement to a return) for any tax year that included December 18, 2015, if the return is filed on or before its due date.[34]

- A taxpayer may not claim an AOTC for any tax year during the disallowance period, which is (*a*) the period of 10 tax years after the most recent tax year for which there was a final determination that a taxpayer's claim of an AOTC was due to fraud; and (*b*) the period of two tax years after

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[31] RC Section 32(m), as amended by PATH Act Sec. 204.

[32] PATH Act Sec. 204(b).

[33] IRC Section 25A(i)(6).

[34] PATH Act Sec. 206(b)(2).

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the most recent tax year for which there was a final determination that a taxpayer's claim of an AOTC was due to reckless or intentional disregard of rules and regulations (but not fraud).[35] Additionally, for a taxpayer who is denied an AOTC for any tax year as a result of the IRC's deficiency procedures, no AOTC is allowed for any later tax year unless the taxpayer provides the information the IRS may require to demonstrate eligibility for the credit.[36]

- If a taxpayer does not provide the eligibility information required by the IRS or makes an entry on a return claiming the AOTC for a tax year for which the credit is barred due to an earlier claim based on fraud or the reckless or intentional disregard of rules and regulations, then the IRS can deny any AOTC claimed by the taxpayer, by summary assessment (i.e., without going through the normal deficiency procedures).[37]

- For tax years beginning after December 31, 2015, and expenses paid after that date for education furnished in academic periods beginning after that date, a taxpayer claiming the AOTC must report the EIN of the educational institution to which the taxpayer makes qualified payments under the credit.[38]

- For expenses paid after December 31, 2015, an eligible educational institution to which qualified tuition and related expenses were paid must include its EIN on the information return (Form 1098-T) that it provides to the IRS.[39]

- For expenses paid after December 31, 2015, for education furnished in academic periods beginning after that date, higher education institutions must report (on Form 1098-T) only qualified tuition and related expenses actually paid (rather than choosing between amounts paid and amounts billed, as under prior law).[40]

  Additionally, under the Trade Preferences Extension Act of 2015, for tax years beginning after June 29, 2015, as a condition for claiming the higher education credit under IRC Section 25A, a taxpayer must receive, or be treated as having received, a payee statement (generally, Form 1098-T, Copy B) that contains all of the information required to be included on the Form 1098-T information return filed with the IRS, including the TIN of the student for whom the qualified tuition and related expenses were paid, or billed, for the tax year.[41]

  In a related change, the Trade Preferences Extension Act of 2015 waives the otherwise applicable information reporting penalty on educational institutions that fail to file Forms 1098-T

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[35] IRC Section 25a(i)(7).

[36] IRC Section 25a(i)(7)(B).

[37] IRC Section 6213(g)(2)(Q).

[38] IRC Section 25A(i)(6).

[39] IRC Section 6050S(b)(2)(C).

[40] IRC Section 6050S(b)(2)(B)(i).

[41] IRC Section 25A(g), IRC Section 222(d)(6)(A).

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with accurate TINs of students attending the educational institution if the institution certifies, under penalty of perjury, that it properly requested TINs from the students as required under Treasury Regulations.[42] This change is effective for returns required to be made, and statements required to be furnished, after December 31, 2015.

Enhanced Child Tax Credit. The child tax credit was expanded in coverage by the American Rescue Plan Act of 2021. See the discussion below. Individuals are barred from claiming the credit for 10 years if they fraudulently claimed the credit and for two years if they are found to have claimed the credit with reckless or intentional disregard of the rules.

Toughened rules for claiming child tax credit (CTC). Under the PATH Act, the following toughened compliance rules apply to taxpayers claiming the CTC. They all apply for tax years beginning after December 31, 2015, except as otherwise noted:

- Effective for returns, and any amendment or supplement to a return, filed after December 18, 2015, an individual may not retroactively claim the CTC by amending a return (or filing an original return if the individual failed to file) for any prior year in which the individual or a qualifying child for whom the credit is claimed did not have an ITIN.[43] But the provision will not apply to any tax return (other than an amendment or supplement to a return) for any tax year that includes December 18, 2015, if the return is filed on or before its due date.[44]

- No CTC is allowed for any tax year in the "disallowance period" which is (*a*) two tax years after the most recent tax year for which there was a final determination that the taxpayer's CTC claim was due to reckless or intentional disregard of rules and regulations (but not due to fraud); and (*b*) 10 tax years after the most recent tax year for which there was a final determination that the taxpayer's CTC claim was due to fraud.[45]

- If a taxpayer is denied the CTC for any tax year as a result of the deficiency procedures, then no CTC is allowed for any later tax year unless the taxpayer provides the information that the IRS requires to demonstrate eligibility for the CTC.[46]

- The following are added to the mathematical or clerical errors for which the IRS can make a summary assessment (i.e., with respect to which the IRS can summarily assess the additional tax due without sending the taxpayer a deficiency notice): an entry on the return claiming the CTC for a tax year for which the CTCs are disallowed under IRC Section 24(g)(1) because of an earlier CTC claim due to reckless or intentional disregard of rules and regulations or fraud; and an omission of information that a taxpayer who has made an earlier CTC claim that was denied

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[42] IRC Section 6724(f).

[43] IRC Section 24(c).

[44] PATH Act Sec. 205(c)(2).

[45] IRC Section 24(g)(1).

[46] IRC Section 24(g)(2).

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as a result of the deficiency procedures must provide under IRC Section 24(g)(2) to demonstrate eligibility for the CTC.[47]

.02 Provisions of Law Extended for 2023

Further Consolidated Appropriations Act of 2020

The Further Consolidated Appropriations Act of 2020, signed into law December 20, 2019 (Public Law No: 116-94), funds federal government operations, extends certain income tax provisions that had already expired or were due to expire at the end of 2019, and provides tax relief for victims of certain disasters.

Some of the key provisions in the law were extended through 2020 (and many of these provisions were extended again through 2021 by the Consolidated Appropriations Act of 2021) including the following:

Tax Extenders

- The exclusion from gross income of discharge of qualified principal residence indebtedness, restoring a tax break that was in place before the TCJA was enacted. This is effective through 2025.

- The treatment of mortgage insurance premiums as qualified residence interest for itemized deduction purposes. This applies to taxpayers below certain income levels and is related only to principal residences. This was not extended for 2022 or 2023.

- The reduction in the medical expense itemized deduction floor to 7.5% of AGI. This means that taxpayers with medical expenses that exceed 7.5% of AGI may take a medical deduction for the portion of expenses above that level. This restores the medical expense itemized deduction floor to 7.5% of AGI, where it had been before the TCJA increased it to 10%. It is now permanent at 7.5%.

- Empowerment zone tax incentives, providing a tax credit to businesses that hire workers who live in distressed areas. The credit is equal to 20% of the first $15,000 in wages earned in a taxable year if the employee both lives and works in an empowerment zone. File Form 8444 to claim this credit.

- The New Markets credit, which provides incentive for business and real estate investment in low-income areas.

- The employer tax credit for paid family and medical leave. This is effective through 2025.

- The Work Opportunity credit, which provides incentive for private sector businesses to hire workers from certain target groups that have historically faced barriers to employment.

[47] Section 6213(g)(2)(P).

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Companies may receive tax credits valued between $2,400 and $9,600 for each qualifying new hire. This is effective through 2025.

- Several additional tax incentives for employment and economic growth and for energy production and efficiency, including the following:

  — Credits for nonbusiness energy property, qualified fuel cell vehicles, alternative fuel vehicle refueling property, and energy-efficient commercial buildings

  — Incentives for biodiesel and renewable diesel fuels

  — Continued reduction in federal excise taxes on beer, wine, and distilled spirits

The legislation also repealed three health care taxes contained in the ACA: the excise tax on certain high-cost employer health plans (the "Cadillac tax"), the excise tax on medical devices, and the annual fee on health insurance providers.

Disaster Tax Relief

The law also provides several tax relief provisions related to disasters occurring in 2018, 2019, 2020, 2021 and up to 30 days after enactment of the legislation: For subsequent years, there are often special legislative provisions enacted from time to time as various disasters occur.

- A provision allowing eligible taxpayers to make tax-favored withdrawals from retirement plans to cover disaster-related expenses.

- An employee-retention tax credit for eligible employers equal to 40% of qualified wages, which are wages paid to an employee during the time the employer's business is not operating due to a natural disaster (up to 150 days after the disaster).

- Special rules for disaster-related personal casualty losses and for determining earned income for purposes of the EITC.

- Automatic 60-day filing extensions for certain taxpayers affected by federally declared disasters.

- Income exclusion for discharged mortgage debt. The PATH Act excluded from income cancelation of mortgage debt on a principal residence of up to $2 million ($1 million for filing separately) through 2017. This debt forgiveness was extended by the Consolidated Appropriations Act of 2021 through 2025, but the amount of excluded forgiven debt is limited to $750,000.

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.02 Business

Laws Permanently Extended. In the "business" category, the following laws were permanently extended:

- **Five-year holding period for S corporation built-in gains for dispositions.** The act makes permanent the five-year recognition period for built-in gain following conversion from a C to an S corporation.[48]

- **Qualified small business stock gain exclusion.** The 100% exclusion allowed for gain on the sale or exchange of qualified small business stock held for more than five years by noncorporate taxpayers is made permanent.[49]

- **Research Tax Credit.** Refundable up to $250,000 against employer payroll taxes for any business less than five years of age and having $5 million in annual gross receipts. Private companies with less than $50 million in gross receipts can use the credit against AMT.[50] The deduction expired after 2021. Congress included in The Tax Cuts and Jobs Act a provision to require companies to capitalize and amortize R&D expenses, beginning January 1, 2022. There is proposed legislation to restore the deduction.

More employers eligible for differential wage payment credit. Eligible small business employers that pay differential wages — payments to employees for periods that they are called to active duty with the U.S. uniformed services (for more than 30 days) that represent all or part of the wages that they would have otherwise received from the employer — can claim a credit. This differential wage payment credit is equal to 20% of up to $20,000 of differential pay made to an employee during the tax year. Under prior law, an eligible small business employer was one that: (1) employed on average less than 50 employees on business days during the tax year; and (2) under a written plan, provides eligible differential wage payments to each of its qualified employees. A qualified employee is one who has been an employee for the 91-day period immediately preceding the period for which any differential wage payment is made.

The PATH Act not only retroactively and permanently extended the credit (which had expired at the end of 2014) but liberalized it, as well. For tax years beginning after December 31, 2015, the credit applies to employers of any size (that is, the less than 50 employee average no longer applies).[51]

Law Changes and Extensions. There have also been other law changes and extensions related to businesses:

- **Accelerated due date for W-2, 1099, and the like.** Effective for returns and statements relating to calendar years after December 18, 2015, the PATH Act requires Forms W-2, W-3, and returns

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[48] IRC Section 1374.

[49] IRC Section 1202.

[50] IRC Section 41.

[51] IRC Section 45P(a).

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reporting nonemployee compensation (e.g., Form 1099-MISC) to be filed on or before January 31 of the year following the calendar year to which such returns relate. Those returns are no longer eligible for the extended filing date for electronically filed returns.[52]

- **Related party loss rules tightened.** Under the IRC Section 267(a) related party loss rules, no deduction is generally allowed for losses from sales or exchanges of property (except in corporate liquidations), directly or indirectly, between certain related persons. Under IRC Section 267(d), if a taxpayer acquires property by purchase or exchange from a transferor who sustained a loss not allowed because of the related taxpayer rules, any subsequent gain realized by the taxpayer on a sale or other disposition of the property is recognized only to the extent that the gain exceeds the amount of the loss that is properly allocable to the property sold or otherwise disposed of by the taxpayer.

  Under the PATH Act, for sales and exchanges of property acquired after December 31, 2015, the general rule of IRC Section 267(d) does not apply to the extent gain or loss on property that has been sold or exchanged is not subject to federal income tax in the hands of the transferor immediately before the transfer, but any gain or loss on the property is subject to federal income tax in the hands of the transferee immediately after the transfer.[53] Therefore, the related party loss rules are modified to prevent losses from being shifted from a tax-indifferent party (e.g., a foreign person not subject to U.S. taxation) to another party in whose hands any gain or loss with respect to the property would be subject to U.S. taxation.

- **Increase in the penalty for tax return preparer willful or reckless conduct.** Under prior law, any tax return preparer who prepared any return or claim for refund for which any part of an understatement of the taxpayer's liability was due to the preparer's willful or reckless conduct, was subject to a penalty in an amount equal to the greater of $5,000 or 50% of the income derived (or to be derived) by the tax return preparer as to the return or claim.

  Under the PATH Act, effective for tax returns prepared for tax years ending after December 18, 2015, the preceding 50% is increased to 75%.[54]

- **Agricultural research organizations are 50% charities.** Contributions by an individual to an organization that is a "50% charity" are deductible up to 50% of the donor's contribution base, which is the donor's AGI, computed without any net operating loss carryback deduction. A 30% limitation applies to an individual's contributions to a 50% charity of appreciated capital gain property (i.e., a capital asset the sale of which at its fair market value at the time of the contribution would have resulted in long-term capital gain).

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[52] IRC Section 6071(c).

[53] IRC Section 267(d).

[54] IRC Section 6694(b)(1)(B).

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For contributions on or after December 18, 2015, the PATH Act adds agricultural research organizations to the list of 60% charities. The organization must commit to use the contribution for agricultural research before January 1 of the fifth calendar year that begins after the date of the contribution.[55]

¶5050 Basis Reporting and Duty of Consistency — Form 8971

The Surface Transportation and Veterans Health Care Choice Improvement Act of 2015 (signed on July 31, 2015) created two new income tax provisions as revenue raisers: IRC Sections 6035(b) and 1014(f).

.01 Overview of IRC Sections 6035(b) and 1014(f)

IRC Section 6035(a)(1) requires executors of estates *required* to file a federal estate tax return to provide a statement identifying the value of each interest in property included in the decedent's gross estate. The "statement" is the required Form 8971.

- An estate is over the filing threshold — and therefore requires an estate tax return (and basis reporting) — if the decedent's "gross estate" plus "adjusted taxable gifts" exceed the "basic exclusion amount" in effect when the decedent died.

- The "gross estate" refers to everything in which the decedent had an interest, such as bank and brokerage accounts, real estate, business interests, life insurance, and retirement accounts.

- "Adjusted taxable gifts" are typically lifetime gifts other than (*a*) annual exclusion gifts ($17,000 per donee for 2023, or $34,000 if the donor's spouse agrees to split the gift), and (*b*) direct payments of tuition, medical expenses, and health insurance premiums to the education or medical care provider. Stated differently, adjusted taxable gifts are lifetime taxable gifts in excess of the annual exclusion that absorb the donor's lifetime exclusion amount.

- The "basic exclusion amount" is $12.92 million, indexed for inflation in 2023. It protects lifetime gifts and transfers at death from gift and estate tax.

The statement must be furnished to the IRS and to "each person acquiring any interest" in such property within 30 days of the date on which the estate tax return is filed or due (including extensions), whichever is earlier.

A conforming amendment to IRC Section 6724(d)(1) makes the failure to furnish this statement to beneficiaries and to the IRS subject to a series of possible penalties. If the executor of an estate or other person required to file Form 8971 fails to file a correct Form 8971 and/or Schedule A of Form 8971 with the IRS by the due date and reasonable cause is not shown, a penalty may be imposed.

- The penalty applies if there is a failure to timely file, a failure to include all information required to be shown on the form or schedule, a failure to include correct information on the form or schedule, or a failure to file a correct supplemental Form 8971 and/or Schedule A by the due date. A complete Form 8971 includes all Schedules A. Each filing of a Form 8971 with

[55] IRC Section 170(b)(1)(A)(ix).

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Schedule(s) A is a separate filing, regardless as to whether the filing is of the initial Form 8971 and Schedule(s) A or a supplemental Form 8971 and Schedule(s) A.

- The penalty is $50 per Form 8971 (including all Schedule(s) A) if it is filed within 30 days after the due date. The maximum penalty for this violation is $532,000 per year, or $186,000 if the taxpayer qualifies for an exception.

- The penalty is $260 per failure to file — or for a filing after the due date — with a cap of $3,193,000. (See the instructions for Form 8971).

- If the failure to file is found to be willful, the penalty is the greater of $530 per failure or 10% of the amount that should have been reported, with no maximum penalty.

- An inconsequential error or omission is not considered a failure to include correct information. An inconsequential error or omission does not prevent or hinder the IRS from processing Form 8971, and the Schedule(s) A required to be filed along with it.

  Errors and omissions that are never inconsequential are those related to a TIN, a beneficiary's surname, and the value of the asset the beneficiary is receiving from the estate.

- The penalties for failing to file correct Forms 8971 and Schedule(s) A with the IRS and for failing to provide correct Schedule(s) A to beneficiaries will not apply to any failure that is shown to be due to reasonable cause and not to willful neglect. In general, it must be shown that the failure was due to an event beyond the taxpayer's control or due to significant mitigating factors. It must also be shown that the executor or other person required to file acted in a responsible manner and took steps to avoid the failure.

Beneficiaries who report basis in property that is inconsistent with the amount on Schedule A may be liable for a 20% accuracy-related penalty under IRC Section 6662.

New IRC Section 1014(f) provides that the basis in property acquired from a decedent cannot exceed the final value that has been "determined" for federal estate tax purposes. Where there has not yet been a "determination" of the property's value, the basis cannot exceed the amount provided in the IRC Section 6035 statement.

Basis is "determined" for federal estate tax purposes where the value is shown on the federal estate tax return and the IRS does not contest it before expiration of the statute of limitations. If the IRS does timely contest the value and the executor relents, the basis of the property will be "determined" as the value set by the IRS.

Basis can also be "determined" by a court or through a settlement agreement between the IRS and the estate.

These rules, which effectively prohibit claiming property has a lower value for estate tax purposes and a higher value for income tax purposes, are applicable to property "with respect to which an estate tax return is filed" after July 31, 2015.

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.02 How the Rules Are to Work

Form 8971 asks for general information about the decedent and executor, as well as the name, taxpayer identification number, and address of each beneficiary. The form includes a Schedule A, the page to be furnished to each beneficiary of the estate.

The Schedule A must provide a "description of property acquired from the decedent," along with an indication of where the item is reported on the estate's Form 706. The schedule must indicate whether the asset increased estate tax liability, the valuation date for the asset, and the "estate tax value (in U.S. dollars)."

Schedule A includes this notice to beneficiaries: "You have received this Schedule to inform you of the value of property you received from the estate of the decedent named above. Retain this Schedule for tax reporting purposes. If the property increased the estate tax liability, Internal Revenue Code Section 1014(f) applies, requiring the consistent reporting of basis information. For more information on determining basis, see IRC section 1014 and/or consult a tax professional."

Instructions accompanying the form indicate that if final distributions have not been made by the time the Form 8971 is due, "the executor must list all items of property that could be used, in whole or in part, to fund the beneficiary's distribution on that beneficiary's Schedule A." Problem: This means that the same property may be reflected on more than one Schedule A distributed to more than one beneficiary.

"A supplemental Form 8971 and corresponding Schedule(s) A should be filed once the distribution to each such beneficiary has been made." Supplemental basis reporting is required:

- If a change in the information the executor initially reported makes that information incorrect or incomplete, the executor must file a supplemental Form 8971 within 30 days.

- Such changes include an adjustment in the property's value because of an audit or litigation, the discovery of property that should have been (but was not) reported on the decedent's estate tax return, a change in the identity of the beneficiary to whom property is to be distributed (perhaps because the original beneficiary died or "disclaimed" the property), or an effective "exchange" of estate property, whereby the "new" property uses the "old" property's basis (as in, for example, a like-kind exchange).

- The executor may, but need not, file a supplemental form to correct an "inconsequential" error or omission, or to specify the property that was actually distributed to a beneficiary and was previously reported as available to satisfy the beneficiary's inheritance.

- Problem: Executors may be reluctant to provide full information about all estate assets to beneficiaries who are only entitled to receive a general bequest that may represent a fairly small portion of the estate. Furthermore, it will be burdensome. In effect, each beneficiary who has not already been funded by the 30-day due date will receive a report that could be as long as Form 706 — including a list of all assets listed on the return that have not yet been sold or distributed and that could be distributed to the beneficiary.

- There are a number of fairly common basis adjustments that may occur during administration of an estate before distributions are made to beneficiaries, including such things as depreciation and amortization, capitalized improvements, distributions from C and S corporations in excess of

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earnings and profits, capital contributions to partnerships, partnership distributions in excess of or less than taxable income, or an IRC Section 754 election. Income recognition might be forced by a number of events such as the funding of a pecuniary bequest, an IRC Section 643(e) election to recognize gain, or some type of a corporate redemption or liquidation.

.03 Proposed Regulations Issued

On March 4, 2016, the Treasury issued proposed regulations offering guidance on the application of IRC Sections 1014(f) and 6035. As of late 2023, these regulations remain proposed. The proposed regulations offer a number of clarifications.

They clarify that while IRC Section 1014(f) caps the initial basis a beneficiary takes in property, subsequent adjustments to basis for improvements, depreciation, and the like will still be allowed.

They clarify that IRC Section 1014(f) applies to property the inclusion of which in the decedent's gross estate actually increases the estate's liability for federal estate taxes; therefore, property eligible for the marital and charitable deductions is not subject to IRC Section 1014(f), nor is any tangible personal property for which an appraisal is not already required under the estate tax regulations. But all other property included in the gross estate is subject to IRC Section 1014(f) if any federal estate tax liability is incurred.

The proposed regulations address property discovered after the filing of Form 706 and property omitted from Form 706 ("omitted property").

- If the omitted property is reported before the expiration of the statute of limitations on the assessment of estate tax (generally three years from when the estate tax return was filed), the regular rules for determining the final value and the basis of property shall apply.

- But if the omitted property is reported after expiration of the statute of limitations, it will have a final value and basis of zero.

- Note that if an estate tax return was not filed because the estate was under the filing threshold and the after-discovered property would have increased the size of the gross estate and triggered estate tax, the basis of all estate property is zero until the executor files an estate tax return and a "final value" for the property is determined.

- The supplemental Form 8971 is generally due within 30 days of (*a*) the determination of the property's "final value," (*b*) the executor's discovery that the initial basis filing was incorrect or incomplete, or (*c*) the supplemental estate tax return is filed reporting after-discovered or omitted property. Nevertheless, if property has not yet been distributed to a beneficiary prior to any of these events, the due date for the supplemental reporting is 30 days after distribution.

- Obviously, this "zero basis" rule underscores how important it is for the executor to make sure that all of the decedent's property has been identified and properly reported.

Similarly, if no estate tax return is ever filed, the final value of all property includible in the gross estate that is subject to IRC Section 1014(f) is deemed to be zero.

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Very significantly, the proposed regulations clarify that the IRC Section 6035 reporting requirement does *not* apply where an estate tax return is filed solely for purposes of making a portability election or a GST tax exemption allocation.

The proposed regulations exempt the following assets from IRC Section 6035 reporting: cash, (other than a coin collection or "other coins or bills with numismatic value"), income in respect of a decedent, items of tangible personal property for which an appraisal is not required under the estate tax regulations (generally property valued at $3,000 or less), and property that will not be distributed to a beneficiary because it has been sold or otherwise disposed of by the estate in a taxable transaction. Problem: What if the decedent made a contribution to an IRA with after-tax dollars, thereby creating a basis? Presumably that should be reported if filing is required.

The proposed regulations make clear that where the executor is also a beneficiary, the executor must still furnish a Schedule A to Form 8971 to himself or herself. If the beneficiary is an estate, trust, or business entity, the notice is to be delivered to the entity and not its beneficiaries or owners.

If the executor cannot locate a beneficiary in time, Form 8971 is to explain the efforts taken to locate the beneficiary.

The proposed regulations provide that where the recipient of property indicated as the recipient on Form 8971 transfers all or any portion of the property to a related transferee, the transferor must file a supplemental Form 8971 within 30 days of the transfer documenting the new ownership if the transferee's basis is to be determined with reference to the transferor's basis.

- A "related transferee" means a member of the beneficiary's family (such as the beneficiary's spouse, descendants, or siblings), an entity that is "controlled" by certain family members (such as siblings, descendants, and their spouses), or a trust the beneficiary "owns" for income tax purposes. This refers to a "grantor" trust and means that the beneficiary is responsible for paying the trust's income taxes.

- Problem: Suppose that Client receives a $10,000 item of personal property from Parent, and that item is duly reported on Parent's estate tax return and the basis reporting forms. Many years later, Client gives the item, which is still worth $10,000 to her own beneficiary (to whom she makes no other gifts that year). Because the item falls within the $16,000 gift tax annual exclusion, no gift tax return is required. Assuming Client is even aware of the subsequent transfer filing requirements, is she likely to observe them? Is a penalty due?

- Problem: With respect to term interests and life estates, who should receive information regarding the basis of the property? Should it be the holder of the current interest, of the remainder interest, or both?

- Problem: IRC Section 6035(a)(1) requires "each person acquiring any interest in property included in the decedent's gross estate" to receive information regarding the basis of the property. If a trust is a beneficiary of the estate, does the executor send the basis information to a trustee or the trust beneficiary(ies) or both? Who ultimately needs the basis information? Trustee or trust beneficiary? Are the trust beneficiaries known to the executor? Is it even possible for the trustee to determine beneficiaries or what distributions they will receive with certainty?

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.04 Examples

Example A-1. Spouse A dies in 2023 and leaves her entire $25 million estate to Spouse B, who is a U.S. citizen. Because the marital deduction applies to the gift, Spouse A has a nontaxable estate. Although Spouse A's executor must file an estate tax return for Spouse A's estate along with the basis reporting statements, the property Spouse B receives is not subject to the basis consistency rule.

Example A-2. X has a $30 million estate and has made no lifetime taxable gifts. X dies in 2023. X's will creates a "credit shelter trust" for Y and their children that equals X's $12.92 million exclusion amount (and is therefore not taxable) and leaves the balance of X's property to Y in a trust that qualifies for the marital deduction (and is therefore not taxable). X's executor files an estate tax return for X's estate and the basis reporting statements. Schedule A goes to the trustees of the two trusts. The property passing to the two trusts is not subject to the basis consistency rule.

Example A-3. Same facts as example 2, except that X gives $15 million in cash and valuable tangible property to the children from X's first marriage; the balance of X's property passes to X's second spouse, Z, in a trust that qualifies for the marital deduction. The gift to X's children generates estate tax. The executor's basis report does not list the cash gifts to X's children but does list the tangible property passing to them; that property is subject to the basis consistency rule. The property passing to Z's trust is also subject to basis reporting, but not to the basis consistency rule.

¶5055 IRC Section 199A and the Qualified Business Income Deduction

.01 Overview of IRC Section 199A

The 2017 Tax Cuts and Jobs Act (TCJA) introduced IRC Section 199A, which permits taxpayers — including trusts and estates — to deduct up to 20% of their "qualified business income," at least until December 31, 2025, when this provision is scheduled to expire.[56] This deduction is taken "below the line" (that is, after AGI is computed) and is in addition to the standard deduction. The details of IRC Section 199A (effective for tax years beginning in 2018) are complex — the objective is to permit business owners and entrepreneurs (as well as trusts and estates) to enjoy an effective tax rate that is roughly comparable to the new, lower 21% corporate tax rate for C corporations.[57]

After the introduction of IRC Section 199A, the IRS issued proposed regulations on August 16, 2018; 274 pages of final regulations were later issued on January 21, 2019, which made numerous substantive changes to the proposed regulations. Following the final regulations, the IRS issued Rev. Proc. 2019-7, which created a "safe harbor" for certain specified rental activities. Afterward, the IRS issued Rev. Proc. 2019-11, which addressed details on how W-2 wages may be calculated. Then the IRS issued corrections to the final regulations on February 3, 2019, which included a few substantive changes.

[56] There is an additional 20% deduction for qualified REIT dividends and qualified publicly traded partnership income, and qualified cooperative dividends. IRC Sections 199A(a)(2)(A), (b)(1)(B).

[57] IRC Section 11.

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On June 24, 2020, the IRS issued additional final regulations (T.D. 9899) concerning the qualified business income (QBI) deduction under Sec. 199A. These final regulations clarify what is considered QBI and how to calculate it in certain situations. More particularly, the new rules provide guidance on:

- The treatment of previously suspended losses included in QBI, and
- The Section 199A deduction for taxpayers that hold interests in regulated investment companies (RICs), split-interest trusts, and charitable remainder trusts.

So the question is: Where does all of this leave us?

.02 Qualified Trade or Business

Qualified Trade or Business. For IRC Section 199A to apply, a taxpayer must own an interest in a "qualified trade or business" (QTB). The IRC's definition of QTB starts off broadly by including any "trade or business" but excludes over certain income thresholds described later, (*a*) a specified service trade or business (SSTB) for taxpayers above certain income levels and (*b*) the trade or business of performing services as an employee (regardless of the taxpayer's income level).[58] But for the effect of these potentially significant exclusions, a trade or business activity conducted by an individual, trust, or estate — whether directly through a sole proprietorship or indirectly through a disregarded entity, partnership, LLC classified as a partnership, or S corporation — should constitute a QTB for purposes of IRC Section 199A.[59]

To be considered a "trade or business," an activity must be carried on with continuity and regularity. Hobbies are excluded. Services performed as an employee are excluded. Rental activity is given a safe harbor to qualify as a trade or business in Rev. Proc. 2019-7 if separate books and records are maintained for each rental activity, or a combined activity if grouped, 250 hours or more of rental services are performed per year, and the taxpayer maintains contemporaneous records. Commercial and residential properties cannot be grouped, and property used as a personal residence for more than 14 days during the year cannot be used. Any property rented on a triple net lease basis is not included in the definition of "rental property". An exception in the regulations is provided to allow self-rental property to count as a trade or business if it is rented to a commonly controlled trade or business owned by the taxpayer (ownership of 50% or more using the family attribution rules).

.03 Specified Service Trade or Business

Specified Service Trade or Business (SSTB). The term is defined, in part, by cross-reference from IRC Section 199A(d)(2)(A) to any trade or business described in IRC Section 1202(e)(3)(A) but without regard to the words *engineering* and *architecture* and substituting the words "owners or employees" for the word "employees." Once these word changes are taken into account, the SSTBs covered by IRC Section 199A(d)(2)(A) may be described as consisting of (*a*) any trade or business involving the performance of services in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics,

[58] IRC Section 199A(d)(1).

[59] QTB status does not depend on whether the taxpayer's activity is "passive" or "active" within the meaning of the passive activity loss limitations of IRC Section 469. Thus, for example, a taxpayer's interest in a trade or business may qualify as a QTB for purposes of the IRC Section 199A deduction even if the income from such QTB is "passive" in nature and thereby potentially subject to the 3.8% tax on "net investment income" imposed by IRC Section 1411.

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financial services, or brokerage services, and (*b*) any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees or owners. In addition, a third category of SSTB is set forth directly in the text of IRC Section 199A(d)(2)(B), consisting of any trade or business which involves the performance of services that consist of investing and investment management, trading or dealing in securities, partnership interests, or commodities.

The final regulations offer guidance as to what activities are included in the SSTB categories. For example, "health" includes radiologists and technicians, but not health club or spa operators, or selling pharmaceuticals or medical devices.

"Law" includes paralegals and arbitrators, but not printing, stenography or delivery services.

"Accounting" includes enrolled agents, return preparers, auditors and bookkeepers.

"Actuarial science" includes actuaries, but not economists, mathematicians and statisticians not engaged in risk assessment.

"Performing arts" includes those leading to the creation of the art (actors, directors, writers, singers, musicians) but not broadcasters or video and audio service providers.

"Consulting" includes those providing professional advice and counsel to achieve goals and solve problems, including lobbyists, but not salespeople and persons providing training or educational courses. Advisory services ancillary to the sale of goods are not "consulting."

"Athletics" includes players, coaches, managers and team owners, but not broadcasters or equipment operators.

"Financial services" includes financial advisers, investment bankers and retirement advisers, but does not include banking.

"Brokers" includes a stockbroker but does not include a real estate broker or an insurance broker.

"Investment management" includes asset management but does not include real estate management.

"Trading" includes trading securities, commodities, or partnership interests, but does not include a farmer or manufacturer who engages in hedging transactions as part of their business.

The catch-all of a business involving "reputation or skill of one or more owners or employees" has been narrowly defined to businesses where endorsements are paid; those where one is paid for licensing one's image, voice, signature, etc.; or those receiving payment for personal appearances.

There are many "narrow distinctions" within these categories that will generate controversy. The regulations offer an example of a celebrity chef endorsing cookware products and owning restaurants. The endorsement activity would be an SSTB, but not the restaurant ownership.

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.04 Threshold Amount

Threshold Amount. The phrase *threshold amount* is defined in 2023 as $364,200 for married individuals filing jointly, $182,100 for married persons filing separately, and $182,100 for all other taxpayers (including trusts, estates, and unmarried individuals) to be adjusted annually for inflation.[60]

There is a key exception to the SSTB exclusion for certain lower income taxpayers. If a taxpayer has *taxable income* less than the *threshold amount*, then the SSTB exclusion does not apply (with the result that the business constitutes a QTB with respect to that particular taxpayer, even though it retains its definitional status as an SSTB for other owners whose taxable income exceeds the applicable threshold).[61] The SSTB limitation is phased in once taxable income exceeds $182,100 (for most individuals and trusts and estates, or $364,200 for married couples filing jointly). The phase-in range is $50,000 (for individuals, or $100,000 for married couples filing jointly). This effectively means that once taxable income exceeds $232,100 or $464,200, respectively, the qualified business income (QBI) deduction is phased down to zero for an SSTB.

But importantly, eligible persons whose income is below the threshold can claim a QBI deduction without concern about the SSTB issues (or the W-2 wages issues and the depreciable property issues) to be discussed later.

.05 Qualified Business Income

Qualified Business Income. Once it is determined that an eligible taxpayer owns an interest in a QTB, the taxpayer's QBI from that business must be ascertained.[62] In general, this computation is determined by reference to the net amount of "items of income, gain, deduction, and loss with respect to any qualified trade or business" to the extent that such items are (*a*) "effectively connected with the conduct of a trade or business" within the United States and (*b*) included or allowed in determining taxable income for the applicable year.[63]

The QBI definition, however, contains many exclusions. Such exclusions include (*a*) portfolio investment-type income, such as dividends, nonbusiness interest income, annuities, and short- and long-term capital gains (and losses); (*b*) reasonable compensation for services rendered by a shareholder-employee of an S Corporation with respect to a QTB; (*c*) IRC Section 707(c) guaranteed payments for services rendered by a partner with respect to the partnership's trade or business; and (*d*) to the extent provided in regulations, IRC Section 707(a) payments for services rendered by a partner with respect to the partnership's trade or business.[64]

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[60] IRC Section 199A(e)(2).

[61] IRC Section 199A(d)(3).

[62] Determining QBI must be done at the entity level.

[63] IRC Section 199A(c).

[64] IRC Section 199A(c)(3)(B).

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.06 Cap Based on Taxable Income, W-2 Wages, and Qualified Property

To protect the tax base, IRC Section 199A's legislative history indicates that Congress sought to "deter high-income taxpayers from attempting to convert wages or other compensation for personal services to income eligible for the 20% deduction."[65] To achieve this objective, Congress instituted a cap on the amount of the allowable QBI deduction applicable to taxpayers who have taxable income above a threshold amount (identical to the SSTB exclusion noted above). Specifically, a taxpayer's tentative deduction for each QTB is equal to the lesser of the following:

(A) 20% of the household's taxable income (i.e., income after *all* deductions, but before the QBI deduction itself) or

(B) The greater of

(i) 50% of the "W-2 wages" with respect to the QTB or

(ii) the sum of 25% of the "W-2 wages" with respect to the QTB, plus 2.5% of the unadjusted basis immediately after acquisition (UBIA) of all "qualified property."[66]

For ease of description, the amount set forth in clause (B) (i.e., the greater of the two formulaic amounts listed in sub-clauses (i) and (ii)) is referred to as the "wage/property cap."

Like the SSTB limitation rules, the wage/property cap does not apply if the taxpayer's taxable income does not exceed the designated threshold amounts.[67]

The wage/property cap contains two terms to be explained.

The first key term is *W-2 wages*. This term generally includes all wages paid by a business and certain deferred compensation arrangements but does not include remuneration paid to independent contractors.[68] The IRS issued Rev. Proc. 2019-11 to allow three alternative methods to be used to calculate W-2 wages. All three look to the reporting on a W-2 Form. The first refers to unmodified box 1 or box 5 wages; the second adds to box 1 entries the entries in box 12 of Form W-2 and subtracts items, not wages, such as unemployment compensation; the third method looks to total wages subject to withholding and adds box 12 of Form W-2. Wages paid to statutory employees are not included in W-2 wages.

The second key term is *qualified property*. The IRC defines this term to include depreciable tangible property that meets the following three conditions: (i) which is held by, and available for use in, the QTB at the close of the taxable year; (ii) which is used at any point during the taxable year in the

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[65] Joint Explanatory Statement of the Committee of Conference submitted to the House and Senate on December 15, 2017 (H. Rept. 115-466) at p. 37.

[66] IRC Section 199A(b)(2).

[67] IRC Section 199A(b)(3).

[68] IRC Section 199A(b)(4).

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production of QBI; and (iii) the "depreciable period" for which has not ended before the close of the taxable year.[69] The term *depreciable period* is defined as the period beginning on the date the taxpayer places the property into service 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 IRC Section 168 (determined without regard to subsection (g) thereof)."[70] In this context, *qualified property* is defined as any tangible property for which depreciation deductions are allowed under IRC Section 167, that was held by and used in the business, and has not already reached the end of the depreciable period. This could potentially include anything from machinery and equipment, to real estate holdings still being depreciated. The *unadjusted basis* of the qualified property is its value immediately after purchase and before actual depreciation; in other words, the *original basis* of the property, without taking into account bonus depreciation, Section 179 depreciation, or any other depreciation.

Note that a taxpayer who has taxable income sufficiently high so that the wage/property cap applies and owns an interest in a QTB that pays no W-2 wages but has qualified property, will have an IRC Section 199A deduction effectively limited to 2.5% of the taxpayer's allocable share of the QTB's unadjusted basis of qualified property.

Once taxpayers have mastered these definitions, limitations, and exceptions, they are poised to take advantage of the IRC Section 199A deduction. This deduction is somewhat unique in that it reduces taxable income (that is, it is to be taken "below the line"), not AGI,[71] but it is not treated as an itemized deduction and, as such, all taxpayers can use it, even if they take the standard deduction.[72]

It is crucial to recognize that the income phase-out for an SSTB is based on the individual's personal tax return, and not based only on the amount of business income. In fact, any income which contributes to an individual's taxable income can cause SSTB income to phase out. It does not need to be just business income over the threshold, nor does it need to be wages or other active income or even ordinary income (like a Roth conversion or portfolio income). Even a sizable long-term capital gain can further phase out the QBI deduction for taxpayers owning SSTBs.

If, for example, a married individual's QBI from an SSTB is $250,000, and the taxable income on the joint return is $475,000, no QBI deduction is allowed because taxable income exceeds the applicable threshold, despite the QBI from the SSTB being less than $364,200.

The final regulations permit aggregation of businesses that are not SSTBs to allow maximizing the advantages of W-2 wages and property basis. In order to aggregate,

- each business must qualify as a trade or business;
- the same persons or group of persons, directly or indirectly, own 50% or more of each business to be aggregated (the attribution rules may be used here);

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[69] IRC Section 199A(b)(6)(A).

[70] IRC Section 199A(b)(6)(B).

[71] IRC Section 62(a) (new sentence at the end thereof added by Section 11011(b)(1) of the Act).

[72] IRC Section 63(b)(3).

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- the 50% ownership test must be satisfied for the majority of the taxable year and must include the last day of the year;

- the businesses share the same taxable year; and

- the businesses satisfy two of the following three tests:

  — they provide similar products, services or property;

  — they share facilities or business elements (personnel, technology, human resources, accounting, legal, etc.); or

  — they are operated in coordination with or reliance upon one or more of the businesses in the aggregated group.

Note that the 20% QBI deduction also applies to a deduction for 20% of the taxpayer's qualified REIT dividends and publicly traded partnership income for the year, as well as 20% of the income from specified agricultural and horticultural cooperatives.

.07 Apportionment of IRC Section 199A Items Between Fiduciary and Beneficiary

To the extent that a trust or estate has QBI, a determination must be made regarding the availability of a QBI deduction at the fiduciary level and beneficiary level. This determination requires the resolution of the following separate and distinct apportionment questions:

a. How should the QBI initially recognized at the trust or estate level be apportioned between the fiduciary and the beneficiary?

b. For purposes of applying the wage/property cap, how should W-2 wages and the unadjusted basis of qualified property be apportioned between the fiduciary and the beneficiary?

As with virtually everything related to trusts and estates, DNI plays a pivotal role in both of these allocation determinations. Based on the language of IRC Section 199A(f)(1)(B), and the final regulations, it is clear that Section 199A issues, including W-2 wages and the adjusted basis of qualified property, should be allocated between a trust and its beneficiaries in proportion to the relative amounts of DNI retained or distributed.[73]

IRC Section 199A has introduced new complications and new planning opportunities for taxpayers at all levels of income. It is anticipated that the IRS will be issuing guidance to fashion taxpayer behavior in a manner the IRS deems acceptable. It is also anticipated that taxpayers will try to test whatever limits the IRS imposes to maximize the opportunities that IRC Section 199A presents.

[73] Treas. Reg. Section 1.199A-5(e)(2)(i).

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¶5060 IRC Section 1400Z — Qualified Opportunity Zone Provisions

The 2017 Tax Cuts and Jobs Act introduced IRC Section 1400Z — Qualified Opportunity Zones (QOZs). QOZs are an attempt to attract investment to designated low-income communities, as the term is defined by IRC Section 45D. The zones were designated by the Treasury based on recommendations by state governors using census tract data. There are nearly 9,000 such zones, comprising both rural and urban areas. Additional zones are added from time to time. The goal is that private investments in these zones will spur economic growth and job creation.

The rules relating to QOZs are complicated and need further clarification. The IRS has issued final regulations (TD 9889) December 19, 2019 that appear to allow investments to proceed with a good understanding of what the law allows.

The key terms of the law and regulations are the following:

- **Qualified opportunity zone (QOZ).** These are the designated areas in which a business must be conducted for any of the tax benefits to come to fruition.

- **Qualified opportunity fund (QOF).** A taxpayer who wishes to defer eligible gain must invest an amount equal to that gain into a QOF within 180 days of the sale. A QOF can be a C corporation, S corporation, or partnership.

- **Qualified opportunity zone property (QOZP).** A QOF must conduct a business in a QOZ, either directly or indirectly. This standard is tested every six months, and at each testing date, at least 90% of the assets of the QOF must be QOZP.

- **Qualified opportunity zone business (QOZB).** A QOF can conduct a business directly, or through a corporate or partnership subsidiary. If done through a subsidiary, the subsidiary must meet the definition of a QOZB.

- **Qualified opportunity zone business property (QOZBP).** QOZBP is property purchased after 2017 from an unrelated party

Section 1400Z-2 offers several valuable federal income tax incentives to a taxpayer who invests in a business located within one of the following zones:

- the temporary deferral of capital gains, to the extent the gains are reinvested into a QOF;

- the partial exclusion of previously deferred gains when certain distinct holding period requirements in a QOF are met; and

- the permanent exclusion of post-acquisition gains from the sale of an investment in a QOF held longer than 10 years.

.01Tax Benefits Resulting from an Investment of Eligible Gain into a QOF

A taxpayer who invests eligible gain (i.e., a realized capital gain) within 180 days into a QOF is eligible for four distinct tax benefits, provided the taxpayer holds the investment in the QOF for at least 10 years. The first three benefits relate to the reinvested eligible gain, and the final benefit relates to gain realized on the disposition of the investment in the QOF.

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- **Tax benefit No. 1: Deferral of eligible gain.** Taxpayer may elect to defer the recognition of the eligible gain. Taxpayer's basis in the QOF is zero.

- **Tax benefit No. 2: Exclusion of 10% of the deferred gain.** If the taxpayer holds the investment in the QOF for five years, the basis of the investment is increased by 10% of the deferred gain. Stated another way, 10% of the deferred gain is now permanently excluded and will never be recognized.

- **Tax benefit No. 3: Exclusion of additional 5% of the deferred gain.** An additional 5% of the deferred gain on the investment is added to the basis if the taxpayer holds the investment in the QOF for another two years. As a result, 15% of the deferred gain is now permanently excluded.

  The seven-year basis increased a sense of urgency for 2019 for investing in opportunity zones. For investments made in 2023, it will be impossible to achieve the seven-year holding period prior to the deferred gain being automatically triggered on December 31, 2026, as explained below, unless the holding period rule is extended.

  - **Recognition of deferred gain.** Any remaining deferred gain must be recognized by December 31, 2026, unless an inclusion event occurs prior to that date. The amount of gain to be recognized is determined by subtracting the taxpayer's basis in the investment — zero before being increased in years 5 and 7, if applicable — from the lesser of (1) the amount of eligible gain originally deferred, or (2) the FMV of the investment in the QOF on December 31, 2026.

    It is important to emphasize that if a taxpayer holds an interest in a QOF until the end of 2026, the deferred gain becomes due without a liquidating event. Thus, it is critical that taxpayers reinvesting deferred gain into a QOF plan accordingly and set aside cash to pay the 2026 tax liability.

- **Tax benefit No. 4: Exclusion from gain on the sale of a QOF interest held longer than 10 years.** If a taxpayer holds an interest in a QOF for 10 years that is attributable to a previous election to defer eligible gain, upon the sale of that investment, the basis of the investment is treated as being equal to its FMV. In simpler terms, this means that no gain is recognized upon the sale of the investment in the QOF. This represents the ultimate benefit offered by Section 1400Z-2: the ability to exclude all gain upon the subsequent disposition of an interest in a QOF that has been held for 10 years. To receive the benefit of the tax-free gain, however, the taxpayer must sell the investment in the QOF before January 1, 2048.

  On June 4, 2020, the IRS released Notice 2020-39, providing relief for QOFs and their investors in response to COVID-19, and updated the "Qualified Opportunity Zones Frequently Asked Questions" on its website to reflect the recent changes. This guidance provided welcome relief and flexibility to QOFs and their investors. It is worth noting that none of the relief provisions under Notice 2020-39 require QOFs or their investors to certify that they have been adversely affected by the virus. In addition, the relief provisions do not require any filing or formal extension request and will automatically apply to those affected.

- Taxpayers with capital gains generally have 180 days to invest those gains into a QOF to capture the QOZ tax benefits.Waiting too long can be costly because the 10-year holding period required to qualify for tax-free appreciation does not start until the QOF investment is made.

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¶5065 The SECURE Act of 2019

On December 20, 2019, with broad bipartisan support, the Setting Every Community Up for Retirement Enhancement Act (the SECURE Act) was enacted into law. The provisions of the SECURE Act have been addressed throughout this guide where specific subject areas are addressed. The highlights of the SECURE Act are discussed as follows.

Repeal of the maximum age for traditional IRA contributions. Before 2020, traditional IRA contributions were not allowed once the individual attained age 70½. Starting in 2020, the new rules allow an individual of any age to make contributions to a traditional IRA, as long as the individual has compensation, which generally means earned income from wages or self-employment.

Required minimum distribution age raised from 70½ to 72. Before 2020, retirement plan participants and IRA owners were generally required to begin taking required minimum distributions from their plan by April 1 of the year following the year they reached age 70½. The age 70½ requirement was first applied in the retirement plan context in the early 1960s and, until recently, had not been adjusted to account for increases in life expectancy. For distributions required to be made after December 31, 2019, for individuals who attain age 70½ after that date, the age at which individuals must begin taking distributions from their retirement plan or IRA is increased from 70½ to 72. Secure Act 2.0 (2021) increased the age from 72 to 73 from 2023 to 2032, and to age 75 for participants attaining 74 in 2033 or later.

Partial elimination of stretch IRAs. For deaths of plan participants or IRA owners occurring before 2020, beneficiaries (both spousal and non-spousal) were generally allowed to stretch out the tax-deferral advantages of the plan or IRA by taking distributions over the beneficiary's life or life expectancy (in the IRA context, this is sometimes referred to as a "stretch IRA"). However, for deaths of plan participants or IRA owners beginning in 2020 (later for some participants in collectively bargained plans and governmental plans), distributions to most nonspouse beneficiaries are generally required to be distributed within 10 years following the plan participant's or IRA owner's death (10-year rule). So, for those beneficiaries, the "stretching" strategy is no longer allowed. Exceptions to the 10-year rule are allowed for distributions to (1) the surviving spouse of the plan participant or IRA owner; (2) a child of the plan participant or IRA owner who has not reached majority; (3) a disabled individual; (4) a chronically ill individual; and (5) any other individual who is not more than 10 years younger than the plan participant or IRA owner. Those beneficiaries who qualify under this exception (called “Eligible Designated Beneficiaries”) may generally still take their distributions over their life expectancy (as allowed under the rules in effect for deaths occurring before 2020). However, the successor beneficiary of an EDB must generally use the 10-year rule. Note also that once a minor child attains the age of majority, the 10-year rule applies. It is also permitted for disabled and chronically ill beneficiaries to use their life expectancy as the beneficiary of a special needs trust that qualifies as either an individual trust or an Applicable Multi-Beneficiary Trust if carefully designed.

The IRS promulgated 275 pages of Proposed Regulations, addressing many aspects of the Secure Act. Among the proposals is clarification that the age of majority is established at 21 and that multiple definitions of disability take into account minors and adults separately. These proposals are not controversial. Some others have raised serious objections, most notably a proposal that beneficiaries of participants older than age 72 who have commenced taking distributions must use their life expectancy for required annual withdrawals until the 10th year after a participant’s death, and then take the balance in year 10. This would be contrasted with beneficiaries of persons not yet age 70, who could withdraw the decedent’s plan funds any time within the 10-year period. It is not clear at this time if these Proposed

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Regulations will be enacted as drafted or modified — or withdrawn in whole or in part. To date, the IRS has said they will not be effective for distributions required for 2021–2023.

Expansion of Section 529 education savings plans to cover registered apprenticeships and distributions to repay certain student loans. A Section 529 education savings plan (a 529 plan, also known as a qualified tuition program) is a tax-exempt program established and maintained by a state, or one or more eligible educational institutions (public or private). Any person can make nondeductible cash contributions to a 529 plan on behalf of a designated beneficiary. The earnings on the contributions accumulate tax-free. Distributions from a 529 plan are excludable up to the amount of the designated beneficiary's qualified higher education expenses. Before 2019, qualified higher education expenses didn't include the expenses of registered apprenticeships or student loan repayments. But for distributions made after December 31, 2018 (the effective date is retroactive), tax-free distributions from 529 plans can be used to pay for fees, books, supplies, and equipment required for the designated beneficiary's participation in an apprenticeship program. In addition, tax-free distributions (up to $10,000) are allowed to pay the principal or interest on a qualified education loan of the designated beneficiary or a sibling of the designated beneficiary. Visit aicpa.org/pfpguides to access more in-depth content in "The Adviser's Guide to Education Planning."

Kiddie tax changes. In 2017, Congress passed the TCJA (P.L. 115-97), which made changes to the so-called kiddie tax, which is a tax on the unearned income of certain children. Before enactment of the TCJA, the net unearned income of a child was taxed at the parents' tax rates if the parents' tax rates were higher than the tax rates of the child. Under the TCJA, for tax years beginning after December 31, 2017, the taxable income of a child attributable to net unearned income was taxed according to the brackets applicable to trusts and estates. Children to whom the kiddie tax rules apply and who have net unearned income also have a reduced exemption amount under the AMT rules. There had been concern that the TCJA changes unfairly increased the tax on certain children, including those who were receiving government payments (that is, unearned income) because they were survivors of deceased military personnel ("gold star children"), first responders, and emergency medical workers. The new rules enacted on December 20, 2019, repeal the kiddie tax measures that were added by the TCJA. So, starting in 2020 (with the option to start retroactively in 2018 or 2019), the unearned income of children is taxed under the pre-TCJA rules (i.e., at the parents' tax rates) and not at trust or estate rates. Starting retroactively in 2018, the new rules also eliminate the reduced AMT exemption amount for children to whom the kiddie tax rules apply and who have net unearned income.

Penalty-free retirement plan withdrawals for expenses related to the birth or adoption of a child. Generally, a distribution from a retirement plan must be included in income. And, unless an exception applies (for example, distributions in case of financial hardship), a distribution before the age of 59½ is subject to a 10% early withdrawal penalty on the amount includible in income. Starting in 2020, plan distributions (up to $5,000) that are used to pay for expenses related to the birth or adoption of a child are penalty-free. That $5,000 amount applies on an individual basis, so for a married couple, each spouse may receive a penalty-free distribution up to $5,000 for a qualified birth or adoption.

Taxable non-tuition fellowship and stipend payments are treated as compensation for IRA purposes. Before 2020, stipends and non-tuition fellowship payments received by graduate and postdoctoral students were not treated as compensation for IRA contribution purposes and so could not be used as the basis for making IRA contributions. Starting in 2020, the new rules remove that obstacle by permitting taxable non-tuition fellowship and stipend payments to be treated as compensation for IRA contribution purposes.

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Tax-exempt difficulty-of-care payments are treated as compensation for determining retirement contribution limits. Many home health care workers do not have taxable income because their only compensation comes from "difficulty-of-care" payments that are exempt from taxation. Because those workers did not have taxable income, they were not able to save for retirement in a qualified retirement plan or IRA.

For contributions made to IRAs after December 20, 2019 (and retroactively starting in 2016 for contributions made to certain qualified retirement plans), the new rules allow home health care workers to contribute to a retirement plan or IRA by providing that tax-exempt difficulty-of-care payments are treated as compensation for purposes of calculating the contribution limits to certain qualified plans and IRAs.

¶5070 The CARES Act of 2020

The Coronavirus Aid, Relief, and Economic Security (CARES) Act is an over-600-page bill signed into law March 27, 2020. The Act contains numerous relief provisions, many of which continue to be revised on an ongoing basis as the pandemic continues. Some of the CARES Act provisions have been discussed throughout this guide where specific subject areas are addressed. The AICPA will continue to provide updates and information on this rapidly changing story.

Note: Almost all of the provisions of the CARES Act addressed issues effective only for 2020 and 2021. (rebates, payroll tax credits, early retirement plan withdrawals without penalty, increased charitable deductions, payroll tax relief, net operating loss deduction expansion, etc. These relief provisions were not extended beyond 2021, and they are not described here. Only a few of the CARES Act provisions were made permanent as described below.

- **Qualified improvement property.** The CARES Act also makes technical corrections regarding qualified improvement property under IRC Section 168 by retroactively making it 15-year property, and thus making it eligible for bonus depreciation. This will allow taxpayers to amend previously filed returns to increase depreciation and possibly cost segregation deductions, potentially generating refunds and net operating losses, which may now be carried back up to five years. The definition of qualified improvement property was modified to include only improvements “made by the taxpayer.” As a result, it can be inferred that improvements to a nonresidential building acquired by a taxpayer, after having been previously placed in service by another taxpayer, will not meet the modified definition of qualified improvement property even if all other criteria are met. The changes noted previously are effective retroactively as of September 27, 2017. Taxpayers should consider evaluating any previous or upcoming capital projects, which may now be eligible for more favorable tax treatment. Although specific procedural guidance is expected, taxpayers generally have the option of amending previously filed returns or filing a Form 3115, *Application for Change in Accounting Method*, with either the 2019 or 2020 tax return to retroactively claim any missed deductions.

- Health plans. The rules for high-deductible health plans are amended to allow them to cover telehealth and other remote care services without charging a deductible.

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¶5075 The Consolidated Appropriations Act of 2021

Key Provisions of the Consolidated Appropriations Act of 2021 for Businesses and Individuals[74]

On Sunday, December 27, 2020, the Consolidated Appropriations Act, 2021 (CAA 2021) was signed into law. A $900 billion emergency relief package is included as part of this omnibus spending bill. It is intended to assist individuals and businesses during the ongoing coronavirus pandemic and accompanying economic crisis. Major relief provisions are summarized here, as well as some additional tax provisions.

NOTE: Almost all of the provisions of the Consolidated Appropriations Act of 2021 addressed issues effective only for 2021, such as temporary increases of unemployment benefits, direct rebates from the federal government, paycheck loans, deduction of business meals, special charitable deduction for non-itemizers, rent payment relief, etc. These special provisions have not been extended further, and are not described here, Several other tax provisions of the Act were extended beyond 2021, and some made permanent, These are described below.

Other tax provisions

The floor for deducting medical expenses has been permanently lowered to 7.5% of AGI (it was scheduled to increase to 10% in 2021).

Starting in 2021, the deduction for qualified tuition and related expenses has been repealed. To make up for it, the modified adjusted gross income (MAGI) phaseout range for the Lifetime Learning Credit has been increased to be the same as the phaseout range for the American Opportunity Tax Credit.

A number of provisions that are periodically extended (often a year at a time) have been extended through 2025, including:

- The exclusion from gross income of discharge of qualified principal residence indebtedness
- The employer credit for paid family and medical leave
- The exclusion from income for certain employer payments of student loans

¶5080 The American Rescue Plan Act of 2021

The American Rescue Plan Act (ARPA) was signed into law March 11, 2021.

NOTE: Almost all of the provisions of the American Rescue Plan Act (ARPA) of 2021 addressed issues effective only for 2021, such as recovery rebate credits, COBRA continuation coverage, expanding child

[74] *Broadridge Advisor Client Alert: Consolidated Appropriations Act Provides Relief to Individuals and Businesses – January 6, 2021.*

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tax credits, dependent care credits, family and sick leave credits, and earned income credits, These special provisions have not been extended further, and are not described here, Several other tax provisions of the Act were extended beyond 2021, and some made permanent, These are described below

Student loans

ARPA provides that gross income does not include any amount that would otherwise be included in income due to the discharge of any student loan after December 31, 2020, and before January 1, 2026.

Miscellaneous tax provisions

ARPA amends IRC Section 162(m), for years after 2026, to add a corporation's five highest-compensated employees (besides the employees already covered by IRC Section 162(m)) to the list of individuals subject to the $1 million cap on deductible compensation.

The Act extends the IRC Section 461(l) limitation on excess business losses of noncorporate taxpayers for one year, through 2027.

The Act provides that targeted Economic Injury Disaster Loan (EIDL) grants received from the SBA are not included in gross income and that this exclusion from gross income will not result in a denial of a deduction, reduction of tax attributes, or denial of basis increase. Similar treatment is afforded SBA restaurant revitalization grants.

¶5085 The Secure Act 2.0 (2022)

Below is a summary of the provision of the Secure Act 2.0, enacted in December 2022.

1. **Later age for required minimum distributions (RMDs).** The 2019 Secure Act raised the age at which retirement savers must begin taking distributions from their traditional IRAs and most work-based retirement savings plans to 72. Secure 2.0 raises that age again for participants attaining age 73 from 2023 to 2032 and age 75 for participants attaining 74 in 2033 or later. This increase applies to RMDs required to be made after December 31, 2022, by taxpayers who reach age 73 after that date. Individuals who have already started taking RMDs may not stop them.

2. **Reduction in the excise tax on delayed retirement plan withdrawals,** Current law requires those who fail to take their full RMD by the applicable deadline to pay a tax of 50% of the amount not taken. The new law reduces that tax amount to 25% in 2023. If the failure to take the RMD is corrected in a timely manner with the full required amount taken and reported (i.e., during the "correction window"), the penalty is reduced from 25% to 10%. The correction window is the period beginning on the date on which the Section 4974(a) excise tax is imposed and ending on the earliest of: (1) the date of mailing of a notice of deficiency with respect to the excise tax; (2) the date on which the excise tax is assessed; or (3) the last day of the second tax year that begins after the end of the tax year in which the excise tax is imposed.

3. **Higher catch-up contributions.** The defined contribution and IRA catch-up contribution limit for persons age 50 and older (currently $1,000) will be indexed annually for inflation, for years after 2023. Also, starting in 2025, people age 60 to 63 will be able to contribute an additional $10,000 for 401(k) and similar plans (and $5,000 extra for SIMPLE plans) each year to their work-based retirement plans. These dollar amounts will be indexed for inflation beginning in 2026.

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4. **Roth IRA Required Treatment of Certain Catch-Up Contributions.** The Secure Act 2.0 makes catch-up contributions under Section 401(k), Section 403(b), or Section 457(b) plans subject to mandatory Roth tax treatment, except those made by participants whose wages for the preceding calendar year do not exceed $145,000, as annually indexed for inflation. That means these contributions will be made on an after-tax basis and qualified distributions will generally be excluded from income when made.

   NOTE: The IRS has delayed implementation of this rule. Notice 2023-62 August 28, 2023). It will now become effective in 2026, not 2024 as originally enacted. The IRS also clarified that plan participants aged 50 or older can make pre-tax catch-up contributions in 2023 despite their income level.

5. **No RMDs Required from Roth 401(k) accounts.** Secure Act 2.0 changes prior law and eliminates the requirement for savers to take minimum distributions from their Roth 401(k) and similar plan accounts.

6. **Enhanced Opportunity for Roth IRA Contributions**. SIMPLE IRAs and SEPs can allow employees to treat contributions as nondeductible Roth contributions. This change is effective for tax years beginning after December 31, 2022. Secure Act 2.0 permits employer matches to be made to Roth accounts. Currently, employer matches must go into an employee's pre-tax account. Under the Act, Section 401(k), Section 403(b), and Section 457(b) plans can allow a participant to designate some or all matching contributions and nonelective contributions as designated Roth contributions. This applies only to the extent that a participant is fully vested in these contributions.

7. **Limited Emergency Withdrawals Permitted without Penalty. Emergency savings accounts.** The legislation includes measures that permit employers to automatically enroll non-highly compensated workers into emergency savings accounts to set aside up to $2,500 (or a lower amount that an employer stipulates) in a Roth-type account. Savings above this limit and any employer matching contributions would go into the traditional retirement account. Specifically, the Act amends the Employee Retirement Income Security Act (ERISA) to allow plans to establish short-term savings accounts as part of an individual account plan on behalf of an eligible participant. Such accounts will be Roth accounts of up to $2,500 with no minimum contribution or account balance requirements that allow for withdrawal or distribution of the account balance, at least once a month, at the participant's discretion. Such distributions will not be subject to the Section 72(t) 10% additional tax for early withdrawals.

8. **Penalty-free Emergency Withdrawals** The Secure Act adds a new exception from the Sec. 72(t) 10% tax on early distributions from retirement accounts. The new exception applies to certain distributions used for emergency expenses, which are used for meeting unforeseeable or immediate financial needs relating to necessary personal or family emergencies. One distribution is allowed per year of up to $1,000. Taxpayers have the option to repay the distribution within three years. No further emergency distributions are allowed during the three-year repayment period unless repayment has been made. The exception is available for distributions made after December 31, 2023.

9. **Tax-free rollovers from IRC Section 529 accounts to Roth IRAs.** The Act permits beneficiaries of Section 529 college savings accounts to make direct trustee-to-trustee rollovers from a Section 529 account to a Roth IRA for the same beneficiary without tax or penalty. The Section 529 account must have been in existence for more than 15 years at the time of the rollover, and

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aggregate rollovers cannot exceed $35,000. Rollovers are also subject to the Roth IRA annual contribution limits. The change is effective for distributions made after December 31, 2023.

10. **Enhanced Opportunity to Use the ABLE Act.** The Secure Act 2.0 increases the age limit before which an individual's disability or blindness must have occurred from 26 to 46 in order for the individual to be eligible to establish and become the designated beneficiary of an achieving a better life experience (ABLE) account. The change is effective for tax years beginning after December 31, 2025.

11. **Higher limits and Enhanced Opportunity for Qualified Charitable Distributions from IRAs.**

    (a) The amount currently eligible for a Qualified Charitable Distribution from an IRA ($100,000) will be indexed for inflation after 2023.

    (b) Beginning in 2023, investors will be able to make a one-time charitable distribution of up to $50,000 from an IRA to a charitable remainder annuity trust, charitable remainder unitrust, or charitable gift annuity.

12. **New Exceptions to the 10% Early Withdrawal Penalty**

    The Secure Act 2.0 includes several amendments to Code Section 72(t) expanding the withdrawals that may be made without imposition of the 10% penalty.

    (a) Penalty-free retirement plan withdrawals for domestic abuse victims. Domestic abuse victims will be allowed to take distributions of up to $10,000 (adjusted for inflation after 2024) from a qualified retirement plan without being subject to the 10% additional tax for early withdrawals. "Domestic abuse" includes physical, psychological, sexual, emotional, or economic abuse by a spouse or domestic partner. Employees or participants can self-certify that they qualify for the exception. The provision is effective for distributions made after December 31, 2023.

    (b) Penalty-free retirement plan withdrawals for individuals with terminal illness. Individuals with a terminal illness may take distributions from a qualified retirement plan without being subject to the 10% additional tax for early withdrawals. Employees or participants will need a physician's certification to qualify for the exception. A terminally ill person is defined as someone who has an illness or physical condition that can reasonably be expected to result in death in 84 months or less after the date of the certification. The provision is effective for distributions made after December 31, 2023.

    (c) Penalty-free retirement plan withdrawals in connection with qualified disasters. Penalty-free withdrawals of up to $22,000 will be allowed for "qualified disaster recovery distributions." These are defined as any distribution made on or after the first day of the "incident period" of a qualified disaster and before 180 days after the "applicable date" for that disaster. Eligible individuals must have their principal place of abode within the qualified disaster area and must have sustained an economic loss as a result of the qualified disaster. The "incident period" means the period designated by the Federal Emergency Management Agency as the period during which the disaster occurred. The "applicable date" is the latest of (1) the date of enactment of the act, (2) the first day of the incident period, or (3) the date of the disaster declaration. Any amount of a qualified disaster recovery distribution that an individual

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must include in income will be included ratably over a three-year period. The provision applies to distributions with respect to disasters for which the incident period begins on or after January 26, 2021 (30 days after the enactment of the Taxpayer Certainty and Disaster Relief Act of 2020, P.L. 116-260). The provision is effective for distributions made after December 31, 2023.

13. Elimination of 10% additional tax on corrective distributions of excess contributions

The Secure Act 2.0 provides that earnings attributable to excess contributions to an IRA that are returned by the due date for the taxpayer's return for the year (including extensions) are exempt from the Sec. 72(t) 10% additional tax.

14. Changes to Qualified Longevity Annuity Contract (QLAC) Rules. Effective in 2023, the Secure Act 2.0 repeals the 25% of the account value limit for qualifying longevity annuity contracts (QLACs). It also increases the dollar limitation on the amount used to purchase these contracts from $145,000 to $200,000. The Act makes changes to facilitate joint and survivor QLAC benefits, and it creates a "free look" period, allowing rescission of the QLAC contract by the employee within 90 days. Qualified annuities are typically purchased with pre-tax money, so withdrawals are fully taxable as ordinary income, and withdrawals prior to age 59½ may be subject to a 10% penalty tax.

15. Election by a Surviving Spouse of an Employee to be Treated as an Employee. In the case of an employee who dies before RMDs have begun under an employer-provided qualified retirement plan, and who has designated a spouse as sole beneficiary, the Act allows the designated beneficiary surviving spouse to elect to be treated as if the surviving spouse were the employee for purposes of the RMD rules of Section 401(a)(9). The IRS will prescribe the time and manner for making the election. This provision is effective for calendar years after 2023.

16. Retroactive first-year elective deferrals for sole proprietors

The Secure Act allows sole proprietors (i.e., an individual who owns the entire interest in an unincorporated trade or business and who is the only employee of that trade or business) to make an elective deferral under a 401(k) plan during the period before the time for filing the individual's return for the tax year (determined without regard to any extensions) ending after or with the end of the 401(k) plan's first plan year, and the deferral will be treated as having been made before the end of the plan's first plan year.

17. Expanded automatic enrollment in retirement plans

Beginning in 2025, the Act requires most new work-sponsored plans to automatically enroll employees with contribution levels between 3% and 10% of income, and it automatically increases their savings rates by 1% a year until they reach at least 10% (but not more than 15%) of income. Workers will be able to opt out of the programs. The Act creates a new Section 414A, under which all Section 401(k) and 403(b) plans will have to provide for automatic enrollment of eligible employees (i.e., there must be an eligible automatic contribution arrangement under Section 414(w)(3)). Such plans must also meet three requirements:

1. They must allow permissible withdrawals (defined in Section 414(w)(2)) within 90 days after the first elective contribution.

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2. As mentioned above, they must provide for automatic contributions, starting with a minimum contribution percentage of between 3% and 10% in the participant's first year of participation, unless the participant specifically elects out. At the end of each year of participation, the contribution percentage must automatically increase by 1 percentage point (unless the participant elects otherwise), to at least 10%, but not more than 15%. For plan years ending before January 1, 2025, the maximum percentage is 10% for any arrangement that is not a safe-harbor plan under Section 401(k)(12) or 401(k)(13).

3. Automatically contributed amounts must be invested in accordance with the requirements of Labor Department regulation 29 C.F.R. Section 2550.404c-5, if the participant makes no investment decision.

Plans established before the Secure Act's enactment date are exempt from the automatic enrollment provision. So are SIMPLE 401(k) plans, Section 414(d) governmental plans, and Section 414(e) church plans. Any plan maintained by an employer that has been in existence for less than three years and any plan maintained by an employer with 10 or fewer employees is also exempt.

For multiemployer plans, the automatic enrollment requirements are applied separately to each employer

The automatic enrollment provision is effective for plan years beginning after December 31, 2024.

18. Saver's match

Low- and moderate-income savers currently benefit from a tax credit of up to $1,000 ($2,000 for married couples filing jointly) for saving in a retirement account. Beginning in 2027, the credit is re-designated as a match that will generally be contributed directly into an individual's retirement account. In addition, the match is allowed even if taxpayers have no income tax obligation. The Secure Act adds a new Section 6433 that provides a matching contribution, up to $2,000, for any eligible individual who makes a qualified retirement savings contribution for a tax year, which the individual will claim as a tax credit. The match will equal 50% of the individual's contribution for the tax year but will phase out for taxpayers with modified adjusted gross income above $41,000, for married taxpayers filing jointly; $30,750, for taxpayers filing as head of household; and $20,500, for single taxpayers (adjusted for inflation after 2027). Eligible individuals are anyone age 18 or older who is not a dependent or full-time student and who is not a nonresident alien.

The saver's match is effective for tax years beginning after December 31, 2026.

19. Starter 401(k) plans and safe-harbor 403(b) plans

The Secure Act establishes two new retirement plans: starter 401(k) deferral-only arrangements and safe-harbor 403(b) plans. An employer is generally eligible to offer a starter 401(k) deferral-only arrangement if neither the employer nor a predecessor employer maintains another qualified plan for the year in which the determination is being made. Under the starter 401(k) deferral-only arrangement, each eligible employee must be treated (unless the employee elects otherwise) as having elected to have the employer make elective contributions in an amount equal to the applicable qualified percentage of compensation.

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All employees of the employer must be eligible to participate in the arrangement other than those that do not meet the age and service requirements. The qualified percentage is determined under the terms of the arrangement, but must not be less than 3% or more than 15%, and it must be applied uniformly.

Employers may not make matching or nonelective contributions to starter 401(k) deferral-only arrangements. An employee's elective contributions for a calendar year may not exceed $6,000, adjusted for cost of living, with up to $1,000 of catch-up contributions permitted for employees who attain age 50 by the end of the tax year.

Similar rules apply to safe-harbor 403(b) plans for tax-exempt employers that do not already maintain a qualified plan.

20. **More part-time employees can participate in retirement plans.** The Secure Act of 2019 required employers to allow workers who clocked at least 500 hours for three consecutive years to participate in a retirement savings plan. Beginning in 2025, the new law reduces the second component of that service requirement to just two years. Previously, Section 401(k) plans generally had to permit long-term part-time employees to make elective deferrals if the employee had worked at least 500 hours per year with the employer for at least three consecutive years and had met the minimum age requirement (age 21) by the end of the three-consecutive-year period. The act reduces the three-year requirement to two years, effective for plan years beginning after December 31, 2024.

21. **Exclusion of disability-related first-responder retirement payments from income**

    The Act creates a new Sec. 139B that allows certain first responders (law enforcement officers, firefighters, paramedics, and emergency medical technicians) to exclude from gross income certain service-related disability pension or annuity payments after they reach retirement age. The exclusion is effective for eligible amounts received after December 31, 2026.

22. **Modified credit for small-employer pension plan startup costs**

    The Secure Act provides an increase to the Section 45E credit for all or a portion of employer contributions to small employer pensions for the first five employer tax years beginning with the one that includes the plan's start date. The amount of the small-employer pension credit would be increased by the applicable percentage of employer contributions on behalf of employees, up to a per-employee cap of $1,000. The applicable percentage is 100% in the first and second tax years, 75% in the third year, 50% in the fourth year, and 25% in the fifth year. No credit is available in the sixth and subsequent years.

    Employers with 50 or fewer employees are eligible for 100% of the credit, which then phases out for employers with between 51 and 100 employees. No credit is allowed for employer contributions on behalf of an employee who makes more than $100,000 (adjusted for inflation after 2023).

    The saver's match is effective for tax years beginning after December 31, 2026.

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23. Small financial incentives for contributing to a plan

The Act allows employers to provide *de minimis* financial incentives (not paid for with plan assets) to employees who elect to have their employer make contributions pursuant to a salary reduction agreement.

24. Credit for military spouses that participate in employer defined contribution plans. Small businesses that provide immediate enrollment and vesting to military spouses in an eligible retirement savings plan will qualify for new tax credits. This provision takes effect immediately

The Act creates a credit for small employers for each military spouse that starts participating in the employer's eligible defined contribution plan (new Section 45AA). A small employer is defined as one with no more than 100 employees who earned at least $5,000 in the preceding year.

The annual credit amount is $200 for each military spouse who participates in the employer's plan, plus the amount of related employer contributions to the plan (but capped at $300 of contributions for any individual). A military spouse counts for purposes of the credit only in the tax year that includes the date the spouse begin participating in the plan and the two succeeding tax years. "Military spouse" is defined as an individual who is married to a member of the uniformed services (as defined in 10 U.S.C. Section 101(a)(5)) serving on active duty. Highly compensated employees (within the meaning of Section 414(q)) are excluded from the definition of “military spouse.”

2.5 Long-term-care contracts purchased with retirement plan distributions

The Act amends Section 401(a) to allow retirement plans to make "qualified long-term care distributions." Under this provision, up to $2,500 can be distributed to purchase long-term-care insurance.

26. Limitation on conservation easement deductions for passthrough entities

The Secure Act disallows a charitable deduction for an otherwise-qualified conservation easement contribution that is made by a partnership, S corporation, or other passthrough entity, if the amount of the contribution exceeds 2.5 times the sum of each partner/member's relevant basis in the contributing entity.

Certain exceptions apply: if the contribution meets a three-year holding period test; if substantially all of the contributing entity is owned by members of a family; or if the contribution relates to the preservation of a certified historic structure.

The Act also creates a safe harbor to allow taxpayers to correct easement deed language regarding extinguishment clauses and boundary line adjustments. The IRS is directed to develop safe-harbor language for this purpose.

27. Retirement savings lost-and-found database

The Act mandates the creation of a retirement savings lost-and-found online searchable database to be managed by the Department of Labor. The database must be established within two years of the date of enactment of the Act. The database will allow individuals to search for plans and

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the contact information of the administrator of any plan in which they are a participant or beneficiary.

28. **Matching contributions for qualified student loan repayments.** Employers may help workers repaying qualified student loans simultaneously save for retirement by investing matching contributions in a retirement account in the employee's name.

¶5090 The Inflation Reduction Act of 2022 (2022 IRA)

The Act contains a wide variety of spending provisions for the environment, healthcare, energy infrastructure, and domestic manufacturing, as well as a number of tax provisions. Many of the Act's provisions are scheduled to be phased in and occur over time.

The primary tax reforms are a new corporate minimum tax, increased spending on IRS enforcement, a new excise tax on stock buybacks, and numerous green energy credits.

.01 Corporate alternative minimum tax

The 2022 IRA extends the alternative minimum tax to corporations who meet an annualized financial statement income test. Generally, to meet the test, the corporation's average annual adjusted financial statement income must exceed $1 billion over a three-year period.

However, there are exceptions, such as for corporations with a foreign-owned parent, which only need to meet a $100 million test for the same period. S corporations, regulated investment companies, and real estate investment trusts are excluded without regard to income.

If a corporation is subject to the alternative minimum tax, the tax is 15% of the adjusted financial statement income less the corporation's alternative minimum foreign tax credit.

.02 Excise Tax on Stock Buybacks

The 2022 IRA creates a 1% excise tax on the fair market value of stock repurchased by a covered corporation. A covered corporation is one whose stock is traded on an established securities market. The 2022 IRA defines repurchase as when a corporation acquires its stock from a shareholder in exchange for property. The amount subject to tax is reduced by stock issued by the covered corporation during the year.

There are special rules for affiliated corporations and foreign corporations. The 2022 IRA provides exceptions for repurchases that are part of a reorganization where no gain or loss is recognized by the shareholder; repurchases where the corporation contributes its stock or stock of equal value to an employee retirement or stock ownership plan; repurchases when the total amount repurchased during the year is less than $1 million; repurchases in the ordinary course of business; repurchases by regulated investment companies or real estate investment trusts; or to the extent the repurchase is treated as a dividend.

.03 Increased funding for the Internal Revenue Service

The 2022 IRA provides nearly $3.2 billion for taxpayer services; over $45 billion for enforcement; over $25 billion for operations; and nearly $4.8 billion to modernize technology. It also provides funds to create a task force to prepare a report on the cost and feasibility of creating a free e-file system.

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.04 Extension of Affordable Care Act subsidies

The 2022 IRA extends the Affordable Care Act credits through 2025.

.05 Green energy credits

The 2022 IRA provides numerous credits aimed at reducing emissions or encouraging the adoption of green energy.

a. Clean electricity and reducing carbon emissions

To encourage the production of clean energy, the 2022 IRA extends the period to build or place in service new wind, closed- or open-loop biomass, geothermal, solar, and other energy facilities to 2025; however, it reduces the base credit amount too. The 2022 IRA also extends the credit for property related to the production of such energy to 2025; provides a credit for solar and wind facilities used in connection with low-income housing; extends the credits for carbon oxide sequestration; and creates a new credit for zero-emissions nuclear power.

b. Clean fuels

The 2022 IRA extends the credits for biodiesel fuels and creates new credits for sustainable aviation fuel and the production of clean hydrogen.

c. Clean energy and efficiency incentives for individuals

The 2022 IRA extends and modifies credits for individuals to install heat pumps and energy efficient windows and doors, or to build energy efficient homes. It also extends the residential clean energy credit to 2032 and increases the energy efficient commercial building deduction.

d. Clean vehicles

The 2022 IRA increases and modifies the credit amounts related to plug-in electric drive motor vehicles and creates a new credit for purchasing pre-owned clean vehicles and for placing in service certain commercial clean vehicles. It also extends the credit for installing charging equipment.

Other credits

e. The 2022 IRA modifies or creates credits related to investment in clean energy manufacturing and energy security; superfund sites; and clean electricity and transportation.

f. Other notable provisions

The 2022 IRA increases the existing $250,000 research credit applied to small businesses' payroll tax liability by an additional $250,000. The first $250,000 will still be applied to the payroll tax, and the additional $250,000 will be applied to the business's Medicare tax.

The 2022 IRA also extended the limitation on excess business losses under section 461(l) through 2028.

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¶5095 The Corporate Transparency Act

The Corporate Transparency Act (CTA) requires a broad range of entities to file a report with the U.S. Department of the Treasury's Financial Crimes Enforcement Network (FinCEN) identifying those who own, control and formed the company.

The CTA is mainly an anti-money laundering law. In it, Congress states that bad actors seek to conceal their ownership of corporations, LLCs, or similar entities in the United States to facilitate money laundering, financing of terrorism, tax fraud, and other illegal acts.

That said, the CTA appears to apply to an exceptionally broad network of entities and persons required to report. It is anticipated that substantial guidance may need to be issued to address the many questions that are likely to arise as this new law becomes effective January 1, 2024.

A summary of the major rules follows.

- The Corporate Transparency Act (CTA) will require privately held entities to report detailed private information to the Treasury. The rules are complex, very different than anything that has previously been required, and provide for stringent penalties for non-compliance.

- CTA reporting will affect the owners or principles involved in almost all business entities. This includes limited liability companies (LLCs), corporations, limited partnerships (LPs and FLPs), and other closely held entities.

- Only Exceptions from CTA Filing Requirements: Large active enterprises with 20+ employees and more than $5 million in revenues, or entities such as banks that are already subject to significant federal reporting requirements. FinCEN also specifically exempted 23 types of entities from reporting, including, U.S. Securities and Exchange Commission registered issuers, pooled investment vehicles, tax-exempt entities, and inactive entities formed prior to Jan. 1, 2020, without foreign owners and that hold no assets. Subsidiaries of exempt entities are also largely exempted from the reporting requirements.

- What Reporting Entities Will Have to Report: Reports will require the legal name and any trade names of the entity, a street address for company's principal place of business, state of formation, the Tax Identification Number (note that for a disregarded single member LLC you might be using your Social Security Number for the entity).

- Every Beneficial Owner Must Report: These are the people behind or controlling each reporting entity. You'll have to disclose your full legal name, date of birth, home address (a PO Box won't suffice) and you'll have to provide a PDF of your U.S. passport or state driver's license.

- Changes in Reported Information: Reporting entities must also report changes to any filing within 30 days.

- The Financial Crimes Enforcement Network: FinCEN will be in charge of creating and maintaining the database of all info the government collects. It will be accessible to a variety of governmental agencies.

- The CTA will affect most small family businesses, including LLCs and other entities designed only to hold a vacation or rental home.

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- Even if an entity has only one owner and is ignored for federal income tax purposes (like a single-member disregarded LLC), it may still have to file reports with FinCEN.

- "Ownership" is not limited to obvious ownership (e.g., you own membership interests in an LLC). It is broadly defined to include any type of equity interests (e.g., a profits interests, convertible instruments, warrants, options, puts, calls, and other entity interests). **Ownership can be interests owned or controlled through joint ownership, through a trust agreement, or other indirect arrangements.** Substantial control individuals required to be reported under the rules explicitly include: (1) senior officers (for example, "president, chief financial officer, general counsel, chief executive officer, chief operating officer, or any other officer, regardless of official title, who performs a similar function") and (2) anyone else who "directs, determines, or has substantial influence over important decisions made by the reporting company" or has "any other form of substantial control over the reporting company."

- If you are not an "owner" of an entity, but you exercise the authority which a senior officer of the entity might hold, you also have to report. If you are not an owner or officer but if you have direct or indirect substantial control over the entity you may have to report. This might include a chief financial officer, general counsel, trust protector, trustee, etc. FinCEN will look through revocable trusts and single beneficiary trusts as well as many non-discretionary trusts. In that context, individuals who will be required to be reported as beneficial owners of reporting entities owned by trusts will generally include:

- trustees of the trust or other individuals (if any) with the authority to dispose of trust assets.

- any beneficiary who:

    - Is the sole permissible recipient of income and principal from the trust; or

    - Has the right to demand a distribution of or withdraw substantially all of the assets from the trust.

- Any grantor or settlor who has the right to revoke the trust or otherwise withdraw the assets of the trust.

- The CTA rules apply January 1, 2024. For entities that already exist by that date, their initial reports are due by January 1, 2025. For entities created on or after that date, an initial report is due within 30 days from the date of the creation of the entity.

- In the event of willful violations (by intentional act or omission) of the reporting requirements, reporting companies could be subject to civil penalties of up to $500 per day of a continuing violation and further criminal penalties of up to $10,000 and imprisonment for up to two years.

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