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SUPPLEMENT TO KOHUT, ESTATE PLANNING BASICS, LAVENDER LAW 2022

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

Lavender Law 2022

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 marital trust must qualify for the martial deduction. In the case of a QTIP trust, a QTIP election must be made.)

B. **Lifetime Estate (Gift) Tax Exemption**: $12,060,000 in 2022, indexed for inflation; sunsets on 12/31/25 to prior exemption approximately $6,000,000 indexed for inflation. GST exemption also $12,060,000 and sunsets on 12/31/25. Tax rate is 40%.

C. **Annual Exclusion Amount**: $17,000 in 2022, 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. There is a Revenue Procedure (Rev Proc 2022-32) which allows for a late filed return to be filed within 5 years of the decedent's date of death (previously a 2 year limit pursuant to Rev Proc 2017-34) if (1) no estate return would have been otherwise due and (2) 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 increase ("step-up") of 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 (the income was "tax-free" growth during the owner's lifetime).

In 2021, there were 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. The exemption would be "portable" to a surviving spouse. If step-up in basis is limited and portable, tax basis planning will be another area in which estate planners can provide valuable assistance to those clients whose estates may have substantial unrealized capital gains (e.g., residences and second homes, investment accounts and properties, etc.).

In March 2022, the Treasury Department released its "Greenbook" for the 2023 fiscal year which also includes the provisions regarding the taxation of unrealized capital gains upon death. The proposed exemptions were increased from $1,000,000 per person to $5,000,000, indexed for inflation. With "portability," a married couple could "step-up" basis by $10,000,000.

The 2023 Greenbook confirms that there would be a deduction (not a tax credit) for any tax paid on capital gains for purposes of the estate tax. But, since the capital gains tax rate on "recognized" capital gains would be income to the decedent and the new proposed capital gain rate of 39.6% for estates in the top bracket, the effective proposed tax rate for large estates could be 63.76% (0.396+.40 x (1-.396) = 0.6376 or 63.76%.

Given the current split in the Senate, the proposals in the Greenbook seem unlikely too pass Congress. However, compromise legislation is possible.

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 - $12,950 in 2022).

i. Choosing the Fiscal Year. An estate (but not a trust) can choose a fiscal (tax) year-end other than December 31 on its first tax return - any month end, including the month of death. A fiscal, as opposed to a calendar year end, may: (A) allow for one income tax return where the estate administration straddles two calendar years but is concluded within 12 months from the date of death, (B) minimize taxable income by choosing a fiscal year end based upon the timing of taxable

income and deductible expenses, and/or (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 the estate for purposes of fiduciary income taxes. The benefits of such are election include: (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.

Additionally, while transfer-on-death designations of investment accounts are often touted to avoid probate, as opposed to titling investments in a revocable trust, the tax benefit of deducting legal and tax advice is not available with respect to investments passing by TOD designation.

iii. **Specific/Pecuniary Gifts versus Residuary:** Specific and pecuniary gifts do not "carry out" income. Residuary bequests do carry out income. It is important to consider these rules when drafting an estate plan. Assume that an estate has a $200,000 investment account and the account generates taxable income of $20,000 from the date of death through the end of the estate's first fiscal year end. If the will provides a gift of "$5,000 for each of my ten (10) grandchildren and the remainder of my estate to my four (4) children," the gifts to grandchildren would not "carry out" taxable income but taxable income be "carried out" to the four (4)

children to the extent they receive distributions. Assume during the first tax year, the executor distributes the $50,000 in gifts to the grandchildren, a total of $20,000 to the four (4) children, and there are $4,000 of legal and probate expenses. The distributions to the children will "carry out" the net income ($20,000 minus $4,000 = $16,000) and be reported on a K-1 in the amount of $4,000 to each of the four children.

PRACTICE NOTE: There are no set drafting rules. Instead, if there are assets in an estate or revocable trust which are likely to generate taxable income, the drafter should consider how taxable income will be "carried out" to the beneficiaries. During an estate administration, similar fiduciary income tax planning should be considered.

G. Trust and Estate Income Tax Rates. The income tax brackets for trusts and estates are "compressed" and in 2022 reach the highest tax bracket (currently 37%) after $13,450 of taxable income. Similarly, the 2022 capital gains tax brackets are: 0% to $2,800; 15% from 2,801 to 13,700; and 20% in excess of $13,700. (The tax brackets are indexed for inflation). A single taxpayer does not reach the 37% bracket in 2022 until $539,900 of taxable income, and capital gains are taxed at 0% up to $41,675, 15% from $41,676 to $459,750 and 20% in excess of $459,750. 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). On February 24, 2022, the IRS issued proposed regulations on Required Minimum Distributions under the SECURE Act https://www.govinfo.gov/content/pkg/FR-2022-02-24/pdf/2022-02522.pdf.

A summary of the most notable changes follows:

i. **Required Beginning Date**: The required beginning date for qualified retirement accounts is now April 1st of the calendar year in which the employee/IRA owner reached 72 years of age (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 the 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. Note: Only a conduit trust will assure a lifetime stretch based upon the surviving spouse life expectancy as the spouse must be the sole countable beneficiary. The status of remainder beneficiaries is irrelevant in determining see-through status and RMDs for conduit trusts, as opposed to accumulation trusts.

2. **Minor of a Child of the Participant (age 21)**. Minor children of the participant can use a life expectancy payout but upon reaching their "majority" the ten-year limitation begins. The proposed regulations provide that the age one reached majority is 21.

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 by "designated beneficiaries" 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 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. **Applicable Multi-Beneficiary Trusts (AMBTs)**: An AMBT is a trust with multiple beneficiaries all of whom are designated beneficiaries and at least one of whom is disabled or chronically ill (as defined in the statute and regs).

1. **Type I AMBT**: An applicable multi-beneficiary trust the terms of which provide for an immediate division into separate trusts for each beneficiary. Each separate trust is then analyzed for the applicable RMD.

2. **Type II AMBT**: An applicable multi-beneficiary trust the terms of which only the beneficiary(ies) who are either disabled or chronically ill are entitled to benefits during the lifetime of such beneficiary(ies) and no other individual has any right to the trust assets prior to the death of the disabled or chronically ill beneficiary(ies).

vii. **New Terminology**: The proposed regulations adopted the terms "see-through trusts," "conduit trusts," and "accumulation trusts."

1. **See-through Trusts**: A trust the beneficiaries of which are designated beneficiaries*, and which meets the following requirements:

a. Trust is valid under state law;
b. Trust is irrevocable or becomes irrevocable upon death of plan/IRA owner;
c. The beneficiaries of the trust are "identifiable" (designated); <u>and</u>
d. The documentation requirements to the plan administrator or IRA custodian have been satisfied.

*Note: The proposed regulations clarify which beneficiaries are disregarded in determining "see-through status.

2. **Conduit Trusts**: A see-through trust which requires that all RMDs be paid, upon receipt of the trustee, to or for the benefit of the specifies beneficiary(ies). Contingent beneficiaries (upon the death of the current beneficiary(ies)) with respect to conduit trusts are generally disregarded.

3. **Accumulation Trusts**: A see-through trust which is not a conduit trust.

a. **Secondary Beneficiaries**: The proposed regulations provide that only secondary beneficiaries are used in testing the trust for see-through status, not tertiary beneficiaries.

b. **10-year After Reaching Minority Trust**: A trust which provides that all retirement benefits will be distributed no later than the tenth year following the year that the beneficiary reached the age of majority. In such cases, remaindermen of the trust are disregarded.

viii. Important Dates After Account Owner/Employee's Death:

1. **RMD not withdrawn in year of death**: Automatic waiver of excise tax if withdrawn by due date for final Form 1040.

2. **Finalization Date (September 30th of year following date of death).**

3. **Certification Date (October 31st of year following date of death)**: The date the certification must be provided to establish see-through status.

4. **Certification Letter for See Through Trusts:** See attached.

ix. **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

Natalie Choate's Free Supplement (until she publishes her new supplement to her 8th Edition). https://ataxplan.com/wp-content/uploads/2022/03/How-the-new-RMD-rules-work.pdf

Natalie's Chart on RMDs: https://ataxplan.com/wp-content/uploads/2022/03/How-the-new-RMD-rules-work.pdf

x. Risk Management Alert from Lawyers Mutual (North Carolina):

Lawyers Mutual | 1001 Winstead Drive, Suite 285, Cary, NC 27513
Common Errors in Estates and Trusts

July 15, 2022

Over the last few years, Lawyers Mutual has seen an increase in Estates and Trusts (E&T) claims. In 2021, E&T claims were the third most common claims according to area of practice. Only Plaintiff's personal injury and residential real estate generated more claims by practice area. Errors occur in both estate planning and estate administration. Two common E&T errors are:

Disbursement Errors: Disbursement errors are common in estate administration. Disbursement errors can include overpayment to one or more beneficiaries, leaving out beneficiaries or payment to the incorrect beneficiary. Once a disbursement error has been made, it can be difficult to get the money returned. Although you can request that the person who received the overpayment return the money and even pursue legal action, it may be difficult to recover the overpayment, especially if the money has already been spent. To prevent disbursement errors, identify the beneficiaries early in the process. Attempt to discern who the beneficiaries are through your client, the personal representative of the estate, public records searches, asking family members or any other means. Do not rush the process.

Defining Scope of Representation: When assisting a client with estate planning, it is very important to communicate the scope of your representation, know who your client is and clearly delineate both in your engagement letter. Oftentimes, an adult child will accompany an elderly parent to a meeting with the attorney to draft estate planning documents. It is important for the attorney to communicate to the adult child that the client is the parent. The attorney should meet with the parent separately to assess the parent's wishes regarding his or her estate planning documents. Although the adult child may be well-intentioned, other beneficiaries may raise issues of undue influence by the adult child and could potentially file a will caveat proceeding. Lawyers Mutual commonly sees the drafting attorney get pulled into these will caveat proceedings through a subpoena for his or her file and/or testimony. At times, the attorney also gets named as a defendant in connection with the litigation. These claims are often emotionally charged and can lead to prolonged litigation. Protect yourself on the front end by having a clearly defined engagement letter and meeting with your client separately from any other family members. If you have questions about the testator's capacity or competence or are concerned about undue influence, refer your client to a mental health professional for evaluation. NC Formal Ethics Opinion 2006 FEO 11 states that "a lawyer may not, at the request of a third party, prepare documents, such as a will or trust instrument, that purport to speak solely for principal without consulting with, exercising independent professional judgment on behalf of, and obtaining consent from the principal." To read the full opinion, click here: https://www.ncbar.gov/for-lawyers/ethics/adopted-opinions/2006-formal-ethics-opinion-11/

E&T is a complicated area of law. If handling an E&T matter is outside your area of expertise, it is advisable to refer the potential client to a colleague who has more experience in the area. Dabbling in areas of practice outside your expertise often leads to errors and eventual claims against you for professional malpractice.

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