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SUPPLEMENT TO KOHUT, ESTATE PLANNING BASICS, LAVENDER LAW 2021

Estate, Gift and Fiduciary Income Tax Basics, Plus, A Brief Summary of The SECURE Act

Lavender Law 2021

Federal Estate and Income Taxes.

A. **Unlimited Marital Deduction**: Lifetime and testamentary gifts of spouses are generally not subject to estate or gift tax (Note: a trust must qualify for the martial deduction).

B. **Lifetime Estate (Gift) Tax Exemption**: $11,700,000 in 2021, indexed for inflation; sunsets on 12/31/25 to prior exemption approximately $5,500,000 indexed for inflation. GST exemption also $11,700,000 and sunsets on 12/31/25. Tax rate is 40%.

C. **Annual Exclusion Amount**: $15,000 in 2021, indexed for inflation.

D. **Portability of Exemption**: A spouse can claim ("port") their deceased spouse's estate tax exemption, but only if an estate tax return (Form 706) claiming the exemption is timely filed. The estate tax return must be timely filed but there is a Revenue Procedure (Rev Proc 2017-34) which allows for a late filed return (if filed within 2 years from the date of date) if there is no estate return would have been otherwise due and the purpose is to claim the deceased spouse's unused exemption.

   PRACTICE NOTE: Always send a letter to the surviving spouse confirming that you have informed the spouse of the right to claim their deceased spouse's exemption and that they have declined to do so (or will do so but engage a qualified tax professional).

E. **Step-Up in Basis**. Currently, Section 1014 of the Internal Revenue Code provides that upon a taxpayer's death the tax basis (cost for purposes of calculating capital gains or depreciating an asset) is equal to the fair market value of the asset on the date of death (whether more or less than the tax basis immediately prior to death). For appreciated assets, the increasing ("stepping-up") the tax basis to the fair market value on the date of death effectively eliminates unrealized capital gains in the hands of the beneficiary (or estate if the estate sells the asset during the estate administration). Annuities, 401k's, IRAs and other qualified retirement accounts do not receive a step up in basis (essentially because they have “tax-free” growth during the owner’s lifetime.

There are proposals to eliminate the step-up in basis upon death with a limited exception for more modest estates. On May 28, 2021, the Treasury Department released its “Greenbook” (the Treasury Department’s 2022 Revenue Proposals) which, among other things, proposed limiting any step-up in basis upon death to $1,000,000 per taxpayer ($2,000,000 for a married couple), plus and exclusion for tangible personal property such as household furnishing and $250,000 of gain for all personal residences. If step-up in basis is eliminated, tax basis planning will another area in which estate planners can provide valuable assistance.

F. **Estate and Trust Income Tax Rates**: Even if an estate is not subject to estate tax, the estate is required to file a fiduciary income tax return (Form 1041) if there is more than $600 of taxable income in a given tax year. Additionally, the executor may be required to file a final income tax return for the decedent if the taxable income from January 1 through the date of death triggers a filing requirement (generally, the basic standard deduction amount - $12,550 in 2021).

i. **Choosing the Fiscal Year**. An estate (but not a trust) can choose a fiscal (tax) yearend other than December 31 on its first tax return. Any month end other the month of death. This can be advantageous to (A) allow for one income tax return, (B) to minimize taxable income by choosing a fiscal year end based upon the timing of taxable income and deductible expenses, and (C) allow the beneficiaries to defer payment of income tax on taxable distributions.

PRACTICE NOTE: If a practitioner is not familiar with fiduciary income tax, it is beneficial to associate a qualified tax professional (e.g., CPA) at the outset of the estate administration to determine the best tax year, identify necessary tax elections and plan the timing of expenses in a manner which will offset taxable income.

ii. **645 Election**: Section 645 of the Internal Revenue Code allows a probate estate and revocable trust to elect to treated as an estate for purposes of fiduciary income taxes. The benefits of such are election can be: (A) the taxable income generated in an investment account owned by the decedent’s revocable trust can be offset by the administrative expenses of the probate estate, (B) without a 645 election, a revocable trust can only use a fiscal (tax) year other than December 31st, and (C) without a 645 election, a revocable trust must pay estimated income tax unlike an estate which is only required to pay estimated income tax if the estate administration exceeds two years.

The deadline for filing a 645 Election is the deadline for filing the first fiduciary income tax return, including any timely extensions. This deadline is easy to miss and a good reason to consult with a tax professional often and early if there will be significant taxable income generated during the estate/trust administration.

PRACTICE NOTE: If a revocable trust has substantial income producing assets and there will be probate expenses, do not distribute the assets in the revocable trust until after a 645 election is made and after a tax year end to assure the expenses will be deductible against and offset the taxable income.

G. Trust and Estate Income Tax Rates. The income tax brackets for trust and estates are "compressed" and reach the highest tax bracket (currently 37%) after $13,050 (for 2021) of taxable income. (The tax brackets are indexed for inflation). A single taxpayer does not reach the 37% bracket in 2021 until $510,300 of taxable income. With good planning, it is possible to "carry out" taxable income to beneficiaries of a decedent's estate.

H. The SECURE Act. The SECURE Act was enacted in December, 2019 and became effective beginning January 1, 2020, making substantial changes to the rules on taxation of inherited retirement accounts (401k, 403b, 457 and IRA accounts). A summary of the most notable changes follows:

i. **Required Beginning Date**: The required beginning date for qualified retirement accounts is now 72 (an increase from 70½).

ii. **Non-Designated Beneficiaries**: The existing rules for "non-designated" beneficiaries remain – the beneficiary must withdraw (and pay any tax) on the account balance within 5 years following the date of death if the plan participant died prior to their required beginning date; the beneficiary must use the remaining life expectancy of the plan participant if the date of death was after the required beginning date.

iii. **Designated Beneficiaries (individuals or see-through trusts)**: The stretch for designated beneficiaries under the old rules is now limited to 10 years, unless the beneficiary is an "eligible designated beneficiary."

iv. **Eligible Designated Beneficiaries**: Under SECURE, there is now a more limited class of "eligible" beneficiaries (and see-through trust for their benefit) who can stretch the payout period beyond the new ten-year limitation. These beneficiaries are called "eligible designated beneficiaries" and are:

1. **Surviving Spouses**. Surviving spouses (and see-through trusts of which they are a beneficiary) can still use the life expectancy payout as was the case pre-SECURE.

2. **Minor of a Child of the Participant**. Minor children of the participant can use a life expectancy payout but upon reaching their "majority" the ten-year limitation begins. Note: There is not a clear definition of minor.

3. **Not More Than 10 Years Younger the Participant**. If an individual (or see-through trust) is not more than 10 years younger than the participant, then the beneficiary can use a life expectancy payout as was the case pre-SECURE.

4. **Disabled Beneficiary**. An individual as defined under Section 72(m)(7) of the Code, essentially "unable to perform any substantial gainful activity by reason of any medically determinable physical or mental impairment…for an indefinite duration."

5. **Chronically Ill**. An individual who is chronically ill as defined in Section 7702B(c)(2)(A) of the Code, including someone "unable to perform (without substantial assistance from another individual) at least 2 activities of daily living for a period of at least 90 days."

v. **Existing Inherited Retirement Accounts**: Accounts inherited with a "designated beneficiary" prior to January 1, 2020 are grandfathered for the life expectancy of the designated beneficiary. However, the SECURE ACT limits any stretch after the death of the designated beneficiary is limited to 10 years. In the case of a "see through trust" (discussed below) for multiple beneficiaries, it is unclear which death triggers the ten-year limitation.

vi. **Resources**: Natalie Choate, *Life and Death Planning for Retirement Benefits* (8th Ed. 2019). Book order form and SECURE Act update (and other useful materials) at author's website – www.ataxplan.com

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