Planning with SLATs and SLANTs Ahead of TCJA Sunset

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Course Outline

I. Estate Tax Exclusion Sunset – Mechanics & Mathematics
II. Financial Analysis – Planning for Solvency
III. Effective SLAT/SLANT Design
IV. Gift Tax Returns
V. Income Tax Returns

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Estate Tax Exclusion Sunset

Mechanics & Mathematics

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The Tax Cuts & Jobs Act Sunset

Coming Sooner than You Think

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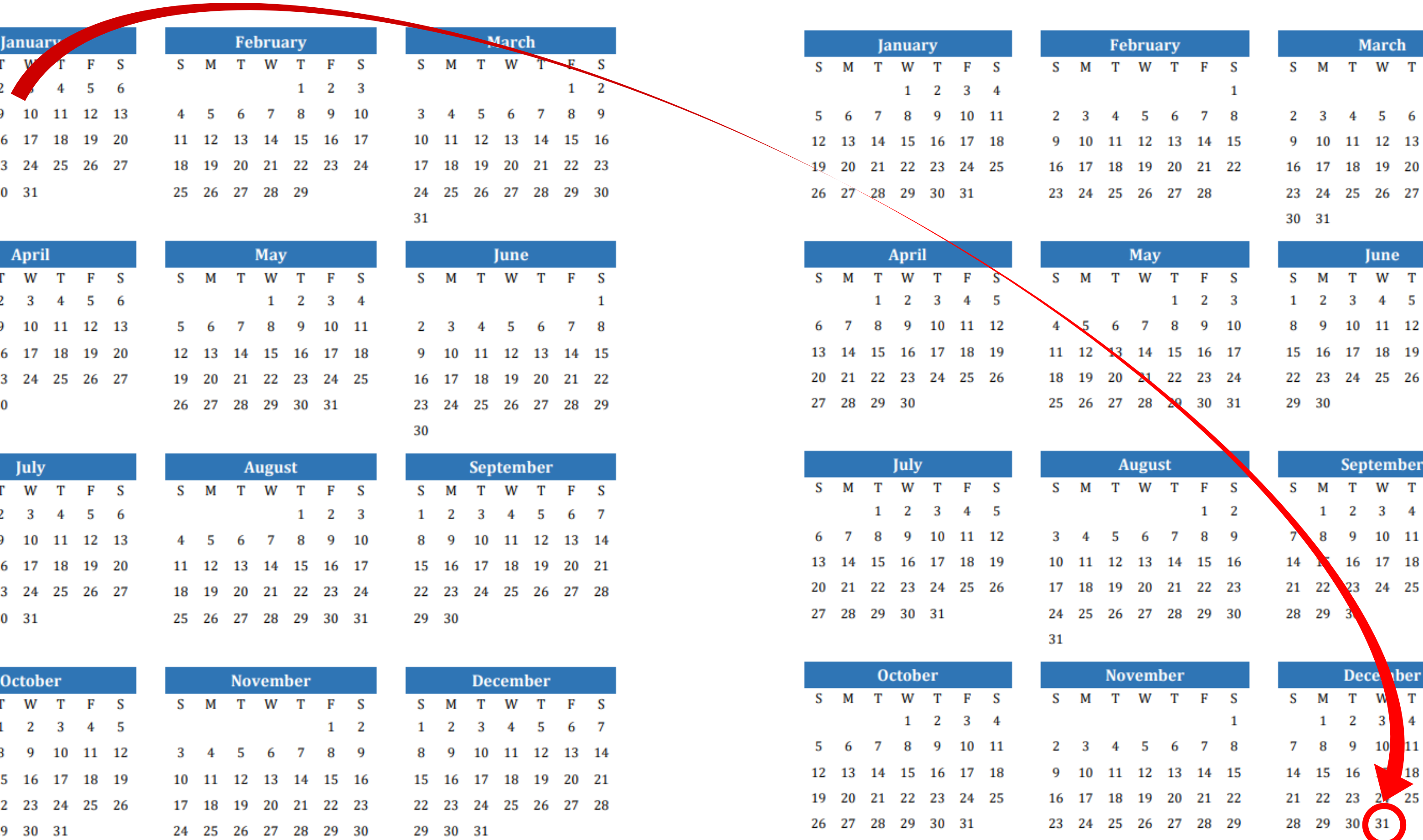
TCJA Sunset – 24 Months Left



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Tax Reform Review – Critical Changes

- Estate & GST tax
  - The TJCA "Doubled" the exemption from 2018 to 2025 ($13.61M in 2024)
  - Sunsets December 31, 2025
  - **NO CLAW BACK FOR THOSE WHO GIFT BEFORE SUNSET, BUT DIE AFTER SUNSET**
  - Step-up in basis retained at death

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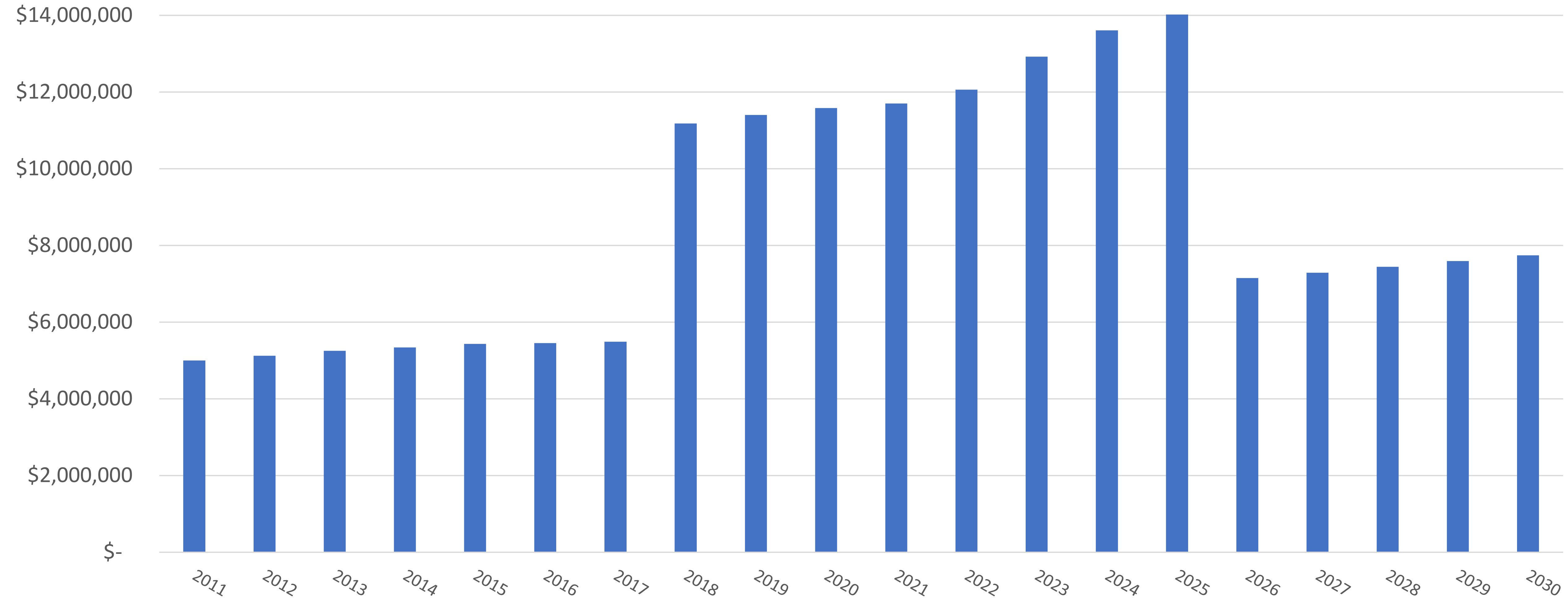
Estate & GST Taxes



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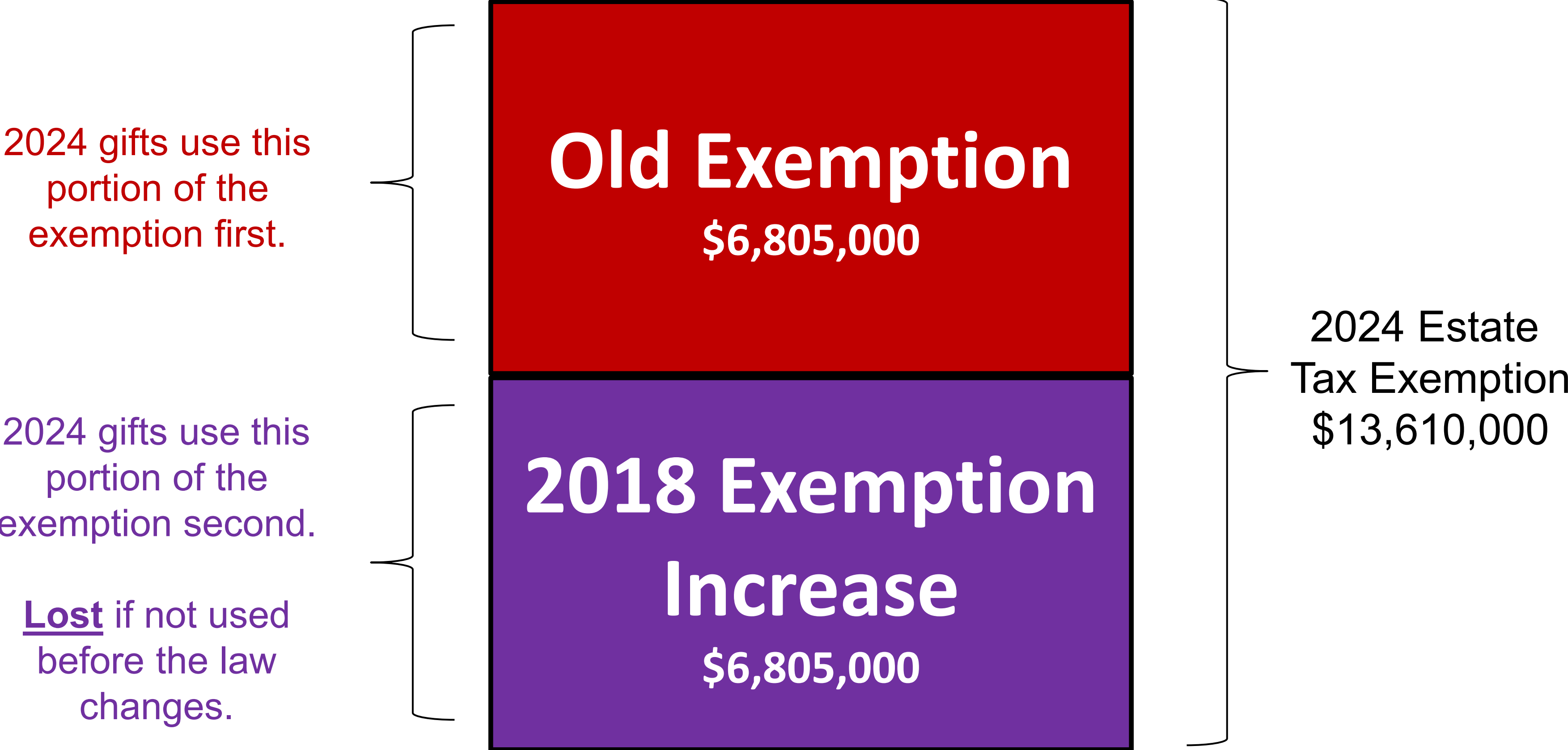
Estate & Gift Taxes

Exemption Reduction Math: "Use It or Lose It"



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Basis Basics

- Donee's basis for computing gain is the same as the donor's basis
- Donee's basis for computing loss is the lesser of—
  - Donor's basis, or
  - FMV of property on date of gift (Reg. § 1.1015-1(a))

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Basis Basics

- The basis calculated in the previous slides is increased by all or a portion of the federal gift tax paid with respect to the gift.

- The increase is the amount of gift tax attributable to the net appreciation in the value of the gift

$$Basis\ increase = \frac{(gift\ tax\ paid)\ \times (net\ appreciation)}{amount\ of\ gift}$$

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Basis Basics

- Basis is generally FMV on date of decedent's death or, if elected, the alternate valuation date (IRC § 1014(a))
- Appreciated assets receive a "step-up" in basis at death – saves income tax when the property is sold by "heirs"
- Depreciated assets receive a "step-down" in basis – deprives "heirs" of the income tax benefit of claiming a loss when the property is sold
  - Less common than stepped-up basis because taxpayers have an incentive to realize losses during life

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What is the Value of a Step-up?

Tax savings

– Federal Capital Gains Tax
– Federal Net Investment Income Tax
– State Capital Gains Tax

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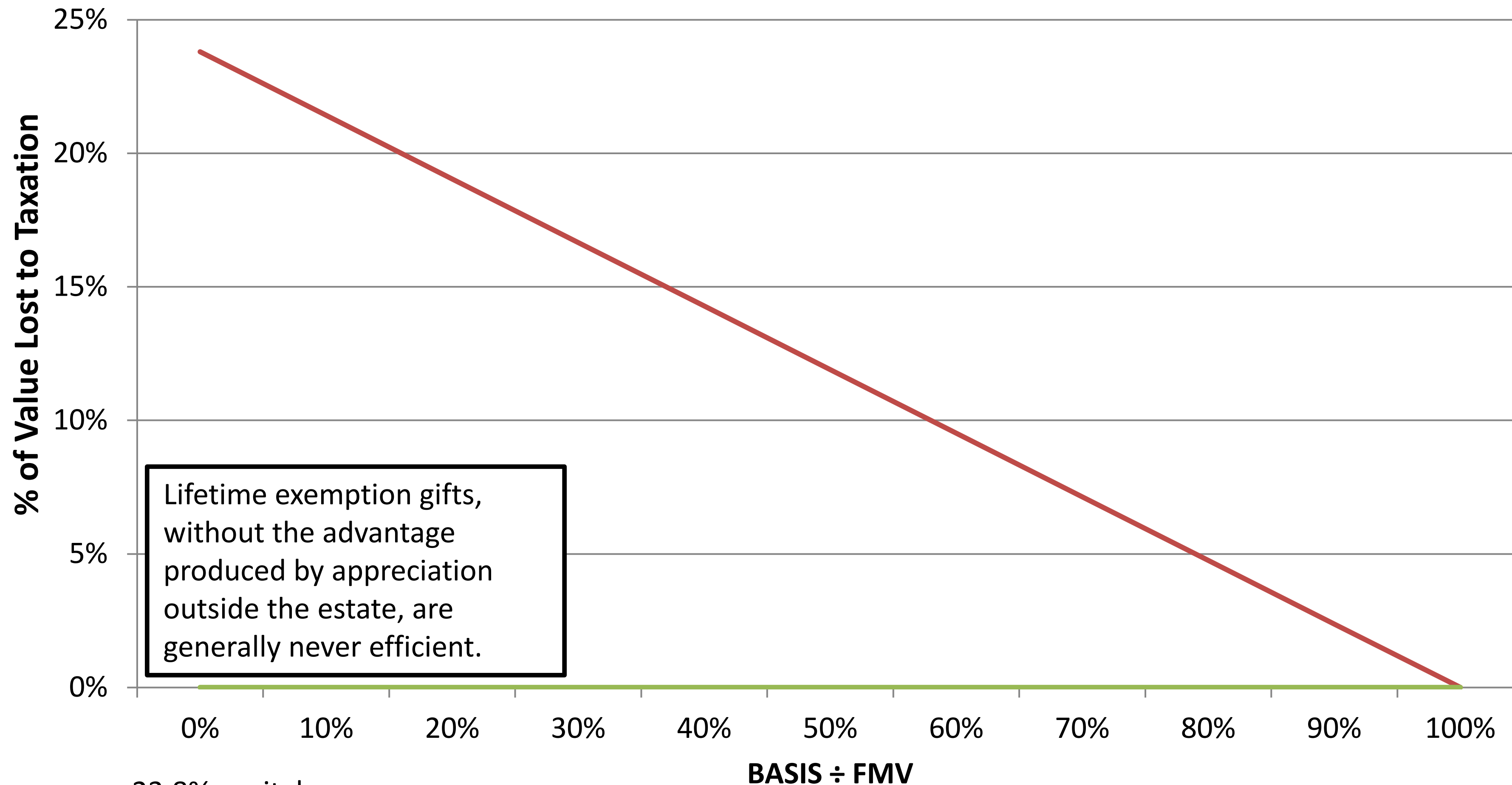
Basis Basics



*assumes a 23.8% capital gains tax rate

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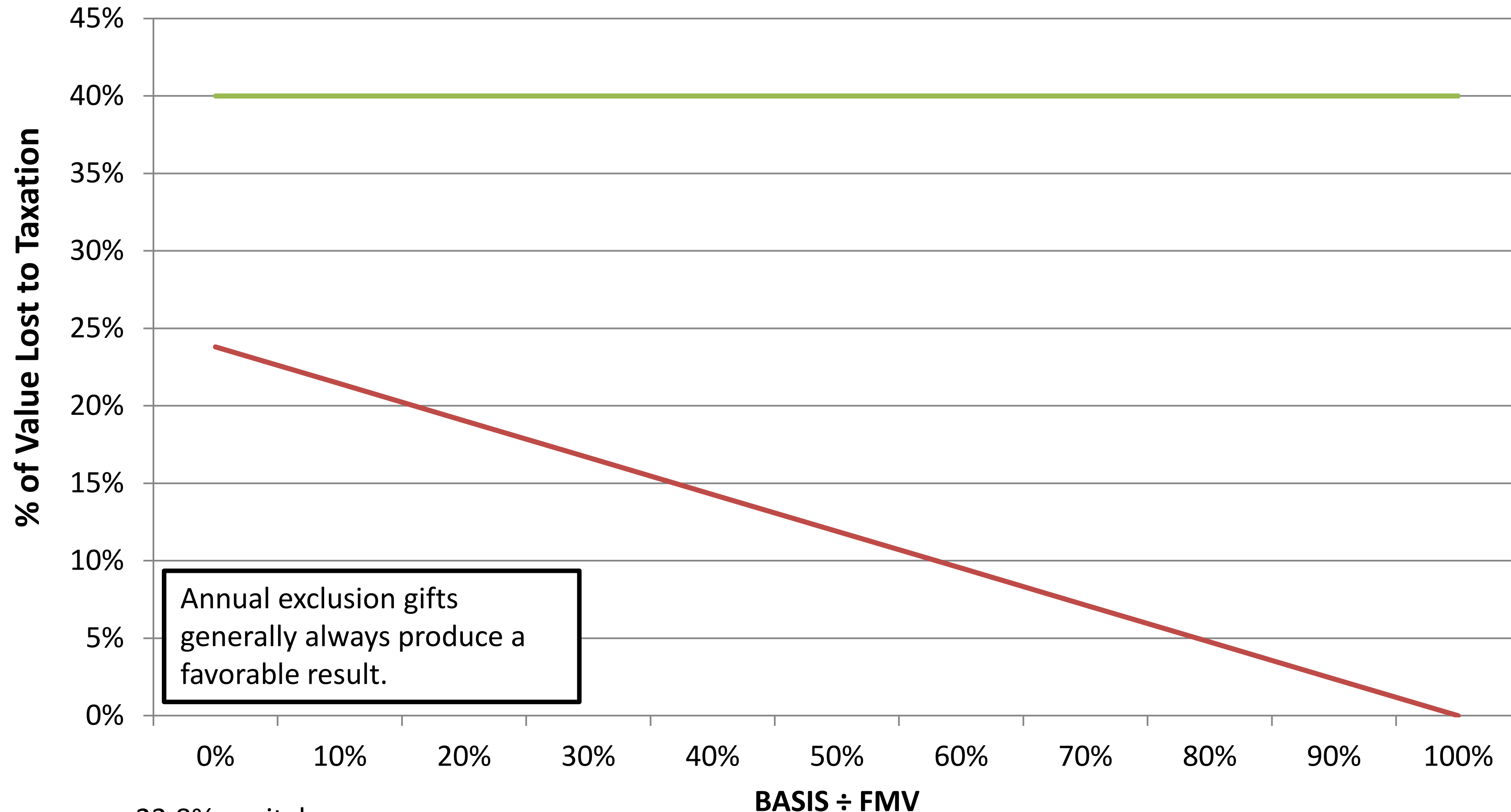
Basis Basics



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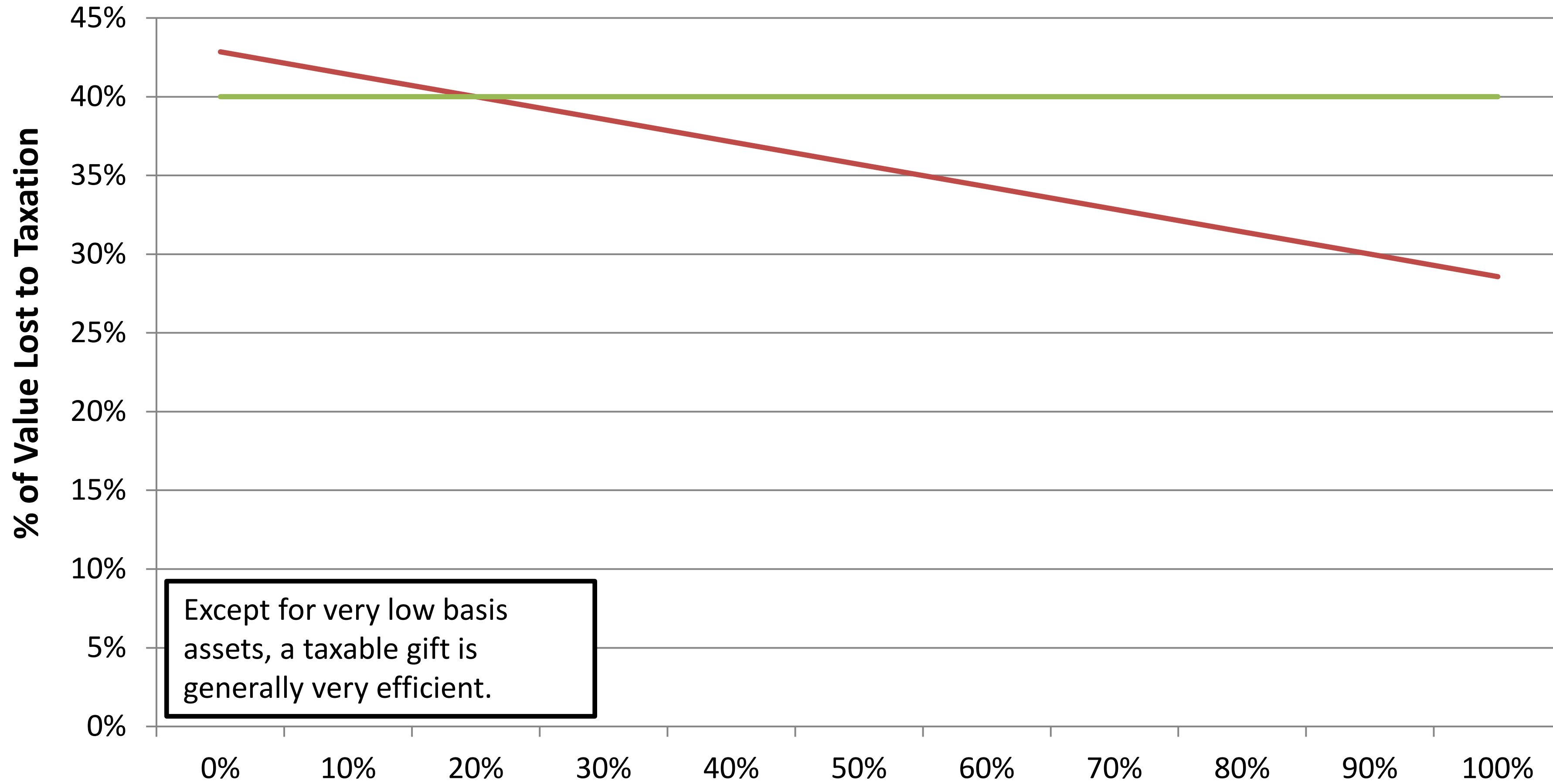

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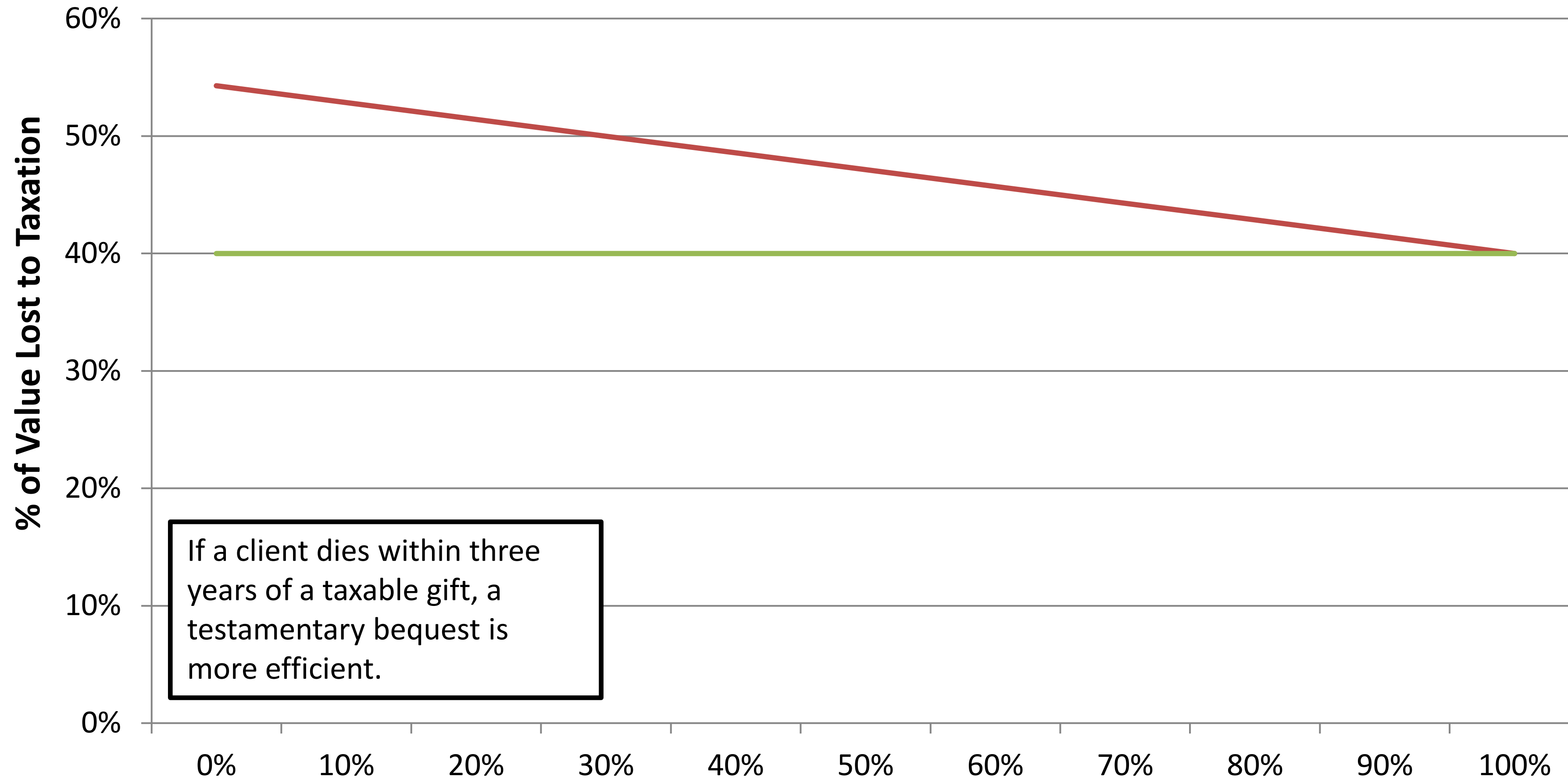
Basis Basics



*assumes a 23.8% capital gains tax rate

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Financial Analysis

Planning for Solvency

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Planning in the Middle

- Families with up to $10M of wealth
  - Planning to best use the BEA is often easy
    - Wealth likely below BEA at death
    - Capturing basis “step-up” critical
  - **1 Solution: “DO NOTHING” – i.e. no inter vivos gifts**
  - **2nd and maybe better solution – gift significant assets to a SLAT to protect assets (for clients for which asset protection is important), to secure a basis step-up with GPOA planning, and/or to save state income tax with a SLANT. This is often valuable planning that is overlooked as practitioners overly focus on just the estate tax implications of planning.**

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Planning in the Middle

- Very Wealthy Families with more than $30M of wealth
  - Planning to best use the BEA is often easy
    - Estate tax likely applies at death
    - Capturing the "double exemption" before sunset is critical
    - Shifting appreciation of the taxable estate is critical
    - Efficient use of GST exemption is critical
    - Exemption gifts won't "bankrupt" client
  - **Solution: Lifetime exemption gifts to GST Exempt trusts – but a key question as will be discussed is what type of trust and with which characteristics.**

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Planning in the Middle

- Families with $10-$30M of wealth
  - Planning to best use the BEA is hard:
    - ➢Unclear whether estate tax will apply at death: Will the “double BEA” sunset?
    - ➢Impossible to make $27.22M of traditional gifts to consume the “double BEA”
    - ➢Is the “step-up” worth more than incremental estate tax?
  - **Solutions – Reasonable from an estate tax math standpoint:**
    - **Do nothing**
    - **“Bankrupt” client**
    - **SLAT/SLANT →** *spouse as beneficiary limits risk of over-gifting*
    - See comments above for clients under $10M. That planning makes even more sense at the 10-30M levels of wealth.

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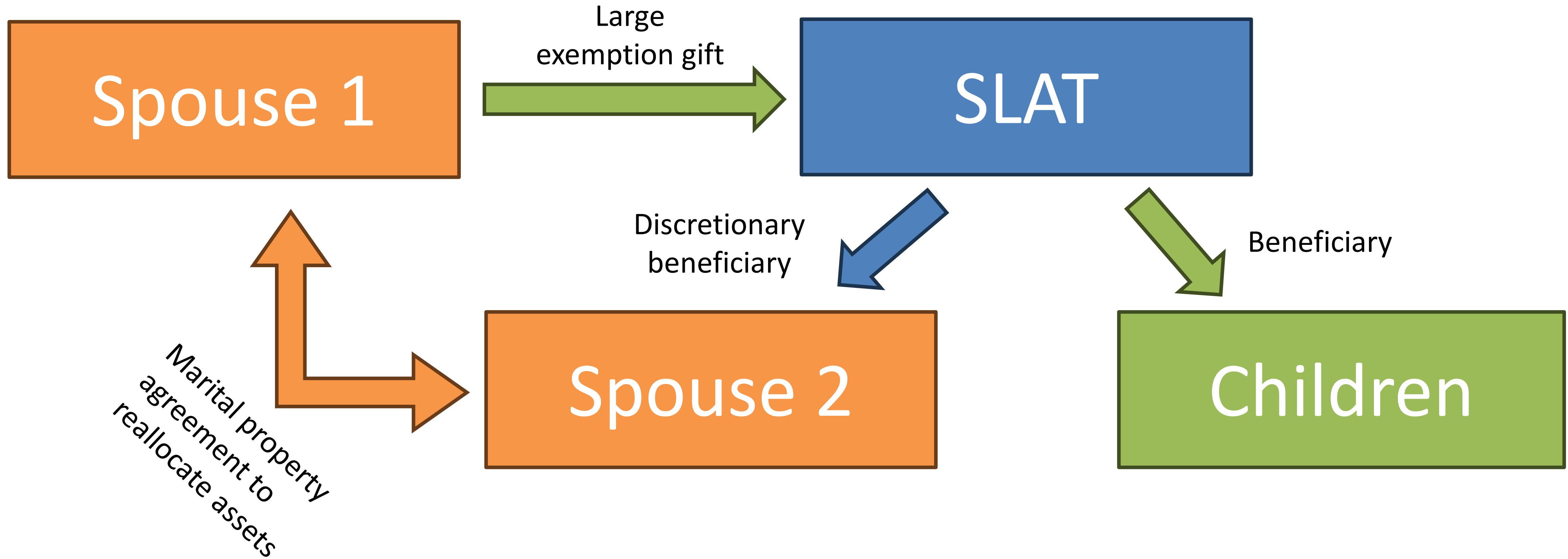
Planning in the Middle



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Suggested SLAT Protocol:

1. Prepare an estate tax balance sheet to determine the amount of estate tax before and after sunset. This should be done immediately and your clients' need to determine if $5,000,000 of additional taxes is too bitter of a pill?
2. Next, prepare after cash-flow projections to determine whether your clients can afford to make large gifts?
3. Next, life is not all spreadsheets, and ask your clients whether they are "comfortable" gifting away a major portion of their net worth – this is a real question when dealing with humans. Why Spock would predictably reply "that is the most logical course of action", your client's may not be so logical.
4. If robust trust planning is used some planning may make sense for many clients.
5. Do NOT only view this as SLATs. There are many variations of SLATs, DAPTs, hybrid-DAPTs, SPATs and more.

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Suggested SLAT Protocol Continued:

6. Explain that the Gordian knot of gifting can be partly solved by using a SLAT or SLANT for your spouse. In the hands of an adroit draftsperson, you can transfer property out of your taxable estate to a trust for your spouse. In even better news, in some states if your spouse dies you can be a beneficiary of the SLAT/SLANT trust[1]. Further, if the Gordian knot is truly tight your spouse might be able to design a trust for your benefit. The best minds, like Jonathan Blattmachr, Edwin Morrow, Steve Oshins, and Marty Shenkman have all written extensively on these techniques. The Hybrid DAPT is another tool to address the Gordian knot of gifting. The bottom line is don't be constrained by one acronym or one "standard" form in your planning.

1 See Analysis of the Viability of Statutes Creating "Back-End SLATS" Leimberg Information Services Webinar October 20, 2023, George D. Karibjanian, Franklin Karibjanian & Law, PLLC

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States that Allow Back-End SLAT

1. Arizona
2. Delaware
3. Florida
4. Kentucky
5. Mississippi
6. North Carolina
7. South Dakota
8. Tennessee
9. Texas
10. Wisconsin

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SPAT

- Special Power of Appointment Trust (SPAT)
  - Offers flexibility by using an "Appointer"
    - The appointer can distribute assets from the trust to anyone but themselves, their estate, their creditors, or creditors of their estate
  - The settlor is not a beneficiary to the trust
    - Settlor can have the appointer give assets back from the trust
  - Normally SPAT are grantor trusts
    - Income from the SPAT is recorded on the settlor's personal income tax return

Hybrid DAPT

- Standard SLAT in DAPT state
- Special power held by third party to add grantor as a beneficiary

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Effective SLAT Design

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Avoiding Disaster – IRC § 2036

(a) GENERAL RULE

The value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, under which he has retained for his life or for any period not ascertainable without reference to his death or for any period which does not in fact end before his death—

(1) the possession or enjoyment of, or the right to the income from, the property, or

(2) the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom.

Also, stress to the client, ideally in writing, that proper administration of the trust or trusts and any entities, is essential to avoid 2036. It is not merely what is in the legal documents that can trigger this issue.

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“Floating” Spouses

- Defining the spouse as: “Whomever the settlor is married to” can mitigate the risk of divorce/death and remarriage.
  - Allows settlor to re-marry and yet retain indirect access
  - Eliminates ex-spouse’s access in the event of divorce

- May cause state law complications
- Be really careful about who are you representing. Consider having disclosures, explanations and disclaimers about this mechanism, divorce generally and related considerations in your form letters/memos.

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Funding

- The property used to fund the SLAT is critical
  - It should be the sole property of the settlor
  - Funding with community or joint property may cause inclusion
  - Funding with community or joint property may allow creditor access
  - Property agreements between spouses can be critical
  - Funding with a settlor controlled FLP interests could cause inclusion
  - Funding with a settlor controlled closely-held business interests could cause inclusion
  - Watch out for the step-transaction doctrine. That can be a significant risk that must be planned for. The closer to end of 2025 the less room there will be to plan.

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Reciprocal Trusts

- The reciprocal trust doctrine is a judicial principal developed to limit abusive tax avoidance.
- Basically, if spouses create identical SLATs which benefit each other the IRS can arguably collapse the transaction – and treat the trusts as self-settled.
- To avoid this result, thoughtful planning is required to draft trusts which are sufficiently different.

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Reciprocal Trusts

- ***Estate of Grace,* 395 U.S. 316 (1969).**
  - Trusts created with nearly identical terms and close in time.
  - The trust settled by each spouse provided the other a life interest.
  - The IRS determined the trusts were reciprocal and included the value of the trust settled by the wife in the husband's gross estate.
  - The Supreme Court agreed with the IRS, reasoning that the trusts were inter-related, part of single transaction, and in substance didn't change either party's economic position.

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Life Insurance

- A grantor SLAT can hold a life insurance policy

- Funding a separate ILIT is often prudent, but simplification may be more important for smaller estates – but in many cases even in large estates folding the insurance into the SLAT-like trust can facilitate better trust administration, avoid annual gifts and Crummey powers, etc. **Practice Point:** This is a great opportunity to clean up old ILITs

- The SLAT-ILIT can protect the surviving spouse in case of early death (and policy loans can provide earlier access)

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Asset Protection

- SLATs can provide asset protection from:
  - Creditors and predators, in general
  - Divorcing spouses
- Avoiding a fraudulent conveyance is critical
  - Basically, state law may allow a creditor to access the trust if the settlor was insolvent after considering the creditor's claim at funding and the settlor knew about the potential claim
  - For those with ongoing potential liabilities, such as Physicians and other professionals, funding the SLAT incrementally over many years may be prudent
  - **Practice Points:** Consider having the client sign a solvency affidavit before any large transfer to an irrevocable trust
  - Consider having the client sign a balance sheet showing all assets and liabilities
  - Consider having the client have projections prepared showing adequate resources to cover lifestyle expenses after the transfers.
- SLATs can provide asset protection while retaining indirect access to assets – without the risks of self-settled trust (DAPT)

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Tax Reimbursement Clauses

- A grantor trust can cause cash flow problems for the settlor and therefore tax reimbursement provisions are common. **Practice Point:** Have forecasts done in advance of funding to identify possible future issues.

- **CCA Memorandum 202352018**
  - Released November 28, 2023
  - Addressed the gift tax consequences of modifying a grantor trust to add a tax reimbursement clause
  - The IRS concluded that adding the reimbursement clause created a taxable gift from the beneficiaries to the settlor

- **Practice Point:** May be prudent to draft trusts with a reimbursement clause just in case it's needed later.

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Gift Tax Returns

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A Few Comments on Gift Tax Returns

- These are not simple returns. If you don't have experience, study up or get outside help.
- Do not get boxed into a corner by a client pressuring you on fees. You won't know how complex the return may become until you waist deep into it. It is not worth the risk of underpricing a return and then not preparing it properly.
- Get all key legal documents early on. Be sure they make sense even though you are not a lawyer. Check dates, signatures, and party names. If something doesn't make sense, seems wrong or missing, raise the issue.
- Prepare a detailed table of contents for the exhibits and be sure they not only meet the requirements of adequate disclosure but that they flow in a logical order and make sense. If they don't ask, why not?
- Quickly eyeball the instructions for form 709 for each return you prepare considering what might be missing in the return. Even for experts this can be helpful.

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Outline

- Basics of the Gift Tax
- Filing Requirements
- Marital Deduction – IRC Sec. 2523
- Gift Splitting– IRC Sec. 2513
- Adequate Disclosure– IRC Sec. 6501(c)(9)
- Generation Skipping Transfer Tax– IRC Sec. 2601
- Defined Value and Related Clauses
- Valuation Adjustments

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Basics of the Gift Tax

Basis

- Donee's basis for computing gain is the same as the donor's basis

- Donee's basis for computing loss is the lesser of—
  - Donor's basis, or
  - FMV of property on date of gift (Reg. § 1.1015-1(a))

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Basics of the Gift Tax

Availability of Annual Exclusion

- Present Interest
  - Immediate use, possession, or enjoyment
  - Annual exclusion available

- Future Interest
  - Donee does not have absolute right to the property at the present time
  - Practice Point: Interest in entities that have never made a distribution may not qualify as present interests.
  - No annual exclusion

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Basics of the Gift Tax

Availability of Annual Exclusion – Crummey Trusts

- Annual Exclusion
- Withdrawal Rights
- Crummey notices
  - Keep copies in file
  - Some practitioners like to attach them to the gift tax return. That they believe will toll the statute of limitations for the IRS to question the language, signatures, etc. Other practitioners intentionally do not ask to see them (and what might that presume?)
  - File gift tax return to run statute of limitations

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Basics of the Gift Tax

Deductions

- Charitable deduction – IRC Sec. 2522
- Marital deduction – IRC Sec. 2523
  - Watch out for states with an estate tax. NY argues that if a gift to a SLAT is made within 3 years of death it is added back to the estate and a QTIP marital savings clause won't work since a marital deduction was not reported on a NY gift tax return
- Both unlimited

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Filing Requirements

- Gifts are not required to be reported when only gifts for the year are:
  - Transfers that qualify for the annual exclusion
  - Transfers that qualify for the educational and medical expenses exclusion
  - Certain transfers for which the unlimited marital deduction is allowed
    - QTIP must be reported to elect QTIP treatment
    - Practice Point – report the above anyhow as it may be relevant to tolling the statute of limitations on a step-transaction challenge as in the Smaldino case.
  - Transfers of entire interests that qualify for the charitable deduction

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Filing Requirements

Gift Tax Return Due Date

- April 15
- If taxpayer dies:
  - No later than due date (with extensions) for estate tax return

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Filing Requirements

Extensions

- Automatic six-month extension
- Income tax return
    - Form 4868
- Form 8892
    - Needs to be filed if gift tax return due
- Check box on return indicating extension

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Marital Deduction

- Unlimited deduction – IRC Sec. 2523
- Requirements:
  - The spouses are married
  - The donee spouse is a U.S. citizen
  - The interest transferred is not a nondeductible terminable interest
  - The property interest transferred is not otherwise deducted for federal gift tax purposes
  - The gifts are included in the total taxable gifts for the year

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Marital Deduction

- Non U.S. citizen Spouse
  - Gifts do not qualify for marital deduction
  - Eligible for increased annual exclusion
    - $175,000 in 2023 ($184,000 in 2024)
    - Must be gift of present interest
    - QTIP does not qualify

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Gift Splitting

- Treats all gifts made by one spouse as made half by each spouse
  - Cannot split gifts to spouse
  - Even if you might be able to support gift splitting on a SLAT is it worth the risk?

- Each spouse must be a citizen or resident of the United States

- Individual considered as the spouse of another individual only if he is married to such individual at the time of the gift and does not remarry during the remainder of the calendar year

IRC § 2513

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Gift Splitting

- Only applies if both spouses have signified their consent to gift splitting in the case of all such gifts made during the calendar year by either while married to the other
  - Executor can sign for deceased spouse
- Each spouse must sign the other spouse's return
  - Mailed to IRS in same envelope

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Gift Splitting

- Community Property
  - Gift splitting generally not necessary
- In the case of split gifts, gifts attributed to the non-donor spouse are deemed adequately disclosed if the gifts are adequately disclosed on the return filed by the donor spouse

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Gift Splitting

- Statutory deadline:
  - Relief under Treas. Reg. 301.9100-3 not available
  - However, an automatic 6-month extension from the due date of a return excluding extensions is granted to make statutory elections provided the taxpayer timely files return and taxpayer takes corrective action (file an original or a supplemental return) within that 6-month extension period

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Gift Splitting

- Gifts to third party and to spouse
  - Gifts to people other than spouse are only gifts eligible to gift split
  - When gift made to spouse and other person (e.g. gift to trust for benefit of spouse and children), gift to third party can be split if **severable and ascertainable** from gift to spouse
  - If spouse's interest not severable and ascertainable, gift splitting not allowed – so this likely will not work in the typical SLAT-like trust which has discretionary distributions to a class including sopuse which is better for tax and asset protection planning. Many SLATs do not include Crummey powers.
  - If spouse's interest is severable and ascertainable, gift splitting not allowed for gift to spouse but is allowed for portion of gift to third party

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Gift Splitting

- Spouse's interest may be severable and ascertainable because of Crummey powers

  - Example:
    - Donor spouse establishes a trust for the benefit of the spouse and three children. The trust gives the non-donor spouse a Crummey power up to $5,000 and the three children Crummey powers up to $15,000. The donor spouse transfers $95,000 to the trust. If all the necessary requirements are met, the entire $95,000 transfer qualifies for split-gift treatment.
    - The $90,000 that can be withdrawn by the children qualifies as a split gift.
    - The $5,000 that can be withdrawn by the non-donor spouse does not qualify for gift splitting.
    - See PLR 200130030. (note, the figures above have been changed to reflect current annual exclusion amounts)

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Gift Splitting

- Spouse's interest severable and ascertainable:
  - Example:
    - Donor spouse establishes a trust in which the spouse has a lifetime income interest in the trust and the children receive the remainder when the spouse dies.
    - The portion of the gift that represents the spouse's lifetime income interest does not qualify for gift splitting.
    - The portion of the gift that represents the children's remainder interest does qualify for gift splitting.

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Gift Splitting

- Spouse's interest **NOT** severable and ascertainable:
  - Example:
    - Donor spouse establishes a trust for the benefit of spouse and descendants. The trustee has complete discretion to make distributions to the spouse and descendants.
    - The portion of the gift to the spouse is not ascertainable. No portion of this gift can be gift split which means that no gifts on such gift tax return can be gift split.

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Statute of Limitations for Assessing Additional Gift Tax

- Statute of limitations is ordinarily three years after the later of:
  - The date the return was filed

    OR
  - The date the return was due
- Time period increases to six years after the later of filing or due date if amounts omitted from the return exceed 25% of the amount reported
- Disclose all charitable gifts!

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Effects of Running of the Statute

- IRS cannot increase the amount of the initial gift
- IRS cannot increase the amount of a future gift based on an increase in the amount of the initial gift
- IRS cannot increase the amount of adjusted taxable gifts included in the estate as a result of the gift

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Disclosure Requirements

- Pre-1990
  - No disclosure requirements

- Special valuation rules of Chapter 14
  - Statute of limitations would not run with respect to a gift subject to the special valuation rules under § 2701 or § 2702 unless there was adequate disclosure
  - Without adequate disclosure, additional tax could be assessed or a proceeding in court for collection of tax without assessment could be commenced <u>at any time</u>

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Disclosure Requirements for Gifts Not Subject to Chapter 14

- See suggestion early to eyeball 709 instructions to if anything missed
- If a gift is adequately disclosed on a gift tax return it may not be revalued by the IRS for gift or estate tax purposes after the statute of limitations has run
- A transfer will be adequately disclosed if it is reported in a manner adequate to apprise the IRS of the nature of the gift and the value so reported
- Two more specific adequate disclosure safe harbors are:
  - Detailed Description Safe Harbor
  - Appraisal Safe Harbor

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Information Required for Both Safe Harbors

- A description of the transferred property and any consideration received by the transferor
- The identity of, and relationship between, the transferor and each transferee
- If the property is transferred in trust, the trust's tax identification number and a brief description of the terms of the trust, or in lieu of a brief description of the trust terms, a copy of the trust instrument
- A statement describing any position taken that is contrary to any proposed, temporary or final Treasury regulations or revenue rulings published at the time of the transfer
- Treas. Reg. Sec. 301.6501(c)-1(e)(2)

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Information Required for Detailed Description Safe Harbor

- The following additional information is required:
  - Any financial data (e.g., balance sheets, etc. with explanations of any adjustments) that were utilized in determining the value of the property interest
  - Any restrictions on the transferred property that were considered in determining the fair market value of the property
  - A description of any discounts, such as discounts for blockage, minority or fractional interests, and lack of marketability, claimed in valuing the property

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Information Required for Detailed Description Safe Harbor

- In the case of a transfer of an interest that is actively traded on an established exchange, the following information will satisfy all additional requirements:
  - Recitation of the exchange where the interest is listed
  - The CUSIP number of the security
  - The mean between the highest and lowest quoted selling prices

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Information Required for Detailed Description Safe Harbor

- For an interest in an entity that is not actively traded, the following rules apply
  - A description of any discounts claimed in valuing the assets
  - If the value of the entity or of the interests in the entity is properly determined based on the net value of the assets held by the entity, an additional statement must be provided

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Information Required for Appraisal Safe Harbor

- An appraisal can be submitted in lieu of the information required for the detailed description safe harbor

- The appraisal must be prepared by a qualified appraiser

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Information Required for Appraisal Safe Harbor

- The appraisal must contain:
  - The date of the transfer, the date on which the transferred property was appraised, and the purpose of the appraisal.
  - A description of the property
  - A description of the appraisal process employed
  - A description of the assumptions, hypothetical conditions, and any limiting conditions and restrictions on the transferred property
  - The information considered in determining the appraised value

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Information Required for Appraisal Safe Harbor

- The appraisal must contain (cont.):
  - The appraisal procedures followed, and the reasoning that supports the analyses, opinions, and conclusions
  - The valuation method utilized, the rationale for the valuation method, and the procedure used in determining the fair market value of the asset transferred
  - The specific basis for the valuation, such as specific comparable sales or transactions, sales of similar interests, asset-based approaches, merger-acquisition transactions, etc.

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Substantial Compliance

- What if taxpayer meets most, but not all, of the requirements in one of the safe harbors?
  - If the disclosure was still adequate “to apprise the IRS of the nature of the gift and the value so reported” under the general rule of Reg. § 301.6501(c)-1(f)(2), the taxpayer would have a strong argument that the return should commence the running of the statute of limitations.
  - The safe harbors could be seen as non-exclusive ways to satisfy the general rule
  - Cautious taxpayers will want to qualify for one of the safe harbors
  - See Schlapfer v. Commissioner, T.C. Memo. 2023-65 but don’t count on that approach upfront, rather try to comply

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Procedural Issues

- Failure to disclose on a timely filed return can sometimes be corrected
  - An original return would evidently start the statute even if it is filed late
  - A timely-filed amended return should start the statute
  - A late-filed amended return would not start the statute
  - Filing of a false return, a fraudulent return or no return at all will not start the statute of limitations

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Generation Skipping Transfer Tax

- Be sure proper election made on Form 709 and be sure to indicate priority of trusts to receive allocation
- Timely allocation permits use of date-of-gift value for purposes of allocation
- Late allocation requires use of values as of date return is filed
  - Special first of the month rule
  - Treas. Reg. Sec. 26.2642-2(a)(2)
  - **Example:** David makes a $100,000 gift to a dynasty trust in 1999 but did not allocate GST exemption on the gift tax return. David files a gift tax return in January 2023 in order to allocate GST exemption to the trust. He must use the value of the trust on January 1, 2023 to fully allocate GST exemption to the trust.

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Generation Skipping Transfer Tax

- Skip Person
  - Person 2 or more generations below
    - Grandchildren
  - Non-relative more than 37½ years younger
  - Certain trusts – all interests held by skip persons
- Non-Skip Person
  - Anyone not a skip person
- Direct skips
  - Gift to skip person
- Indirect skips
  - Not a direct skip
  - Subject to gift tax
  - Made to a GST Trust

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Generation Skipping Transfer Tax

- GST annual exclusion
  - $18,000 in 2024
  - Available to direct skips
  - Trusts can only qualify if:
    - (1) Single Beneficiary. During the life of the beneficiary, no distributions may be made to anyone other than the beneficiary; and
    - (2) Inclusion in Beneficiary's Estate. At the individual's death, if the trust is still in existence, the trust assets will be included in the beneficiary's gross estate.

  IRC Sec. 2642(c)

  Practice Tip – be sure the trusts is properly designed to hold assets for long term or perpetually if state law permits. Some trusts still have kick out ages say age 35 and practitioners mistakenly allocate GST

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Generation Skipping Transfer Tax

Automatic Allocation Rules

- Lifetime Direct Skips
  - Example: Gift to grandchild
- Automatic Allocation Rules for “Indirect Skips”
- Indirect Skip - a transfer that is not a direct skip which is made to a “GST Trust”
- “GST Trust” - any trust that could have a taxable termination or taxable distribution unless one of six exceptions applies. Practice tip – this is a technical definition so be sure you have tested the trust if in doubt

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Generation Skipping Transfer Tax

Automatic Allocation

- Automatic Allocation
  - Direct Skips
  - GST Trust
    - Election into automatic allocation
    - Election out of automatic allocation

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Generation Skipping Transfer Tax

Automatic Allocation

- Elections into or out of automatic allocation
  - Attach to Form 709
  - Describe the transfer and the extent to which the automatic allocation is not to or is to apply
  - Reporting a direct skip on a timely-filed Form 709 and paying the GST tax on the transfer qualifies as an election out of automatic allocation
  - Once made, the election is irrevocable after the due date of the Form 709 on which it is made
  - Election can be made for all future transfers to such trust – remains in effect unless and until terminated

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Defined Value and Related Clauses

- Attempt to avoid risk associated with increase in value of gift on audit

- Set the value of the property transferred equal to its value as finally determined for federal gift tax purposes.

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Defined Value and Related Clauses

- Four ways to structure:
  - Provide that any excess value returns to the donor;
  - Provide that any excess value passes to another person or entity/charity (overflow clause);
  - Transfer all the property, but adjust the price to the value as finally determined for federal gift tax purposes; or
  - Use a formula allocation clause
- But remember there are many variations of each, e.g., double Wandry, double King, giving a GRAT spillover equity so it has skin in the game and many more approaches. If a DAF is used watch out for UBIT

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Valuation Adjustments

- Minority Interest Discount
- Marketability Discount
- Fractional Interest Discount
- And perhaps other depending on unique facts, e.g. real estate market saturation discount
- Gift Tax Return
  - Check box
  - Attach valuation report/fractional interest statement

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Income Tax Returns

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Income Taxation of Trusts & Estates

- Nongrantor Trusts – SLANTs
- Grantor Trusts – SLATs
- Charitable Deductions
- Bracket Management
- Shifting Income with Trust Distributions
- Limit on Miscellaneous Itemized Deductions
- State Income Tax Planning for Trusts

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Foundational Concepts

Be certain that all income tax returns reflect valuation adjustment mechanism used. E.g. don't say 40% on K-1 only, attach a statement saying $20M value transfer estimated at 40% pursuant to defined value clause. And when the statute runs change that disclosure.

General Rules for Taxation of Estates and Trusts §641- §646

- §641 – Imposition of Tax
- §642 – Special Rules for Credits and Deductions
- §643 – Definitions applicable to subparts A,B,C and D
- §644 – Taxable Year of Trusts
- §645 – Certain Revocable Trusts Treated as Part of Estate
- §646 – Tax Treatment of Electing Alaska Native Settlement Trusts

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Foundational Concepts

Trusts Which Distribute Current Income Only §651- §652

- §651 – Deductions for Trusts Distributing Current Income Only
- §652 – Inclusion of Amounts in Gross Income of Beneficiaries of Trusts Distributing Current Income Only

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Foundational Concepts

Estates Which May Accumulate Income or Which Distribute Corpus §661 - §664

- §661 – Deduction for Estates and Trusts Accumulating Income or Distributing Corpus
- §662 – Inclusion of Amounts in Gross Income of Beneficiaries of Estates and Trusts Accumulating Income or Distributing Corpus
- §663 – Special Rules Applicable to §661 and §662
- §664 – Charitable Remainder Trusts

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Grantors and Others treated as Substantial Owners §671 - §679

- §671 – Trust Income, Deduction, and Credits Attributed to Grantors and Others as Substantial Owners
- §672 – Definitions and Rules
- §673 – Reversionary Interests
- §674 – Power to Control Beneficial Enjoyment
- §675 – Administrative Powers
- §676 - Power to Revoke
- §677– Income for Benefit of Grantor
- §678– Person Other Than Grantor Treated as Substantial Owner
- §679 – Foreign Trusts Having One or More United States Beneficiaries

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Foundational Concepts

- **SLANTs** are separate taxable entities
  - Receive income and pay expenses
- Taxable income computed similar to individuals
  - Exemption
    - $100 complex trust
    - $300 simple trust
- Method of tax accounting
  - Trusts – Calendar year (i.e. Jan. 1st – Dec. 31st)
  - Estates – Fiscal or calendar year
- Estimated tax payments
  - First year estimates
  - Protective estimates

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Foundational Concepts
General Tax Rules

- Income taxed to either the trust/estate or the beneficiary
  - If income is accumulated, then the income is taxed to the trust/estate
  - If income is distributed, then the trust/estate gets an income tax deduction and beneficiaries report taxable income

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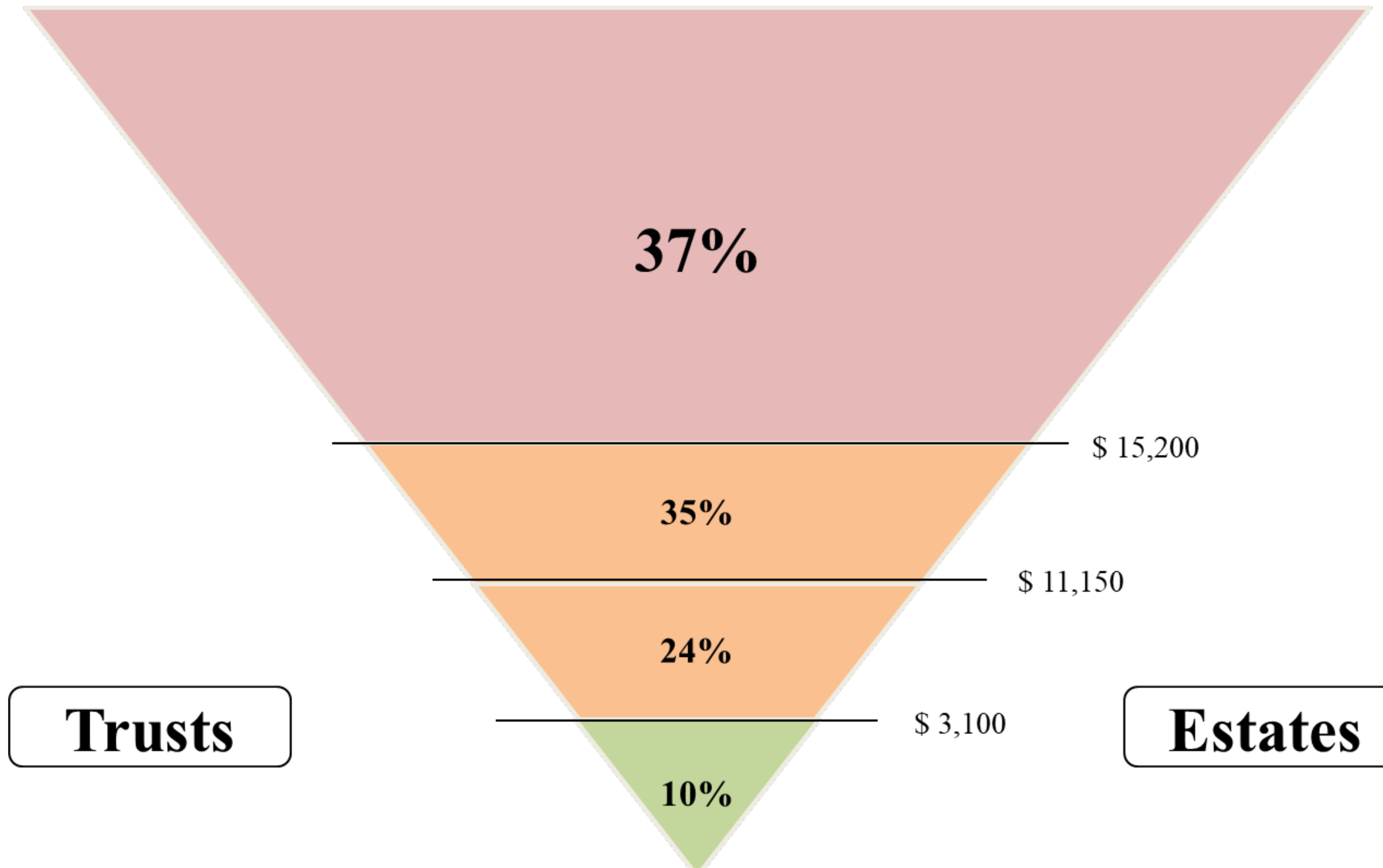
Foundational Concepts

2024 Ordinary Income Tax Rates for Estates & Trusts



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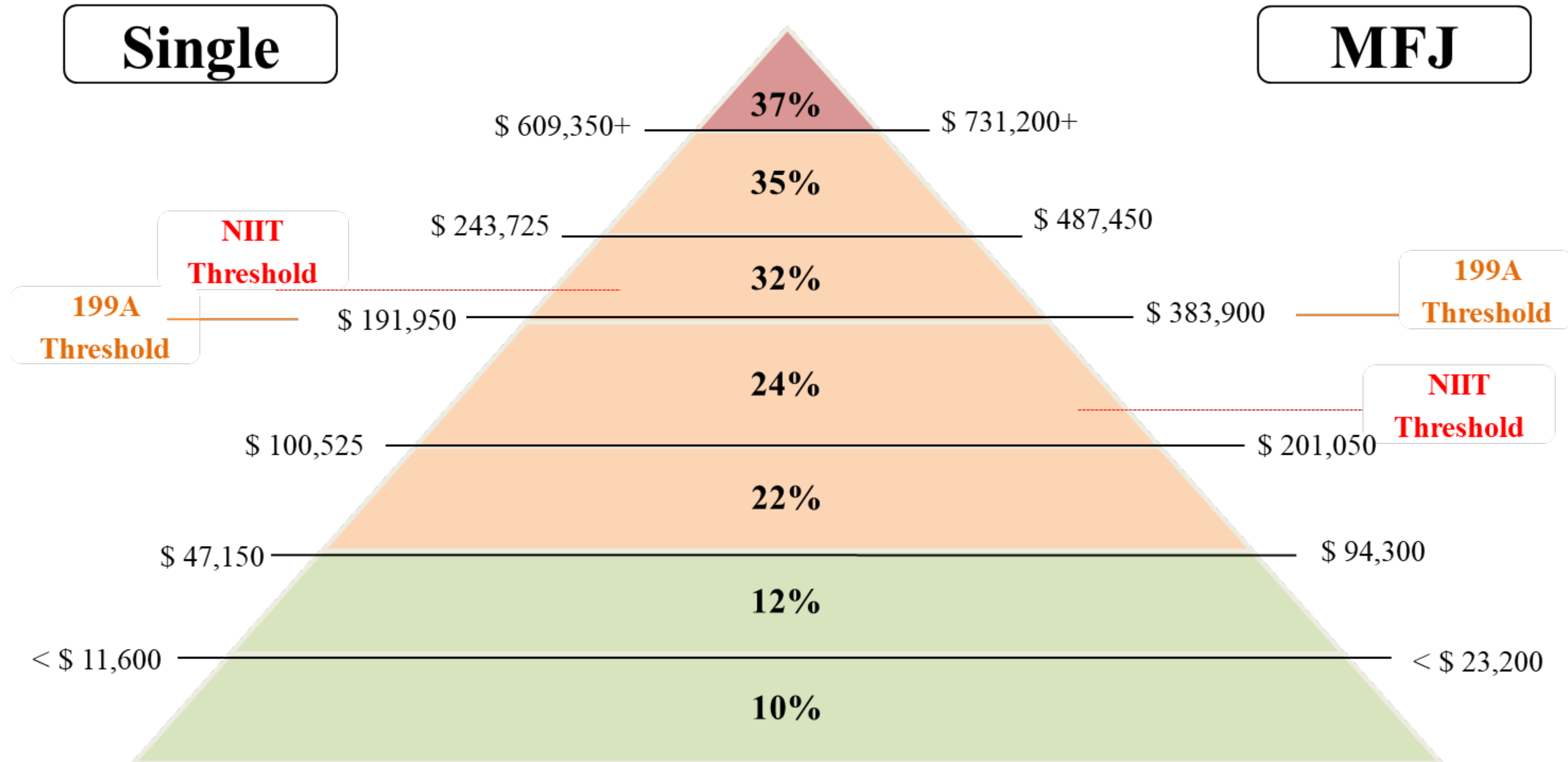
Foundational Concepts

2024 Ordinary Income Tax Rates for Individuals



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Foundational Concepts
Types of Non-Grantor Trusts

- Simple trusts
  - Required to distribute accounting income annually
  - Cannot make principal distributions
  - Cannot make distributions to charity
- Complex trusts
  - May accumulate income
  - May make either discretionary or mandatory distributions of income and/or principal
  - May make distributions to charity
- ESBT – Electing Small Businesses Trust
- QSST – Qualified Subchapter “S” Trust

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Foundational Concepts
Types of "Income"

- Fiduciary accounting income
  - Governed by state law and the trust instrument
  - Determines the amount that may or must pass to the trust's or estate's beneficiaries
- Tax accounting income
  - Governed by state and federal income tax law
  - Determines who is taxed on the income

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Typical Types of "Income" Under Traditional Fiduciary Accounting

- Interest
  - Taxable
  - Tax-exempt
- Dividends
- Rents (net of expenses)
- Royalties
- Partnership or S-corporation distributions

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Typical Types of "Principal" Under Traditional Fiduciary Accounting

- IRA value as of date of death
- Increases in asset value (i.e. growth)
- Realized long-term capital gain
- Realized short-term capital gain
- Proceeds from covered call writing

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Fiduciary Accounting vs. Taxable Income

Example

Assume that a complex trust had the following sources of income and deductions during the current tax year:

Interest income	$3,000	
Tax-exempt interest income	1,000	
Dividend income	6,000	
Rental income	10,000	
Royalty income	5,000	
Long-term capital gains	15,000	
Taxes	3,000	All indirect expenses
Trustee fees	3,000	
Attorney/accountant fees	1,000	

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Fiduciary Accounting vs. Taxable Income

Example (cont.)

	Fiduciary Accounting Income		Taxable Income	
Interest income	$	3,000	$	3,000
Tax-exempt interest income		1,000		-
Dividend income		6,000		6,000
Rental income		10,000		10,000
Royalty income		5,000		5,000
Long-term capital gains		-		15,000
Gross income	**$**	**25,000**	**$**	**39,000**
Less: Taxes		(1,875)		(2,925)
Less: Trustee fees		(1,875)		(2,925)
Less: Attorney/accountant fees		(625)		(975)
Less: Exemption		-		(100)
Net Income	**$**	**20,625**	**$**	**32,075**

<u>NOTE 1:</u> Trust expenses (for fiduciary accounting purposes) were apportioned on a pro-rata basis between income and principal.
<u>NOTE 2</u>: Under IRC §265, the trust's deductible expenses (for income tax purposes) must be reduced for the portion that are allocable to tax-exempt income.

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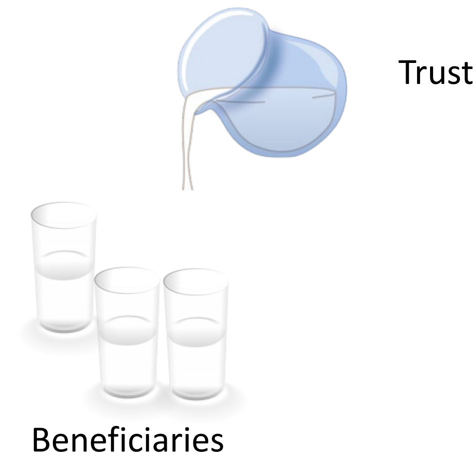
Distributable Net Income (DNI)

- Determines the amount of the trust’s or estate’s income distribution deduction.
- Determines how much the beneficiaries must report as income on their tax returns.
- Determines the character (e.g. interest, dividends, etc.) of the taxable income in beneficiaries’ hands.



IRC § 661

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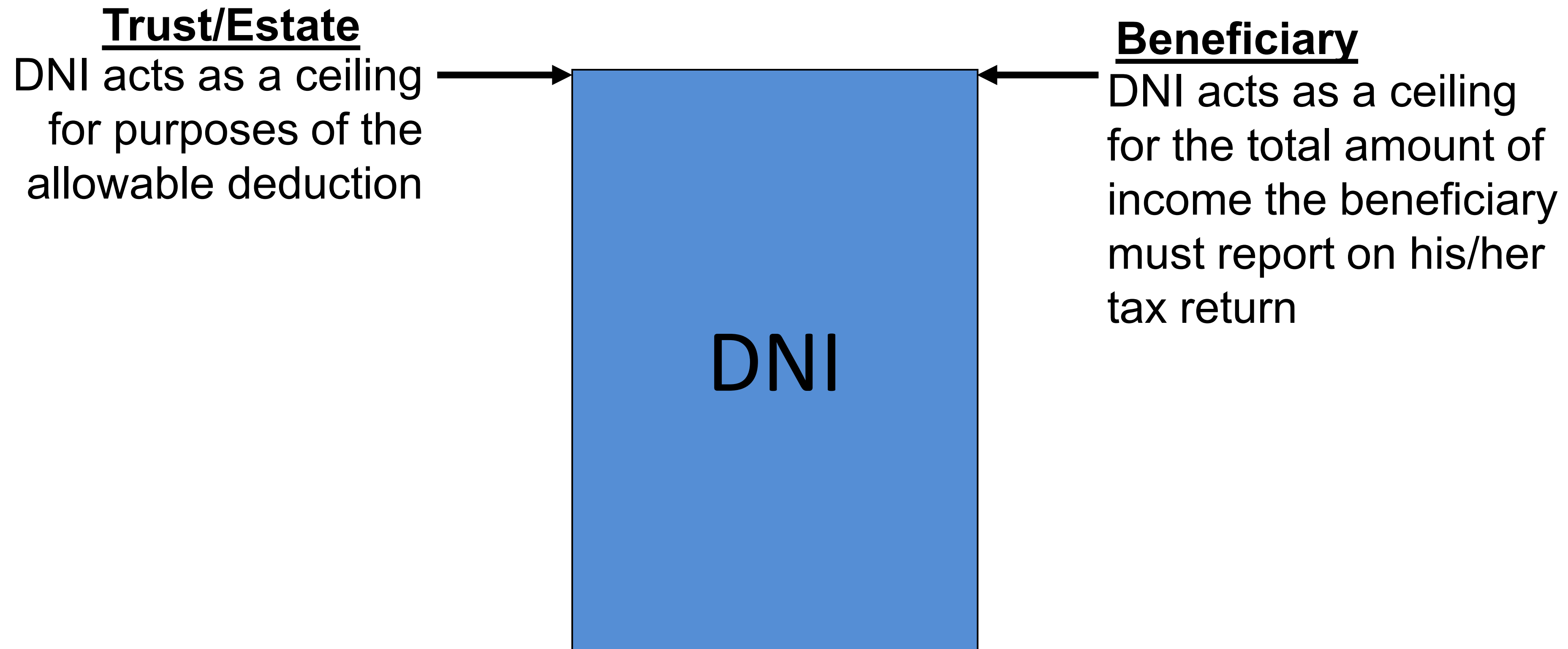
Foundational Concepts
Distributable Net Income (DNI)



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"65-Day" Rule (IRC §663(b))

- Applies to estates and complex trusts
- Allows fiduciary to treat distributions made within 65 days after year-end to be treated as if they were made as of December 31st of the prior year
  - Limited to DNI (reduced by distributions made during the prior year)
- Election must be made by the due date of the tax return
  - Election is irrevocable
  - Annual election

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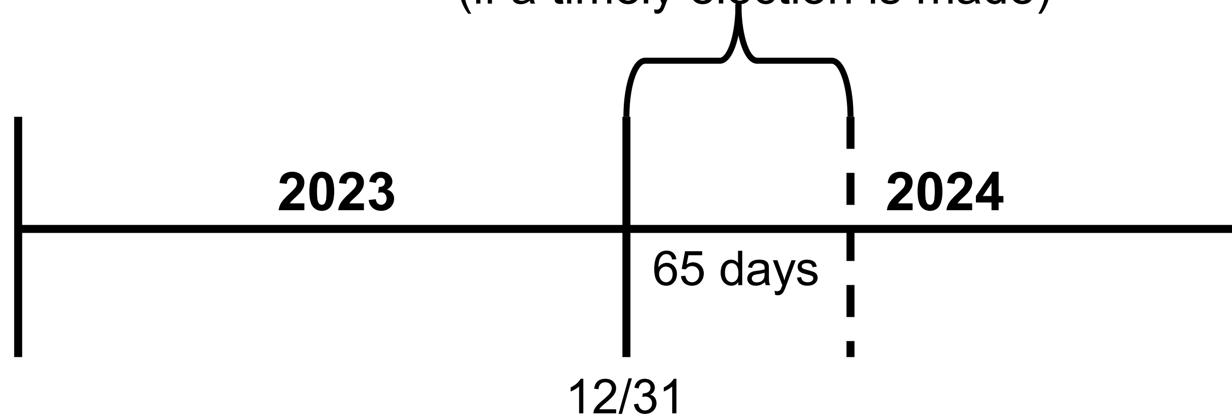
“65-Day” Rule (IRC §663(b))



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SLATs are Grantor Trusts

NOTE: A special thank you to Scott Schrader, Esq. of Miller & Schrader, P.A. for the use of the following slides regarding qualifying trusts for grantor status

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Grantor Trusts

- Grantor trusts were created to eliminate income tax abuses involving (then-lower) trusts brackets
- Grantor trust as to:
  - Income
  - Principal
  - Both
- All trusts must be reviewed to determine grantor trust status

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Grantor Trusts

Benefits of Utilizing a Grantor Trust

- Removal of highly-appreciating assets from taxable estate
- Payment of taxes on behalf of trust are not considered gifts for gift tax purposes
- Tax-free distributions to trust beneficiaries
- Permissible transferee of life insurance policy outside of transfer for value rules

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Grantor Trusts

- §672 Definitions
  - Adverse = beneficial interest that is substantial and whose interest is adversely affected by exercise or non-exercise
  - Non-adverse = Not adverse
  - Related or Subordinate = Non-adverse + parent/issue/sibling/employee/corporation
  - Spousal Attribution

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Grantor Trusts

- §674 Power to Affect Beneficial Enjoyment
  - Grantor is treated as owner of *any portion* of the trust over which grantor controls beneficial enjoyment or corpus or income, exercisable by grantor or non-adverse party or both, without the consent of any adverse party (674(a))
  - Powers found in 674(b) will *never* cause grantor trust status
  - 674(c) – power to distribute income or principal, or to add beneficiaries

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Grantor Trusts

- §674 Power to Affect Beneficial Enjoyment
  - 674(d) – Power to allocate income
    - Power granted to someone other than grantor or "spouse living with grantor" to distribute, apportion or accumulate income to or for beneficiaries if limited by reasonably definite external standard
    - Power creates grantor trust as to income only
    - Possible to switch grantor trust status on and off merely by spouse moving out and back in?

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Grantor Trusts

- §675 Administrative Powers
  - 675(2) – Power given to nonadverse party to make loans to grantor without adequate interest or security
  - N/A if trustee has authority to make loans to anyone without regard to interest or security
  - Power alone will cause grantor trust status, even if no loan is made (PLR 199942017, 9645013)

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Grantor Trusts

- §675 Administrative Powers
  - 675(3) – Actual borrowing of funds
    - Direct or indirect loan to grantor or grantor's spouse which is unrepaid at the end of year
    - N/A to loans with adequate interest and security
    - Creates grantor trust to extent amounts are unrepaid at year end, but . . .
    - IRS has apparently ignored the requirement that loan remains outstanding until year end

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- §675 Administrative Powers
  - 675(4) – General
    - Right exercisable in a non-fiduciary capacity by any person to reacquire trust corpus by substituting other property

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Grantor Trusts

- §675 Administrative Powers
  - 675(4) – General
    - Right exercisable in a non-fiduciary capacity by any person to reacquire trust corpus by substituting other property
    - Service's position is that power alone isn't sufficient, and applies a facts and circumstances analysis
    - Defective as to both income and principal
    - Grantor can release
    - Protector can re-grant

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Grantor Trusts

- §677 Power to Use Income for Benefit of Grantor
  - Grantor treated as owner of *any portion* of trust, whether or not under §674, *the income* of which, without the approval or consent of adverse party is, or in discretion of grantor or nonadverse party may be, distributed to or for benefit of grantor or spouse
  - Or used to pay premiums on life insurance on the life of grantor or spouse

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Grantor Trusts

- §677 Power to Use Income for Benefit of Grantor
  - Trust should disallow use of income to satisfy obligation of support
  - Discretionary power to pay income to grantor may cause inclusion under state law
  - Some states have changed their laws to not cause inclusion (Alaska, Delaware, and others)

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Grantor Trusts

- §678 Persons other than Grantor Treated as Owner
  - Only Code section attributing ownership to someone other than the actual grantor
  - Power to vest corpus or income exercisable solely by that person
    - surviving spouse as sole trustee of bypass trust?
    - limitation to ascertainable standard (HEMS) prevents estate tax inclusion
    - switch on/off grantor trust status by appointing/firing co-trustee

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Grantor Trusts

- §678 Persons other than Grantor Treated as Owner
  - N/A with respect to power over "income" during any period actual grantor is treated as owner under §§671-677
  - Service has interpreted §678(b) as applying to principal as well as income
    - PLRs 9309023, 8701007, 8326074, 8308033, 8142061

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Grantor Trusts

- §678 Persons other than Grantor Treated as Owner
  - Power to distribute income or principal which is "partially released or otherwise modified" that would cause grantor trust status under 671-677
    - 5/5 power holder, until released, modified, or allowed to lapse, is treated as grantor over portion of trust subject to power
    - Upon lapse, power holder is treated as grantor of amount in excess of 5/5
    - Rev. Rul. 67-241 and PLR 200022035

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Grantor Trusts

- §678 Persons other than Grantor Treated as Owner
  - Power to distribute income or principal which is “partially released or otherwise modified” that would cause grantor trust status under 671-677

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Grantor Trusts

- Terminating grantor status
  - Maintain Flexibility
  - Power to terminate grantor trust status should not be in hands of grantor
  - Tax issues upon termination

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Conclusion

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