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Flex Your Beneficiaries:

Reducing the Income Tax Burden on Non-Grantor Trusts

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"Thank You, Nevada Trust Conference for Inviting Me".

-Jonathan G. Blattmachr

Types of Trusts and Their Taxation

- Trusts are either grantor trusts or non-grantor trusts (or a combination of both)

- Grantor trusts are “deemed owner” trusts – their income, deductions, and credits are attributed directly to the deemed owner under Section 671, who either is the grantor of the trust or (under Section 678) a beneficiary of the trust

- At one time, grantor trusts were considered to be so adverse that they were called “defective”

- Trusts and individuals used to have the same income tax brackets, but that changed in the Tax Reform Act of 1986. Trusts reached the top income tax bracket at only $7,500 of income at that time, and in 2022, with inflation adjustments, now reach the top bracket with income of $13,450.

- So now dividing income with one or more trusts (especially with the Section 643(f) multiple trust rule) likely doesn’t save any federal income tax (although using trusts may save state income tax)

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How Grantor Trusts Help with Estate Tax Planning

- Swapping or selling assets to a grantor trust so lower basis assets are in the gross estate to secure the step up in basis under Section 1014
- No gain recognition on completing a swap
- Have assets producing greater returns held by the trust to maximize appreciation
- Because assets may be sold to the trust for an AFR note (which has a lower return on average than market returns) the sale to a grantor trust for an AFR note may be beneficial is shifting wealth out of the client's estate
- Because the income received by a grantor trust is included in the gross income of the grantor, without causing the grantor to be treated as making a gift (although in essence the grantor pays what would otherwise be the trust's tax bill), it permits the trust to grow on a tax-free compounded basis, one of the most powerful forces in building wealth. This "burning" of the grantor's gross estate (and all of it excluded from the grantor's gross estate) is one of the most important estate tax planning opportunities. This is commonly called "Tax Burn."

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When Grantor Trust Status Will End and Why You May Want It to End

- Grantor trust status may only exist while the deemed owner is alive
- The deemed owner may not wish to be responsible for the income tax
- The deemed owner may be subject to state income tax (while a non-grantor trust would not be). See *North Carolina v. Kaestner* (USSC 2019)
- Adverse consequences may arise by "toggling" grantor trust status off or on during the grantor's lifetime as with a "negative basis" asset. Cf. Rev. Rul. 77-402. Arguably, this may not apply to indebtedness owed by the trust to the grantor as no debt is deemed to exist. See Rev. Rul. 85-13.
- A transfer of the right to IRD to a grantor trust by the grantor should not be an income recognition event but ending grantor trust status during the grantor's lifetime may cause the gain to be recognized (although arguably not if returned to the grantor)

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When Non-Grantor Trusts May Be Beneficial

- When the trust can avoid state income tax and the person who would be the deemed owner could not. The mysterious ING (incomplete non-grantor trust—important but beyond today's presentation)
- When the trust is entitled to additional deductions or other tax benefits that the person who would be the deemed owner could not take advantage of—e.g., an additional $10,000 SALT deduction
- When the person who would be the deemed owner could not get the benefit of contributions to charity because of the AGI limitations individual donors face

Additional Income Taxes a Trust May Face

- Individuals generally do not reach the top (37%) federal income tax bracket until income exceeds $500,000 but a trust reaches the top bracket (in 2022) at $13,450
  - Tax due on $25,000 of income by Single Individual ($1,342), Married Couple ($60), or Trust ($7,551)
  - Tax due on $100,000 of income by Single Individual ($15,247), Married Couple ($8,684), or Trust ($35,301)
  - Tax due on $200,000 of income by Single Individual ($41,413). Married Couple ($30,493), or Trust ($72,301)
- Individuals pay the 3.8% tax on the lesser of NIT or the amount of above the excess of modified adjusted gross income over the following threshold amounts:
  - $250,000 for married filing jointly or qualifying widow(er)
  - $125,000 for married filing separately
  - $200,000 in all other cases
- Trusts pay the 3.8% tax on undistributed NIT or the excess of modified AGI above (for 2022) $13,450
- Proposed surcharges: for individuals, 5% on amounts above $10 million and 8% on amounts above $25 million. But for trusts and decedents' estates, the thresholds are $200,000 and $500,000.

Reduce Income Tax on Trust Income by Distributing Gross Income to Charity

- Section 642(c) allows an unlimited income tax deduction for gross income paid, pursuant to the terms of the governing instrument, for a charitable purpose.

- However, Section 681 imposes the same percentage limits tied to an individual's contribution base (essentially, AGI) to the extent the distribution to charity from the trust constitutes essentially of unrelated business [taxable] income (under Section 512). But the taint of UBTI seems to be washed away when distributed from a trust to charity. See Schmolka, "Income Taxation of Charitable Remainder Trusts and Decedents' Estates: Sixty-Six Years of Astigmatism," 40 Tax Law Rev. 1, 294, n. 653.

- The Section 642(c) deduction is allowed not only if the governing instrument directs payments for a charitable purpose but also if it merely authorizes them.

- In addition, if a trust is a partner is a partnership that makes a donation to charity from its gross income, the trust, as a partner, may deduct its proportionate share of the charitable donation. Rev. Rul. 2004-5.

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Reduce Income Tax on Trust Income by Distributing DNI to Beneficiaries

- Although, in general, a non-grantor trust is taxed as an individual is, in addition to a different deduction for charitable contributions, a trust is entitled to a deduction for distributions of its distributable net income (DNI) to its non-charitable beneficiaries, subject to exceptions and special rules
- DNI is defined in Section 643(a) and is the trust's taxable income for the year with special rules and exceptions. For example, except for the year of termination of the trust, capital gain is not included in DNI unless it is actually distributed (or deemed distributed). The regulations explain ways for that to happen, such as allocating capital gain to fiduciary accounting income or by "deeming" a distribution of corpus as consisting of capital gain
- In any event, distributing DNI to a beneficiary shifts the income to the beneficiary and away from the trust. And to that extent, the trust's tax brackets and other income tax attributes will not apply.
- Also, the trust may be able to avoid state income tax that a beneficiary who receives DNI cannot. See *North Carolina v. Kaestner* (USSC 2019)

Distributing DNI Among a Class of Beneficiaries that May Include the Spouses of Descendants

- Subject to exceptions and special rules, DNI can be distributed to any discretionary beneficiary (that is, a beneficiary who is eligible in the discretion of a non-beneficiary trustee to receive trust distributions; if the trustee may distribute to himself or herself, it may be a deemed owner trust under Section 678)
- A beneficiary may be any beneficiary other than charity (for which a shift of income out of the trust to the beneficiary is allowed only under Section 642(c)) and may include other trusts or any other non-charitable "person," including a corporation
- Hence, distributions may be authorized to be made to the spouses of the primary beneficiaries (such as the spouses of descendants of the person whose wealth funded the trust)
- It may make sense to include such spouses as discretionary beneficiaries for at least two reasons:
    - First, the descendant may be under the threat of a creditor claim
    - Second, the descendant may have an addiction or spendthrift problem or be incompetent
- Distributions to the descendant's spouse can be conditioned on the spouse being married to and living as a married couple with the descendant and/or obtaining the descendant's consent (only minimal risk of any real risk tax exposure to the consenting descendants as the gift would likely be de minimus and/or qualifying for the gift tax marital deduction, or the expanded annual exclusion if the spouse is not a US citizen).

Distributing DNI Among a Class of Beneficiaries that Includes Other Trusts, Such as CRTs for Descendants

- Subject to exceptions and special rules, DNI can be distributed to any discretionary beneficiary (that is, a beneficiary who is eligible in the discretion of a non-beneficiary trustee to receive trust distributions)
- A beneficiary, who may receive DNI, may include any other non-charitable "person" including other trusts
- Before making the distribution to another trust, consideration should be given to the tax attributes of the "receiving" trust, such as whether the receiving trust is GST exempt or subject to a particular rule against perpetuities or subject to state income tax
- A distribution to a charitable remainder trust (CRT) described in Section 664 might be considered, as CRTs are income tax exempt (but are subject to a 100% excise tax on their unrelated [taxable] business income, essentially as defined under Section 512)
- However, a trust is a CRT described in Section 664 only if it meets the definition of a charitable remainder annuity trust (CRAT) or a charitable remainder unitrust (CRUT) including an income only unitrust such as a NIMCRUT (a CRUT with make-up provisions) and has property for which an income tax charitable deduction was allowable under Section 170, 2055, 2106 or 2522. Reg. 1.664-1(a)(1)(iii)(*a*)
- Note several points: the charitable deduction under Section 642(c) is not mentioned; a distribution of DNI falls under Sections 651/652 or 661/662; there is no requirement that all of the property in the CRT qualified for the charitable deduction under Section 170, 2055, 2106 or 2522 (indeed, it never could).

More on Distributing DNI to CRTs for Descendants

- A distribution of DNI to a CRAT will not produce any deduction under Section 170, 2055, 2106 or 2522 and it would, therefore, seem to fail to be a CRT as described in Reg 1.664-1(a)(1)(iii)(*a*) ("a trust with respect to which a deduction is allowable under section 170, 2055, 2106, or 2522")
- Although additional contributions cannot be made to a CRAT, they may be made to a CRUT. So distributing DNI to a pre-existing CRUT, which holds some property for which a charitable deduction was allowed under 170, 2055, 2106 or 2522 should mean that the DNI is not taxed at all. (Any UBTI taint in the distributing trust seems to be washed away when distributed.)
- And if the distribution is made to a pre-existing NIMCRUT, it may be possible to avoid having the DNI income taxed for a long time. See "Using a Charitable Remainder Trust as the Recipient of Qualified Plans and IRAs," 47 Estate Planning 3 (May 2020).
- Hence, someone (other than the trustee) should create the CRUT for those descendants who may not need current distributions and to which the trustee of the "main" trust may distribute DNI. These need not have been in existence when the main trust was created.

Distributing DNI to an S Corporation Which Has Descendants or a QSSTs for Descendants as its Shareholders

- Subject to exceptions and special rules, DNI can be distributed to any discretionary beneficiary (that is, a beneficiary who is eligible in the discretion of a non-beneficiary trustee to receive trust distributions), including an S corporation
- The income of an S corporation is not taxed to the corporation, but to its shareholders
- The class of permissible S corporation shareholders is limited but includes US individual taxpayers and qualified subchapter S trusts (QSSTs) described in Section 1361(d)(3). A QSST is a trust that has a US individual taxpayer as its sole beneficiary and must currently distribute all of its fiduciary accounting income to that beneficiary.
- DNI distributed to an S corporation will be included (directly) in the gross income of its shareholders. Hence, if a descendant is the shareholder, the DNI will be included in that descendant's gross income, without necessitating any distribution to the descendant other than for fiduciary accounting income which can be minimized—see discussion in "Using a Charitable Remainder Trust as the Recipient of Qualified Plans and IRAs," 47 Estate Planning 3 (May 2020). Although that might directly protect the income from attachment by a creditor of the descendant shareholder, the stock owned by the descendant will not be protected.
- Hence, instead of having the stock in the S corporation owned by a descendant, it might be preferable to have the stock owned by a QSST for the descendant. The income of the S corporation (including any DNI distributed to it) will be taxed to the descendant as the beneficiary of the QSST without making either the income (if not distributed or distributable from the S corporation) or the stock subject to the claims of the descendant's creditors, and should not cause the descendant to exceed thresholds for government entitlements such as Medicaid. Obviously, the descendant should not be able to control distributions from the S corporation.

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Some Drafting Considerations

- “Flexible” beneficiaries can be added to any continuing trust for descendants of the grantor (or testator) – either a single/pot trust for all descendants, or separate pro-rata trusts
- However, the flexible beneficiary options only appear if the trustee has discretion to make distributions. If income distributions to the primary beneficiary are mandatory, or if distributions are limited to only an ascertainable standard, the options for additional beneficiaries are not applicable and will not appear.

DRAFTING TIP

DRAFTING TIP: OPTIONS TO INCLUDE ADDITIONAL BENEFICIARIES

This interview offers the option to allow distributions to certain beneficiaries in addition to the primary beneficiaries of the trust, namely the spouse of the Beneficiary, a CRT, or a Subchapter S Corporation. This may be desirable for several reasons, including income tax planning and creditor protection. In order for the option to include additional beneficiaries in your document to appear, you will need to ensure that your choices related to the distribution of income and principal are compatible with a plan that includes additional beneficiaries. To that end, both of your choices related to the Distribution of Income and Distribution of Principal must include a choice that gives discretion to the Trustee to make distributions. In addition, the standard to be used for such discretionary distributions of income and of principal must include an option that allows the Trustee to distribute for any purpose. You can use either the "any purpose" standard or the standard that permits distributions both for health, education, maintenance and support and for any purpose. If the appropriate options for Distribution of Income and Distribution of Principal are selected, along with the discretionary standard described above, the option to include additional beneficiaries will appear below the options relating to distribution standards, on this screen. Please see the Help Text below for more information about these options.

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More Drafting Considerations

- Note that options for additional beneficiaries will not appear if income is mandatory or the trust is set up as a unitrust
- Includes option to require beneficiary's consent for distributions to charity, if desired
- If eldest beneficiary (who would provide consent) is a minor or incompetent, consent can be given by a representative of that beneficiary

DISTRIBUTIONS

Distribution of income
- Discretionary to Beneficiary and descendants
- Discretionary to Beneficiary
- All income to Beneficiary
- Unitrust payment to Beneficiary

Authority to distribute gross income to charity

Authorize Representative to act in place of eldest descendant if not adult and com

Distribution of principal
- Discretionary to Beneficiary and descendants
- Discretionary to Beneficiary
- No principal distributions by Trustee

Who has authority to distribute income to charity?

Trustee may distribute with consent of eldest beneficiary to whom dis

Trustee may distribute without any other person's consent

Trustee may distribute with consent of eldest beneficiary to whom distributions may be paid

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Some Drafting Options - Spouse, CRT, S-Corp

- Choose any or all options for additional beneficiaries – spouses, charitable remainder trusts, or qualifying S corporations
- Adding more potential beneficiaries can provide more flexibility for lowering income taxation and addressing other situations (such as the spendthrift beneficiary or beneficiary with creditor issues)

Give Trustee authority to make distributions to beneficiaries other than descendants and charity

- (●) Yes
- ( ) No

DRAFTING TIP: This option will enable the Trustee to make distributions to certain additional beneficiaries other than descendants. Please see Help Text for details on this option.

Select which of the following beneficiaries to whom the Trustee may make distributions. Select as many as may apply.

- [x] Spouses
- [x] Charitable Remainder Trust
- [x] S Corporation

DRAFTING TIP: The option to make distributions to spouses includes both the spouses and surviving spouses of current beneficiaries of the trust. The option to make distributions to a charitable remainder trust ("CRT") includes only those trusts of which an individual beneficiary of the descendants' single trust is the non-charitable beneficiary. The option to make distributions to an S Corporation includes only those S corporations of which one or more of the individual beneficiaries of the trust are shareholders or of which one or more shareholders are qualified subchapter S trusts ("QSSTs") of which an individual beneficiary of the trust is the sole beneficiary. See Help Text for additional details.

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Drafting Options –Some Options for Spouses

- If distributions can be made to a descendant's spouse (or surviving spouse), additional limits can be added, either to require beneficiary's consent, require the beneficiary and spouse to be living together, or both.

Select which of the following beneficiaries to whom the Trustee may make distributions. Select as many as may apply.

- [x] Spouses
- [x] Charitable Remainder Trust
- [x] S Corporation

DRAFTING TIP: The option to make distributions to spouses includes both the spouses and surviving spouses of current beneficiaries of the trust. The option to make distributions to a charitable remainder trust ("CRT") includes only those trusts of which an individual beneficiary of the descendants' single trust is the non-charitable beneficiary. The option to make distributions to an S Corporation includes only those S corporations of which one or more of the individual beneficiaries of the trust are shareholders or of which one or more shareholders are qualified subchapter S trusts ("QSSTs") of which an individual beneficiary of the trust is the sole beneficiary. See Help Text for additional details.

Require consent of the Beneficiary to make distributions to Spouse of the Beneficiary

- (•) Yes
- ( ) No

Limit distributions to spouse to periods when spouse is living with the Beneficiary

- (•) Yes
- ( ) No

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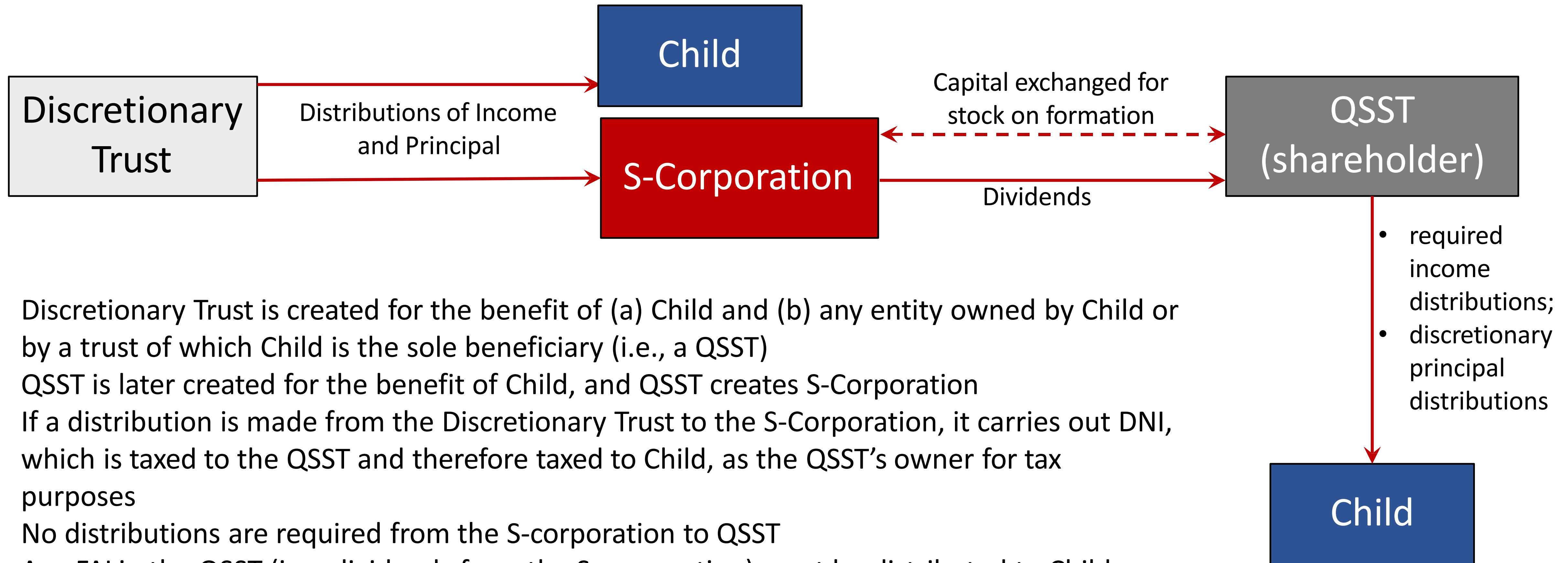
Non-Grantor Trust with Beneficiary as Taxpayer using QSST/S-Corp



- Discretionary Trust is created for the benefit of (a) Child and (b) any entity owned by Child or by a trust of which Child is the sole beneficiary (i.e., a QSST)
- QSST is later created for the benefit of Child, and QSST creates S-Corporation
- If a distribution is made from the Discretionary Trust to the S-Corporation, it carries out DNI, which is taxed to the QSST and therefore taxed to Child, as the QSST's owner for tax purposes
- No distributions are required from the S-corporation to QSST
- Any FAI in the QSST (i.e., dividends from the S-corporation) must be distributed to Child
- Accordingly, assets can be accumulated at the S-corporation level, and only pass to Child when a dividend is declared, but income is taxed to Child (at individual rates, instead of trust rates)

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Summary & Conclusions

- Under current law, grantor trusts are often an effective tool for estate planning.
- However, a trust cannot be governed by the grantor trust rules once its "deemed owner" dies
- Non-grantor trusts may be beneficial for certain purposes, such as avoiding state income tax or providing certain additional tax benefits (such as an additional SALT deduction or Section 199A deduction)
- Unfortunately, non-grantor trusts face extremely high federal income taxes compared to individuals, but distributions of trust income can, in a flexibly drafted trust, be distributed to charity and/or non-charitable beneficiaries that may include descendants, their spouses, CRTs for them and S corporations of which descendants or QSSTs for them are the shareholders
- And remember the flexibility of the Section 663(b) sixty-five day rule that applies to distributions of DNI (and for Section 642(c) the trust has the entire next year to make the distribution)

NIMCRUT/Qualified Plans

Using a Charitable Remainder Trust as the Recipient of Qualified Plan and IRA Interests[1]

In light of the changes to qualified plan distributions under the SECURE Act, charitably minded individuals may want to consider naming a charitable remainder trust as a beneficiary to ensure deferred income tax payment.

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There are currently approximately 28 trillion dollars of assets in the United States that are held in pension type plans,[2] such as Section 401(k) and 457 plans and individual retirement accounts (IRAs). These arrangements provide at least three significant benefits.[3] The first is protection from claims of creditors of the plan participant or IRA owner, subject to certain exceptions. The second is that the amount of earnings contributed to the plan or account is generally not subject to income tax. The third is that the earnings realized inside the plan or account are, in general, not subject to income tax. This allows the earnings to grow tax-free, one of the most powerful phenomena in financial planning.[4] Deferral of taxation of earnings can last until the plan participant or IRA owner reaches their mandatory beginning date to receive distributions. Typically, this is April 1 following the year the individual reaches the age of 72, at which point the participant will be required, so as to avoid excise tax (in the nature of a penalty) under Section 4974, to take required minimum distributions (RMDs) over the participant's recalculated life expectancy.[5]

Prior to the effective date of the Setting Every Community Up for Retirement Enhancement Act (the SECURE Act),[6] once the plan participant or IRA owner died, the law required the property in the plan or account to be distributed by the end of the fifth calendar year following the death of the participant or owner (unless the plan or account was left to an identified individual, known as a “Designated Beneficiary” or a so-called “see-through” trust, in which case RMDs could be taken over the unrecalculated (or fixed at death) life expectancy of the identified individual.[7] There were, and even after the effective date of the SECURE Act are, two types of “see-through” trusts. One was and is called a “conduit trust” which mandates that all distributions received by the trust from the plan or account be distributed immediately to the Designated Beneficiary; essentially, for RDMs, the trust is treated as if it were that individual. The other see-through trust was and is called an “accumulation trust” which, as the name indicates, need not make any distributions to any beneficiary, only has beneficiaries who are identifiable individuals, and may take RMDs over the unrecalculated life expectancy of the oldest individual beneficiary of the trust.

Plans and IRAs in the Context of Estate Planning[8]

Except for distributions from a Roth IRA,[9] distributions from plans and IRAs following the death of the participant or owner constitute income in respect of a decedent described in Section 691(a) and, therefore, are included in the gross income of the recipient. They may also be subject to estate tax in the estate of the participant or owner. The combined taxes may be very significant, especially if there are state estate and income taxes. For example, in the state of Washington, the top state estate tax

rate is 20%.[10] State death taxes imposed on property included in the federal gross estate are deductible, under Section 2058, for purposes of determining the federal taxable estate, meaning, for example, where the state rate is 20%, that only 80% of what otherwise would be the taxable estate is exposed to the 40% federal estate tax rate. 40% of 80% is 32% which then is the effective federal estate tax rate, in such a case. When that is added to a 20% state estate tax, the combined effective estate tax rate is 52%. The 32% federal estate tax rate is deductible, pursuant to Section 691(c), for purposes of determining the amount that is subject to income tax on distributions from a plan or IRA. So only 68% of the plan or IRA distributions may be subject to income tax. The top federal income tax rate on plan or IRA distributions is 37%. State income tax can be as high as 13% (in California) meaning a potential combined income tax rate of 50% which if applied to the 68% of the distributions, after the Section 691(c) deduction, produces a net income tax on the distributions of 34% which, when added to the possible state and federal estate taxes, could bring the combined taxes to 86%.[11]

In addition, a transfer of an interest in a plan causes acceleration of the income except where it is transferred pursuant to a QDRO.[12] There is at least some question whether an interest in an IRA may be transferred by the owner prior to death without causing the account to lose its tax-exempt status.[13] Hence, interests in plans and IRAs are often the most difficult assets to deal with in the estate plan. And, as indicated, if estate tax cannot be reduced, it may make sense to try to reduce the present value income tax burden on a plan or IRA. Before the SECURE Act, that was somewhat possible by having plan or IRA distributions spread over a long period of time. However, the Act, as described below, has curbed that in many situations. Nonetheless, using a charitable remainder trust (CRT) as the receptacle for them may help reduce the burden in some cases.

Brief Overview of the SECURE Act

The SECURE Act, signed into law in December 2019 and effective at the beginning of 2020, made significant changes to qualified (retirement) plans (“plans”) and IRAs. Probably the most significant change was the elimination of the ability of most beneficiaries (upon the death of the plan participant or IRA owner) to take distributions, without additional tax (in the nature of a penalty) under Section 4974, over the successor beneficiary's life expectancy. Except for five categories of individuals (known as “Eligible Designated Beneficiaries” or “EDBs”) and except with respect to a plan participant or IRA owner who at death was taking distributions over his or her life expectancy, beneficiaries must take the entire amount from the plan or account by the end of the fifth calendar year or, if there is a Designated Beneficiary (essentially an identifiable individual) or a conduit or accumulation trust, by the end of the tenth calendar year following the calendar year of the death of the participant or owner.

Perhaps, the two most important impacts of such changes are (1) to shorten the period following the death of the participant or owner of tax-free compounding provided by the use of the plan or IRA (the so called “stretch”) and (2) to shorten the period that the plan or IRA interests may remain free from

the claims of creditors, although using a trust may provide significant creditor protection for the beneficiary or beneficiaries.

The five categories of EDBs, who may continue to use their life expectancies for payouts from a plan or IRA, are (1) the surviving spouse or (2) a minor child of the participant or owner, (3) an individual who is not more than ten years younger than the participant or owner, and an individual who at the death of the participant or owner is (4) disabled or (5) chronically ill within the meaning of Sections 72(m)(7) or 7702B(c)(2), respectively. Note that the life expectancy of a minor child of the participant or owner may be used only until the minor reaches majority, when the ten-year payout rule commences. Just as under prior law, if there is no Designated Beneficiary (whether or not also an EDB), the entire plan or account must be distributed under the same five-year payout regime as under prior law (or, if the participant died after commencing required minimum distributions, over the participant's remaining life expectancy).

Unless the beneficiary is an EDB, the proceeds payable to an individual (or to a conduit or a see-through accumulation trust) must be withdrawn in their entirety by the end of the tenth calendar year following the calendar year of the death of the plan participant or IRA owner, so as to avoid the additional tax (in the nature of a penalty) under Section 4974. There are no annual minimum distributions required for individual beneficiaries (who are not EDBs) as there were under prior law. Rather, a non-EDB individual need take nothing from the plan or IRA, so income tax deferral may continue for that ten-year period.

Power of Tax Deferred Compounding

Probably, the most important factor in efficient financial planning is tax-free compounding. Next best is tax-deferred compounding. The longer the period of deferral the better for building wealth, all other things being equal.[14] Indeed, the inability to use the ten-year payout regime (which has been substituted for the life expectancy regime except for the plan participant or owner, and for EDBs), in which case the five-year payout regime must be used, retards the accumulation of wealth, all other things being equal.

Here is a comparison. Taxpayer at death has a $1 million IRA. If it grows 20% a year, it will be worth $2,488,000 in five years[15] and is then subject to an assumed 37% income tax,[16] which would leave $1,567,000 at the end of five years. If that amount then grew at a rate of 12.6% (the net after-tax net earnings of a 20% a year return taxed at 37%) for five more years, the taxpayer would have $2,837,000. If, instead the ten-year regime applies and the IRA grows income tax-free for ten years (instead of only five years), the IRA would be worth $6,191,000 in ten years when it is subject to an assumed 37% tax, leaving about $3,900,000. So, the postponement of taxation from five years to ten years would produce a significant financial benefit: $3.9 million vs. $2.837 million. This analysis, however, assumed a very high rate of return (20% a year). Suppose instead the annual return (before any income tax) were only 1% a year. After five years, the IRA would be worth $1,051,000 when it

would be subject (it is assumed) to a 37% income tax, leaving $662,000. That amount then grows for five more years at a 1% rate or .63% after tax (that is .0063 annual growth after tax) to $683,000. If the IRA grows income tax-free for ten years (instead of five years) at 1% annually, it would be worth $1,104,000 before tax and $696,000 after a 37% income tax. So, tax deferral is always better (all other things being equal, like growth inside and outside the IRA or plan and income tax rates being the same on all amounts) if, but only if, there is growth. What can be gained by a slower payout is a longer time for tax-deferred compounding, again all other things being equal. This is attributable to attaining tax-deferred earnings on the income tax postponed - it is, in theory, the primary reason taxpayers contribute to plans and IRAs.[17]

So, the question naturally arises: what can a taxpayer do to extend the period of tax-free compounding? The answer, for some, is to have the plan or IRA paid to a CRT described in Section 664 which will receive the proceeds free of income tax (because a CRT is exempt from such tax under Section 664(c)(1)) and distributions from the CRT may be made, if certain actuarial requirements are not violated, over the life of one or more individuals or for a fixed term of up to 20 years and not just within the ten-years provided by the SECURE Act. However, because the remainder interest of the CRT must pass to charity, the additional time the trust is exempt from income taxation may not always offset the cost to individuals of the loss of the value of the remainder interest passing to charity upon the termination of the CRT. In effect, when using a CRT, the taxpayer is renting the trust's exemption from income taxation. The price paid is the value of the remainder interest that must be committed to charity. Of course, for individuals who are charitably inclined, including those wanting to fund their own private foundations, the “price paid” in this context may be of no real consequence, particularly since (as discussed further below) the minimum actuarial value of the remainder interest need only be equal to 10% of the value contributed to the CRT.

There are many distinctions between CRTs and plans and IRAs that one must consider. A CRT is subject to a 100% excise tax under Section 664(c)(2) on any unrelated business taxable income (UBTI) it receives. A plan or IRA, on the other hand, simply pays the corporate tax rate on any UBTI received. All distributions from a plan or IRA (other than a Roth IRA) are taxed as ordinary income. Under Section 664(b), distributions from a CRT retain their tax character (*e.g.*, as ordinary income, capital gain, or tax-exempt income), although the highest taxed income a CRT receives is deemed to be distributed until an income subject to a lower (or no) tax is deemed distributed. Those distinctions make the comparison of using a CRT more complicated.

In any event, as indicated below, it will be rare for a CRT to be the best choice for a surviving spouse of the participant or owner who otherwise would have the proceeds pass directly to the survivor. Similarly, it will be rare to have a CRT be the best choice for a Roth IRA.

Brief Discussion of CRTs

As virtually everyone who deals with them knows, a CRT described in Section 664 must either be a charitable remainder annuity trust (CRAT) or charitable remainder unitrust (CRUT) as described in that section.[18] A CRAT must provide each year for a minimum annuity payment, to and for the life or lives of identified living individuals or to or for an individual or a groups of persons (including charity although at least one person must not be a charity) for a fixed-term of not more than 20 years, of a minimum of 5% and a maximum payment of 50% of the value of the assets contributed to the trust at the time of their contribution. A CRUT must provide each year for a minimum annual payment to an individual or a group of persons of 5% and a maximum payment of 50% of the annual value of the assets then held by the trust. A CRUT may also provide for annual payment of the lesser of the 5% minimum/50% maximum or the trust's fiduciary accounting income (FAI), described in Section 643(b) and its regulations thereunder, and may provide that, if the FAI is less than the unitrust amount for any year, the “short fall” may be made up in a later year if and to the extent the FAI for the subsequent year exceeds the unitrust amount for that year.[19] This latter type of unitrust is commonly called a “net income with make-up charitable remainder unitrust” or “NIMCRUT.”[20] In addition, the actuarial value of the remainder, which will pass ultimately to or for charity, must be at least 10% of the actuarial value of the assets at the time of their contribution to the trust.[21] Moreover, there cannot be more than a 5% probability that the trust will be exhausted by the payments,[22] which as a practical matter cannot happen with a CRUT as the unitrust payments will diminish if the value of the trust declines.[23]

The value of the remainder of a CRT is determined by how long the trust is expected to last, and the required payout (for a CRUT that limits payments to FAI, the calculation will be based upon the unitrust percentage even if that is greater than the assumed rate of FAI to be earned in the trust).[24] For an annuity trust, the value will depend on the Section 7520 rate that must be used to value interests in CRTs. Except for the timing during each year when the unitrust will be paid, the value of the remainder in a CRUT will not be affected by the Section 7520 rate.[25] Also, the probability of exhaustion of the trust by payments cannot be greater than 5%.[26] This may occur for a CRAT but probably not a CRUT as previously stated. Whenever the Section 7520 (which is the assumed annual rate of growth the CRAT will experience) is less than the annuity percentage used (which as mentioned earlier cannot be less than 5%), the trust may exhaust. Even if the Section 7520 rate is the same as the annuity rate, the 10% value of the remainder test may not be met. For example, if both the Section 7520 rate and the annuity rate are 5%, the trust will fail the 10% value of the remainder test if the annuitant (for life) is under age 25. If the annuity is limited to 5% and the Section 7520 rate is at least 5.4%, the test will be met. In fact, the higher the Section 7520 rate, the higher the annuity can be without violating the 10% value of the remainder test or the 5% probability of exhaustion test. As the Section 7520 rate increases, the value of the remainder increases, all other things being equal. Unfortunately, this violates the premise of using a CRT: renting the trust's exemption from taxation and paying the lowest rent possible, which is the value of the remainder. Ideally, this would be 10% of the value of what is being contributed to the trust and not more.

For CRUTs, the analysis may be quite different. Unlike an annuitant of a CRAT, a unitrust recipient will receive more if the value of the trust increases. For example, at a 5% unitrust, the recipient will receive more if the trust grows more than 5% a year. For example, if the trust starts at $1 million and grows to $1,050,000 by year end, when the unitrust amount of $50,000 is paid, the unitrust recipient will receive a $50,000 payment if the 5% unitrust payment is calculated at the beginning of each year. The trust will then drop back to $1 million and the unitrust amount for the second year will also be $50,000. However, if the trust grows at 6% a year, there would be $1,010,000 at the beginning of the second and year producing a $50,500 for the second year. That does not seem like much of a difference, but over time it could grow significantly and that may be especially important in later years when the value of a fixed (annuity) payment may be eroded by inflation. Of course, if the trust assets grow at a much higher rate (as equities historically have[27]), the difference will be quite stark.

Benefit of Exemption from Income Taxation

There seem to be some “truths” about CRTs. First, for many taxpayers, the most significant benefit of a CRT is its exemption from income taxation.[28] Although distributions to taxable beneficiaries (*e.g.*, an individual who is the annuitant or unitrust recipient) will be included in the recipient's gross income to the extent the trust has experienced and is not treated as already having distributed taxable income (with the highest taxed class of income being deemed distributed first), the CRT itself is not subject to income tax under Section 664(c)(1). When someone creates a CRT, he or she (or it) may (indirectly) benefit from the CRT's exemption from taxation to the extent, if any, the trust has taxable income in excess of the amount currently payable to an annuitant or unitrust recipient. That is because the next best thing to avoiding income tax is postponing income taxation, as a general rule.[29] This often occurs when a taxpayer holds appreciated property that the taxpayer decides to sell (or is compelled to sell). Subject to exceptions,[30] a taxpayer must pay income tax on gain recognized, leaving a smaller base of wealth to generate future earnings. By contributing the appreciated assets to a CRT, the trust may sell them without paying income tax because the trust is exempt from such taxes[31] so the amount in the trust is not eroded by taxes as a result of the sale, even though the sale would otherwise be subject to tax if sold outside the confines of a CRT.

For an annuity trust, that may not be important. For example, a taxpayer holds an asset that produces little current income and is worth $1 million with a zero basis. She anticipates that if she sells it, she will pay a 24% tax on the gain, leaving her only $760,000. Instead, she intends to contribute the asset to a CRT with the hope that trustee will sell it.[32] She wants to receive an annuity of $50,000 each year for her life. Before we even begin to look at the “economics” of that move and consider alternatives, it is appropriate to note that she will violate the 5% probability of exhaustion test if she is under age 72 with a Section 7520 rate of 2%. Even at a 4% Section 7520 rate, she will violate the test if she is under 56. Moreover, at younger ages, she will also violate the 10% value of the remainder requirement. Also, she cannot provide for a payment of less than $50,000 a year so the 10% minimum value of the remainder and 5% probability of exhaustion tests will not be violated as a CRAT must pay an annuity equal to at least 5% (5% of the $1 million is $50,000). Although if the Section

7520 rate is at least 5%, a 5% CRAT can be created without violating the 5% probability of exhaustion test, the grantor who creates a CRAT at death will not be able to know what Section 7520 rate might apply.[33] Note, however, that the remainder value may vastly exceed 10% so the taxpayer will have paid very high rent for the trust's exemption from taxation.

Consider that if she sold the asset and paid the 24% tax and there are no earnings on the $760,000, the after tax wealth will be exhausted before the 16th year. Of course, she will have received the annuity payment of $50,000 for 15 years free of any income tax which, if reinvested, may grow in value. With the CRAT, even if it never grows in value, the $50,000 annual payments will last 20 years, but each annuity payment will be subject to income tax. The same result presumably would occur by simply selling $50,000 of the property each year for 20 years. Perhaps, the CRAT is preferable if the property must be sold and gain recognized. Although an installment sale might be considered, such a sale can be complicated from both a management and tax perspective.[34]

The major advantage of a CRAT is that the same payments continue (unless and until the trust is exhausted) even if the trust diminishes in value each year. With a CRUT, the payments will decline for each year the trust decreases in value. But, as mentioned below, a taxpayer may be better off acquiring a commercial annuity if he or she believes there will be no increase in the value of the funds.

Of course, with a CRAT, an increase in value of the assets in the trust does not benefit the noncharitable beneficiary except to ensure the payments will continue beyond the payment of the amount of the original corpus. For example, if the original corpus is $1 million and the CRAT provides for annual payments of $100,000 for ten years, the payments will cease by the end of tenth year (and if the Section 7520 rate is less than 2.6%, the trust will not meet the minimum 10% value for the remainder requirement). Even if the Section 7520 rate is above 2.6%, the beneficiary may fail to receive the payments for ten (10) year if the assets decline in value while in the trust.

With a CRUT, the taxpayer participates with growth in the assets and the trust should never be exhausted by payments (although it could be if the assets' investment performance decline in value to zero, which would also mean a loss of all payments from a CRAT as well). In any case, the beneficiary of a CRUT will receive more than a beneficiary of a CRAT, all other things being equal, if the trust increases in value (after making the required annual payments) over the life of the CRT. Note that if the annuity percentage, unitrust percentage, and the Section 7520 rate are the same, the tax value of the payments and the remainders will be the same. Of course, in the real world, the return almost certainly will not remain the same for the life of the trust.[35] If the property owner is concerned that value of the trust will not increase, then consideration likely should be given to acquiring a commercial annuity as that likely will provide greater payments[36] than the CRAT would. For example, the taxpayer could buy a commercial annuity[37] to receive an annual payment that would at least equal the amount to be paid from the CRAT and contribute a smaller amount to the CRAT. However, to buy a commercial annuity the taxpayer would have to sell the assets. Nonetheless, the commercial annuity may well pay more than a CRAT even if the CRAT can pay 5% for life.[38] It might

not even be possible to create a $1 million CRAT to pay $50,000 a year, if the Section 7520 rate is below the 5% payout. For example, the exhaustion test will be violated with a 5% annuity (payable at year end), if the Section 7520 rate is below 3.8%. In fact, even if both the payout and Section 7520 rate are 5%, the 10% value of the remainder will not be met if the annuity is to be paid for life for someone under the age of 24 years. In any case, as explained, even if the actuarial tests are not violated, the value of the remainder may exceed 10%, which means too high of a price has been paid to rent the trust's exemption from income tax.

Historically, stocks do increase in value over time.[39] "According to historical records, the average annual return since its inception in 1926 through 2018 is approximately 10%. The average annual return since adopting 500 stocks into the index in 1957 through 2018 is roughly 8% (7.96%)."[40]

As explained, a taxpayer seems to benefit very little from the trust's exemption from income tax when creating a CRAT but may receive considerably more with a CRUT, if it increases in value. For example, with a $50,000 a year CRAT payment, the annuitant will receive $1,000,000 over 20 years ($50,000 × 20). With a CRUT, a unitrust recipient entitled to a 5% unitrust payment each year would receive approximately $1,650,000 over the same 20 year period if the assets grow at 5% a year (much lower than then S&P 500 returns for any 20 year period in modern times).

In effect, the taxpayer is "renting" the exemption from taxation of charity and is paying for it by committing the remainder of the CRT to charity. In a CRT, that must be at least 10% percent of the value of the assets donated to the trust (the minimum the law allows). Note if a taxpayer wants charity to get more, the taxpayer should limit the value of the remainder of the CRT to 10% and simply donate more directly to charity.

The postponement of the taxation of income earned inside the CRT may or may not be beneficial for the taxpayer. For example, as indicated, for a CRAT, it seems that other than locking in the base of wealth with no tax, the beneficiary really does not benefit from the tax exemption from the trust. But for a CRUT, the beneficiary may benefit from the trust's exemption from income tax in the same way the participant in a qualified plan does (at least to the extent growth and income each year exceed distributions to the unitrust recipient for the year).

If a CRT could be a good receptacle for an IRA or plan, it may be best to name a non-see-through accumulation trust with discretionary beneficiaries which include a CRT. The IRA or plan proceeds will have to be entirely distributed by the end of the calendar year following the year of the death of the owner of participant. Even if the trustee chooses to distribute all proceeds to the CRT, there will be no requirements for distributions from the CRT until it receives the proceeds, adding to flexibility. In fact, making the plan or IRA proceeds payable to such a non-see through accumulation trust with both a CRT and those individuals whom the owner or participant wishes to benefit as the beneficiaries will allow the trustee to wait to see where it would be best to dedicate the proceeds including, perhaps, in whole or in part, to the CRT. However, that structure, compared to naming the CRT as of death, means no charitable estate tax deduction will be allowed.

A NIMCRUT May Be Best

Another option with a unitrust is to make it an “income only with make-up” (a NIMCRUT).[41] By investing, for example, in growth stocks that pay little (if any) dividends, no significant distributions need be made. At the appropriate time, the trustee may be able to change the investments so receipts do constitute FAI and are well in excess of the unitrust amount for the year of the change. For example, the trust may have been invested in growth stocks that pay no dividends. The stock can be sold without income tax (because the NIMCRUT is income tax exempt) and then invest in bonds, for example, with a yield more than the unitrust amount. There are some restrictions, however, imposed by the regulations on converting corpus into FAI for purposes of this strategy. For example, although having gain treated as FAI is permitted in an income-only unitrust, any gain arising from a sale or exchange of assets contributed to the trust may be treated as FAI only to the extent the assets have appreciated in value, such that pre-contribution gain cannot be taken into account in computing FAI.[42] Similarly, gain arising from a sale or exchange of assets later acquired by the trust may be treated as FAI only to the extent they have appreciated after acquisition.[43]

Some states have statutes which seem to permit significant flexibility in controlling the amount and timing of FAI. For example, Alaska's income and principal act, which is based upon the uniform act, provides essentially that there is no accounting income merely by the imputation of tax income to a trust. So, a NIMCRUT trust must report all income imputed or allocated to it for income tax purposes, such as where the trust is a partner in a partnership (or LLC treated as a partnership for income tax purposes). Partnerships are 'flow-through' entities. Flow-through taxation means that the entity does not pay taxes on its income. Instead, the owners of the entity pay tax on their 'distributive share' of the entity's taxable income, even if no funds are distributed by the partnership to the owners.”[44] Hence, if a NIMCRUT is a partner, it will report as its income any income of the partnership properly allocated to it, but if the trust received no FAI from the partnership, none of the partnership (imputed) income will be distributable to or taxed to the unitrust recipient.

Alaska law, essentially limits FAI from a partnership to be limited to distributions only of money (except for reinvested dividends) and then only if the money was

> (1) money received in one distribution or a series of related distributions in exchange for part or all of a trust's interest in the entity,
>
> (2) money received in total or partial liquidation of the entity, or
>
> (3) money received from an entity that is a regulated investment company or a real estate investment trust if the money distributed is a short-term or long-term capital gain dividend for federal income tax purposes.

Money is deemed received in a partial liquidation to the extent, and presumably only to the extent,

(1) the entity, at or near the time of a distribution, indicates that it is a distribution in partial liquidation, or

(2) the total amount of money and property received in a distribution or series of related distributions is greater than 20% of the entity's gross assets, as shown by the entity's year-end financial statements immediately preceding the initial receipt.[45]

Hence, if an Alaska NIMCRUT invests in a limited partnership, nothing will be distributable to the unitrust recipient based purely on imputed income from the partnership. Hence, if the NIMCRUT receives no FAI, the share of income it earns (through the partnership) essentially will accumulate in the NIMCRUT income tax free.[46] If and when the trustee wishes to generate FAI, it could seek a distribution in cash from the partnership that is not indicated to be of a partial liquidation and is not a distribution as part of related distributions consisting of greater than 20% of the entity's gross assets, which would cause the money received to be treated as corpus under the act. This can be made more certain by having the trust itself provide that distributions of profits experienced by the entity shall be FAI and that only a distribution that the partnership advises is in partial liquidation of the partnership shall be considered principal. This almost certainly would be respected for tax purposes. Reg. 1.643(b)-1 provides, in part, that FAI “means the amount of income of an estate or trust for the taxable year determined under the terms of the governing instrument and applicable local law. Trust provisions that depart fundamentally from traditional principles of income and principal will generally not be recognized.” Until the Uniform Income and Principal Act was promulgated (in 1997) there was little, if any, developed law on how distributions from business entities (such as a limited partnership) were to be treated for income and corpus purposes. Indeed, common entities used today, such as LLCs, just did not exist.[47] Hence, it is very difficult to see how specific provisions on how receipts from such an entity could depart fundamentally from *traditional* principles of income and principal.

Expressed IRS Concern on NIMCRUTs.

However, the Internal Revenue Service has indicated some concern over the ability of a NIMCRUT to “manipulate” what is income (FAI) and principal. For example, although the Uniform Act permits a trust to pay a unitrust amount (generally, of between 3% and 5%) and for it to be treated as FAI for tax purposes, Reg. 1.664-3(a)(1)(b)(3) provides that “trust income may not be determined by reference to a fixed percentage of the annual fair market value of the trust property, notwithstanding any contrary provision in applicable state law. Proceeds from the sale or exchange of any assets contributed to the trust by the donor must be allocated to principal and not to trust [accounting] income at least to the extent of the fair market value of those assets on the date of their contribution to the trust. Proceeds from the sale or exchange of any assets purchased by the trust must be allocated to principal and not to [fiduciary accounting] income at least to the extent of the trust's purchase price of those assets.”

Shoemaker and Jones, "Charitable Remainder Trusts: The Income Deferral Abuse and Other Issues", IRS exempt Organizations CPE Textbook 1997-139, discusses other possible manipulation of distributions from NIMCRUTs. That report did not make specific proposals, and none has yet to be

implemented after more than 20 years. In Rev. Proc. 97-23, 1997-1 CB 654, the IRS announced it would not issue rulings on whether an income only CRT qualifies under Section 664 where the grantor, trustee, beneficiary, or a person related or subordinate to any of them controls the timing of the CRT's receipt of trust income from a partnership or a deferred annuity contract. It is understood the IRS was studying whether other investments might disqualify the trust as a CRT. Again, it has been more than 20 years since the revenue procedure and the Shoemaker report were issued. And in National Office Technical Advice Memorandum (TAM) 9825001 (not precedent), the IRS ruled that the acquisition by a NIMCRUT of deferred payment annuities (which avoid the current generation of FAI) was not an act of self-dealing under Section 4941,[48] and would not prevent the trust from being a "qualified" CRT. Perhaps, more important, after the issuance of the Shoemaker report and Rev. Proc. 97-23, the Treasury revised the CRT regulations and basically only inhibited controlling the amount of FAI by prohibiting the allocation of proceeds of sale or exchange to FAI to the extent not in excess of the value of the assets when contributed to or purchased by the NIMCRUT and by prohibiting the use of a unitrust percentage to determine FAI of an income only CRT.[49]

Hence, it seems that managing a NIMCRUT to produce minimum or maximum FAI is permitted (subject to the prohibitions just mentioned).[50] Nonetheless, if a partnership, LLC, or other entity will be used to control the amount of FAI the NIMCRUT receives, the person in control of the distributions from the entity should be someone other than the grantor, trustee, beneficiary, or a person related or subordinate[51] to any of them.

Are Individual Beneficiaries Better Off with a CRT?

The answer is: it depends. If the ability to postpone income taxation of the plan or IRA proceeds is desirable (for example, to have tax deferred growth), the answer may well be yes. As demonstrated above, postponement of taxation of the proceeds from a plan or IRA may produce overall greater wealth if the assets grow in value. Due to the fact that, except for EDBs, plan and IRA proceeds must be distributed essentially within ten years of the death of the plan participant or IRA owner, a mechanism to postpone their taxation for a longer period may also be beneficial.

For example, a taxpayer may create a CRUT to pay 11% a year to a beneficiary for 20 years (the maximum fixed period for a CRT) without violating the 10% value of the remainder requirement. If it is assumed that the trust will grow at 6% a year and no unitrust payments are made for the first 19 years because there is no FAI, the NIMCRUT will be worth $3,207,135. If instead, the beneficiary received the amount in the plan or IRA in ten years (which would be $1,790,847 or $1,128,234 after a 37% income tax) and that were invested at 6% taxable each year (or 3.78% after a 37% tax) for another ten years, the beneficiary would then have $1,635,068. With the NIMCRUT, if no unitrust payments were made until the end of 20 years, the recipient would have faced total shortfalls for the first 19 and a unitrust payment for year 20 of $ 4,289,200. The CRT would then be worth $3,207,135. Note that, although the shortfall in unitrust payments are nearly $4.3 million, the CRT is worth only about $3.2 million and, obviously, no more than the trust's value could be transferred to a beneficiary.

The increase in value from the inception would be $2,207,135 and if that entire amount were paid out at the end of the 20-year term and was FAI, the beneficiary would net $1,390,495 after a 37% income tax. Perhaps, it would be possible for the trust to pay more of the shortfall of $4,289,200 to the unitrust recipient (although, again, never more than the $3,201,135 in the trust), so that, after a 37% income tax, the recipient would have more than $1,635,068. That obviously would mean charity would get after 20 years less than $1,000,000. But that result is not unfair or constitute "cheating" of the charitable remainder beneficiary, which was to receive a present value interest, at inception, of $100,000 (that is 10% of the $1,000,000 account). Indeed, if the charitable remainder beneficiary received $600,000 at the end of 20 years that would represent a 9% compounded growth for the 20 years on the $100,000 value of the remainder at inception of the trust. So, if $2,607,135 of FAI were received in the 20th year and paid to the unitrust recipient and subjected to a 37% tax, the recipient would have $1,642,495, slightly more than if the CRT were not used. Even if only part of the increase in value in the trust (from inception) constitutes FAI, the unitrust recipient may receive more if the growth in the trust is greater. For example, if the trust grew not at 6% annually but at 11% a year (the same as the 11% unitrust percentage), the unitrust recipient would receive approximately $4.5 million after income tax compared to approximately $3.5 million after tax if the plan or account grows tax free at 11% annually for ten years, is then withdrawn subject to a 37% tax and reinvested at 11% (6.39% after a 37% tax) for another ten years.

NIMCRUT for Life

A NIMCRUT may provide for payments for the life of an individual. However, to avoid violating the 10% minimum value of the remainder, no one younger than 23 years of age may be the unitrust recipient (and then only with a 5% unitrust payout and having the percentage applied and paid after 12 months from the funding of the trust). The older the unitrust recipient the higher that unitrust percentage may be for life. For example, an 11% unitrust payout can be provided for life for someone 51 years of age or older, the same maximum percentage for a fixed 20-year term unitrust.

With a unitrust for life of someone relatively young, the tax-free compounding inside a NIMCRUT can also mean more ultimately for the unitrust recipient. For example, if the beneficiary received the amount in the plan or IRA in ten years (which would be $1,790,847 if it earned 6% a year or $1,128,234 after a 37% income tax) and that were invested at 6% taxable each year (or 3.78% after a 37% tax) for 30 more years, the beneficiary would then have $3,434,070. If instead, the beneficiary received no distributions from the NIMCRUT for 40 years and it grew at 6% a year, the unitrust recipient would receive $10.2 million (on account of the shortfalls in FAI during the years), leaving approximately $6.5 million after tax and having the original $1 million corpus pass to charity at that time, which represents an approximate 6% compounded growth in the $100,000 value of the remainder for 40 years. An alternative would be not to make up payments made to the unitrust recipient but to convert the NIMCRUT to a standard CRUT at some time.

Another Option to Build In: A Flip Unitrust

For a variety of reasons, one of which may be that the amount of FAI generated each year is insufficient from what the beneficiary will desired and that a "standard" unitrust would have been preferred as payments would not be limited to FAI. Reg. 1.664-3(a)(1)(i)(c) permits the conversion of an income only unitrust to a standard unitrust (one that pays the unitrust amount each year regardless of the amount of FAI the trust receives). Once the conversion occurs, the beneficiary will receive the amount of the unitrust determined without regard to the amount of FAI. The conversion has to occur at a date certain which the regulations call a "triggering event," a single event whose occurrence is not discretionary with or within the control of the trustee or any other person. Regulations specifically provide that the sale of unmarketable assets,[52] or the marriage, divorce, death, or birth of a child with respect to any individual may be such a triggering event.

What About for EDBs?

Whether a CRT is suitable for an EDB depends on facts and circumstances. For the surviving spouse of the participant or IRA owner, it likely is best to name the spouse or a conduit trust for the spouse as the beneficiary on account of the unique options the spouse has such as rolling the plan or IRA into his or her own IRA (or adding it to his or her employer's plan). That will permit RMDs to be taken over the recalculated life expectancy of the surviving spouse. Unless the survivor wants the proceeds never to be taxed (or to be taxed at a much later time), a CRT may not be the best choice. However, if a CRT is not used, the spouse (or conduit trust for the spouse) will have to take distributions over his or her recalculated life expectancy. The survivor may delay taking RMDs until the survivor reaches his or her required beginning date (RBD) but only if survivor is named as the "outright" beneficiary (and not through a conduit trust) and rolls the benefits owner to his or her own IRA (in which case the survivor may take RMDs under the Uniform Lifetime Table, which is a joint life table which is more favorable than the single life table which would be applicable to a conduit trust). If a conduit trust for the spouse is named as the beneficiary (or the spouse is named but does not rollover the funds to his or her own IRA), RMDs must commence no later than the later of

(1) the year of the participant's death or

(2) the year the participant would have reached age 72.

If the spouse is quite young, naming the spouse as the outright beneficiary and having him or her rollover the proceeds to his or her own IRA may be the best move (having the spouse delay payments until his or her RBD) rather than paying the proceeds to a CRT. The survivor will get the benefit of a long stretch where the entire plan or account can continue to grow tax-free. This seems especially beneficial for a Roth IRA as the survivor can delay taking any distributions during the balance of his or her lifetime, greatly benefitting from long term tax-free (not just tax-deferred) compounding.

A minor child of the participant or owner does not have the same flexibility as does the surviving spouse. The minor need not take distributions out under the ten-year regime but can wait until he or

she reaches majority[53] when the ten-year payout rule will commence. During minority, however, it seems the minor does need to take RMDs based on his or her (long) life expectancy (account balance divided by life expectancy). Once he or she reaches majority and the ten-year rule kicks in, the minor can wait until the end of the tenth calendar year following the year of majority. This treatment of minor children of the participant or owner is complicated.

Some might feel a CRT for the life of the minor is best, but as explained above, a CRUT cannot be created for the life of anyone under the age of 25 and, as also explained, usually a CRUT is better than a CRAT (which could be created for a minor if the Section 7520 rate is high enough, something very difficult to forecast very far into the future). If the plan participant or owner does not want the child to receive much of the proceeds early in life, there is little, it seems, that can be done if the participant or owner want to use the special treatment for a minor who is an EDB. Although, a conduit trust for the minor could be used once he or she reaches majority, the entire amount in the plan or account will have to be taken by the trust within the ten year period after majority is reached and then immediately distributed outright to the former minor. While not absolutely certain, it does not seem that an accumulation trust may be created for a minor of the participant or owner and have the minor treated as an EDB so payment during his or her lifetime can be made under the RMD rules until he or she reaches majority when the ten year rule must be used.

One possible option is to have the conduit trust be a grantor trust as to the minor by granting him or her a unilateral right described in Section 678 to withdraw everything in the trust for a time and then having it be withdrawable only with the consent of a non-adverse party, such as the trustee.[54] This would be similar to a so-called “Crummey Trust” with a so-called “hanging power.”[55] Even assuming such a trust may be used, it may be subject to the claims of creditors in some jurisdictions and presumably the trustee would at least distribute to the minor (or former minor) an amount equal to the income tax he or she will owe on the income attributed to him or her under the grantor trust rules.

For an EDB, who is not the spouse of the participant or owner, and not more than ten years younger than him or her (such as a sibling or significant other whom the participant or owner does not marry), unrecalculated life expectancy can be used. A conduit trust can be used but probably not an accumulation trust. Depending upon the age, health and financial needs of the beneficiary, a charitable remainder trust may be considered (at least for part of the proceeds of the plan or IRA).

It seems virtually certain that an accumulation trust may be used for a beneficiary who is chronically ill or disabled if the person is the only one to whom the trustee may make distributions during his or her lifetime. This should provide maximum asset protection for the beneficiary including entitlement to government benefits (for which such a beneficiary may well be entitled). Although the trustee will be required to take RMDs based upon the beneficiary's unrecalculated life expectancy, the accumulation trust may be drafted so no distributions are required to be made from the trust to the beneficiary. Of course, that will mean the RMDs will be subject to tax at the highest rate of income taxation (which for a trust occurs when the trust has nearly $13,000 of income). A CRT might be considered for such a beneficiary as payment of plan or IRA proceeds received by the trust would not be subject, upon their

receipt by the trust to any income tax. It could be created for a class so distributions would not be required to be made to that beneficiary, but could be made to others (such as a sibling of the beneficiary) who could apply the CRT distributions to benefit the disabled or chronically ill person. Or, as mentioned above, a NIMCRUT could be created for him or her and managed to produce little if any FAI until a need for a trust distribution is appropriate keeping in mind that the receipt of too much property may disqualify the beneficiary from certain government benefits such as Medicaid which may be critical for him or her.

Conclusion

Interests in plans and IRAs often are the most complicated assets with which to deal in an estate plan. They may be subject to both estate tax and to income tax. It seems that little lifetime planning can be done with such plans or accounts during lifetime to reduce estate tax on them. Except for Roth IRAs, distributions from a plan or IRA (both before and after death) almost always will be subject to income tax as ordinary income. Because deferring income tax is a powerful income tax planning tool, individuals often sought to have payments from plans and IRAs stretch over as long as period as possible. The SECURE Act has significantly reduced that ability by generally requiring that all plan or IRA interests be distributed by the end of the tenth calendar year following the death of the plan participant or IRA owner. In order to delay the taxation of distributions, some individuals may wish to consider paying the plan or IRA to a charitable remainder trust where distributions can be paid over a 20-year period or, in some cases, for the life or lives of individual beneficiaries. In some case, the beneficiaries will succeed to more wealth over time with a CRT than if one were not used. A careful analysis of the CRT option should be undertaken for some taxpayers. In doing that, we think the following generalities should be considered:

- The next best thing to income avoidance is income tax deferral which is why individuals contribute to qualified (retirement) plans and IRAs.
- The principal benefit to the non-charitable beneficiaries of a CRT is the trust's exemption from income taxation.
- This benefit will occur whenever the CRT has tax income greater than the amount payable each year.
- This benefit essentially is the renting for the individual beneficiaries of the CRT of the trust's exemption from income taxation.
- Individuals wish to pay the lowest rent possible when renting and, with a CRT, that rent is the minimum allowed value of the remainder (10%).
- Because property tends to increase in value over an extended period of time, a CRUT almost always will be superior to a CRAT and a carefully administered NIMCRUT may be best of all.

[1] Portions of this article are derived from Blattmachr, "Using Charitable Remainder Trusts as Asset Management, Estate Planning and Private Retirement Plansm Tools," The Chase Review (July 1989). The authors greatly thank Natalie B. Choate, Esq., probably the leading expert on estate planning for retirement plans, Professor F. Ladson Boyle, and Lawrence Macklin for reviewing a draft of this article. However, any errors contain in the article are to be attributed solely to the authors.

[2] *See* https://www.pionline.com/article/20180621/INTERACTIVE/180629958/u-s-retirement-assets-at-28-trillion-in-q1-little-changed-from-end-of-2017

[3] *See*, generally, Choate, Lifetime and Testamentary Planning for Retirement Plans, 8th Ed. (Tax Plan 2017), available at Ataxplan Publications c/o Nutter McClennen & Fish LLP 155 Seaport Blvd. Boston MA 02210-2604, (617) 439-2995, nataliechoate@cs.com.

[4] The importance of this phenomenon is highlighted in Glickman & Blattmachr, "High Returns and Tax -Free Compounding: Important Goals in Building Wealth," 43 Estate Planning 11 (May 2016).

[5] Although someone of a particular age has a fixed (definite) life expectancy (or a specified time when such a person is expected to die), the longer the person lives, the later the age at which he or she is expected to die. Recalculation means that the individual's life expectancy is extended for each additional year he or she lives. Essentially, this allows the plan participant or IRA owner to continue to receive payments from the plan or account without the imposition of tax under Section 4974, regardless as to what age he or she lives.

[6] The SECURE Act is part of the Further Consolidated Appropriations Act, 2020 (P.L. 116-94, 12/20/2019), which was signed into law by the President on 12/20/2019. The SECURE Act significantly modifies many requirements for employer-provided retirement plans, IRAs, and other tax-favored savings accounts.

[7] For the surviving spouse of the participant or owner, distributions could be taken over the spouse's recalculated life expectancy in some cases.

[8] *See* Choate, supra, for a thorough discussion of this topic.

[9] *See* Section 408A.

[10] In many other states, it is 16%.

[11] The result could be worse after 2025 when the deduction limitation under Section 68 is restored.

[12] Section 414(p).

[13] Cf. Horwitz & Damicone, "A Decent Proposal," 150 Tr. & Est. 46 (November 2011) with CCA 201343021 (“PLRs 20117042 and 201129045 appear to conflict with Rev. Rul. 85-13. PLRs 20117042 and 201129045 were issued by IRS Employee Plans, and *state that an individual retirement account (IRA) cannot be transferred to a grantor trust of the IRA owner.* The conflict between these rulings and Rev. Rul. 85-13 was noted in Beers, Deborah M., 'IRS Issues Two Seemingly Contradictory Rulings on Effects of Transfer of IRA to Special Needs “Grantor” Trust', 36 Tax Mgmt. Est. & Tr. J 230 (2011) and Jones, Michael J., 'The Economy and other Retirement Mysteries', Trusts & Estates, January 2012, at 35. Both articles mention prior PLRs issued by the same office appearing to accept that the owner of a grantor trust is the owner of its assets, which may include an IRA. See PLRs 200620025, 200826008, and 201116005.” Emphasis added.)

[14] These concepts are explained in detail in Glickman & Blattmachr, supra.

[15] Under the five-year regime, the payout period could be somewhat longer than five years as the account must be fully distributed, to avoid the tax under Section 4974, by the end of the fifth calendar year following the year of death.

[16] The highest income tax rate is 37%. The net investment income tax imposed by Section 1411 does not apply to plan or IRA proceeds. See Section 1411(c)(5). This avoidance of the NIIT for plans and IRAs applies if and when the proceeds are payable to a trust and then treated as distributed to a beneficiary of the trust, including a charitable remainder trust. *See* Blattmachr and Boyle**,** Income Taxation of Estates and Trusts (PLI 2019), at section 4:7.3

[17] It, perhaps, is even more obvious that the longer assets are held in a Roth IRA (described in Section 408A) the better, as they not only grow income tax-free but are not included in gross income, in most cases.

[18] For a further discussion of CRATs and CRUTs, including their governing instruments, see Fox, A Guide to the IRS Sample Charitable Remainder Trust Forms, 33 Estate Planning 01 (Jan. 2006).

[19] Adjustments are required for any “short” year and the percentage payout for either a CRAT or a CRUT may not vary from year-to-year.

[20] If the governing instrument does not provide for the make-up of the short fall, the trust is typically called a “net income charitable remainder unitrust” or a “NICRUT.”

[21] Section 664(d)(1)(D) and (d)(2)(D).

[22] Rev. Rul. 77-374, 1977-2 CB 329.

[23] For a discussion of the 5% probability test, see Fox & Blattmachr, "IRS Provides Guidance to Avoid 5% Probability Test for Charitable Remainder Annuity Trusts", 94 Journal of Taxation 246 (June 2017).

[24] Treas. Reg. section 1.664-4. In essence, that regulation requires that the charitable remainder (and the annuity or unitrust interest or interests that precede it) must be determined using the rate in effect under Section 7520. (Section 7520(a) provides that if an income, estate, or gift tax charitable contribution deduction is allowable for any part of the property transferred, the taxpayer may elect to use such Federal midterm rate for either of the 2 months preceding the month in which the valuation date falls.) The Section 7520 rate is equal to 120% of the applicable federal midterm rate (determined under Section 1274) rounded to the nearest even two-tenths of one percent. Since the Section 7520 rate has been in effect (beginning in May 1989), it has reached a high of 11.6% and a low of 1.0%. http://www.leimberg.com/software/7520rate.

[25] This is explained in detail in Blattmachr & Hastings, "Valuing Certain Split Interests," 123 Trusts & Estates 27 (June 1983).

[26] Rev. Rul. 77-374, supra.

[27] *See* https://www.macrotrends.net/2526/sp-500-historical-annual-returns.

[28] A CRT is subject to a 100% excise tax on any unrelated business taxable income attributed to it. Section 664(c)(2). It seems this income will form the pool of taxable income that may be taxed to the trust's annuitant or unitrust recipient which may cause the UBIT to be subject to overall taxation of more than one hundred percent (100%).

[29] Just Google it. And note that the trillions of dollars that are in qualified retirement plans and individual retirement accounts (IRAs) got there based upon that assumption. *See*, also, Glickman & Blattmachr, supra.

[30] *See*, *e.g.*, Sections 1033 and 1244.

[31] However, a CRT is liable for 100% excise tax on any unrelated business taxable income it has. See Section 664(c)(2).

[32] At least in some circumstances, gain experienced by a CRT will be attributed to the trust's grantor. *See* discussion in Blattmachr & Hastings, "Charitable Remainder Trusts," The Chase Review (October 1988).

[33] In valuing the interests in a CRT, the taxpayer may use the Section 7520 rate in effect when created (which will be the date of death for one created at death) or either of the two preceding months. Section 7520(a). Hence, for an individual who is known with medical certainty that he or

she will die within the next two months, he or she can be morally certain of what type of CRAT will qualify. Also, a formula may be used. See the CRT forms available at InterActive Legal.

[34] The creditworthiness of the buyer must be considered although sometimes an escrow may help eliminate that concerns. And *see* Sections 453, 453A and 453B.

[35] Even if the trust purchases a bond that pays each year interest equal to the Section 7520 rate used to value interests in the trust for tax purposes, the value of the bond will change over time and that will affect the unitrust payments in future years.

[36] "According to Fidelity, a $100,000 deferred income annuity today that is purchased by someone at age 60 would generate $671.81 a month ($8,061.72 a year) in income for a woman and $696.89 a month ($8,362.68 a year) in income for a man," available at https://money.usnews.com/money/blogs/the-best-life/2013/07/09/when-to-convert-your-savings-into-an-annuity. For a $1 million payment, that would be $83,627 a year not $50,000. Charity might be better off as well—for example, giving $100,000 to charity now and using $900,000 for the annuity which based upon the same assumptions would produce an annual payment of $75,264 each year.

[37] There may be an income tax advantage to a commercial annuity compared to a CRAT. All ordinary income is first treated as coming out of the CRAT, then long term gain, then tax free return of basis. With a commercial annuity, the payments will be deemed to consist proportionately of ordinary income (interest), gain, and corpus until original basis is exhausted.

[38] For example, if the $1 million is sold, leaving $760,000 and $100,000 is given to charity, a commercial annuity purchased with the remaining $900,000 for the 60 year old male would be about $55,000 a year, more than the $50,000 sought annually from the CRAT.

[39] See https://www.macrotrends.net/2526/sp-500-historical-annual-returns.

[40] https://www.investopedia.com/ask/answers/042415/what-average-annual-return-sp-500.asp

[41] Although an income only CRUT need not provide for the make-up payments for years when FAI exceeds the unitrust payment for the year (such a trust is commonly called a "net income charitable remainder trust" or "NICRUT"), there seems to be little downside in using the NIMCRUT design. However, it the taxpayer wants insure no "leaking" out of the trust for the long haul, the NICRUT may be best. The taxpayer may be waiting to convert (or flip) the income only trust to a regular CRUT until a later time.

[42] Reg. 1.664- 3(a)(1)(i)(b)(3).

[43] Id.

[44] Id., and Google "taxation of partners."

[45] There is a further limitation: Money is not received in partial liquidation, and it may be taken into account as a partial liquidation only to the extent that it does not exceed the amount of income tax that a trustee or beneficiary must pay on taxable income of the entity that distributes the money.

[46] As mentioned above, the trust will have to pay a 100% excise tax on any UBIT it must report. See Section 664(c)(2).

[47] "In 1977, when the state of Wyoming first passed legislation allowing a new type of company called a Limited Liability Company (LLC), hardly anyone noticed. Today, over two-thirds of all new companies formed are LLCs." Search "How long have LLC been around?" at www.quora.com.What-was-the-first-known-Limited-Company.

[48] Section 4941 imposes an excise tax on what it describes of acts of self-dealing.

[49] See Treasury Decision 8791.

[50] The IRS has ruled (privately) that plan proceeds may be made payable to a CRT. PLR 199901023 (not precedent) and PLR 9634019 (not precedent); and see PLR 9919039 (not precedent).

[51] A related or subordinate person is defined in Section 672(c).

[52] A related or subordinate person is defined in Section 672(c).

[53] There is some uncertainty what majority means. It may be the age under the minor's domicile that determines it (which in almost all but not all states is 18) or, for some, when the child completes a "specified course of education" within the meaning of Section 409(a)(9)(F).

[54] Cf. PLR 200949012 (not precedent).

[55] These concepts are discussed in detail in Blattmachr & Graham, "The Extra Crummey Trust SM: Maybe the Best Annual Exclusion Vehicle Around," 22 Probate & Property, No. 4, (July/August 2008).

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BUILDING TRUST SOLUTIONS TO WITHSTAND SCRUTINY & ATTACK

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Summary

Building an estate plan, or even a single trust that is a portion of a larger plan is very much like a large construction project. It involves detailed discussion in advance regarding goals the client is hoping to accomplish, and exploring options that a client many not is available or that a client has not considered in advance. Once the engineering and design is complete, the plan has be to be constructed or drafted; and then it must be finalized and executed by the client. But even after the plan is complete, it now has to stand the test of time and function in order to accomplish the intended goals during the trust administration. Despite the best of planning, drafting, executing and administering, estate plans and trusts in particular will likely be challenged in a variety of ways. The true test of whether the plan has accomplished the client's goals is how that plan performs and survives in the face challenge. The ability of the plan to survive a challenge in the face of scrutiny of others is often dependent on not only inclusion of tools contained in the plan, but also knowledge of new and developing tools that might be useful.

Disclaimer - The ideas set forth in these materials are for use in continuing education programing for participating professionals to facilitate discussion and consideration in using Nevada law in estate planning matters; but are not intended to provide legal advice to any person nor to create an attorney/client relationship between the authors/presenters. Planning professionals must consider the individual client circumstances and ascertain application to their own practices and clients; and make their own conclusions in advising their respective clients.

ESTATE PLANNING PROCESS

- Initial consultations and review
- Evaluation of planning options
- Evaluation of planning costs
- Selection of planning instrument(s) and design
- Drafting of planning instruments
- Execution of planning instruments
- Funding of plan
- Administration of plan

…Now, can it withstand long term scrutiny?

SOURCES OF SCRUTINY/ATTACK

- Tax Authorities (IRS, State, Local, Foreign)
- Creditors
- Beneficiaries/Heirs
- Courts

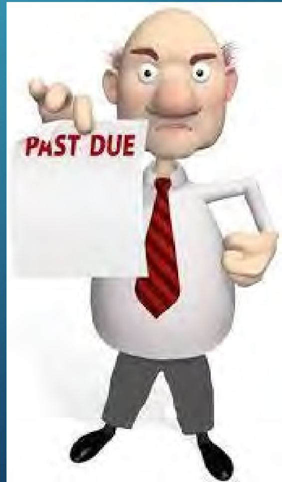
TAXING AUTHORITIES

- Understand Sources of Tax Scrutiny
  - IRS - Income, Estate, Gift, GST Taxes
  - Foreign Jurisdictions
  - State - Income, Estate, Gift, GST, Property, Business Licenses, & Transfer Taxes
  - Local – Business licenses
- Understand Period of Scrutiny (Audit Period/Statute of Limitations)
  - Calculated from date of filing return
  - Amending returns extends time to audit
  - Clawback Periods - Can it be reopened for inadequacy of return; fraud; changes in circumstances; changes in law
  - Failure to file returns
- Understand Impact of Trust Administration Actions
  - Grantor exercising powers or control/retained interest (real or perceived) – IRC 2036/2038
  - Distributions
  - Decanting; Reformations; Relocating to New Situs; Altering Applicable Law

CREDITORS

COME IN MANY FORMS, AND SOMETIMES IN ENTIRELY UNEXPECTED FORMS SUCH AS:

- Divorcing spouse/claims of support & alimony
- Child support
- Employees
- Medicaid/Government Benefit Programs
- Traditional creditors (credit cards; bills; mortgages; secured & unsecured)
- Personal guaranty issues (grantor/beneficiary guarantying obligations of others)
- Personal injury issues (wrongful death actions, injures caused to others by grantor/decedent)
- Business debts & obligations (capital calls and contractual obligations)
- Business creditors who attack limited liability veil to get through to the trust/grantor
- Taxing Authorities (for past due taxes)
- Bankruptcy Trustee



BENEFICIARIES & HEIRS
CONTESTS, LITIGATION, OR DISSATISFACTION

- Challenges by existing beneficiaries to plan/amendments/ and actions for breach of fiduciary duties
- Dissatisfaction of terms or provisions that are not working well
- Challenges by heirs or individuals who are not beneficiaries but think they should be
- Challenges by disinherited individuals or individuals who were in prior versions of the plan that have since been removed
- Remote/Contingent/Unborn

COURTS

WHILE MANY OF THE ABOVE SOURCES CAN TRIGGER COURT PROCEEDINGS, COURTS ON THEIR OWN CAN ALSO TRIGGER SCRUTINY NOT OTHERWISE ANTICIPATED

- Probate Court - Probate Judges/Commissioners may, even in uncontested and non-adversarial matters find problems with validity or interpret laws in a manner not anticipated.
- Federal/Bankruptcy Court – May have rights to unwind or even disregard certain planning *sua sponte*. *Magliarditi v. Transfirst Grp,* 450 P.3d 911 (Nev. 2019)
- Family Court - May have broad jurisdiction if grantor/beneficiaries are subject to divorce or guardianships. See *Klabacka* v. *Nelson, 390 P.3d 940 (Nev. 2017)*

THE TERMS OF THE TRUST INSTRUMENT ITSELF

SOMETIMES IT'S THE TRUST ITSELF THAT IS A PROBLEM

- Inflexibility.
- Forced distributions at an unfortunate time.
- Unfriendly changes to applicable law governing trust.
- Changes to status of beneficiaries or problems with beneficiaries.
- Changes to tax exemptions; old formula provisions that no longer work as intended.
- Mistakes/Scribner's Errors/ Substantive Errors.

SURVIVING THE TIGHTROPE WALK

PLANNING & EXECUTION

- *Plan like you will be audited and your file will be discoverable.*
- *Decide who is involved on the planning team?* Does attorney client privilege apply to all? Do you need to consider "joint" engagements and "Covell Letters". Do you have conflict waivers in place; Do you need separate counsel?
- *Optics Matter.* Step-transactions/bad optics are not a concern of the past. They still matter. See *Smaldino* v. *Commissioner, 2021 TC Memo 127 (Tax Court, 2021).*
- *Formalities Matter.* Don't forget the simplest of things like execution formalities (notary, declarations, witness qualifications; location of execution). Do you need transmutation agreement? Separate counsel? See *Smaldino* v. *Commissioner, 2021 TC Memo 127 (Tax Court, 2021); See Klabacka* v. *Nelson, 390 P.3d 940 (Nev. 2017)*
- *Caution With Electronic Trusts/Signatures.* Nevada recognizes e-Wills and e-trusts. But the rules are very specific. Electronic signature acts are NOT the same as electronic will/trust laws. Know the difference.
- Incapacity Concerns/Elder Abuse/Undue Influence. Growth area for litigators and growing; baby-boomer class is vulnerable; and these vulnerabilities can destroy even the best of plans.

DRAFTING SOLUTIONS AT INCEPTION

- Statements of Grantor Intent – NV provides broad flexibility & freedom of disposition (NRS 163.004). Grantors can revise investment standards; alter standards of care; release trustees (NRS 163.160).
- "Designated Representative"/Confidential Accountings – Grantor may alter/limit disclosure requirements and draft "silent trusts). NRS 163.004; 165.145. But Trustees can also use designated persons for accounting to run statute of limitations.
- Discretionary Powers - Draft with a mind toward flexibility and discretion; rather than mandates. Helps limit creditors rights under spendthrift trust provisions (NRS Chapter 163/166). Limit access to accountings (NRS 165.1207(1)(b)(5)). Allow Trustee to merge trusts/divide trusts/decant.
- Independent Trustees/Directed Trust Provisions - Independent Trustee need not be limited by ascertainable standard. Bifurcate duties among Trustees. (NRS 163.419, NRS 163.553-163.556)
- Law/Situs - Pay attention of change of law/situs/place of administration and jurisdiction provisions to make it easy to move if necessary.
- Doctrine of Virtual Representation. Draft with a current beneficiary who can represent subsequent classes under Doctrine of Virtual Representation. (NRS 164.038)
- Savings Clauses. Include savings clauses to prevent inadvertent failures (Request Trustee replacement if Trustee no longer qualified or causes a jurisdiction issues; Independent Trustee for certain distributions; Grantor vs. Non Grantor Trust limitations.)
- Dynastic/Perpetual Provisions. Include broad flexibility and trust protector powers.
- Trust Protectors/Power of Appointment. Include powers that add flexibility. NRS 163.5553

TAKE ADVANTAGE OF NV LAW
STATUTORY PROTECTIONS FOR GRANTORS & TRUSTEES

- Declaratory Relief Validating Plan - Grantors may seek Declaratory Relief that the plan is valid which is an underused tool. NRS 30.040(2); NRS 164.010-.015.
- Notice to Creditors. NRS 164.024 (90 Day claim period)
- Time to Contest – Often statutorily will be based on disclosure of terms of trust. No notice, no running of time to contest. See NRS 164.021 (180 Day Contest Period)
- Time to Object to Accounting – NRS 165.1214(4)(a) (90 days) Often statutory time to object is based on an accounting; and in ability to account will limit the release of the Trustee or keep the accounting period open
- Time to Object to Fiduciary Action – Notice of Proposed Action (30 days to object). NRS Often statutory time to object to a Trustee's actions is based on receipt of notice of the act, which time never runs if no notice.
- Waivers/Consents. Trustees can obtain a broad array of releases/waivers of obligations. Waiver of Accounting (including waiver of form of accounting) NRS 165.121; Consents to Acts of Self Dealing NRS 163.030; Release of Liability by Beneficiaries NRS 163.170; Release by Court (NRS 163.180).

EVALUATING TRUST WHEN ITS NOT WORKING

- What flexibility tools exist in the Trust Agreement to address problem?
- Consider outside review for new ideas.
- Is applicable law still appropriate?
- Remember that irrevocable does not mean “irrevocable”.
- Consider possible options outside of trust.

HOW DO I MOVE THE TRUST SITUS

- Clients are mobile; so to are trusts.
- Nevada is a "welcoming" state with broad authority for Court to accept jurisdiction. NRS 164.010(2) – Nevada Courts can assume jurisdiction over a wide array of trusts based on (1) Trustee's domicile; (2) Trust terms declare NV as situs; (3) Trust statues NV Court can assume jurisdiction; (4) real property in NV; (5) personal property in NV where Trustee is doing business; (6) one beneficiary resides in NV; **or** (7) part of administration occurs in NV.
- Review Situs/Law Provisions under Trust. More modern trusts often have flexibility to allow trustee or trust protector to relocate the trust; older trusts may be more rigid and require some extra steps to be able to move it (including need to seek court authority in original state or possibly in NV).
- Name a NV Trustee - If its possible to name a NV Trustee under the instrument or applicable law, that may be sufficient to allow you to relocate the Trust situs/administration. But not always. Be sure to evaluate if this is permitted. Some trusts still restrict situs/administration to a specific jurisdiction regardless of domicile of Trustee.

CHANGING APPLICABLE LAW

- Changing law may be possible under agreement; but is not always advisable or necessary. Review these changes and confirm change will be positive without creating other consequences.
- Caution to retain RAP on irrevocable trusts/GST exempt status issues.
- Caution to understand spendthrift provisions and impact on change.
- Caution to understand impact of changes to identity of “heirs” or beneficiaries.

EFFECTUATING CHANGE BY DECANTING, REFORMATION, MERGER, EXERCISE POWERS OF APPOINTMENT.

- Evaluate the existing documents for what tools already exist in the document.
- Exercise Powers of Appointment or Trust Protector powers that may exist under Trust.
- Decant - NRS 163.556.
- Merge/Divide - NRS 163.025.
- Reform Trust through Non-Judicial Settlement - NRS 164.940-942.
- Reform Trust through Judicial Proceeding (Petition for Instructions NRS 164.010; NRS 164.015: NRS 164.033; NRS 153.030)
- Review Possible Waivers/Release of Liability by Beneficiaries/Court

NEVADA'S DECANTING STATUTE – NRS 163.556

- Builds on common law decanting powers of a trustee; and codifies requirements for a statutory decanting. It's very similar to a power of appointment that might be given to a trust protector or other holder of a power of appointment.
- Its Applicable UNLESS Trust Agreement prohibits. Trust Agreement can alter the application.
- To use:
  - Trust must be irrevocable (and Trust must be governed by, sitused in **or** administered under the laws of NV (whether originally or moved here),
  - Trustee must be granted discretion or authority to distribution trust income or principal
  - Appoint to a second trust (which can be a modified version of current trust; or an entirely new trust; or an other existing trust that may have been created by trustee or someone else)
  - Limitations on acting contrary to marital/charitable deduction
  - Limitations on decanting by a Trustee who is a beneficiary
  - Limitation on adding new beneficiaries
- Popular uses:
  - Granting new powers of appointment to beneficiaries or other holders that can expand a beneficial class
  - Elimination of HEMS (ascertainable standard) limitations
  - Adding indemnities/releases
  - Expanding/retracting discretion
  - Notice not required (discussed in more detail below)
- Risks:
  - IRS claims it will not issue PLR on decanting (but it has; in many cases there are PLRs that involve reformations/modifications that appear to have been done through a decanting process)
  - GST issues - Caution with implications on GST Exempt (both grandfathered and exempt gst trusts). May violate issues with RAP; and expand class.
  - Grantor Trust vs. Non Grantor Trust issues - There are some academic articles that raise questions about whether overly broad decanting statutes could be interpreted by IRS to convert Non-Grantor Trusts to Grantor Trusts.

EXERCISING POWERS OF APPOINTMENT UNDER NEVADA LAW

- Nevada has adopted the Uniform Powers of Appointment Act (NRS Chapter 162B)
- Exercise of a Power of Appointment is a NON-FIDUCIARY ACT (unless trust says otherwise. "Power to Appoint or Disappoint". (NRS 165.149)
- No notice is required to excise (discussed further below)
- Caution in exercising as required in instrument (i.e., notarized signature, delivery of exercise, time limitations in instrument, effective power)
- Testamentary power that has been exercised is <u>not</u> effective until death of power holder and any other requirements (i.e., validation of will if applicable)

MERGER/DIVISION UNDER NRS 163.025

- Merger of two substantially similar trusts
- Relocation of a trust in another location can be accomplished by merger of a trust in NV with a trust elsewhere, as long as the "substantially similar" standard is applicable.
- Not as flexible as decanting; but may be useful to overcome initial challenges or for minimal modification issues.
- Caution if merger alters trust duration/RAP/beneficial terms

NON-JUDICIAL SETTLEMENT (NJSA) TO EFFECTUATE REFORMATION OR CHANGE - NRS 164.940-942

- Changes in Trust terms/reformation can be accomplished by an agreement between all indispensable parties (usually means trustee and beneficiaries)
- Limitations/Additional Methods to Validate:
  - Is NV law applicable to the Trust or is administration subject to NV law? Many states do not recognize a NJSA and if NV law is not applicable substantively or administratively, it may not apply.
  - NJSA may not violate material purpose of trust.
  - NJSA may not agree to resolutions that a court would not be permitted to order *under the law governing the trust*. This indicates that if applicable governing court could not order the terms of NJSA, then it can't be used.
  - Requires all indispensable parties to be valid (but there is an "out" to this under NRS 164.942 for use of Doctrine of Virtual Representation and pursuant to a Notice of Proposed Action under NRS 164.725 discussed below.)
  - NJSA can be subsequently "ratified" or "confirmed" by a Court under a Petition for Instructions (See NRS 164.942(4) and NRS 164.010/164.015.
  - REMEMBER – NJSA may be evidence in tax disputes of the nature and extent of the agreement and party actions. Do not overlook the terms of settlement, and who is "consenting" or "a party". Should the Settlor be a party or is that an act of controlling dispositions?

NOTICE OF PROPOSED ACTION (NPA) – NRS 164.725 - A VERY POWERFUL TOOL

- NPA is grossly underused statutes that has significant benefits to a Trustee
- NPA can insulate Trustee from personal liability for the proposed action disclosed, even if a court later deems the action inappropriate.
- NPA is referenced in decanting (NRS 164.556) and NJSA (NRS 164.725) statutes as "optional"
- NPA can have effect of binding beneficiaries to a NJSA who do not object. NRS 164.942(3)
- NPA can be used to insulate Trustee as to a variety of fiduciary actions including (1) investment decisions; (2) exercise of discretion; (3) adjustments to principal and income under Uniform Principal & Income Act
- NPA applies to all advisors (trustee, investment trust advisors, distribution trust advisors, trust protectors.
- TO BE VALID AND EFFECTIVE: NOTICE MUST COMPLY WITH THE REQUIREMENT OF NRS 164.725 AND BE SUFFICIENT TO GIVE ADEQUATE INFORMATION FOR A RECIPIENT TO MAKE AN INFORMED DECISION.
- REMEMBER – NPA may be evidence in tax disputes of the nature and extent of the agreement and party actions. Do not overlook the terms of the NPA, and who is "consenting" for tax purposes vs. state law. Notice to a settlor of an event may be appropriate but should settlor affirmatively consent to the action or is that an act of control?

COURT REFORMATION – NRS 164.015, 164.030, & NRS 153.031

- Nevada Courts have broad powers of reformation
- Nevada Court can approve the reformation action itself; or ratify a NJSA that provides for reformation
- But be cautious - Reformation approved by court is not necessarily binding by taxing authorities for tax implications and may still trigger tax ramifications.

DOCTRINE OF VIRTUAL REPRESENTATION – NRS 164.038 DEFINING WHO RECEIVES "NOTICE"

- NRS 164.038 – "Unless otherwise represented by counsel, a minor, incapacitated person, unborn person or person whose identity or location is unknown and not reasonably ascertainable may be represented by another person who has a substantially similar interest with respect to the question or dispute."
  - LIMITATION: no material conflict of interest between the person and the representative
  - POWER HOLDERS: A powerholder may represent and bind a person who is a permissible appointee or taker in default of appointment.

BELTS & SUSPENDERS - COMBINING TOOLS FOR MORE PROTECTION

- Consider multiple tools if necessary to deal with relocation and effectuate the desired change.
- Example:
  - May need to first initiate use of one or more tools to get the trust to Nevada. (Could require appointment of Trustee; Court order in current jurisdiction; decanting under laws of current jurisdiction.)
  - Once in Nevada, may need a decanting by an independent trustee without a conflict if you are considering adding provisions that would create a conflict of interest (i.e., release of liability/releases of prudent investor rule/ indemnifications/distributions).
  - May want to use an NJSA to make sure all parties are in actual agreement; and further, an NPA to approve the action of trustee entering into the agreement/taking the action under the NJSA.
  - May want to have the above ratified by a Court/Appoint Guardian Ad Litem or address any overriding issues of concern.
  - PLR - State law approvals may not be sufficient to address IRS tax concerns. Be sure to consider use of PLRs where appropriate.

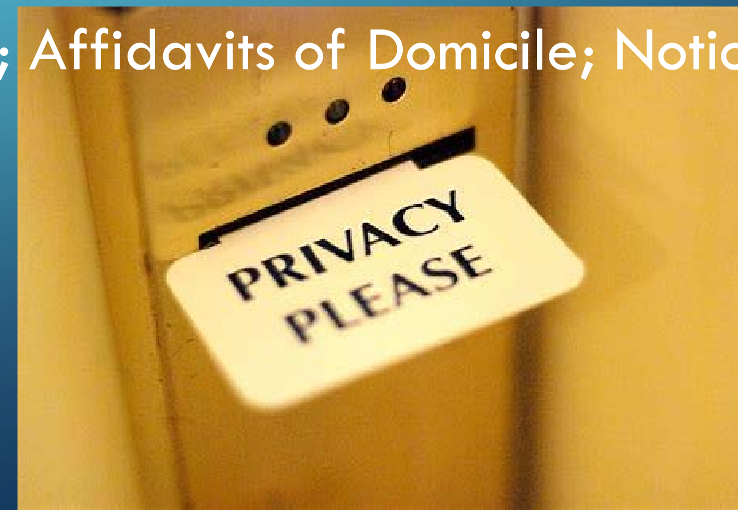
PREPARING FOR SCRUTINY BY TAXING AUTHORITIES

- File tax returns - no statutes of limitations run if there is no filing.
- File complete returns – gift tax return disclosures must be satisfied to trigger statute of limitations.
- Consider PLRs
- Engage in review of appraisers/appraisals
- Prepare clients and planning team for do's/don'ts
- Beware of rules of consistency
- Assume its all discoverable
- Confirm there are no pre-ordained agreements/avoid step transactions

ADD ON OPTIONS… SOME ADDITIONAL TOOLS IN NV TRUST LAW

ADDING PRIVACY, ASSET PROTECTION, & PROTECTIVE PROVISIONS

- Public Policy of Protecting Information - Identity theft and privacy concerns
- Sealing/Confidentiality of Court proceedings
- Submitting Trust to Jurisdiction of NV Court to confirm jurisdiction. *Princess Lida of Thurn & Taxis v. Thompson*, 305 U.S. 456, 59 S.Ct. 275 (1939)
- Recording Existing of Marital Agreements; Affidavits of Domicile; Notice of Funding of DAPTs



WE ARE PRACTICING IN A TIME WHEN . . .

NEVADA BANKERS ASSOCIATION

2022 NEVADA TRUST CONFERENCE

March 1 and 2, 2022

UPDATE ON NEVADA TRUST LAW, WHAT'S NEW

Recent Nevada Trust Related Case Law Developments

Recent Nevada Entity Statutory Law Developments

Beneficial Owner of Trusts Under Corporate Transparency Act Proposed Regulations

AML BSA Process Map

Nevada Trust Situs Standing Update

By:

ROBERT E. ARMSTRONG

MCDONALD CARANO LLP

Reno, Nevada

1. Recent Nevada Case Law Developments

Key Nevada Supreme Court decisions in the area of trusts and estates were:

***In the Matter of the Christian Family Trust U.A.D. 10/11/16*, 136 Nev. 637, 476 P.3d 861 (2020)**

Affirming a district court order allowing payment of a creditor's claim in a trust action. **Held:**

- Creditor may bring a claim against a settlor of a trust so long as the settlor's interest in the trust is not solely discretionary and there is not a spendthrift provision precluding payment of the claim.
- Where a trust provides broad discretion to its trustees, the trustees may approve a creditor's claim against the trust.

Addresses: NRS 132.390(1)(c)(8), NRS 163.5559(1), NRS 164.025(3), NRS 163.115(1)(i) and NRS 155.123

Opinion Date: December 3, 2020

Before Parraguirre, Hardesty and Cadish, JJ.

Author: Hardesty, J.

***In the Matter of the Estate of Ella E. Horst Revocable Trust, U/A/D 05/21/1991*, 478 P.3d 861478 P.3d 861 (2020)**

Reversing and remanding a district court order granting a petition to confirm a trust. **Held:**

- To trigger the 120-day limitation period under NRS 164.021(4), a trustee's notice must include "[a]ny provision of the trust instrument which pertains to the beneficiary."
- NRS 164.021(2)(c) requires strict compliance in order to further the Legislature's intent to give a beneficiary all the information necessary to decide whether to contest a trust.

Addresses: NRS 164.021

Opinion Date: December 31, 2020

Before Parraguirre, Hardesty and Cadish, JJ.

Author: Cadish, J.

***Guzman v. Johnson*, 137 Nev. Adv., Op. 13, 483 P.3d 531 (2021)**

Affirming order granting motion to dismiss for failure to state a claim. **Held:**

- A plaintiff cannot use the "inherent-fairness" (or "entire-fairness") standard to rebut the business-judgment rule and shift the burden of proof.
- To overcome Nevada's business-judgment rule, a plaintiff must not only rebut the presumption of good faith, but also show a breach of fiduciary duty involving intentional misconduct, fraud, or a knowing violation of the law.

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Addresses: NRS 78.138(3), NRS 78.138(7)

Opinion Date: March 25, 2021

Before the Court En Banc

Author: Silver, J.

2. **Recent Nevada Key Entity Statutory Law Developments**

The 2021 Nevada Legislature passed several laws of importance in the area of business entities that generally became effective **October 1, 2021**. OF principal importance is SB 95. The Legislative Counsel Bureau digest of SB 95 is set forth below and we have highlighted areas of particular importance to retail and family trust companies coupled with our selected comments bolded:

Existing law establishes various provisions relating to business entities, including private corporations and limited-liability companies. (Chapters 78 and 86 of NRS) This bill revises certain provisions relating to business entities and makes certain other changes generally relating to business entities.

Section 1 *removes the requirement that a clerk of the court mail to certain management persons of a business entity true and attested copies of the process served on the registered agent of the entity, and instead requires that the party serving the registered agent mail to such management persons a copy of any document served upon the registered agent.*

Section 4 *authorizes a corporation to include a federal forum selection clause in its articles of incorporation or bylaws under certain circumstances.*

Section 5 *expressly provides that the directors and officers of a corporation may consider one or more facts, circumstances, contingencies or constituencies when exercising their respective powers.*

This is a further enhancement to the statutory business judgment rule at NRS 78.138

Section 6 *revises the definition of "distribution," as it relates to distributions made by corporations, by delineating that the term applies to all holders of shares of any one or more classes or series of the capital stock of the corporation. Sections 9 and 10 of this bill make conforming changes related to distributions made by corporations.*

Section 11 *authorizes a meeting of stockholders to be held solely by means of remote communication unless otherwise prescribed by the board of directors. Section 11 also provides that, in addition to the stockholders, the corporation may permit certain other persons to attend the remote meeting. Moreover, section 11 provides that the corporation must implement measures to verify the identity of the permitted persons.*

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Section 12 *provides that the record date for a meeting of stockholders of the corporation: (1) must be fixed through a resolution adopted by the board of directors; and (2) must not precede the day on which the resolution is adopted by the board of directors, regardless of the effective date of the resolution.*

Section 12 *also provides that the date upon which the stockholders of record are entitled to give written consent for certain actions taken by the corporation must not precede the day on which the resolution fixing such a date is adopted by the board of directors, regardless of the effective date of the resolution.*

Section 13 *establishes provisions concerning the validity and enforceability of certain voting agreements; and revises provisions relating to the limitation on the duration of certain voting agreements.*

Section 14 *revises the form of notice for meetings of stockholders by requiring the notice to include the following information: (1) the date of the meeting; (2) if the meeting is to be held by means of remote communication, the form of the remote communication; and (3) if the meeting is not going to be held solely by means of remote communication, the physical location of the meeting.*

This amendment is typical of changes to corporate meetings spurred by COVID. Note the requirement of notice requirements for meetings conducted by remote communication.

Section 14 *additionally applies these changes to the form of notice required for adjourned meetings of stockholders.*

Section 14 *also revises provisions related to notice by publication; and establishes provisions authorizing certain publicly traded corporations to provide notice by proxy statement under certain circumstances.*

Section 14.5 *expressly provides that whenever a corporation is insolvent and in certain other circumstances, any creditors holding at least 10 percent of the outstanding indebtedness, or stockholders owning at least 10 percent of the outstanding stock entitled to vote, may petition a district court for a writ of injunction and the appointment of receivers or trustees.*

Section 15 *expands the circumstances by which a corporation may discretionally indemnify a person who is or was a party to an action, or threatened to be made a party to an action, by authorizing the corporation to indemnify any such person who is or was serving at the request of the corporation as a manager of a limited-liability company.*

Section 16 *provides exception for corporations that are associations or unit-owners' associations from the requirement that corporations issue a certificate of membership to any person who becomes a member of the corporation.*

Section 19 *defines the term "distribution" for the purposes of section 21 of this bill concerning noneconomic members of limited-liability*

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Section 38 *repeals the selectively applicable definitions of "publicly traded corporation," "Securities Exchange Act" and "voting shares," respectively, and replaces the definitions in section 2 of this bill in order to expand the applicability of such definitions to the entirety of chapter 78 of NRS. Sections 3, 7 and 8 of this bill make conforming changes related to the definition of the "Securities Exchange Act." Section 14.2 of this bill makes a conforming change related to the definition of "voting shares."*

3. Beneficial Owner of Trust Under Corporate Transparency Act Proposed Regulations

Many privately held corporations, limited-liability companies, and other business entities formed or registered to do business in any state of the United States will soon be required to disclose their beneficial ownership to the U.S. government. *This includes trusts.*

The new disclosure requirements, which are scheduled to become effective sometime within the next year, are contained in the Corporate Transparency Act (CTA), which was enacted into law on January 1, 2021, as part of the National Defense Authorization Act. Any business entity subject to the CTA (called a "reporting company" in the legislation) must report to the U.S. Department of the Treasury's Financial Crimes Enforcement Network (FinCEN) its beneficial owners. Such entities will also have a continuing obligation to file updates reporting any changes in such beneficial ownership. The new reporting requirements provide governmental agencies with additional information that may identify and combat illegal activities, including money laundering, terrorism financing, serious tax fraud and other financial crimes. However, the new reporting requirements are broad and will subject millions of businesses to beneficial ownership reporting obligations.

Here are key excerpts from the notice of proposed ruling making for **Beneficial Ownership Reporting Requirements Proposed Rule** by the Financial Crimes Enforcement Network (FinCEN) Docket Number: FINCEN-2021-0005 (https://www.regulations.gove/docket/FINCEN-2021-0005 at page 69935 of the Federal Register Vol 86, No.233, December 8, 2021 which will require registration of entities within 14 calendar days of the date on which a new entity was created or registered or within one year of the finalization of this regulation for previously formed entities:

In Section-By-Section Analysis

Proposed 31 CFR 1010.380(d)(3)(ii)(C) specifies that an individual may directly or indirectly own or control an ownership interest in a reporting company through a *trust or similar arrangement*. The proposed language aims to clarify that an individual may own or control ownership interests by way of the individual's position as a *grantor* or *settlor*, a *beneficiary*, a *trustee*, or *another individual with authority to dispose of trust assets*. In relation to trust beneficiaries in particular, FinCEN believes that it is appropriate to consider an individual as owning or controlling ownership interests held in trust *if the individual is the sole permissible recipient of both 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. Other individuals with authority to dispose of trust assets, such as trustees, will also be considered as controlling the ownership interests held in trust, as will grantors or*

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settlors that have retained the right to revoke the trust, or to otherwise withdraw the assets of the trust. FinCEN believes that these circumstances comport with the general understanding of ownership and control in the context of trusts and furthers the CTA's objective of identifying true beneficial owners regardless of formalities that may vary across different jurisdictions. However, FinCEN acknowledges that these concepts do not map easily onto every trust or similar arrangement. Accordingly, FinCEN is seeking comment on its general approach to the attribution of ownership interests held in trust to certain individuals, as well as the circumstances in which individuals may be considered to own or control ownerships interests held in trust. More broadly, FinCEN seeks comments on whether these and the other proposed examples of how one might own, or control ownership interests are clear and useful, and which, if any, require elaboration." **(Italic added)**

The CTA decided not to solely use the identity of the trustee for the ownership prong as FinCEN did in its Customer Due Diligence (CDD) Rule at 31 CFR 1010.230(d)(3). Here is the explanation for enlarging disclosure of trusts at 66936:

Many commenters urged FinCEN to adopt the CDD Rule approach to trusts. However, FinCEN has declined to follow the CDD Rule approach for a combination of reasons. First, as discussed above, the CTA does not require following the CDD Rule by default. The same statutory interpretation arguments that led FinCEN to believe that the CDD Rule is not an appropriate standard in connection with substantial control apply equally to the subject of ownership interests. Second, the CDD Rule does not provide transparency with respect to complex ownership structures, extensive use of trusts, voting arrangements among owners, golden shares entitling their owners to voting rights disproportionate to their equity stake, and other mechanisms that can obscure the connection between an individual owner and a reporting company. Therefore, it is not at all clear that the CDD Rule results in the identification of all individuals who should be identified as 25 percent owners. Instead, the CDD Rule standard could permit obfuscatory behavior. In connection with trusts, for example, FinCEN believes that requiring the reporting only of the trustee under the ownership interests component would promote the misuse of trusts to hide beneficial ownership interests and complicate the ability of reporting companies to comply with the CTA and the proposed rule. As with the definition of substantial control, FinCEN believes its proposed approach would provide law enforcement with a more accurate and complete picture of an entity's true ownership, regardless of formalities. Finally, FinCEN considered the burden this proposed approach would have on reporting companies. FinCEN is mindful of the effect of new regulations on small businesses, given their critical role in the U.S. economy and the special consideration that Congress and successive administrations have mandated that federal agencies should give to small business concerns. FinCEN expects that most reporting companies that are small businesses will have simple ownership structures with easily identifiable beneficial owners, thereby minimizing the potential burden on such entities. FinCEN's expectation is supported by a recent empirical analysis on the compliance burden that resulted from the creation of a beneficial ownership registry in the UK. In its post-implementation review of the PSC Register, the UK Government found that only 13% of companies had three or more beneficial owners.113 It also found that the mean overall cost of compliance for small and micro businesses (defined as businesses with less than 50 employees) to file an initial report and provide required updates was £265 (approximately $358 at current exchange rates).114 Notably, the UK's beneficial owner database is public and the UK requires businesses to provide considerably more information about

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each beneficial owner. This suggests that the reporting burden of FinCEN's approach may be materially less than the burden of compliance borne by small businesses and other reporting companies in the UK since the establishment of the PSC Register. FinCEN seeks comments on these considerations, particularly regarding its assessment of the effect on small businesses based on the assessment of the UK's implementation of its register. FinCEN further welcomes specific data on this topic. Entities for which relative burden may be higher are likely very small entities with complex structures. As noted above, FinCEN believes that most reporting companies will not have complex ownership structures, and that the few that do previously chose their structures recognizing that costs associated with legal and tax advice and other filing and compliance obligations might be higher as a result. Moreover, in FinCEN's experience administering the BSA and other AML efforts, small-but complex entities often are the highest risk for money laundering, terrorist financing, and other illicit financial activity. Indeed, both the CTA's statutory text and legislative history indicate that Congress was concerned with ensuring effective BOI reporting for these entities. Thus, in FinCEN's experience, such a reporting burden is justified because these are the entities most at risk for abuse of the corporate form and, therefore, an additional compliance burden is necessary to make the BOI database ''highly useful to law enforcement'' under the statute.

Regulatory Section Addressing Trusts

Here is the proposed regulation Proposed 31 CFR 1010.380(d)(3)(ii)(C) addressing trusts at page 66973:

"(C) With regard to a trust or similar arrangement that holds such ownership interest: (1) As a trustee of the trust or other individual (if any) with the authority to dispose of trust assets; (2) As a beneficiary who: (i) Is the sole permissible recipient of income and principal from the trust; or (ii) Has the right to demand a distribution of or withdraw substantially all of the assets from the trust; or (3) As a grantor or settlor who has the right to revoke the trust or otherwise withdraw the assets of the trust: (i) Through ownership or control of one or more intermediary entities, or ownership or control of the ownership interests of any such entities, that separately or collectively own or control ownership interests of the reporting company; or (ii) Through any other contract, arrangement, understanding, or relationship; (iii) In determining whether an individual owns or controls 25 percent of the ownership interests of a reporting company, the ownership interests of the reporting company shall include all ownership interests of any class or type, and the percentage of such ownership interests that an individual owns or controls shall be determined by aggregating all of the individual's ownership interests in comparison to the undiluted ownership interests of the company….

" (4) Exceptions. Notwithstanding any other provision of paragraph (d) of this section, the term ''beneficial owner'' does not include: (i) A minor child, as defined under the law of the State or Indian tribe in which a domestic reporting company is created or a foreign reporting company is first registered, provided the reporting company reports the required information of a parent or legal guardian of the minor child as specified in paragraph (b)(3)(ii) of this section; (ii) An individual acting as a nominee, intermediary, custodian, or agent on behalf of another individual; (iii) An employee of a reporting company, acting solely as an employee and not as a senior officer, whose substantial control over or economic benefits from such entity are derived solely from the

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employment status of the employee; (iv) An individual whose only interest in a reporting company is a future interest through a right of inheritance; (v) A creditor of a reporting company. For purposes of this paragraph (d)(4)(v), a creditor is an individual who would be a beneficial owner under the other provisions of paragraph (d) of this section solely through rights or interests in the company for the payment of a predetermined sum of money, such as a debt and the payment of interest on such debt. For the avoidance of doubt, any capital interest in the reporting company, or any right or interest in the value of the reporting company or its profits, are not such rights or interests for payment of a predetermined sum, regardless of whether they take the form of a debt instrument. If the individual has a right or ability to convert the right to payment of a predetermined sum to any form of ownership interest in the company, that individual is not a creditor of a reporting company for purposes of this section."

Sanction for Reporting Violations

"The provision at 31 U.S.C. 5336(h)(1) makes it unlawful for any person to ''willfully provide, or attempt to provide, false or fraudulent beneficial ownership information . . . to FinCEN'' or to ''willfully fail to report complete or updated beneficial ownership information to FinCEN.'' The CTA further provides for civil and criminal penalties for any person violating that obligation. Such person shall be liable for a civil penalty of up to $500 for each day a violation continues or has not been remedied, and may be fined up to $10,000 and imprisoned for up to two years, or both, for a criminal violation."

Questions:

- Do swap powers cause the grantor to be disclosed?
- Do we need to disclose trust protectors, discretionary trust advisers, and investment trust advisers if vested with the authority to dispose of assets?
- How do trustees obtain necessary information from beneficiaries if a silent trust is involved if required privacy notices are involved?

4. **AML BSA Process Map**

On March 15, 2021, the Financial Crimes Enforcement Network final rules to expand the anti-money laundering (AML) obligations of certain banks, trust companies, and credit unions under the Bank Secrecy Act (BSA) became effective. These amendments are important to banks, private banks, credit unions, and trust companies that lack a "Federal functional regulator" (Non-FFR institutions) such as state chartered trust companies and perhaps private family trust companies. (The Federal functional regulators are the Office of the Comptroller of the Currency, Federal Deposit Insurance Corporation (FDIC), Board of Governors of the Federal Reserve System, and the Securities and Exchange Commission.)

Before these new rules, these Non-FFR institutions had relatively limited AML obligations under BSA regulations as compared to most banks and savings associations. They had to file currency transaction reports for many transactions in currency exceeding $10,000, file suspicious activity reports, and make and maintain certain records. Credit unions, private banks, and trust companies also had to perform formal customer identification procedures (CIP) for all customers, even if they

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did not have a Federal functional regulator, but other banks lacking a Federal functional regulator were not subject to a CIP requirement.

Under the new rules, all banks that are Non-FFR institutions, including but not limited to private banks, non-federally insured credit unions, and trust companies, will now be subject to essentially the same rules as apply to any FDIC-insured depository institution. Of most importance, they will have to establish and maintain a written AML program approved by the institution's board of directors or, if the institution does not have a board of directors, an equivalent governing body within the institution. Each AML program must include the "Five Pillars" of an appropriate AML program:

[1] A system of internal controls designed to ensure ongoing compliance with the BSA;

[2] Periodic independent compliance testing by the institution or an outside party;

[3] The designation of a qualified AML officer responsible for coordinating and monitoring day-to-day BSA compliance;

[4] Training for appropriate personnel; and

[5] Appropriate risk-based procedures for conducting ongoing customer due diligence, which must include, among other things, ongoing monitoring to identify and report suspicious transactions and, on a risk basis, to maintain and update customer information regarding the beneficial owners of legal entity customers.

The requirement to verify the identity of the "beneficial owners" of legal entity customers will mean that the institution would need to determine who its "legal entity" customers are, what types of businesses are excluded from that definition, and who the beneficial owners are for all covered legal entity customers.

The requirement to maintain a written AML program will also mean that the institution will be subject to formal BSA/AML compliance examinations. The Internal Revenue Service performs such examinations for Non-FFR institutions. An institution that previously did not have robust customer and transaction monitoring systems, an AML officer, or periodic AML compliance testing might find these regulatory examinations to be challenging. In any case, the institution will need to prepare and implement an AML program that is tailored to the institution, evidences a "culture of compliance," and that is otherwise designed to minimize risks to the institution arising from money laundering, terrorist financing, or other criminal activities. Preparation of a carefully tailored AML program will first require the performance of a risk assessment so that the institution may identify the risks arising from its customer base, products and services, and the geographies in which those products and services are offered.

Those banks that are Non-FFR institutions, including private banks, non-federally insured credit unions, and certain trust companies, will need to comply with the AML program, CIP, and beneficial ownership requirements by **March 15, 2021**.

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Affected trust companies should consider acquiring software programs that will assist personnel in recording tracking and updating this critical information with a real time capability of comparing select data with the governmental website.

Attached is an AML/BSA Flowchart For Reference.

5. **Continued Federal Legislative Examination of Trusts**

Attached hearing report.

6. **Nevada Trust Situs Standing Update**

In the *Trusts & Estates* January 2022 article entitled "**Which Trust Situs Is Best in 2022**", pages 44-61 by Daniel G. Worthington and Mark Merric, the authors updated their ranking index for which trust situs is best. The top four jurisdictions identified were South Dakota, Alaska, **Nevada** and Delaware. The authors used a matrix consisting of five broad categories (including twenty five subcategories). The five broad categories included: " (1) a jurisdiction's form of any applicable rule against perpetuity or the laws that determined how long a trust may legally exist; (2) whether a jurisdiction has inheritance, income or premium taxes; (3) what modern trust laws have been adopted, how state courts interpreted those laws and how accommodating the financial and legal system is to trusts; (4) what asset protection laws exist and their legal interpretations; and (5) the effect of migration on the rights of beneficial interests from jurisdiction to jurisdiction.

Based on the matrix analysis, the authors determined that Nevada remains a top jurisdiction based on its lack of income taxation, and adoption and maintenance of a broad set of modern trust laws necessary to successfully administer irrevocable, intergenerational, long-term trusts such as flexible trust decanting, directed trust provisions, broad virtual representation, private licensed and unlicensed family trust companies. The authors mentioned that Nevada led all states in the subcategory of self-settled trusts and the permitting of a charging order as the sole remedy against LLC members, but noted Nevada's high insurance premium taxes, the lack of national accreditation of the Nevada Financial Institution Division by the Conference of State Bank Supervisors, an ambiguity concerning its definition of discretionary trusts and uncertainty over the constitutionality of NRS 111.1031 which is Nevada's Uniform Statutory Rule Against Perpetuities. The issue was intially.raised in a Vanderbilt Law Review Article in 2014 as a potential negative indicator. Steven J. Horowitz and Robert H. Sitkoff, *Unconstitutional Perpetual Trusts*, 67 Vanderbilt L.Rev. 1769, 1773 (2014).

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Initial assessment

Develop AML policy and procedure manual[1]

AML policy and procedure[1]

Designate BSA officer

Provide data[2]

Collect data

Run through FinCen AML database

Clear OFAC screen-ing?

Yes

Sign off on report

No

Notify trust officer

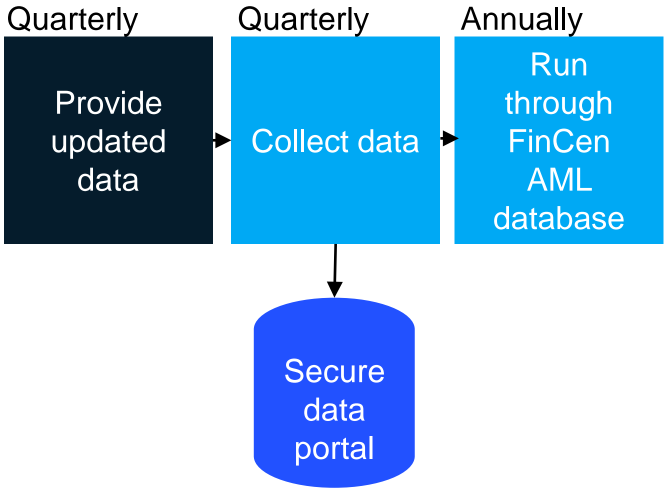
Trust accepts client

Data stored in secure portal

Secure data portal

Trust conducts onboarding

Ongoing updates needed



Legend

Responsible party

- Ownership/officers
- BSA officer
- Trust company

Additional considerations

Transaction monitoring: Ongoing cross-check mechanism needed for wire transfers

Training: Required for directors, officers, and other employees to be aware of AML/BSA, developments, GDPR/CPRA/Corporate Transparency act

Testing: Performed for AML/BSA monthly, performed by independent testing performed quarterly

Auditing: Required by an independent party annually

Process subject to change with new federal registration requirements at the end of 2022

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1. Includes BSA Officer Appointment/ Duties, Customer Due Diligence (CDD), Transaction Monitoring, Training, Independent Testing & Auditing, Report to Board, Risk Assessment
2. Includes Names/aliases, addresses, ID, passport, SSN, utility bill, etc.

PRESENT LAW AND BACKGROUND ON THE FEDERAL TAXATION OF DOMESTIC TRUSTS

Scheduled for a Public Hearing
Before the
SUBCOMMITTEE ON OVERSIGHT
of the
HOUSE COMMITTEE ON WAYS AND MEANS
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INTRODUCTION

The Subcommittee on Oversight of the House Committee on Ways and Means has scheduled a public hearing for December 8, 2021, called "The Pandora Papers and Hidden Wealth." This document,[1] prepared by the staff of the Joint Committee on Taxation, describes empirical information, legal background, and policy considerations related to certain topics to be considered in the hearing.

Trusts

Trusts, the main subject of this document, are legal arrangements that may be created upon the transfer of wealth.[2]

A trust is a three-party legal arrangement for the ownership of property arranged as follows: (1) A settlor or grantor transfers legal title to the property to (2) one or more fiduciaries called trustees, who hold title on behalf of (3) one or more beneficiaries. The trustee has a fiduciary duty to protect the beneficial or equitable rights of the beneficiaries with respect to the property; the trustee may be subject to certain requirements related to the property held by the trust and the income derived by the trust. The three parties to the trust need not be different; a grantor may also be a trustee or a beneficiary, and a trustee may be a beneficiary. The beneficiaries of a trust are generally individuals but may also include, for example, charitable organizations and business entities.

The beneficiary of a trust may not be a specified person. For example, a grandparent may create a trust that has as a class of beneficiaries all grandchildren, including grandchildren not born at the time of the trust's creation. Similarly, a person's status as beneficiary may be contingent on future events. For example, a grandparent may create a trust for the benefit of her daughter and, in the case of her daughter's death, her grandchild.

Individuals create trusts for various tax planning and non-tax-planning purposes. For example:

- A parent may wish to transfer legal ownership of property to a minor child and may want a trustee to make decisions about the property until the child reaches a certain age.
- The owner of a business may use a trust as the legal arrangement for transferring ownership interests in the business over time to family members or employees.
- A married couple may place assets in trust with the intention that, after one spouse dies, the other spouse will benefit from the assets until death (by, for example, using

[1] This document may be cited as follows: Joint Committee on Taxation, *Present Law and Background on the Federal Taxation of Domestic Trusts* (JCX-49-21), December 6, 2021. This document can be found on the Joint Committee on Taxation website, www.jct.gov. In this document, references to the "Code" are to the Internal Revenue Code of 1986, as amended. Section references are to the Code, unless otherwise indicated.

[2] See Lane and Zaritzky, *Federal Income Taxation of Estates and Trusts*, 3d. edition, Chapter 1; see also Treas. Reg. sec. 301.7701-4(a) (trusts); *Commissioner v. Beebe*, 67 F.2d 662, 664 (1933) (estates).

the income from the assets) and that the principal of the assets placed in trust will be preserved for the couple's children.

- A trust might be used to manage assets for a disabled relative or to protect assets from creditors.
- An individual may organize a trust to hold an insurance policy outside the individual's taxable estate, to remove from the individual's taxable estate future appreciation in the value of property placed in trust, or to transfer wealth through multiple generations of family members without paying transfer tax on each generational transfer.

A person — for example, the parent who wishes to transfer legal ownership but not control of property to a minor child — may create a trust to hold property during the person's life. This sort of trust is referred to as an *inter vivos* (during life) trust. Alternatively, during life a person may arrange for a trust to arise only when the individual dies. For example, a person may specify in her will that, on her death, certain property will be held in trust for the benefit of an heir until certain conditions are satisfied. This sort of trust is referred to as a testamentary trust (because it is provided in what is sometimes referred to as a "will and testament").

An individual who creates a trust may retain certain powers over the trust, such as the power to make decisions about distributions of trust assets. In this case the trust may be considered a grantor trust for Federal income tax purposes, with the consequence that the grantor is considered to own the trust's assets directly. Trusts that are not grantor trusts are referred to as nongrantor trusts.

A trust is governed by a trust instrument and is also subject to State statutes and common law.

Estates

Estates, like trusts, are legal arrangements related to the transfer of wealth.

Unlike a trust, which may hold property during the life of an individual or after an individual dies, an estate arises only on the death of an individual. A decedent's property is held in an estate by a fiduciary (referred to as an executor) who controls the property on behalf of one or more beneficiaries, the heirs of the estate, until the affairs of the estate are concluded and the property is distributed to the heirs.

An estate may be governed by a will but may also arise even if the decedent does not have a will. Like a trust, an estate is subject to State statutes and common law.

Present law, data, and issues related to trusts and estates

Part I of this document gives an overview of the income tax rules relating to trusts and estates and the estate, gift, and generation-skipping transfer tax rules in relation to which trusts may be organized.

Part II of this document describes the Federal tax reporting rules applicable to trusts and estates. These reporting rules include requirements under the Federal income tax for non-grantor trusts and grantor trusts. The reporting rules also include requirements under the Federal transfer tax in respect of transfers made (in trust or otherwise) during life or at death.

Part III of this document provides Federal tax data related to trusts and estates.

Part IV of this document describes issues related to trusts' and estates' beneficial ownership of interests in entities or accounts; beneficial ownership of trusts; and tax planning using trusts. Beneficial ownership generally refers to the substantive benefits associated with owning property, in contrast with the holding of formal legal title to the property. Sometimes the person who has formal legal title to property is also the beneficial owner of the property. In other situations the title holder is not the beneficial owner because, for example, the title holder acts as a nominee for the person who has the substantive benefits of ownership. Features of Federal and State (non-tax) law have allowed the identities of beneficial owners of trusts to remain undisclosed. Congress enacted a law in 2020 in part to address this problem. Policymakers also may be concerned about features of Federal tax law that have facilitated the use of trusts to minimize taxation of intergenerational wealth transfers.

I. PRESENT LAW RELATING TO DOMESTIC TRUSTS AND ESTATES

A. Income Tax

Income tax treatment of trusts and estates

Trusts and estates are generally subject to Federal income tax.[3] The taxable income of a trust is generally computed in the same manner as the taxable income of an individual. Estates generally compute taxable income in a similar manner to trusts. The computation is subject to certain modifications:[4] (1) no standard deduction is allowed;[5] (2) a small personal exemption is allowed;[6] (3) an unlimited charitable deduction is allowed for amounts paid to (or in the case of an estate or certain trusts, amounts permanently set aside for) charity;[7] and (4) trusts and estates may deduct trust administration costs.[8]

Trusts and estates are allowed a deduction for amounts distributed to beneficiaries during the taxable year.[9] The amount of the deduction is limited by distributable net income, a measure of income to be distributed.[10] Because of this deduction, the beneficiary, not the trust, is generally subject to income tax on the distributed amount. By use of this deduction, trusts may eliminate income tax liability to the extent they distribute (rather than retain) income.

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[3] Sec. 1(e), Part 1 of Subchapter J of Chapter 1. The term "trust" may also refer to a number of other types of arrangements or entities. Certain trusts may be classified as business entities. See Treas. Reg. sec. 301.7701-4(a). Trusts may also be pension trusts, sec. 401, or charitable entities, sec. 501. These types of trusts are all outside the scope of the document.

In addition, many trusts are subject to special rules beyond the ones discussed herein. See, *e.g.*, sec. 641(c) (small business trusts), sec. 642(b) (qualified disability trusts), sec. 644 (charitable remainder trusts), and sec. 646 (Alaska Native Settlement Trusts).

[4] Sec. 641(b).

[5] Sec. 63(c)(6)(D).

[6] Sec. 642(b). For estates, the amount of the exemption is $600. For trusts required to currently distribute all income, the amount is $300, while for other trusts, the amount is $100.

[7] Sec. 642(c).

[8] Sec. 67(e).

[9] See secs. 651 (simple trusts) and 661 (complex trusts). A trust that is not a grantor trust (discussed below) may be a simple trust or a complex trust. A trust is a simple trust if: (1) the trust instrument requires that all income be distributed currently; (2) the trust instrument does not provide that any amounts are to be paid, permanently set aside, or used for charitable purposes; and (3) the trust does not distribute amounts allocated to the corpus of the trust. Treas. Reg. sec. 1.651(a). A complex trust is a non-grantor trust that does not qualify as a simple trust.

[10] Sec. 643(a).

The tax rates for trusts and estates are the same as the tax rates that apply to individuals. If, however, a trust or estate retains income and has taxable income, the rate brackets[11] that apply are more compressed than the individual tax brackets, meaning that a trust is subject to tax at the highest marginal rate at lower income levels than an individual.[12] If a trust or estate is subject to tax, it generally pays the tax using income or assets of the trust. Thus, for example, the trust grantor does not pay the tax. This reduces the funds of the trust or estate held for the beneficiaries.

Table 1.–2021 Federal Income Tax Rates for Estates and Trusts

If taxable income is:	Then income tax equals:
Not over $2,65......................................	10% of the taxable income
Over $2,650 but not over $9,550	$265 plus 24% of the excess over $2,650
Over $9,550 but not over $13,050............	$1,921 plus 35% of the excess over $9,550
Over $13,050	$3,146 plus 37% of the excess over $13,050

Like individuals, trusts and estates may claim the foreign tax credit[13] or credits under the general business credit.[14] However, these credits may in some cases instead be allocated to the beneficiaries of the trust or estate.[15] Similarly, trusts and estates are subject to the alternative minimum tax ("AMT").

Trusts and estates, like individuals, are subject to lower rates on certain capital gains and certain dividends.[16] They may claim a deduction for qualified business income.[17] Trusts and estates are also subject to a separate net investment income tax on certain income.[18]

[11] Sec. 1(e), (j)(2).

[12] For example, for taxable years beginning in 2021, trusts are subject to the highest marginal rate of 37 percent on taxable income above $13,050, while married filing separately taxpayers (the next most "compressed" bracket) are subject to the highest marginal rate on taxable income above $314,150.

[13] Sec. 642(a).

[14] Subpart D of Subchapter A of Chapter 1 of the Code.

[15] See, *e.g.*, secs. 52(d) and 901(b)(5).

[16] Sec. 1(h), (j)(5). These lower rates apply for both the regular tax and the AMT. Sec. 55(b)(3).

[17] Sec. 199A.

[18] Sec. 1411.

Two or more trusts are treated as a single trust generally where the trusts have substantially the same grantors and beneficiaries and a principal purpose of the trusts is avoiding Federal income tax.[19]

Tax treatment of grantors and beneficiaries

Grantors

A grantor or settlor generally cannot take a deduction for a transfer to a trust or estate. However, a grantor may be able to claim a charitable deduction if the transfer is to a trust with a charitable organization as a beneficiary.[20]

Different rules (discussed below) apply to transactions between grantors and grantor trusts.

Beneficiaries

The transfer of property to a trust or estate is not a taxable event for the beneficiary.[21]

If a beneficiary receives a distribution from a trust or estate, the amount of the distribution, limited by distributable net income, is included in the beneficiary's gross income.[22] An item of income retains its character when received by the beneficiary.

Grantor trusts

Under the grantor trust rules, if the grantor or settlor of a trust retains certain rights or powers with respect to a trust, the grantor of the trust is treated as the owner of the trust.[23] A grantor may own only a portion of a trust. Additionally, these rules may apply to an individual other than the grantor who possesses the requisite rights or powers.[24] The common estate planning tool sometimes known as a revocable living trust is a grantor trust.

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[19] Sec. 643(f).

[20] Sec. 170(f)(2). The charitable organization, exempt from tax, will not have to pay tax on the income received.

[21] The transfer may be a gift or bequest to the beneficiary, excluded from gross income under section 102. Alternatively, if the transfer is to a grantor trust (discussed more below), the Secretary generally has held that the transaction has no effect for income tax purposes.

[22] Secs. 652 and 662.

[23] Secs. 671-679. A grantor is treated as the owner of any portion of a trust if: (1) the grantor has a reversionary interest in either the corpus or the income from the corpus, if certain conditions are satisfied; (2) the grantor has a power of disposition without the approval or consent of any adverse party; (3) the grantor can exercise certain administrative powers of over the trust; (4) the grantor or a nonadverse party has the power to revoke, *i.e.*, revest in the grantor title of a portion of the trust; and (5) without prior approval of an adverse party, the income from the trust may be distributed to or for the benefit of the grantor or the grantor's spouse.

[24] See sec. 678.

If a trust is a grantor trust, the grantor (and not the trust) is taxed on the income of the trust. The grantor may pay the tax out of funds not owned by the trust. If the grantor does so, the funds of the trust available to the beneficiaries are undiminished by the tax payment. Additionally, IRS guidance provides that transactions between the grantor and the grantor trust are disregarded.[25] Thus, for income tax purposes, a transfer of property to a grantor trust is not a gift, and a sale to a grantor trust is not a sale for tax purposes and does not give rise to gain or loss. The transfer tax consequences of a transfer to a grantor trust may be different.

Just as grantor trusts are not separate income tax taxpayers, they are not separately subject to the net investment income tax.[26]

Foreign trusts and estates

Domestic trusts are generally subject to tax on worldwide income. Foreign trusts are generally taxed similarly to nonresident aliens.[27]

In general, a trust is considered to be a domestic trust if it meets both a court test and a control test.[28] A foreign trust is any trust that is not a domestic trust.[29] The terms of the trust instrument and applicable law are applied to determine whether the tests are met.[30]

The court test is satisfied if a court within the United States is able to exercise primary supervision over the administration of the trust.[31] The regulations provide a safe harbor under which a trust satisfies the court test if: (1) the trust instrument does not direct that the trust be administered outside of the United States; (2) the trust in fact is administered exclusively in the United States; and (3) the trust is not subject to an automatic migration provision.[32] If both a U.S. court and a foreign court are able to exercise primary supervision over the administration of the trust, the court test is satisfied.[33]

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[25] Rev. Rul. 85-13, 1985-1 C.B. 184, 1985-7 I.R.B. 28.

[26] Treas. Reg. sec. 1.1411-3(b)(1)(v).

[27] Sec. 641(b) ("[A] foreign trust or foreign estate shall be treated as a nonresident alien individual who is not present in the United States at any time.").

[28] Sec. 7701(a)(30); Treas. Reg. sec. 301.7701-7(a)(1).

[29] Treas. Reg. sec. 301.7701-7(a)(2).

[30] Treas. Reg. sec. 301.7701-7(b).

[31] Treas. Reg. sec. 301.7701-7(a)(1)(i).

[32] Treas. Reg. sec. 301.7701-7(c)(1). A court within the United States generally is not considered to have primary supervision over the administration of the trust if the trust instrument provides that a U.S. court's attempt to assert jurisdiction or otherwise supervise the administration of the trust directly or indirectly would cause the trust to migrate from the United States. Treas. Reg. sec. 301.7701-7(c)(4)(ii).

[33] Treas. Reg. sec. 301.7701-7(c)(4)(i)(D).

The control test is satisfied if one or more United States persons have the authority to control all substantial decisions of the trust.[34] The term control means having the power, by vote or otherwise, to make all of the substantial decisions of the trust, with no other person having the power to veto any of the substantial decisions.[35] Substantial decisions are those decisions that persons are authorized or required to make under the terms of the trust instrument and applicable law and that are not ministerial. Substantial decisions include: (1) whether and when to distribute income and corpus; (2) the amount of any distributions; (3) the selection of a beneficiary; (4) whether a receipt is allocable to income or principal; (5) whether to terminate the trust; (6) whether to compromise, arbitrate, or abandon claims of the trust; (6) whether to sue on behalf of the trust or to defend suits against the trust; (7) whether to remove, add, or replace a trustee; (8) in certain cases, whether to appoint a successor trustee; and (9) in general, investment decisions.[36]

Because of these rules, the trust's status as foreign or domestic is not solely determined based on where it is formed. In other words, a trust that is formed under the laws of a U.S. State may be treated as a foreign trust for U.S. Federal income tax purposes, and a trust that is formed under the laws of a foreign jurisdiction may be treated as a U.S. domestic trust for U.S. Federal income tax purposes. A trust's status as foreign or domestic may change depending on the circumstances.

In certain cases, the transfer of property by a U.S. person to a foreign trust results in grantor trust treatment.[37]

A foreign estate is an estate the income of which, from sources without the United States which is not effectively connected with the conduct of a trade or business within the United States, is not includible in gross income.[38] A domestic estate is any estate that is not a foreign estate.[39]

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[34] Treas. Reg. sec. 301.7701-7(a)(1)(ii).

[35] Treas. Reg. sec. 301.7701-7(d)(1)(iii).

[36] Treas. Reg. sec. 301.7701-7(d)(1)(ii).

[37] Sec. 679.

[38] Sec. 7701(a)(31)(A).

[39] Sec. 7701(a)(30)(D).

B. Transfer Tax

Separate from the taxes imposed on the income of a trust or estate, there are Federal wealth transfer taxes, which include the gift tax, the estate tax, and the generation-skipping transfer tax.[40] These taxes are imposed on individual taxpayers. A gift tax is imposed on certain lifetime transfers, and an estate tax is imposed on certain transfers at death. Transfers subject to tax include both direct transfers and transfers in trust. A generation-skipping transfer tax generally is imposed on transfers, either directly or in trust or through similar arrangement, to a "skip person" (generally a beneficiary in a generation more than one generation below the generation of the transferor).

A unified credit effectively exempts a total of $11.7 million (for 2021) in cumulative taxable transfers from the gift tax[41] or the estate tax. Transfers in excess of this amount generally are taxed at a 40-percent rate.[42] A transfer to a spouse or to charity generally is not subject to gift or estate tax.

The generation-skipping transfer tax is imposed using a flat rate equal to the highest estate tax rate (40 percent) on cumulative generation-skipping transfers in excess of an exemption amount ($11.7 million for 2021). Generation-skipping transfer tax exemption may be allocated to a trust to which a donor or decedent transfers assets. In some cases, the trust assets can then grow indefinitely and benefit multiple successive generations with no further generation-skipping transfer tax consequences.

As discussed in the introduction, a taxpayer might engage in trust planning to reduce tax liability, to achieve a non-tax-related goal, or both, and taxpayers sometimes use a trust as a vehicle for transferring wealth by gift or at death. As discussed in Part IV, a taxpayer might seek to reduce transfer taxes using a trust through an "estate freeze" transaction or by transferring assets to a "perpetual dynasty trust" that is exempt from generation-skipping transfer tax.

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[40] See Chapters 11, 12, and 13 of the Code.

[41] Rev. Proc. 2020-45, I.R.B. 2020-46, p. 1024. Donors of certain lifetime gifts are also provided an annual exclusion of $15,000 per donee in 2021 that does not count against the unified credit. Sec. 2503(b).

[42] Sec. 2001(c).

II. SELECTED REPORTING REQUIREMENTS RELATING TO DOMESTIC TRUSTS

A. Income Tax Reporting

An entity that is subject to Federal income tax generally files a tax return with the IRS to report its income tax liability. An entity that is itself not subject to Federal income tax, such as a partnership, certain foreign persons, and certain tax-exempt organizations, but whose payees or beneficiaries may be U.S. taxpayers, generally files one or more information returns rather than an income tax return.

A trust might be required to file both income tax and information returns. As a separate income tax taxpayer, a trust that meets certain thresholds must file an annual income tax return. As discussed in Part I, however, certain income of a trust might be taxed to a beneficiary rather than to the trust. The Code thus requires that certain information be shared between the fiduciary of a trust and a person who holds an interest in the trust, such as a beneficiary. Similar rules apply to an estate. These rules are described in the following subsections.

Additional reporting rules and tax consequences apply to a foreign trust or to a grantor or beneficiary of a trust that is foreign for Federal tax purposes.[43] A detailed discussion of these rules is beyond the scope of this publication.

Depending on the circumstances, a trust also might file other types of returns or forms, including employment tax returns.[44]

Annual income tax reporting

A domestic taxable trust is required to file an income tax return for a taxable year if it has (1) any taxable income or (2) gross income of $600 or more regardless of the amount of taxable income.[45] An estate is required to file an income tax return for a taxable year if it has gross income of $600 or more.[46] A trust or an estate also must file an income tax return for a taxable

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[43] A trust organized under the laws of one of the States may be considered a foreign trust for Federal tax purposes, as discussed in Part I. The consequences of such a determination may include third-party reporting obligations (for example, section 6048 requires: (1) disclosure of certain reportable events involving a foreign trust, including the creation of, or transfer of money or property to, a foreign trust by a U.S. person (sec. 6048(a)); (2) reporting by a trust that is treated as owned by a U.S. person under the grantor trust rules (sec. 6048(b)); and (3) reporting by a U.S. person who receives a distribution from a foreign trust (sec. 6048(c)) as well as penalties (see sec. 6677). See also IRS Form 3520, *Annual Return to Report Transactions with Foreign Trusts and Receipt of Certain Foreign Gifts*, and IRS Form 3520-A, *Annual Information Return of Foreign Trust with a U.S. Owner*. A foreign trust with U.S. sourced income might be required to file IRS Form 1041-NR, *U.S. Nonresident Alien Income Tax Return*.

[44] For a general description of other types of returns or forms that might have to be filed, see Internal Revenue Service, *2020 Instructions for Form 1041 and Schedules A, B, G, J, and K-1*, pp. 11-12. A discussion of these returns and forms is beyond the scope of this publication.

[45] Sec. 6012(a)(4).

[46] Sec. 6012(a)(3).

year if it has a beneficiary that is a nonresident alien.[47] A fiduciary generally arranges for filing of the annual return using IRS Form 1041, "U.S. Income Tax Return for Estates and Trusts." Form 1041 is due by the 15th day of the fourth month following the close of the trust's or estate's tax year[48] (for example, April 15, 2021, for a trust with a tax year that ended December 31, 2020).[49]

Information provided to beneficiaries

If a fiduciary of a trust or estate is required to file an income tax return for the trust or estate for a year, the fiduciary also must provide a statement to each beneficiary (or nominee of a beneficiary) who receives a distribution with respect to the taxable year or to whom any item with respect to the taxable year is allocated.[50] The fiduciary is required to request and provide a proper identifying number for each recipient of income. The IRS provides that a fiduciary may use Form W-9, "Request for Taxpayer Identification Number and Certification," to request a beneficiary's identifying number.[51]

A nongrantor trust or an estate generally uses Schedule K-1 (Form 1041) to report a beneficiary's share of income, deductions, and credits from a trust or estate, using the beneficiary's taxpayer identification number. A trust or estate that claims a distribution deduction must include with its Form 1041 a Schedule K-1 for each beneficiary. The fiduciary also must provide a copy of Schedule K-1 to the beneficiary.

A beneficiary who receives a distribution or to whom any item with respect to the taxable year is allocated must treat, on the beneficiary's income tax return, any reported item in a manner that is consistent with the treatment of the item by the applicable trust or estate.[52] This consistency requirement generally does not apply if the beneficiary files with the Secretary a statement identifying an inconsistency.[53] A beneficiary makes such a statement by filing Form 8082, "Notice of Inconsistent Treatment or Administrative Adjustment Request (AAR)."

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[47] Sec. 6012(a)(5).

[48] A trust or estate may apply for an automatic five and one-half month extension by filing IRS Form 7004, *Application for Automatic Extension of time to File Certain Business Income Tax Information and Other Returns*.

[49] A trust that is exempt from Federal income tax might file a different return, such as IRS Form 990, *Return of Organization Exempt from Income Tax*, IRS Form 990-PF, *Return of Private Foundation or Section 4947(a)(1) Nonexempt Charitable Trust Treated as a Private Foundation*, or IRS Form 5227, *Split-Interest Trust Information Return*.

[50] Sec. 6034A(a).

[51] See Internal Revenue Service, *2020 Instructions for Form 1041 and Schedules A, B, G, J, and K-1*, p. 40.

[52] Sec. 6034A(c)(1).

[53] Sec. 6034A(c)(2)(a). Where the applicable trust or estate has filed a return and the beneficiary has not filed a statement with the Secretary identifying any inconsistency, any adjustments required to make the treatment by the beneficiary consistent with the treatment of the items on the entity's return are treated as arising out of mathematical or clerical errors and assessed according to section 6213(b)(1). Sec. 6034A(c)(3).

If a person holds an interest in a trust or estate as a nominee for another person, the nominee must furnish to the trust or estate the name and address of such other person and any other information that the Secretary may require. The nominee is also required to furnish to such other person the information provided by the trust or estate.[54]

Reporting rules for grantor trusts

Special reporting rules apply for grantor trusts. If an entire trust is a grantor trust, only the entity information is completed on Form 1041. Dollar amounts are not shown on the face of the form; they are instead shown on an attachment to the form. If only part of a trust is a grantor trust, any income, deductions, and other items that are allocable to the nongrantor portion of the trust are reported on Form 1041 under normal reporting rules. Amounts allocable to the grantor portion of the trust are shown only on an attachment. The fiduciary is required to provide a copy of the attachment to the person who is treated as the deemed owner of the grantor portion of the trust.

A grantor trust may also use one of three optional filing methods.[55]

- **Optional method 1**: If a trust is treated as owned by only one person, the trustee may provide all payers of income to the trust during the year the name and taxpayer identification number for the deemed owner, while providing the address of the trust rather than the address of the deemed owner. To use this method, the deemed owner must provide the trustee with a signed form W-9, "Request for Taxpayer Identification Number and Certification." Unless the deemed owner is a trustee of the trust, the trustee must provide a statement to the deemed owner that shows all items of income, deduction, and credit of the trust and includes certain other required information.
- **Optional method 2**: If a trust is treated as owned by only one person, the trustee may provide all payers of income to the trust during the year the name, address, and taxpayer identification number for the trust. The trustee then files with the IRS appropriate Forms 1099 showing the trustee as payer and the deemed owner as the payee, essentially treating all items of income, deduction, and credit as if earned directly by the deemed owner. Unless the deemed owner is a trustee of the trust, the trustee must provide a statement to the deemed owner that shows all items of income, deduction, and credit of the trust and includes certain other required information.

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[54] Sec. 6034A(b).

[55] See Internal Revenue Service, *2020 Instructions for Form 1041 and Schedules A, B, G, J, and K-1*, pp. 13-14.

- **Optional method 3**: If a trust has two or more deemed owners, the trustee provides all payers of income to the trust during the tax year the name, address, and taxpayer identification number of the trust. The trustee then files one or more Forms 1099 with the IRS with respect to each deemed owner showing the trust as the payer and the deemed owner as the recipient. The trustee must provide a statement to each deemed owner that shows all items of income, deduction, and credit of the trust attributable to the portion of the trust that is treated as owned by the deemed owner and includes certain other required information.

B. Transfer Tax Reporting

Certain taxpayers who make a gift during life, and the estates of certain decedents, must file a gift tax return or an estate tax return, whether assets are transferred outright to recipients or heirs or are transferred in trust.

A citizen or resident of the United States generally must file a gift tax return for a year if he or she gave gifts during the year to someone (other than a spouse) that total more than $15,000 in value (in 2021), although a return may also be required in certain other cases. Only taxpayers who are individuals must file a return. If a trust, estate, partnership, or corporation makes a gift, the individual beneficiaries or owners generally are treated as having made the gift. The information is reported using Form 709, "United States Gift (and Generation-Skipping Transfer) Tax Return."

For a decedent who is a U.S. citizen or resident, an estate tax return generally must be filed if the gross estate plus adjusted taxable gifts (generally, taxable gifts made by the decedent after December 31, 1976) exceed the estate tax exemption amount of $11,700,000 (for decedents dying in 2021). The information is reported using Form 706, "United States Estate (and Generation-Skipping Transfer) Tax Return."

Special versions of Form 706 must be filed by the trustee of certain trusts to which generation-skipping transfer tax exemption has been allocated in the event of a taxable distribution or a taxable termination. If a trust makes a distribution that is treated as a taxable distribution for generation-skipping transfer tax purposes — generally, a distribution to a person two or more generations below the generation of the transferor (a "skip person") — the trustee of the trust must file Form 706-GS(D-1), "Notification of Distribution from a Generation-Skipping Trust." The form includes the recipient's identifying number, the trust's employer identification number, and information about the distribution. A skip person who receives a taxable distribution from a trust must file Form 706-GS(D), "Generation-Skipping Transfer Tax Return for Distributions." If a generation-skipping trust has a taxable termination, the trustee generally must file Form 706-GS(T), "Generation-Skipping Transfer Tax Return for Terminations."

III. DATA ON THE INCOME TAXATION OF TRUSTS AND ESTATES

This section provides income tax data for trusts and estates. As mentioned above, trusts and estates are generally taxed in the same manner as individuals. However, they are allowed a deduction for amounts distributed to beneficiaries. Beneficiaries are taxed on distributions. The information below comes from taxpayers who filed Form 1041 for taxable years beginning in 2017.[56]

In 2017, 3.2 million Form 1041s were filed. Trusts and estates generally are subject to tax on income that is not distributed but is instead retained. For 2017, 1.1 million trust and estate income tax returns reported net taxable income. Total trust and estate income was $178 billion, and total net taxable income (*i.e.*, income after exemptions and deductions including the deduction for income distributed to beneficiaries) was $90 billion. Total tax liability was $24 billion.[57]

Based on income distributions reported on Schedule K-1 (Form 1041), beneficiaries who are U.S. taxpayers received on net $56.0 billion of distributions from trusts and estates. The $56.0 billion consists of interest (5.0 percent), dividends (33.7 percent), business income (7.7 percent), short-term capital gains (0.7 percent), long-term capital gains (20.8 percent), rent (17.6 percent), and other/unknown sources (14.7 percent).

Table 2 provides additional information about trust and estate distributions for 2017. The Joint Committee staff calculated an income distribution table of total net income from trusts and estates. The income groups are based on beneficiary adjusted gross income ("AGI") exclusive of distributions received from trusts or estates. Because of this, there is a "negative" AGI category of taxpayers who, absent distributions, do not have positive AGI.

Table 2 shows the number of individual returns that report trust distributions received, the amount of distributions, the group's percentage share of total distributions, the average distribution received, and average AGI excluding distributions. The last six columns, for each income group, represent the percentage of returns for which the distributions are less than a certain percent of total AGI. The $100,000-$200,000 income group reported the largest number of returns (318 thousand) totaling $8.3 billion, which represents 14.8 percent of the total amount

[56] Thus, it excludes two types of trusts which file different income tax returns, Qualified Funeral Trusts (which file Form 1041-QF), and Electing Alaska Native Settlement Trusts (which file Form 1041-N). *See also* sec. 646 (Electing Alaska Native Settlement Trusts), sec. 685 (Qualified Funeral Trusts).

The data also includes a small number of bankruptcy estates, which are subject to tax under section 1398 and 1399, and which file Form 1041.

[57] In comparison, for 2017, 152.4 million individuals had a total income tax liability, after credits, of $1,581.5 billion, and 1.6 million corporations had a total income tax liability of $264.6 billion. (Most of these 1.6 million corporations are domestic corporations that are subject to tax under subchapter C of the Code. A smaller portion of the 1.6 million corporations in this group includes other Form 1120 filers such as homeowners associations (Form 1120-H), life insurance companies (Form 1120-L), and foreign corporations (Form 1120-F). This group of 1.6 million corporations excludes S corporations, RICs, and REITs.)

reported in the year 2017. However, the less than $0 income group reported the largest amount, $10.0 billion, which represents 17.9 percent of the total amount reported in the year 2017. The less than $0 income group had an average distribution of $129,348 and an average AGI of -$141,493. The $1 million and over income group had the largest average distribution and average AGI of $303,373 and $4,271,561, respectively. As shown in the table, taxpayers across income groups receive distributions from trusts and estates, as measured by both the total distributions received and the percentage shares. However, individuals in higher income groups receive on average higher distributions, while, at the same time, those distributions are more likely to account for a smaller percentage of AGI.

Table 2.–Distribution from Trusts and Estates by Distribution-Exclusive AGI Group, 2017

Income Group	Number of Returns (Thousands)	Total Distributions Received ($ Millions)	Share (%)	Average Distribution Received ($)	Average AGI Excluding Distributions ($)	Distributions as Percentage of AGI					
						<10% (Percent)	10%-25% (Percent)	25%-50% (Percent)	50%-75% (Percent)	75%-90% (Percent)	>90% (Percent)[1]
Less than $0	77	10,000	17 9	129,348	-141,493	*	*	*	*	*	*
$0-$15,000	231	3,026	5 4	13,075	18,577	24 9	9 5	18 2	21 4	13 7	12 3
$15,000-$30,000	139	3,724	6 7	26,875	49,357	35 8	18 0	18 2	16 4	9 9	1 7
$30,000-$50,000	144	3,812	6 8	26,391	66,846	40 2	24 4	17 2	14 0	3 8	0 5
$50,0000-$75,000	180	4,153	7 4	23,070	85,949	50 4	20 7	20 7	6 6	1 4	0 2
$75,000-$100,000	147	3,235	5 8	22,056	108,733	59 3	20 3	16 0	3 5	0 9	0 1
$100,000-$200,000	318	8,294	14 8	26,101	168,166	65 9	21 0	10 2	2 5	0 3	0 1
$200,000-$500,000	174	7,238	12 9	41,553	338,492	73 3	16 4	8 5	1 4	0 3	0 0
$500,000-$1,000,000	44	3,604	6 4	82,048	770,709	78 2	13 4	6 4	1 7	0 3	0 0
$1,000,000 and Over	29	8,899	15 9	303,373	4,271,561	83 6	9 9	4 8	1 5	0 2	0 1
Total	**1,484**	**55,987**	**100**	**37,735**	**210,854**	**53.3**	**18.2**	**14.4**	**8.2**	**3.8**	**2.0**

Note: "*" Distribution as a percentage of AGI is not calculated for returns with negative AGI Details may not add due to rounding
[1] "0 0" less than 0 5 percent
Source: Joint Committee staff calculations

IV. DISCUSSION

A. Beneficial Ownership Determination and Information Reporting

Policymakers may be interested in whether there are patterns of noncompliance among taxpayers. Differing degrees of tax compliance may be associated with higher or lower income taxpayers and may further vary among types of taxpayers, including trusts, depending on whether taxpayers have sources of income that are more difficult for the IRS to identify and monitor than others. When taxpayers misreport their incomes, their "true" income is often invisible to the IRS, to policymakers, and to researchers. Because noncompliance may be attributable to actions ranging from unintentional taxpayer errors to intentional fraud, the Code provides a series of information reporting requirements, both self-reporting requirements as well as third-party information reporting.

Information reporting is intended to enable taxpayers in receipt of such reports to prepare their income tax returns accurately as well as to help the IRS determine whether such returns are correct and complete. These reporting rules affect trusts and estates in three ways. First, as explained in part II, trusts may be required to file tax returns. Information reporting may help ensure that trusts and estates properly report income with respect to entity interests or other assets they own. Second, individuals or other taxpayers may be beneficiaries of trusts or estates, and information reporting may help ensure that such ownership and related income is taken into account for income tax purposes. Finally, beneficial ownership determination and information reporting may help with transfer tax compliance.

In addition to information returns filed by trusts, trusts that are considered to be foreign for purposes of the Code are also subject to third-party reporting.[58] Such reporting provides the IRS with independent information about income received and taxes withheld, thus enabling the IRS to fulfill its oversight and enforcement roles.[59] The availability of reliable and objective third-party verification of income increases the probability that underreporting is detected, thereby potentially improving the overall level of compliance. The value of such reporting is limited however if the report does not identify, or enable identification of, the beneficial owner of the subject of the report. To the extent that trusts are formed under laws of jurisdictions that do not require disclosure of the identity of persons holding beneficial interests in the trusts, otherwise reportable receipts or transactions may go unreported.

1. Developments in beneficial owner concept under the Code

Until recently, none of the reporting or withholding provisions of the Code referred to beneficial owners, although the Code frequently refers to beneficial interests in property,

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[58] Sections 6041 through 6060 encompass the third-party reporting requirements of the Code; section 6048 specifically applies to trusts that are foreign for Federal tax purposes.

[59] In fiscal year 2019, the IRS received more than 3.5 billion third-party information returns, 89.6 percent of which were filed electronically. In addition, individual income tax withheld totaled $1.35 trillion out of $1.98 trillion of individual income tax collected, before refunds. See Internal Revenue Service, *Data Book 2019*, Publication 55-B, Washington, DC, June 2020, Tables 1 and 22.

including in provisions relating to interests in trusts.[60] Because all persons required to make certain returns or statements must furnish a taxpayer identification number ("TIN") when doing so, a trust that is subject to reporting requirements will need to obtain its own TIN, by applying for an EIN. As part of that process, the IRS will identify an appropriate party as "the responsible party."[61] Where there is more than one responsible party with respect to an entity, the entity may list the party the entity wants the IRS to recognize as the responsible party.

In contrast, "beneficial owners" rather than responsible parties are required to be identified under the anti-money laundering regulations under the Bank Secrecy Act of 1970,[62] which require U.S. financial institutions to exercise due diligence in ascertaining the identity of persons opening financial accounts in addition to requiring banks to maintain records and submit reports on certain cash or cash equivalent transactions. Financial institutions are required to verify enough customer information to enable the financial institution to form a "reasonable belief that it knows the true identity of each customer."[63] To partially bridge the gap between the Code and the Bank Secrecy Act, the concept of a beneficial owner was introduced to the Code in designing the new withholding and reporting regime with respect to foreign account tax compliance and cross-border transactions in 2010, commonly referred to as FATCA.[64]

FATCA imposes a withholding tax equal to 30 percent of the gross amount of withholdable payments[65] to a foreign financial institution unless the foreign financial institution enters into an information reporting agreement with the Secretary under which the institution

[60] Secs. 672, 674, 676, 677. As discussed in Part II, section 6034A specifically addresses the need for trusts to report with respect to beneficiaries, including a TIN.

[61] Sec. 6109; Internal Revenue Service Website, *Small Business & Self Employed,* "Responsible Parties and Nominees," available at http://www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/Responsible-Parties-and-Nominees. Where there is a nominee, the true responsible party is the principal officer, general partner, etc., not the nominee. Since 2019, the IRS has required that the applicant for the EIN be an individual with a valid tax ID number (whether SSN or Individual TIN), precluding entities from using their own numbers to obtain additional numbers. The application must disclose the name and TIN of the "true principal officer, general partner, grantor, owner or trustor," who will be considered by the IRS to be the responsible party. The term "beneficial owner" does appear in forms that enable foreign owners to establish foreign status, *e.g.,* Form W-8BEN (Certificate of Foreign Status of Beneficial Owner for United States Tax Withholding) or Form W-8BEN-E, (Certificate of Status of Beneficial Owner for United States Tax Withholding and Reporting (Entities)), used by foreign individuals and foreign entities, respectively.

[62] 31 U.S.C. secs. 5311-5314e, 5316-5332e; 12 U.S.C. secs. 1829b and 1951-1959e.

[63] See 31 C.F.R. sec. 1020.220(a)(2).

[64] The Hiring Incentives to Restore Employment ("HIRE") Act, Pub. L. No. 111-147. Subtitle A of Title V of the HIRE Act, entitled "Foreign Account Tax Compliance," was based on legislative proposals in the Foreign Account Tax Compliance Act ("FATCA"), a bill introduced in both the House and Senate on October 27, 2009, as H.R. 3933 and S. 1934, respectively. FATCA added new Chapter 4 to Subtitle A of the Code. FATCA was enacted in the aftermath of private banking scandals involving evasion of U.S. tax by U.S. persons through the use of offshore accounts in certain low-tax or no-tax jurisdictions. For a discussion of those events, see Joint Committee on Taxation, *Explanation of Proposed Protocol to the Income Tax Treaty Between the United States and Switzerland* (JCX-31-11), pp. 23-38, May 20, 2011.

[65] Section 1473(1).

agrees to obtain information necessary to determine whether any accounts at such institution are U.S. accounts within the scope of FATCA.[66] The information to be reported for U.S. accounts includes (1) the name, address, and taxpayer identification number of each U.S. person or a foreign entity with one or more substantial U.S. owners holding an account, (2) the account number, (3) the account balance or value, and (4) except as provided by the Secretary, the gross receipts and gross withdrawals or payments from the accounts.[67] In contrast, U.S. financial institutions are required to report under the Code with respect to specific payments, such as interest received from a debtor or paid to an account holder, but not with respect to ownership of legal entities that may be recipients or payors of such interest.

In addition to the added responsibilities of foreign financial institutions, Congress also enacted a Code provision that loosely paralleled existing reporting obligations under the Bank Secrecy Act with respect to foreign accounts. Under these disclosure requirements, U.S. individuals with foreign financial assets must disclose on their Federal income tax returns their foreign financial assets and foreign financial accounts if the aggregate value of such assets exceeds $50,000.[68] To the extent required by regulations, a specified domestic entity that such an individual uses to hold such assets, directly or indirectly must also report. Regulations provide that domestic trusts described in section 7701(a)(30)(E) are generally within the scope of the term "specified domestic entity" if the trust was formed or availed of for the purpose of holding foreign financial assets and the current beneficiaries of the trust include at least one "specified person,"[69] but exceptions exist for certain domestic trusts owned by publicly traded entities, governmental units, banks, or exempt organizations.[70] Failure to comply with this reporting requirement results in a failure to disclose penalty, an increased accuracy-related penalty, and an extended limitations period for assessment of additional tax attributable to underreported income associated with the foreign financial assets.

2. Beneficial ownership information and multilateral efforts toward transparency

Roughly contemporaneously with the enactment of FATCA, the United States agreed to be one of the first jurisdictions subjected to peer review for compliance with new standards on exchange of information that the United States had helped develop as a member of the Organization for Economic Cooperation and Development ("OECD"). These standards are

[66] A United States account is any financial account held by one or more specified United States persons or United States owned foreign entities. Sec. 1471(d). Depository accounts are not treated as United States accounts for these purposes if (1) each holder of the account is a natural person and (2) the aggregate value of all depository accounts held (in whole or in part) by each holder of the account maintained by the financial institution does not exceed $50,000. Sec. 1471(d)(1)(B).

[67] Sec. 1471(c).

[68] Sec. 6038D.

[69] Treas. Reg. sec. 1.6038D-6(c) defines specified domestic entities that must report foreign financial assets.

[70] Treas. Reg. sec. 1.6038D-6(d). Even if required to report, certain assets may be exempt from inclusion in the report to the extent that the reporting entity included such assets in other required reports. See Treas. Reg. sec. 1.6038D-7.

generally consistent with the obligations imposed by the United States under FATCA on foreign financial institutions, in that they require that countries maintain adequate information on cross-border transactions and financial accounts, including information on beneficial ownership of financial accounts. In addition, tax administrators must have access to such information for use in their exchange of information programs, the information requested to be exchanged need only be "foreseeably relevant" to the administration and enforcement of the domestic laws of a requesting State, and otherwise applicable bank secrecy laws in the jurisdiction receiving the request or lack of a domestic tax interest in the information are not acceptable objections to complying with the obligation to exchange information. Finally, the standards require strict confidentiality as to the information exchanged and are monitored for compliance by periodic peer reviews. These standards have since been widely accepted.[71]

The peer review process quickly identified a major shortcoming in the ability of the United States to retrieve and exchange information about beneficial ownership of financial accounts, resulting in a "largely compliant" rating in 2011 and an admonishment to improve its ability to provide beneficial ownership information. The failure to do so resulted in a rating of only "partially compliant" with respect to the ownership and identity information measures in the second round of reviews in 2018.[72]

The inability to comply with requests for information about foreign persons believed to have an interest in financial accounts maintained in the United States stems from the fact that State law controls the formation of legal entities and the record keeping required of those entities. Although banks are required to exercise due diligence (*i.e.,* "know your customer" rules) when opening an account, that does not necessarily result in maintenance of adequate information to identify all ultimate owners. No uniform system of determining the identity of owners of an interest in a U.S. entity is available to the Federal authorities, impairing enforcement of U.S. tax law as well as precluding reciprocity in exchanges of information with the many countries that do maintain such information at the national level.

Revisions of the Bank Secrecy Act were included in the National Defense Authorization Act in 2020, in the form of the Corporate Transparency Act. The legislation may alleviate the barrier to piercing bank secrecy and address the U.S. shortcomings identified in the OECD peer review reports, depending on how the new legislation is implemented. Among other things, it adds a provision on beneficial ownership reporting requirements.[73] The new provision requires

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[71] The OECD work on international transparency and international tax evasion was undertaken at the request of the G-20 in 2008 and 2009, leading directly to publication of the standards as "terms of reference" for members of the OECD and formation of the Global Form on Transparency and Exchange of Information for Tax Purposes ("Global Forum"). The OECD has since updated the standards to reflect automatic exchange of information standards. The Global Forum oversees and conducts the peer reviews for adherence to the standards. For an overview of the work of the Global Forum and the standards, see Global Forum, *Transparency and Exchange of Information for Tax Purposes: Multilateral Cooperation Changing the World 10th Anniversary Report,* November 2019, available at https://www.oecd.org/tax/transparency/documents/global-forum-10-years-report.pdf. For updates, see https://www.oecd.org/tax/transparency.

[72] A chart displaying the specific categories and ratings assigned the United States in each peer review can be found at https://www.oecd.org/tax/transparency/documents/exchange-of-information-on-request-ratings.htm.

[73] 31 U.S.C. sec 5336, added by section 6403 of the Corporate Transparency Act.

that any person applying to form a legal entity under the laws of a State or Indian Tribe must provide acceptable identification of the applicant.

The entity formed after such application must submit to the Secretary a report including information identifying each beneficial owner and applicant. The legislation establishes a standard for determining beneficial ownership and requires creation of a Federal database to which reporting entities must report their beneficial ownership information.[74] Reporting entities are limited to corporations, limited liability companies and "similar entities." The Secretary has published an advance notice of proposed rulemaking for implementation of the standard and solicited public comments on the new database at FinCEN.[75]

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[74] National Defense Authorization Act for Fiscal Year 2021, Title LXIV, Pub. L. No. 116-283, January 1, 2021; Conference Report to Accompany H.R. 6395, H.R. Rep. 116-617, p. 4458.

[75] Treasury's Financial Crimes Enforcement Network (FinCEN) will create and maintain the new database. See FinCEN, "Beneficial Ownership Information Reporting Requirements," ANPRM, 86 Fed. Reg. 17557, 31 CFR Part 1010, April 5, 2021.

B. Use of Trusts to Avoid Transfer Tax

Taxpayers sometimes use trust arrangements to avoid transfer tax. First, grantors sometimes structure estate "freeze" transactions that leverage the ability to create a trust that is treated as separate from the grantor for transfer tax purposes but not for income tax purposes, sometimes referred to as an "intentionally defective grantor trust," or IDGT. In a simple estate freeze transaction, a grantor might transfer assets to an IDGT by way of a taxable gift during his or her lifetime. The gift tax value is measured ("frozen") at the time of the transfer, and any subsequent appreciation accrues to the trust (and ultimately the trust beneficiaries) without further gift or estate tax consequences, provided the trust is structured to avoid inclusion in the grantor's gross estate.

Some argue that the compressed rate brackets for trusts reduce or eliminate the need for the grantor trust rules as a tool to prevent the inappropriate shifting of income to lower tax brackets; the rules now are used primarily for transfer tax avoidance.[76] Other commentators seek to address the use of IDGTs for transfer tax avoidance by harmonizing or coordinating the income and transfer tax rules governing grantor trusts. For example, one academic would repeal most of the grantor trust rules and replace them with a single rule based on the standards for determining whether a transfer is a completed gift for gift tax purposes.[77] Alternatively, the Treasury Department has proposed harmonizing the income and transfer tax rules by imposing certain transfer tax consequences on a grantor trust.[78]

Second, taxpayers sometimes use grantor retained annuity trusts, or GRATs, to avoid gift or estate tax. A GRAT is an irrevocable grantor trust in which the grantor retains an annuity interest, with the remainder passing to other trust beneficiaries, such as the grantor's children, in a taxable gift. Because the interests are valued using rules that often overstate the value of the retained annuity and understate the value of the remainder interest, the grantor often is able to value the taxable gift at an amount far below the real economic value of the remainder interest.[79]

[76] Leo L. Schmolka, "FLPs and GRATs: What to Do?," *Tax Notes*, March 13, 2000 (special supplement), p. 1473; Jay A. Soled and Mitchell Gans, "Sales to Grantor Trusts: A Case Study of What the IRS and Congress Can Do to Curb Aggressive Transfer Tax Techniques," *Tennessee Law Review*, vol. 78, Summer 2011, pp. 973, 1005.

[77] See Robert T. Danforth, "A Proposal for Integrating the Income and Transfer Taxation of Trusts," *Virginia Tax Review,* vol. 18, Winter 1999, pp. 545, 611-615.

[78] See, *e.g.*, Department of the Treasury, *General Explanations of the Administration's Fiscal Year 2017 Revenue Proposals*, February 2016, pp. 180-182.

[79] The annuity is valued under tables prescribed by section 7520 of the Code, which requires use of an interest rate equal to 120 percent of the Federal midterm rate in effect under section 1274(d)(1). Sec. 2702(a). The remainder interest is valued by subtracting the value of the annuity interest (as derived from the annuity tables) from the value of assets transferred to the trust. If returns on trust assets exceed the rate of return assumed under the annuity tables, any excess appreciation may pass to the remainder beneficiaries and escape gift or estate taxation.

Some have proposed additional requirements for GRATs, including a minimum 10-year term, that likely would sharply limit their utility as tools to avoid gift or estate tax.[80]

Third, taxpayers sometimes avoid generation-skipping transfer ("GST") tax by allocating GST exemption to a "perpetual dynasty trust." Once a taxpayer allocates GST exemption to a trust, the trust assets often may grow indefinitely, benefiting beneficiaries in multiple successive generations without further GST tax consequences. Some have argued that this result is inconsistent with one of the principal purposes of the GST tax: to impose transfer tax at each generational level.[81]

Policymakers could address the use of perpetual dynasty trusts by prohibiting any allocation of generation skipping tax exemption to a trust that could benefit generations other than the transferor's children or grandchildren.[82] Others have suggested that the GST exemption allocated to a trust should expire within a specified period of time. For example, in its revenue proposals for Fiscal Year 2017, the Administration proposed a rule under which the generation skipping transfer exclusion allocated to a trust terminates on the 90th anniversary of the creation of the trust.[83]

These changes may make the transfer tax system administratively less complex and increase tax collection. However, policymakers should consider how these changes may interact with each other, as well as with the transfer tax system and the income tax system.

[80] See, *e.g.*, Department of the Treasury, *General Explanations of the Administration's Fiscal Year 2017 Revenue Proposals,* February 2016, pp. 180-182.

[81] Since the original enactment of the GST tax, many States have repealed or sharply limited application of their rules against perpetuities, which limited the maximum duration of a trust.

[82] See, *e.g.*, Joint Committee on Taxation, *Options to Improve Tax Compliance and Reform Tax Expenditures* (JCS-02-05), January 27, 2005, p. 392.

[83] See, *e.g.*, Department of the Treasury, *General Explanations of the Administration's Fiscal Year 2017 Revenue Proposals*, February 2016, pp. 183-184.

UPDATES ON NEVADA TRUSTS

ALAN D. FREER, ESQ.

USING THE NEVADA COURT SYSTEM TO AID IN ADMINISTRATION

JURISDICTION IN NEVADA

- WHO CAN REQUEST ASSUMPTION OF JURISDICTION
  - TRUSTEE, SETTLOR, OR BENEFICIARY (NRS 164.010(1))
- WHEN IS JURISDICTION APPROPRIATE
  - TRUSTEE RESIDES OR CONDUCTS BUSINESS IN NEVADA (164.010(1))
  - NEVADA TRUST, SITUS OR BENEFICIARY (164.010(2)(B) AND (F))
  - ADMINISTRATION IN NEVADA (164.010(2)(F))
- EFFECTS OF JURISDICTION
  - IN REM JURISDICTION OVER TRUST (164.010(4); 164.015(1))
  - PERSONAL JURISDICTION OVER TRUSTEE (164.010(4))

LITIGATION TOOLS

- DECLARATORY RELIEF TO APPROVE ESTATE PLAN
  - NRS 30.040(2)
- PETITION FOR INSTRUCTIONS PRIOR TO APPROVE ACTION
  - NRS 164.015(1)
- REFORMATION OF TRUSTS
  - NRS 153.031(N);
  - *IN RE IRREVOCABLE TRUST AGREEMENT OF 1979*, 130 NEV. 597, 607, 331 P.3D 881, 889 (2014)

BENEFITS OF NEVADA JUDICIAL SYSTEM

- ADVERSARIAL SYSTEM / CONSENT CALENDAR
  - NRS 155.160
  - EDCR 4.13, 4.14; WDCR 57.4
- VIRTUAL REPRESENTATION
  - NRS 155.140(C), (D), (E)
  - NRS 164.038
- EASY TO RELINQUISH ONGOING JURISDICTION AT ANY TIME
  - 164.010(6)

Greetings
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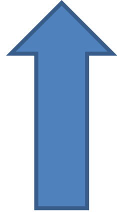
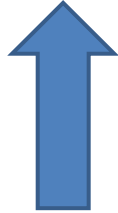
RELEVANT LEGISLATIVE CHANGES AB 318 (EFF. OCTOBER 1, 2021*)

HOW TO CHECK LEGISLATIVE WEBSITE FOR MOST UP TO DATE VERSION

[Rev. 12/21/2019 10:37:04 AM--2019]





TITLE 12 - WILLS AND ESTATES OF DECEASED PERSONS

CHAPTER 132 - GENERAL PROVISIONS

NRS 132.010 **Construction of title: Liberal construction.**
NRS 132.015 **Construction of title: Title to be construed consistent with chapter 719 of NRS.**
NRS 132.025 **Definitions.**
NRS 132.030 **"Abatement" defined.**
NRS 132.035 **"Acknowledgment" defined.**
NRS 132.040 **"Administrator" defined.**
NRS 132.045 **"Agent" defined.**
NRS 132.050 **"Beneficiary" defined.**
NRS 132.053 **"Certified paper original" defined.**
NRS 132.055 **"Child" defined.**
NRS 132.060 **"Citation" defined.**
NRS 132.065 **"Claim" defined.**
NRS 132.070 **"Codicil" defined.**
NRS 132.075 **"Community property" defined.**
NRS 132.080 **"Community property with right of survivorship" defined.**
NRS 132.085 **"Descendant" defined.**
NRS 132.090 **"Designation of beneficiary" defined.**
NRS 132.095 **"Devise" defined.**
NRS 132.100 **"Devisee" defined.**
NRS 132.115 **"Distributee" defined.**
NRS 132.116 **"District court" and "court" defined.**
NRS 132.1165 **"Domestic partners" defined.**
NRS 132.1168 **"Electronic notary public" defined.**
NRS 132.117 **"Electronic record" defined.**
NRS 132.118 **"Electronic signature" defined.**
NRS 132.119 **"Electronic will" defined.**
NRS 132.120 **"Estate" defined.**
NRS 132.125 **"Estate tax" defined.**
NRS 132.130 **"Executor" defined.**
NRS 132.135 **"Expenses of administration" defined.**
NRS 132.140 **"Family allowance" defined.**
NRS 132.145 **"Fiduciary" defined.**

BILL TEXT CAN BE LOCATED AT

HTTPS://WWW.LEG.STATE.NV.US/APP/NELIS/REL/81ST2021/BILL/7839/TEXT

AB 318 § § 4-16

AMENDS STATUTES RELATING TO ELECTRONIC WILLS AND AUDIO/VISUAL WITNESSING

(NRS 132 AND 133)

- Amends provisions of NRS Chapters 132 and 133 to facilitate the execution of electronic wills.
- Updates and relaxes remote execution of electronic wills.
- Done in light of the current Covid-19 global pandemic.
- Also includes statutes to create clear procedure for the conversion of an electronic will into a certified paper original will.

AB 318 § 34

AMENDS STATUTES RELATING TO ELECTRONIC TRUSTS (163.0095)

- ESTABLISHES THE CIRCUMSTANCES IN WHICH THE CUSTODIAN OF AN ELECTRONIC TRUST MAY CONVERT THE ELECTRONIC TRUST INTO A CERTIFIED PAPER ORIGINAL OF THE ELECTRONIC TRUST AND THE METHOD BY WHICH AN ELECTRONIC TRUST MAY BE CONVERTED INTO A CERTIFIED PAPER ORIGINAL.
- AUTHORIZES THE CUSTODIAN TO DESTROY THE ELECTRONIC RECORD OF THE ELECTRONIC TRUST AFTER CONVERTING THE ELECTRONIC TRUST INTO A CERTIFIED PAPER ORIGINAL IF THE CUSTODIAN FIRST TAKES CERTAIN ACTIONS. EXISTING LAW GENERALLY AUTHORIZES A TRUSTEE TO COMBINE TWO OR MORE TRUSTS INTO A SINGLE TRUST OR DIVIDE A TRUST INTO TWO OR MORE SEPARATE TRUSTS IN CERTAIN CIRCUMSTANCES AFTER GIVING NOTICE TO CERTAIN PERSONS.

SIMILAR TO ELECTRONIC WILLS EXCEPT FOR TRUSTS!

AB 318 § 18

NEW SECTION TO NRS 143

- ESTABLISHES THE CIRCUMSTANCES IN WHICH A PERSON IS REQUIRED TO ACCEPT OR NOT ACCEPT CERTIFIED LETTERS OF ADMINISTRATION OR LETTERS TESTAMENTARY
- PROVIDES THAT A PERSON WHO UNLAWFULLY REFUSES TO ACCEPT SUCH CERTIFIED LETTERS ARE SUBJECT TO A COURT ORDER REQUIRING ACCEPTANCE OF THE CERTIFIED LETTERS AND LIABILITY FOR REASONABLE ATTORNEY'S FEES AND COSTS.
- AUTHORIZES A PERSON, AFTER ACCEPTING CERTIFIED LETTERS OF ADMINISTRATION OR LETTERS TESTAMENTARY, TO SUBSEQUENTLY REQUEST NEWLY CERTIFIED LETTERS AFTER A CERTAIN PERIOD FOR THE PURPOSE OF VALIDATING THE CONTINUED AUTHORITY OF THE PERSONAL REPRESENTATIVE.

AB 318 § 19

NEW SECTION TO NRS 143

- AUTHORIZES A PERSON HOLDING PROPERTY OF A DECEDENT TO REQUEST THE PRESENTATION OF CERTAIN DOCUMENTS PRIOR TO TRANSFERRING PROPERTY IN ACCORDANCE WITH A COURT ORDER
  - A CERTIFIED COPY OF THE COURT ORDER;
  - A CERTIFIED COPY OF LETTERS OF ADMINISTRATION OR LETTERS TESTAMENTARY;
  - THE IDENTIFICATION AND CONTACT INFORMATION OF THE PERSONAL REPRESENTATIVE;
  - TAX INFORMATION, IF NECESSARY; AND
  - DOCUMENTS EVIDENCING THE DEATH OF THE DECEDENT.
- REQUIRES THE PERSON TO ACCEPT AND COMPLY WITH SUCH A COURT ORDER NOT LATER THAN 10 DAYS AFTER THE PRESENTATION OF ALL REQUESTED.
- IF REFUSE TO ACCEPT OR COMPLY WITH COURT ORDER, MAY BE LIABLE FOR ATTORNEY’S FEES, COSTS AND ANY DAMAGES RESULTING FROM DELAY.

AB 318 § 27

AMENDMENT TO NRS 146.070

- AMENDS SET-ASIDE STATUTE (NRS 146.070) TO PERMIT THE PROBATE COURT DISCRETION TO ENTER AN ORDER SETTING ASIDE THE ESTATE IN "POUR-OVER" ESTATES WHERE THE BENEFICIARY IS A INTERVIVOS TRUST ESTABLISHED BY THE DECEDENT.
- ANY PORTIONS SET-ASIDE TO THE TRUST UNDER THIS PROVISION ARE SUBJECT TO THE ESTATE'S CREDITORS UNLESS IT IS DEMONSTRATED TO THE COURT THAT THE ESTATE'S CREDITORS WERE PROVIDED NOTICE TO CREDITORS BY THE TRUST PURSUANT TO NRS 164.025.

AB 318 § 31

NEW SECTION TO NRS 163

- ALLOWS A GOVERNING TRUST INSTRUMENT TO AUTHORIZE A TRUSTEE TO REIMBURSE A SETTLOR FOR ALL OR A PORTION OF TAX ON TRUST INCOME OR PRINCIPAL THAT IS TO BE PAID BY THE SETTLOR AND AUTHORIZES THE TRUSTEE TO PAY THE SETTLOR DIRECTLY OR PAY THE APPROPRIATE TAXING AUTHORITY ON BEHALF OF THE SETTLOR.
- ALSO PROVIDES THAT THE POWER OF A TRUSTEE TO MAKE SUCH A PAYMENT OR THE DECISION OF A TRUSTEE TO EXERCISE SUCH POWER IN FAVOR OF THE SETTLOR MUST NOT CAUSE THE SETTLOR TO BE TREATED AS A BENEFICIARY FOR THE PURPOSES OF NEVADA LAW.

AB 318 § 37

AMENDMENT TO NRS 163.5557

AMENDS POWERS OF INVESTMENT TRUST ADVISOR STATUTE (NRS 163.5557) TO PERMIT SUCH TRUST ADVISOR THE POWER TO VALUE NON-PUBLICLY TRADED INVESTMENTS HELD IN TRUST THAT ARE WITHIN SUCH TRUST ADVISOR'S MANAGEMENT AUTHORITY.

AB 318 § 39

AMENDMENT TO NRS 163.556

- AMENDS NEVADA'S TRUST DECANTING STATUTE (NRS 163.556) TO CLARIFY THAT A TRUSTEE WHO HAS THE DISCRETION OR AUTHORITY TO ACT WITH THE CONSENT OF ANOTHER MAY DECANT TRUST PROPERTY IF SUCH CONSENT IS OBTAINED.
- CLARIFIES THAT SUCH DECANTING POWER IS AN ADMINISTRATIVE POWER OF THE TRUSTEE THAT MAY BE EXERCISED IN A TRUST THAT IS ADMINISTERED IN, SITUSED IN OR GOVERNED BY NEVADA LAW.
- LASTLY, PERMITS THE TRUSTEE TO APPOINT TRUST PROPERTY PURSUANT TO THIS SECTION TO A TRUST WITH THE SAME NAME WITHOUT ACTUALLY DISTRIBUTING THE PROPERTY TO A SEPARATE TRUST TO AVOID TAX IMPLICATIONS AND ADMINISTRATIVE HASSLE OF RETITLING ASSETS.

AB 318 § 40

AMENDMENT TO NRS 164.021

AMENDS THE NOTICE TO CREDITORS PROVISIONS RELATING TO TRUSTS (NRS 164.021) TO CLARIFY THAT THE 120 DAY LIMITATIONS PERIOD APPLIES TO BAR CREDITORS IN JUDICIAL AND NON-JUDICIAL SETTINGS.

AB 318 § 41

AMENDMENT TO NRS 164.025

- ESTABLISHES A FORM FOR A CLAIM AGAINST THE SETTLOR AND THE TRUST AND PROVIDES THAT A CLAIM FILED WITH THE TRUSTEE IS PRESUMED TO BE TIMELY FILED IF IT MEETS CERTAIN REQUIREMENTS.
- ESTABLISHES PROVISIONS CONCERNING THE DISCOVERY OF THE EXISTENCE OF AN ADDITIONAL CREDITOR AFTER THE INITIAL NOTICE TO CREDITORS IS PROVIDED.

AB 318 § 45

NEW SECTION TO NRS 239A

REQUIRES A FINANCIAL INSTITUTION TO PROVIDE A PUBLIC ADMINISTRATOR OR SIMILAR PERSON WITH ACCESS TO A SAFE DEPOSIT BOX OF A DECEDENT FOR THE PURPOSE OF INSPECTING AND REMOVING ANY WILL OR INSTRUCTIONS FOR DISPOSITION OF THE REMAINS OF THE DECEDENT.

A PRIMER ON TAX AND OTHER ISSUES RELEVANT TO ART COLLECTORS AND THEIR ADVISORS

Paul N. Frimmer

Los Angeles
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8-28-18

A PRIMER ON TAX AND OTHER ISSUES

RELEVANT TO ART COLLECTORS AND THEIR ADVISORS

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A PRIMER ON TAX AND OTHER ISSUES RELEVANT TO ART COLLECTORS AND THEIR ADVISORS

I. Sales of Art.

A. Income Tax: General Rules.

1. If the art has been held for more than one year, any gain on sale is long term capital gain[1] unless the seller is a dealer, in which case the gain is ordinary income.[2]

2. If the art has been held for one year or less, or if the seller is a dealer, the gain is short term capital gain or ordinary income.[3]

3. The federal long term capital gains rate for sales of art (and tangible personal property in general) is 28% plus 3.8% for the Medicare surtax.[4] When combined with a California rate that can be as high as 13% (without any benefit of the California income tax deduction against the federal income tax if the taxpayer pays tax at the alternative minimum tax rate[5]), the total long term capital gains tax rate on art can approach 45%. If the gain is short term capital gain or ordinary income, the rate can be over 50%.

4. Based on the rules for valuing tangible personal property sold at auction, estates of deceased collectors may have what might be called an "artificial" tax loss that can be used against capital gain from the sale of other property. Tangible personal property sold at auction is valued for estate tax purposes at the selling price, which is the hammer price plus any buyer's premium that is paid to the auction house. However, the seller may deduct the buyer's premium paid to the auction house as a selling expense on the estate tax return or on its income tax return. If the deduction is taken on the estate tax return, an artificial loss is created. For example, assume a painting sells at auction for a hammer price of $1,000, and the buyer pays the auction house $120 as the buyer's premium. For estate tax purposes, the fair market value of the painting is $1,120. If the estate deducts the $120 as an administration expense, estate tax will be paid on $1,000, which is the net amount that the estate received from the sale. For income tax purposes, the estate's basis is $1,120, but the estate only received $1,000. Therefore, there is a loss of $120 that can be used against other gain. If instead of deducting the

[1] IRC §§ 1(h)(4) & (5); IRC § 1222.

[2] IRC § 1221(a)(3)(c).

[3] IRC § 1221(a)(3)(c) & 1222.

[4] IRC §§ 1(h)(4) & 1411.

[5] IRC § 56(b)(1)(A)(ii).

LOEB & LOEB LLP

buyer's premium on the estate tax return, the buyer's premium is deducted on the income tax return as an expense of sale, there is a similar result. The estate received $1,000, but its basis is $1,120. Therefore, there is a $120 capital loss and when the selling expense of $120 is deducted, the loss increases to $240. However, the estate paid an additional $48 in estate tax because the full $1,120 was includable in the gross estate. The estate can do the math to determine whether deducting the buyer's premium on the estate tax return or on the income tax return is more beneficial, but in either case, there is an artificial loss as a result of the rules relating to the valuation of tangible personal property sold at auction.

B. Deferral of Income Tax: 1031 Exchange of Work of Art. Prior to the Tax Cut and Jobs Act of 2018, it was possible to accomplish an IRC §1031 exchange of art in a manner similar to an exchange of real property.[6] Even when one could use IRC §1031, a valid exchange was not accomplished by transferring a work of art to a dealer and having the dealer give the collector a credit toward the purchase of another work of art. Even though the availability of IRC §1031 has been eliminated, the prohibition is scheduled to expire for 2026 and beyond unless the law is changed. When IRC §1031 was available, there were some interesting issues that needed to be considered.

1. The taxpayer must have been an investor and not a dealer or collector.[7] A dealer is someone primarily engaged in the trade or business of selling works of art.[8] In contrast, an investor is someone who buys and sells with the primary motive of making a profit, but does not hold himself out to be a dealer or engage in a sufficient number of transactions that he is deemed to be engaged in the business of selling art.[9] For most collectors, the "investor" requirement was the biggest hurdle because most collectors buy art (and occasionally sell art) not necessarily to make a profit (although many do in an art world with exploding values), but rather for the personal enjoyment of owning the art. A true investor is likely to keep the art in storage rather than hanging it on his walls.

2. Both the property exchanged and the property acquired in the exchange must have been held for investment.[10]

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[6] IRC § 1031(a), modified to eliminate tangible personal property from its application by the Tax Cut and Jobs Act of 2018. P.L. No. 115-97.

[7] In order to qualify for a like-kind exchange under section 1031, the property must be held for "productive use in a trade or business or for investment." In addition, a 1031 exchange is not available for property held primarily for sale. IRC § 1031(a)(1) & (2).

[8] *Comm'r v. Groetzinger*, 480 US 23 (1978).

[9] *Drummond v. Comm'r*, 155 F.3d 558 (4th Cir. 1998). Treasury Regulation § 1031-1(b) provides that unproductive real estate held by a person other than a dealer for future use or future realization of the increment in value is held for investment and not primarily for sale. Treas. Reg. § 1031-1(b).

[10] Treas. Reg. § 1031-1(b), (c).

3. The art that is exchanged must have been "like kind" to the art being acquired. While there is very little law on the subject, the fact that a work of art was being exchanged for another work of art was not sufficient. For example, in the context of a 1033 exchange, the IRS ruled that destroyed lithographs could not be replaced with other artistic media.[11] Query whether a water color is like kind as to an acrylic, or a painting is like kind as to a collage or an assemblage in a frame?

4. The transaction must be accomplished through a qualified intermediary, which is usually an escrow company or other professional "accommodator" who is licensed to carry out exchanges.[12] Many of the accommodators who handle real estate exchanges also handled exchanges of works of art.

5. All of the technical rules for exchanges had to be followed, such as the filing of IRS Form 8824.

C. Sales Tax. A seller of art is liable for sales tax for sales within the state, unless an exemption applies.

1. A seller may elect to collect sales tax from the buyer, but the seller is ultimately liable for the sales tax in the event the buyer fails to pay.

2. In California, for example, a seller is not liable for the payment of sales tax if one of the following common exemptions applies:

   (a) A sale to a dealer or someone else who has a valid resale number for resale.[13]

   (b) Occasional sales, which in California means less than three sales in a twelve month period.[14]

   (c) Shipments out of state pursuant to the contract of sale.[15]

3. Other states have different exemptions, so it is important to review the state's law in which the sale occurs.

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[11] PLR 8127089.

[12] Treas. Reg. § 1031-1(k)-1(g)(4).

[13] Cal. Rev. & Tax'n Code §§ 6091; 6092.

[14] Cal. Rev. & Tax'n Code § 6006.5; Cal. Sales & Use Tax Regs. § 1595(a)(1).

[15] Cal. Rev. & Tax'n Code § 6396.

D. California Resale Royalty Act.[16]

1. The California Resale Royalty Act provides that a 5% royalty must be paid to certain artists upon the sale of that artist's works of art. The royalty is payable if the seller is a California resident, or the sale occurs in California, unless the artist has been dead for more than 20 years.

2. Historically, the Act has been ignored more often than it has been honored, although some artists and their estates have been very aggressive in claiming the royalty. California is the only state in the United States that has a statute like the Act, although most of the European countries have laws similar to the Act and from which the act was patterned.

3. The Act has been found to be invalid, except perhaps for sales occurring in 1977.[17]

E. Federal Act. There is a federal resale royalty act making its way through Congress, but it is not yet the law.[18]

F. Dealing with Dealers – Consignment Agreements.

1. Transparency is critical. Obligate the dealer to disclose the selling price, the dealer's commission, commissions received from or paid to anyone else, and include "audit" rights (redacted, if necessary to protect the identity of a buyer).

2. Sellers should file for a security interest in the work while it is in the possession of the dealer. Title should pass upon payment to the seller, and not necessarily upon payment to the dealer.

3. Limit the time to sell and showings to select prospective purchasers to avoid "burning" the work.

4. Choose a favorable choice of law provision so that disputes are resolved at minimum cost to seller and maximum cost to dealer.

5. Limit warranties to title and authority to sell if possible.

6. Limit seller's liability to rescission and refund of the purchase price; no consequential damages.

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[16] Cal. Civil Code § 986.

[17] The Act was found partially unconstitutional in 2012, *Estate of Graham v. Sotheby's*, 860 F. Supp. 2d 1117 (C.D. Cal. 2012), and completely invalid in 2018 except for sales in 1977. *Close, et al. v. Christies, Inc.*, No. 16-56235, July 6, 2018 (9th Cir. 2018).

[18] The most recent bill proposed by the House of Representatives is the American Royalties, Too (ART) Act of 2014, HR 4103.

7. Obligate dealer to pay all costs of packing, shipping (both ways if the work is not sold) and insurance at the high estimate of value.

8. Obligate dealer to collect sales tax, resale royalties (if applicable), export and import duties and other “costs” of sale.

9. Major auction houses are now in “competition” with dealers for private sales, which often gives the seller leverage.

10. For artists whose works are in high demand, be prepared for dealers to impose other conditions on the purchaser, some of which may be of questionable validity:

    (a) If the purchaser wants to sell the work at a later date, the purchaser must allow the dealer to sell it.

    (b) If the purchaser wants to sell the work at a later date, the dealer has first right of refusal, sometimes at fair market value and sometimes at the purchase price plus some artificial appreciation factor that has no relationship to the then current fair market value.

    (c) The dealer or the artist imposes a “private” royalty arrangement under which if the work is sold by the purchaser, the artist and perhaps the dealer are entitled to a percentage of the selling price. If California’s Resale Royalty Act continues to be unconstitutional, and whether or not the federal act is enacted, dealers and artists may be more or less aggressive in demanding some portion of the profit on the later sale of a work.

G. Sales at Auction –Consignment Agreements.

1. Despite the “boilerplate” contract, most sellers of major works do not pay any costs of sale. The auction houses will pay for pick up, return, crating, conservation to a limited extent, insurance (at the highest estimate instead of the standard contract provision insuring at the lowest or the median between the high and the low estimate).

2. Limit representations to title, authority to sell, and seller’s actual knowledge, with no duty to investigate, for representations such as payment of import/export taxes or whether there has been restoration.

3. For major works or major sales in the aggregate, the auction houses will give seller part of the buyer’s premium.

4. Unless there is a specific need for a certain amount of proceeds, guarantees usually are not a good economic deal for sellers because third-party guarantors want too much of the “upside.” In effect, a

guarantee is a willingness to sell for the guaranteed price, which is usually below even the low-end of market.

5. Include the right to cancel or postpone the sale of the work if there is an economic crisis immediately prior to the sale (the Dow falls by 20%, an emergency closes the markets, etc.).

6. Auction houses usually want the freedom to grant a purchaser terms without interest because they believe that many high-end purchasers expect interest-free terms. Six months is usually the maximum period, and if the auction house is given the ability to grant terms, there should be a substantial down payment.

7. The agreement should provide that if the auction house releases the work prior to payment (whether or not there are terms), the auction house is responsible for payment.

8. A seller is usually not allowed to withdraw the work from the auction without a financial penalty, but the criteria for the seller being able to withdraw should be narrowed to breaches of seller's obligations that are within seller's control. The criteria for an auction house being allowed to withdraw an item should be based on objective evidence and not upon the auction house's "belief" that something is wrong. Always have a provision allowing either party to "cure" within a reasonable time prior to the auction.

9. Check the auction house's "terms and conditions of sale" to make certain that the only remedy of a buyer is rescission and refund of the purchase price; no consequential damages.

10. The auction house's is seller's agent, and the normal rules of agency apply unless overruled in the agreement.

11. If a work is damaged while in possession of the auction house, the standard agreement provides that the auction house or its insurer will determine the extent of the damage and the amount to be paid. For significant works, this provision should be altered to interpose a neutral party to avoid a "one-sided" assessment of damage.

12. Most auction houses' standard agreements provide that the reserve, which is the lowest price that the work can be sold, is determined by the auction house. Modify this provision to provide for a joint determination or better yet, agree on the reserve in advance, subject to change with the seller's consent.

13. For sales of more expensive works or large sales in the aggregate, there may be "perks" other than a part of the buyer's commission. Some examples include putting the work on the front cover, the back cover or

pages inside the covers of the auction catalogue; placing the work within the auction in a certain position (in the first third); having a senior member of the auction team "travel" with the work to venues where it will be shown (typically, London and Hong Kong); having a separate catalog with an extensive discussion of the seller, the artist, the work, the context of the work, etc.; an agreed upon marketing plan outlining the number of venues to which the work will travel, the size and frequency and location of ads for the auction; and paying for family members to fly to the auction site and for hotel rooms at the auction site.

II. Purchases of Art: Sales and Use Tax. In addition to the usual issues of condition, authenticity, etc., the purchaser should consider the impact of the sales tax and the use tax:

A. All but three states (Oregon, Delaware and New Hampshire) have statewide sales tax and use tax laws.

B. Sales tax is payable when tangible personal property (e.g. art) is purchased within the state, and use tax is payable when it is purchased out of state with the intent to bring it into the state. The use tax is a compliment to the sales tax, and without the use tax, a person could purchase a car, for example, in a state that has no sales tax and bring the car into a state that has a sales tax without paying any sales tax.

C. California has been very aggressive in tracking purchases of art to determine whether a use tax is payable. For example, California has a sales tax office in New York that tracks auction sales. Under New York's sales and use tax law, if a work is purchased and is shipped out of New York via a common carrier, there is no New York sales tax obligation.[19] However, if the purchaser is a California resident, and the work is shipped to California for use in California, a California use tax is payable by the purchaser.[20] By checking auction records, bills of lading, export and import documents, etc., the California sales tax office in New York can determine whether works of art purchased in New York or coming into the United States from abroad are destined for California with a use tax obligation on the part of the purchaser. There is a question on the California income tax return that asks whether the taxpayer owes California use tax for the taxable year.[21]

D. It may be possible to avoid all sales and use tax if the transaction is properly structured. For example, if a work of art is purchased in New York and shipped from New York via a common carrier, there is no New York sales or use tax obligation. If the purchaser is a California resident, but the work is shipped to a state that has no use tax for use within that state, there may be no California use

[19] N.Y. Sales & Use Tax Regs. § 526.7(e)(2).

[20] Cal. Rev. & Tax'n Code § 6201.

[21] Cal. Form 540, Line 95.

tax obligation even if the work is ultimately brought back into California by the California purchaser. There is a presumption that if a work is first used outside of California for a period of at least 90 days, the work is not being purchased for use within California.[22] Although the law has not been tested, it is common for purchasers of high end art to have the works sent to a museum in Oregon or New Hampshire on loan for more than 90 days. If lending art to a museum is a "first use" (the law is not clear, but storage out of state is not a "use"), then when the art is brought back into California at the expiration of the loan period, no California use tax should be due. Shipping the art to a state that has a use tax may avoid California sales and use tax if a loan to a museum in that state is a "use," but the purchaser may be liable for the use tax in that state. Many states that have a use tax are not as aggressive as California in enforcing the tax, but the use tax obligation exists nonetheless.

III. Non-Charitable Gifts of Art. Lifetime gifts of art to family members (including trusts for family members) may prove beneficial if structured in the proper manner. In general, the rules relating to lifetime gifts of any property, including art, are as follows:

A. General Principles.

1. Each individual can give $15,000 per year to each other individual, and in addition, an individual can give $11,180,000 (as of January 1, 2018) over his or her lifetime. The $15,000 and the $11,180,000 are indexed for inflation, so they should continue to increase over time.

2. If gifts exceed the exclusions and exemption in Paragraph 1 above, the gift tax is 40% of the excess.

3. The donor's tax basis carries over to the donee unless gift tax is paid, in which case a portion of the gift tax is added to the donee's basis.

B. Lifetime Gifts v. Step-up in Basis.

1. In California, because the combined state and federal income tax rate for sales of art (see Section I above) can be greater than the 40% estate tax rate, gifts of art, even though appreciating, may not be as beneficial as they have been in the past when the estate tax rate was significantly higher than the income tax rate. Under the current rate structure, absent other considerations, it likely is better to pay estate tax at 40% on any appreciation (and receive a step-up in basis to the work's date of death value) than have the donee pay an income tax at 45% on any appreciation when the work is sold.[23]

[22] Cal. Sales & Use Tax Regs. § 1620(b)(3).

[23] This analysis is specific to California. For states like New York that impose a state estate tax, the tax benefits of lifetime transfers may continue to outweigh the income tax consequences.

2. Because it is more expensive to pay income tax on the sale of art in high tax states such as California than it is to pay estate tax, transferring art to avoid estate taxes is most likely not tax efficient unless the art is "legacy" art (art that will not be sold for many years), in which case an immediate reduction in the estate tax at death is more than likely to be more than offset by the hypothetical payment of capital gains tax when the work is sold many years subsequent to the date of death. If generation-skipping transfer tax planning is appropriate, there may be some benefit in transferring work during lifetime or at death.

C. Discounts for Gift of Fractional Interest in Art Work.

1. The law with respect to whether discounts are available for transfers of fractional interests in works of art is in a state of flux. There are two court cases on the subject, one of which allowed a 5% discount based on the fact that neither the taxpayer nor the Internal Revenue Service could prove what the appropriate discount should be, but the court instinctively knew that some discount was appropriate.[24] The second case, which was a more recent appellate court decision, allowed discounts of over 65% (the lower court allowed a 10% discount) based on the hypothetical "willing buyer, willing seller" test.[25] In the latest case, neither the taxpayer nor the Internal Revenue Service could demonstrate what the discount should be in the "real world" because there are no public instances of transactions involving fractional interests in art, but the Internal Revenue Service offered no evidence of value so the taxpayer's evidence, although not very persuasive, was accepted by default. Dealers often purchase fractional interests with other dealers and sometimes a dealer will sell his interest to another dealer, but usually those transactions are at "face value" with no discounts.

2. One alternative may be to place the works of art in an entity such as a limited liability company or partnership, and then make transfers of interests in the entity. Transfers of minority, non-marketable interests in entities are subject to discounts in the 35% to 50% range, but it is not clear whether a court would "look through" the entity and determine that the transfers were really transfers of works of art rather than transfers of interests in the entity (as the courts do in the family limited partnership context[26]).

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[24] *Stone v. U.S.*, 99 AFTR 2d 2007-2992 (2007, DC CA).

[25] *Estate of Elkins v. Comm'r*, 140 TC 86 (2013), *aff'd in part, rev'd in part*, 2014-2 U.S. Tax Cas. (CCH) P60,683 (5th Cir., Sept. 15, 2014).

[26] *See, e.g.*, *Estate of Nancy H. Powell v. Comm'r*, 148 T.C. No. 18 (2017); *Estate of Strangi v. Comm'r*, TC Memo 2003-145, *aff'd*, 417 F3d 468 (5th Cir. 2005)

D. Gift/Sale Leaseback.

1. Many collectors would like to transfer works of art to their children, but want to retain possession of the works during their lifetimes. It is clear that a transfer with a retained right to use and possess the transferred item will not accomplish anything because the transferred item will be subject to estate tax in the transferor's estate.[27]

2. One method of accomplishing the collector's goals of transferring the art and retaining its use is a sale (or gift) and leaseback to a grantor trust.

(a) To allow the donor to retain possession and enjoyment of the transferred art, the donor must pay fair rental value to the new owner.

(b) If the transfer is structured properly, and is made to a certain type of trust, called a "grantor" trust, the rent paid by the parent to the trust is not subject to income tax in the hands of the trust, and thus is a gift, estate and income tax free transfer of the rent from the parent to the children each year that the parent rents the art from the trust. Depending on how long the parent lives and continues to rent the art, the cumulative payment of rent may more than offset the "negative arbitrage" between the capital gains tax rate and the estate tax rate. (See Section III.A above).

(c) A gift/leaseback or sale/leaseback is a complex transaction with many risks, but if properly planned and the risks acknowledged, there can be a very substantial transfer of wealth at minimal tax costs. For example, determining the fair rental value for valuable works of art is virtually impossible at the present time because there is no market to prove what a reasonable rental rate is for valuable works of art. Many auction houses and others have started giving appraisals of "fair rental value," but in the author's experience, the appraisals are not persuasive because there are no comparables. If the rental value is too low, the value of the artwork is included in the donor's gross estate under IRC § 2036. If the rental value is too high, the donor may be making an annual gift to the trust. To eliminate the gift tax risk, the rental value could be determined based on a formula valuation clause, although valuation clauses are subject to IRS scrutiny.[28]

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[27] IRC § 2036(a)(1).

[28] Despite the IRS's continued challenges to valuation clauses, the taxpayer has enjoyed considerable success in recent years in withstanding such challenges. *Estate of Petter v. Comm'r*, 653 F.3d 1012 (9th Cir. 2011) (upholding formula clause where excess value passed to charity); *Hendrix v. Comm'r*, TC Memo 2011-133 (upholding formula clause where excess value passed to charity); *Wandry v. Comm'r*, TC Memo 2012-88 (court upheld gift of LLC units having a value, as finally determined for gift tax purposes, equal to a stated dollar amount).

E. Charitable Remainder Trusts.

1. An owner of a work of art can avoid paying the income tax on the appreciation at the time of sale by utilizing a charitable remainder trust. While a complete discussion of charitable remainder trusts is beyond the scope of this outline, in general, a charitable remainder trust is a trust that pays either a fixed annuity or a fixed percentage of the annual fair market value of the trust assets to the creator of the trust (and the creator's spouse if desired) for life, and upon the death of the creator (and the creator's spouse), the assets pass to charity.

2. There are several advantages to the creation of a charitable remainder trust:

(a) The creator receives an income tax deduction in the year the work of art is sold, not in the year the work of art is transferred initially to the charitable remainder trust.[29] The taxpayer is not eligible for an immediate income tax deduction because the taxpayer has retained an income interest in the tangible personal property. The deduction is available only when the retained income interest terminates.

(b) The amount of the deduction depends on whether the work of art is long term or short term capital gain property or ordinary income property. In addition, the amount of the deduction for capital gain property depends on the use to which the property will be put. If the donor establishes that the property will be reasonably expected to be put to a related used by the charity, the deduction for long term capital gain property will be based on fair market value.[30] It is almost impossible to demonstrate that the property will be put to a related use because the property is usually sold after contribution to the trust. Even if the property is intended to be retained by the trust, and the remainderman is a charity that will use the property in furtherance of its exempt function (a work of art given to a trust with a museum as the remainderman), the trust cannot restrict the trustee's ability to sell the property so there is no reasonable expectation that the work ultimately will be transferred to the charity.[31] If the contributed property does not relate to the charity's exempt purpose or function, the deduction is

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[29] IRC § 170(a)(3); Treas. Reg. § 1.170A-5. The taxpayer is eligible for an income tax deduction only when the taxpayer's rights to possession and enjoyment of the artwork have expired. The Treasury Regulations under Internal Revenue section 664 suggest that this rule applies to gifts of tangible personal property to a charitable remainder trust. Treas. Regs. §§ 1.664-2(d), -3(d).

[30] IRC § 170(e)(1)(B)(i); Treas. Reg. § 1.170A-4.

[31] *See* Treas. Reg. § 1.664-1(a)(3).

limited to the cost basis.[32] The IRS' position, as illustrated in Private Letter Ruling 9452026 (which is the only "authority" on point), is that the donor is entitled to an income tax deduction for the discounted value of the basis in the work of art contributed. The reasoning in the Ruling is that it cannot be demonstrated at the time of the gift that the work of art will be used in furtherance of the exempt purposes of the charitable remainder beneficiary even if the charitable beneficiary would be of the type that normally would use the work of art in furtherance of its exempt purposes (e.g., a museum). The author believes that the IRS' position in the Ruling is incorrect. Because the donor does not receive an income tax deduction until the work of art is sold because that is the time when the non-charitable interests terminate, at the time the deduction is allowed, the property of the trust is cash and not a work of art. Accordingly, the author believes that the deduction should be deemed to be a gift of cash rather than a gift of a work of art. It seems inconsistent for the IRS to treat the gift of a work of art as a gift of tangible personal property when the gift is made, but not to treat the gift as a gift of cash when the deduction is allowed. Of course, even if the deduction is based on fair market value, the deduction is never equal to the fair market value of the work because the right to receive payments during the creator's lifetime must be valued and subtracted from the value of the work because the charity only receives the work when the creator dies.

(c) The charitable remainder trust does not pay any income tax when it sells the work of art, thus making more assets available to earn income with which to make the payments to the creator.[33] For example, if a person has a work of art that he purchased for $10,000 that is now worth $1,010,000, a sale of the art would generate approximately $450,000 of capital gains tax, leaving the creator with $560,000 on which to earn income. If the charitable remainder trust sells the work, no income tax is payable, and the trust has $1,010,000 on which to earn income. In most cases, the income earned by the trust will be taxable to the creator as it is received, but with the capital gains rate approaching 45%, the trust will have approximately double the assets to invest over what the creator would have if the creator sells the work outside of the trust.

3. There are several negative aspects to charitable remainder trusts:

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[32] *Id*.

[33] IRC § 664(c). Charitable remainder trusts are not subject to the 3.8% net investment income tax, which is generally applicable for tax years beginning after 2012, but special rules apply for determining whether items of income allocated to annuity or unitrust payments constitute net investment income to the recipient beneficiary. See T.D. 9644, 78 Fed. Reg. 72394 (12/2/13); Treas. Regs. § 1.1411-3(b), (d).

(a) The creator cannot use the work after it has been given to the trust even if he is willing to pay the fair rental value. If it takes time to sell the work, the work must be placed in storage or lent to a museum during the period that the work is for sale.

(b) Upon the creator's death, the assets of the trust pass to charity so the assets are not available for the creator's family.

(c) Before a charitable remainder trust is created, there should be a financial analysis to see whether there is a reasonable possibility that the creator will be better off by creating the charitable remainder trust than he or she would have been by selling the work and paying the capital gains tax. Whether the creator is better off depends on many factors, such as the amount and availability of the charitable deduction, the capital gains rates in effect at the time of sale, the percentage payment that is made from the trust, the work's income tax basis and the creator's age.[34]

F. Other Estate Planning Techniques. Certain other estate planning techniques have been suggested for the transfer of art, but either the techniques do not work as well with art as they do with other assets, or the facts of a particular case have to be "perfect" for the technique to have a chance of working. For example, a grantor retained annuity trust ("GRAT") is a useful technique for passing appreciation over an assumed rate of return from the creator of the trust to family members. Although a complete discussion of GRATs is beyond the scope of this outline, a GRAT requires an annual annuity payment for a fixed number of years to the creator of the trust based on the initial fair market value of the property contributed to the trust. In the case of works of art, the transfer back will be a percentage of the work of art because the trust usually will not have liquidity with which to pay the annuity to the creator. Determining the annual fair market value of a work of art is expensive and often not productive because the GRAT works best when the appreciation can be demonstrated each year during the term of the GRAT. Works of art typically do not appreciate dramatically within a relatively short period of time, so within the term of a typical GRAT, it may not be possible to demonstrate what the appreciation is each year. Also, the GRAT and the creator of the GRAT are likely to own fractional interests in the work of art during the GRAT term, and usage of the art must be shared. While a GRAT could be an appropriate vehicle for transferring interests in works of art, the logistics and the inability to demonstrate increases in value over relatively short periods of time make the GRAT inappropriate for works of art in most cases.

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[34] See, William L. Hoisington, "The Truth About Charitable Remainder Trusts (How to Separate True Help From The Hype)," 45 Tax Law 293 (1992).

IV. Charitable Gifts of Art.

A. Deduction Limits. A gift of art to charity during the donor's lifetime generally entitles the donor to an income tax deduction, the amount of which is determined as follows:

1. The amount of the deduction depends on the nature of the gain that would be realized upon sale and the use to which the charity puts the work.

(a) If the sale of the work would generate long term capital gain, the deduction is equal to the fair market value of the work on the date of the gift if the charitable donee uses the work for a "related use" in furtherance of its exempt purposes.[35] The donor must receive written acknowledgement from the charity that the work will be so used.[36] If, however, the work will be used for a use that is unrelated to the purpose of function of the charitable donee, the deduction is limited to the donor's tax basis.[37] For example, if a donor gives a work to a museum to be added to the museum's collection, the fair market value deduction is available. If the donor gives the work to a church to be sold in the annual fund raiser silent auction, the deduction will be limited to the donor's tax basis. However, if the donor gives the work to a church to be hung in the church offices, a fair market deduction will be allowed. The deduction is subject to recapture if the donated art is sold within three years of the contribution.[38]

(b) If the sale of the work would generate short term capital gain or ordinary income, the deduction is limited to the donor's tax basis.[39] Works of art created by the donor or received by the donor as a gift from the creator are considered ordinary income property and therefore the deduction is limited to tax basis.[40]

2. Further, the deduction available to the donor is subject to certain percentage limitations based on the type of charity receiving the work and the nature of the gain.

(a) If the work is contributed to a public charity or a private operating foundation, the deduction limits are as follows:

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[35] IRC § 170(e)(1)(B)(i); Treas. Reg. § 1.170A-4.

[36] IRC §§ 170(e)(1)(B)(II); 170(e)(7)(D).

[37] IRC § 170(e)(1)(B)(i); Treas. Reg. § 1.170A-4.

[38] IRC § 170(e)(7).

[39] IRC § 170(e)(1)(A).

[40] IRC § 1221(a)(3).

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(1) If a sale of the art would generate long term capital gain, the deduction may be taken up to 30% of the donor's adjusted gross income (adjusted gross income is generally the same as taxable income).[41] If the donor is willing to reduce the value of the contribution by the gain that would be realized upon sale, the reduced value may be deducted up to 50% of the donor's adjusted gross income.[42]

(2) If the sale of the art would generate short term capital gain or ordinary income, the deduction may be used up to 50% of the donor's adjusted gross income.[43]

(b) If the work is contributed to a private non-operating foundation, the deduction limits are as follows:

(1) For capital gains, the deduction is limited to 20% of the donor's adjusted gross income.[44]

(2) For ordinary income, the deduction is limited to 30% of the donor's adjusted gross income.[45]

B. Qualified Appraisal Requirement. If the work has a value of $5,000 or more, no deduction will be allowed unless the donor obtains a qualified appraisal of value and certain other reporting requirements are complied with by the charity and by the donor.[46] The Pension Protection Act of 2006 created new definitions of "qualified appraisal" and "qualified appraiser."[47] The IRS has issued guidance relating to these definitions.[48]

1. A "qualified appraisal" means an appraisal that is (1) treated as a qualified appraisal under regulations or other guidance prescribed by the Secretary of the Treasury, and (2) conducted by a qualified appraiser in accordance with generally accepted appraisal standards and any regulations or guidance prescribed by the Secretary of the Treasury. An appraisal will be treated as having been conducted in accordance with generally accepted appraisal standards if, for example, the appraisal is consistent

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[41] IRC § 170(b)(1)(C)(i).

[42] IRC § 170(b)(1)(C)(iii).

[43] IRC § 170(b)(1).

[44] IRC § 170(b)(1)(C)(i), (e)(1)(B)(ii).

[45] IRC § 170(b)(1)(B).

[46] IRC § 170(f)(11).

[47] IRC § 170(f)(11)(E).

[48] Prop. Regs. §§ 1.170A-17; *see also*, Notice 2006-96, 2006-2 C.B. 902. Final regulations were issued and effective on July 30, 2018, without substantive changes to the qualified appraisal and qualified appraiser definitions.

with the substance and principles of the Uniform Standards of Professional Appraisal Practice as developed by the Appraisal Standards Board of the Appraisal Foundation.[49]

2. The term "qualified appraiser" means an individual who:

   (a) has earned an appraisal designation from a recognized professional appraiser organization or has otherwise met minimum education and experience requirements set forth in regulations prescribed by the Secretary of the Treasury;

   (b) regularly performs appraisals for which the individual receives compensation; and

   (c) meets such other requirements as may be prescribed by the Secretary of the Treasury in regulations or other guidance.[50]

3. An individual will not be treated as a qualified appraiser unless that individual:

   (a) has not been prohibited from practicing before the Internal Revenue Service by the Secretary of the Treasury at any time during the 3-year period ending on the date of the appraisal;[51] and

   (b) demonstrates verifiable education and experience in valuing the type of property subject to the appraisal.[52] For returns filed after February 16, 2007, such education and experience requirements are satisfied if the appraiser has successfully completed college or professional level course work that is relevant to the property being valued; obtained at least two years of experience in the trade or business of buying, selling, or valuing the type of property being valued; and fully described in the appraisal the appraiser's education and experience that qualify the appraiser to value the type of property being valued.[53]

4. Certain persons can never be qualified appraisers:

   (a) the donor;

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[49] IRC § 170(f)(11)(E)(i). See The Appraisal Foundation's website, www.appraisalfoundation.org, for the uniform standards of professional appraisal practice.

[50] IRC § 170(f)(11)(E)(ii).

[51] IRC § 170(f)(11)(E)(iii).

[52] *Id.*

[53] Prop. Regs. §§ 1.170A-17; see also, Notice 2006-96, 2006-2 C.B. 902. Final regulations were issued and effective on July 30, 2018, without substantive changes to the qualified appraisal and qualified appraiser definitions.

(b) a party to the transaction in which the donor acquired the property being appraised, unless the property is donated within two months of acquisition and its appraised value is no higher than its acquisition price;

(c) the charity/donee;

(d) anyone employed by any of the foregoing, or related to any of the foregoing; and

(e) anyone whose relationship to any of the foregoing individuals or entities would cause a reasonable person to question the appraiser's independence.[54]

5. Failure to obtain a qualified appraisal will result in the loss of the deduction even though it is obvious that the value is as claimed.[55] Taxpayers consistently have lost this battle with the IRS.[56] For example, if a donor purchases a work of art for $50,000 and gives the work to a museum for its collection the next day, no deduction will be allowed if the donor does not obtain a qualified appraisal even though it is obvious and provable that the value of the work is $50,000.

C. <u>Filing Requirements: Form 8283 and Form 8282</u>.

1. Form 8283

(a) The donor is required to file Form 8283 if the donor's deduction in a given year for all noncash gifts is more than $5,000.

(b) The form must be filed with the donor's tax return for the year in which the property was contributed and the deduction is first claimed.

(c) For art worth more than $20,000, a copy of the appraisal must be attached to Form 8283 with an 8 x 10 color photograph of the work.[57]

(d) For gifts over $500,000 the qualified appraisal also must be attached to the donor's income tax return.[58]

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[54] Treas. Reg. § 1.170A-13(c)(5)(iv).

[55] IRC § 170(f)11)(A)(i);

[56] *See, e.g., Gomez v. Comm'r*, T.C. Memo 1999-94; *Jones v. Comm'r*, T.C. Memo 1998-444; *Stephens v. Comm'r*, TC Memo 1997-204; *Novick v. Comm'r*, T.C. Memo 1996-564; *Hammann v. Comm'r*, T.C. Memo 1996-160; *Bradley v. Comm'r*, TC Memo 1996-461. Taxpayers may be subject to negligence penalties for failure to obtain an appraisal and, although less likely, fraud penalties. *Purnell v. Comm'r*, T.C. Memo 1993-593 (negligence penalty); *Manning v. Comm'r*, T.C. Memo 1993-377 (fraud penalty).

[57] Announcement 90-25, 1990-8 I.R.B. 25.

2. Form 8282:

(a) If the charity disposes of the contributed item within three years of receipt, it must report such disposition on Form 8282. Note that this was changed from two years by the Pension Protection Act of 2006.

(b) This rule does not apply if the donor certifies that the item was worth $5,000 or less.

(c) The Form 8282 advises the IRS of the amount of proceeds received upon disposition.

(d) A copy must be provided to the donor.

(e) Consider a three-year holding commitment on the part of the charitable donee, but this condition must be disclosed as a condition of the gift on Form 8283 and may affect value. Many charities observe a "voluntary" three-year holding period.

(f) Just because property is held for three years, it is not necessarily "related use" property for purposes of obtaining the fair market value deduction.[59]

D. IRS Statement of Value. Under certain circumstances, donors of art may request a Statement of Value from the IRS after making the gift, but before filing a tax return claiming the deduction.[60]

1. A Statement of Value can be requested for any item that has been appraised at $50,000 or more and has been transferred as a charitable gift. The IRS may issue a statement for lesser-valued items if at least one of the items has been appraised at $50,000 and it determines that issuing a statement would be in the interest of efficient tax administration.

2. The request for an IRS statement must include:

(a) A copy of the qualified appraisal. Additionally, the appraisal must include a complete description of the artwork and a photograph.

(b) There is a $2,500 fee for a statement for up to three items, plus $250 for each additional item.

(c) A declaration under penalties of perjury that the information is accurate.

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[58] IRC § 170(f)(11)(d).

[59] See Part IV.A.1 *supra*.

[60] Rev. Proc. 96-15, 1996-1 C.B. 627.

3. Requests received by January 15 will "ordinarily" result in a statement being issued by June 30. Requests received by July 15 will "ordinarily" result in a statement being issued by December 31.

4. If the IRS agrees with the donor's appraisal, it will issue a statement approving the appraisal. The donor may rely on such approval. If the IRS disagrees, it will issue a statement indicating the basis of its disagreement and its own determination of value.

5. A copy of the IRS's statement must be attached to and filed with the return on which the contribution is reported. If the return is filed before the statement is received, the return must indicate that a statement has been requested and attach a copy of the request.

6. The Statement of Value may be used for income tax, gift tax, or estate tax purposes.

7. In the author's experience, this process is rarely used and is helpful only for planning purposes if the donor makes gifts early in the year and would like to determine with relative certainly the donor's remaining available charitable deduction for the balance of the year.

E. Audits of Valuations of Art Work: Art Advisory Panel. If a work of art has a value in excess of $50,000, the donor should be prepared to have the work reviewed by the IRS Art Advisory Panel. The Panel is made up of volunteers who are active in the art community. Among its members are dealers, museum curators, and others who have significant experience in the art community. If the donor's income tax return is audited, the auditor will send photographs of the work (supplied by the taxpayer) and the qualified appraisal to the Panel. The Panel meets each April and October to review the values that taxpayers have placed on works of art.

1. In theory, the Panel does not know whether the taxpayer wants a "high value" because the gift is a gift to charity, or a "low" value because the owner has died and estate tax is payable on the value. However, for major works of art, the Panel often knows the purpose of the review because the Panel members are experienced members of the art community who generally track major collections and works in the ordinary course of their business.

2. After reviewing the work, the Panel will issue a report setting forth what it believes is the value of the work. While the Panel's report can be challenged, it usually does an excellent job of determining value, and it is difficult and expensive to challenge its determination of value.

F. Gift of Fractional Interest to Charity. Until recently, a popular method for donating art to charity, while retaining the use of the art, was a gift of a fractional interest. For example, a donor gives 20% of a work to a museum. The donor

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and the museum enter into an agreement that the donor will have the right of possession for 80% of the time and the museum will have the right of possession for 20% of the time. The donor usually kept the work initially, but was obligated to allow the museum to have possession 20% of the time. In most cases, the museum never exercised its right to possession except for perhaps a show of the artist's work. Thus, the donor received an income tax deduction for the 20% gift, but never actually gave up possession.[61] The law was amended a few years ago to impose the following somewhat draconian rules for dealing with gifts of partial interests, and the effect of these rules has been to eliminate gifts of partial interests except in very limited circumstances:[62]

1. The initial gift is valued at fair market value multiplied by the fractional interest given, with no discount for the fact that a fractional interest is given.[63]

2. Subsequent gifts of interests in the work are valued at the lesser of the value at the time of the gift of the first interest and the fair market value at the time of the gift of the subsequent interest. Accordingly, the donor gets no deduction for any appreciation.[64]

3. The entire work must be donated prior to the earlier of 10 years from the initial contribution and the date of the donor's death.[65]

4. The charity must actually have possession and use of the work for the fractional period equal to the fractional interest given.[66]

5. If the donor violates the 10 year requirement or the "possession" requirement, prior years' deductions are recaptured.[67]

G. Gift of Partial Interests. A donor may impose restrictions on the use or disposition of works of art given to charity, especially gifts to museums. Because a gift of a partial interest is not eligible for the income tax charitable deduction unless it is structured to fall within a narrow group of exceptions,[68] the issue becomes whether the imposition of the restrictions cause the gift to be a gift of a partial interest. Typical restrictions include requiring a credit line indicating that the gift was a gift of the donor; a restriction on deaccessing the work, either in perpetuity or for a limited period of time; a requirement that the work be displayed

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[61] *Winokur v. Comm'r*, 90 T.C. 733 (1988), acq. 1989-1 C.B. 1.

[62] IRC § 170(o).

[63] IRC § 170(o)(2).

[64] IRC § 170(o)(2).

[65] IRC § 170(o)(3).

[66] IRC § 170(o)(3).

[67] IRC § 170(o)(3).

[68] IRC § 170(f)(3).

for a minimum period of time within a certain period; and a requirement that the work be displayed in a specific location or with other specific works. The IRS has been liberal in favor of the taxpayer in ruling that restrictions such as these do not cause the gift to be a gift of a partial interest, although in one Private Letter Ruling, the gift agreement was required to be amended to eliminate the prohibition against deaccession in perpetuity.[69]

H. Bargain Sale to Charity. A donor may sell a work to charity for less than the fair market value of the work. This is known as a "bargain sale." For tax purposes, the bargain sale is treated as a part-gift part-sale.[70] A charitable contribution deduction is allowed for the excess of the fair market value of the work over the selling price. The donor must recognize gain to the extent of the excess of the selling price over the part of the donor's basis that has been allocated to the sale portion of the gift. The bargain sale rules only apply if a deduction is allowable under Internal Revenue Code section 170. Therefore, if the donor sells a work to a charity for an unrelated use and the purchase price is equal to the donor's tax basis in the work, there can be no bargain sale because the deduction allowable under Internal Revenue Code section 170(e)(1) is limited to the donor's tax basis.[71]

I. Promised Gifts to Charity. A promised gift to charity does not entitle the donor to an income tax deduction until the work is actually given.[72] Therefore, there is usually no economic benefit to making a promised gift, although there may be intangible benefits such as current recognition, satisfaction of a moral commitment, etc.

1. Many artists have "attached" a promised gift requirement to the purchase of their work. For example, an artist may allow the collector to purchase two paintings if the purchaser agrees to donate one of the paintings to charity. A purchaser often will receive a discount on the purchase price if the purchaser agrees to a binding promised gift agreement. If the collector is obligated to give the work to charity as part of the purchase transaction, the collector will not get an income tax deduction when the work is given during lifetime.

2. Promised gift agreements must be reviewed carefully to make certain that there are no hidden tax issues and that the donor's rights and obligations with respect to the work prior to actually transferring title are carefully delineated in the agreement.

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[69] See Priv. Ltr. Rul. 200202032; 200418002.

[70] IRC § 1011(b); Treas. Reg. § 1011-2.

[71] Treas. Reg. § 1.1011-2(a)(1).

[72] Treas. Reg. § 1.170A-1(a); Rev. Rul. 55-410, 1955-1 C.B. 297; Rev. Rul. 68-174, 1968-1 C.B. 81; *Petty v. Comm'r*, 40 T.C. 521 (1963); *Guren v. Comm'r*, 66 T.C. 118 (1976).

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3. Until recently, there has been little or no attention paid to whether a promised gift of a work of art to a museum results in a gift taxable event for the donor. There is a gift tax deduction for remainder gifts to charity during the donor's lifetime, but the deduction only applies if the gift is in the appropriate format , such as interests in a charitable remainder trust, a charitable gift annuity, and a remainder interest in a personal residence or farm.[73]

In the typical promised gift agreement, the donor promises to give the work on or before the donor's death. In effect, the gift is a gift of a remainder interest with a reservation of a life estate. The promised gift agreement usually prohibits the donor from selling or encumbering the work during the donor's lifetime so the charitable donee has some assurance that it will obtain the work upon the donor's death. Some museums file a UCC-1 to "perfect" a security interest in the promised work. Because a gift of a remainder interest, other than a remainder interest in a charitable remainder trust, personal residence or farm, or charitable gift annuity, is not deductible for gift tax purposes, a promised gift may be subject to gift tax.

In Private Letter Ruling 201825003, the taxpayer and his spouse "deeded" works of art to museums, but reserved a life estate. The taxpayer and his spouse were prohibited from selling the works during taxpayers' lifetimes, and there were a number of other restrictions included within the gift instrument. The IRS took the position that the transfer was a taxable gift because the donors gave up dominion and control, and none of the circumstances that would have permitted the gift to fail were within the control of the taxpayers.

The taxpayers did not raise the argument that the works were subject to claims of their creditors during lifetime. Although the taxpayers were prohibited from selling the works, theoretically, they could have incurred obligations during lifetime that would put the works at risk of their creditors. If assets are transferred but remain subject to the donor's creditors, the transfer is an incomplete gift.[74]

If relying on these authorities is not enough, the author believes that a solution to the problem is to provide in the promised gift agreement that the donor has the obligation to give the charity either the work or cash equal to the fair market value of the work at the time of the donor's death. If the donor gives cash, the charity has an option to purchase the work from the donor's estate for its fair market value. The charity will have the cash with which to purchase the work, and the charity's goal of obtaining the work will be achieved. Because the ability of the charity to get the

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[73] See footnote 68, supra.

[74] See, Rev. Rul. 76-103, 1976-1 C.B. 293; *Outwin v. Comm'r*, 76 T.C. 153 (1981).

work is within the control of the charity, the gift should be incomplete because the donor has a choice; the donor can give cash or the work.

J. Gifts to Foreign Charities. A donor does not get an income tax deduction for a gift to a foreign charity during lifetime,[75] but a decedent's estate will get an estate tax deduction for a gift to a foreign charity at death.[76] Many foreign charities have U.S. "friends of" organizations to which deductible gifts can be made during lifetime.[77] For example, the Tate in London has a "feeder" organization called American Friends of the Tate. A gift to American Friends of the Tate will be deductible for income tax purposes. For estate tax purposes, the gift can be left directly to the Tate in London.

K. No Deduction for Loans of Art Work to Charity. No deduction is available for allowing a charity to use art, nor is there a taxable gift if the loan is to a charity other than a private foundation and the use of the art is related to the charity's exempt function.[78]

L. Transfer of Copyright to Charity. While it is unusual for a collector or an investor to own both a work and the copyright associated with the work, if he or she does own both interests, there are special rules relating to the deductibility of transfers to charity:

1. For estate and gift tax purposes, the work itself and the copyright relating to the work are separate interests, and if someone owns both the work and the copyright, he or she can separate those interests for estate and gift tax purposes. However, only gifts that are made to charitable organizations other than private foundations (a private operating foundation is not considered a private foundation for this purpose) and for use by the charity in furtherance of its exempt purpose will qualify for the treatment of the work and the copyright associated with the work as separate interests.[79]

2. For income tax purposes, the work and the copyright associated with the work are considered to be one interest, and if the collector owns both, he will not receive an income tax deduction for a gift unless both the work and the copyright associated with the work are given at the same time.[80]

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[75] IRC § 170(c)(2); Rev. Rul. 63-252.

[76] IRC § 2055(a)(2); Treas. Reg. § 20.2055-1(a).

[77] Rev. Rul. 75-65, 1975-1 C.B. 79; Rev. Rul. 66-79, 1966-1 C.B. 48.

[78] IRC § 170(f)(3)(A); Treas. Reg. § 1.170A-7(a); IRC § 2503(g).

[79] IRC §§ 2055(e)(4); 2522(c)(3).

[80] IRC § 170.

V. Maintaining a Client's Collection After Death.

A. Many collectors think about donating all or part of their collections to recognized museums or other educational institutions. Historically, museums have been "judged" by the depth of their collections even though at any given time, a tiny fraction of the collection is exhibited, and for most works of art in the collections, the period of exhibition is almost non-existent over a long period of time. Collectors have begun to realize that if the collector wants his or her works shown to the public, giving the works to established museums or educational institutions is not likely to accomplish that goal unless the works are so significant that the donee museum or educational institution will agree to exhibit the work for a significant period of time during any period. Because of space limitations and the pressure to exhibit as many works as the museum thinks is appropriate, museums are reluctant to agree as part of the terms of a gift to exhibit donated works for any specific period of time. Usually, a museum will agree to exhibit a work for several months during a five-year period, but the structure of the gift must anticipate that the museum will breach the agreement (most of the time unintentionally due to lack of adequate record keeping or monitoring), and therefore, there should be a mechanism in the agreement for someone to monitor the museum's use and enforce the agreement if the agreement is being breached, whether intentionally or unintentionally.

B. In recent years, collectors have tried to find alternative ways of insuring that their collections will be viewed. One common alternative is to create a private operating foundation which becomes a "lending library" of art work. The works are stored (they cannot be hung in the creator's home or business), and are lent to museums and educational institutions around the United States or around the world. The foundation usually needs a financial endowment to help defray expenses of storage, conservation, insurance, and other expenses that are associated with owning and lending art. Depending on the borrower, expenses of packing, shipping and insurance while on loan may be borne by the borrower, but if the borrower is a small museum or educational institution, the foundation may pay the expenses in order to make the work available for viewing. Usually, the creation of a lending foundation is only practical for individuals with substantial collections and the financial wherewithal to "endow" the foundation for operations, but the lending foundation is a viable alternative to just leaving the works to a museum.

C. If the collection is donated to a lending foundation during lifetime, then the creator will receive an income tax deduction for the fair market value of the works, and if the lending foundation is created at death, the creator's estate will receive an estate tax deduction for the value of the works.

D. Another alternative is to find "lesser" museums for whom a work would be important to display because of the limited collection of the museum. There are many small museums throughout the country that would be happy to have works of art that the major museums will access, but not show very often. In many

cases, the reluctance to give to smaller museums is based on the collector's unrealistic view that his or her work is the "best" example of the artist's work.

VI. Special Rules for Artists. Artists often are collectors of the works of other artists whose works they received as gifts or in exchange for their own works. Ignoring the income tax consequences of artists' exchanges of their own works for works of other artists, several issues arise when artists make gifts, sales or bequests of other artists' work:

A. If the work was a gift from another artist, the donor artist's basis (which is most likely zero) carries over to the donee, and any sale will result in 100% gain, which will be ordinary income because the work is not a capital asset in the hands of the donee artist.[81]

B. A gift by the donee artist to charity results in a deduction for basis (again, most likely zero) because the donated work is deemed to have the same character (e.g., ordinary income property) in the hands of the donee artist.[82] Accordingly, most artists would be better off buying a work from another artist at fair market value if it is anticipated that the work will be sold or given to charity at a later date. However, if the selling price is below fair market value at the time of the sale, the rules set forth in paragraph 1 above will be applicable because the donee/purchaser artist's basis is determined in part by the donor artist's basis.[83]

C. Although an artist's ordinary income "taint" disappears at death, and any recipient of the artist's work receives a new basis and capital gain status for the work, the death of the artist does not remove the taint for previously gifted works because previously gifted works are not includable in the deceased artist's estate. Unless the donee artist dies owning the work that was previously gifted to him or her, in which case the ordinary income taint is removed because the basis is stepped up, the ordinary income taint remains with the gifted work, even if the donor artist dies.

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[81] IRC § 1221(a)(3).

[82] IRC § 1221(a)(3).

[83] IRC § 1221(a)(3).

Tax Planning for the Sale of a Business

Nevada Bankers Association

Presented by

Robert S. Keebler, CPA/PFS, MSP AEP (Distinguished)

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Overview

1. Build Back Better Act – *Rate Hike Fears*
2. Tax Incentives for Equity Investments in Small Business Corporations
3. Installment Sales
4. Incomplete Gift Non-grantor Trusts
5. Charitable Remainder Trusts

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Important Topics NOT Covered Today

- Ordinary Income v. Capital Gain
- “Double” Taxation
- Stock v. Asset Sales
- Tax-free Reorganizations
- Purchase Price Allocations

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Build Back Better Act

Rate Hike Fears

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Individuals, Trusts & Estates

- **State & Local Tax Deduction**
  - Increase the cap from $10,000 to $80,000
  - Increase effective from 2022 – 2030
  - The cap will not sunset in 2026 as planning
  - The cap will revert to $10,000 for 2031

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Individuals, Trusts & Estates

- 3.8% Net Investment Income Tax (NIIT) expansion
  - Expands the NIIT to cover income derived in the ordinary course of a trade or business for high income taxpayers
  - Does not apply to income on which FICA is already imposed
  - Applies after 12/31/21

CLOSES THE S-CORP LOOPHOLE

Expanded NIIT Threshold	
Married Filing Jointly (MFJ)	$500,000
Head of Household (HoH)	$400,000
Single	$400,000
Married Filing Separately	$250,000
Estates & Trusts	$400,000

NOT INDEXED FOR INFLATION

REAL ESTATE PROFESIONAL TREATMENT UNCLEAR

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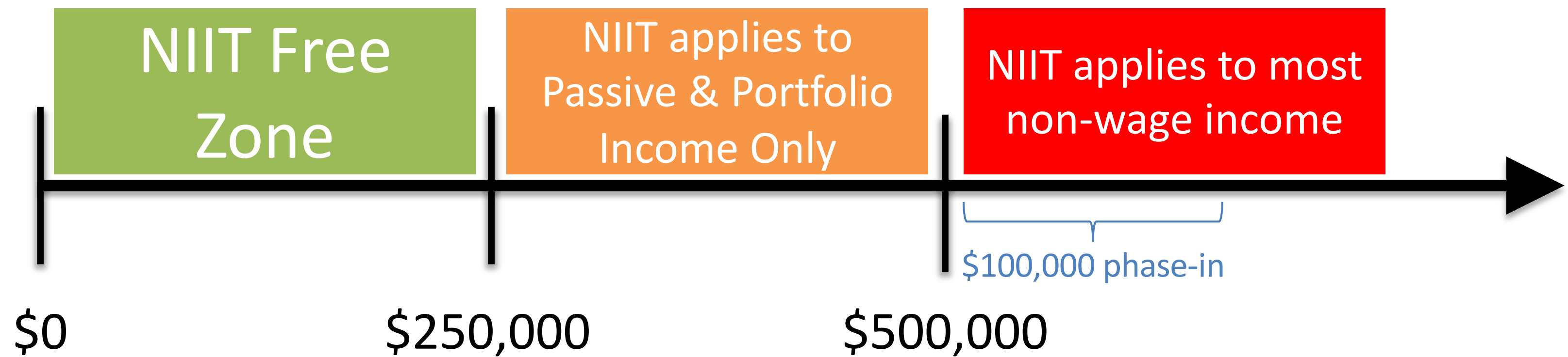
Individuals, Trusts & Estates

3.8% Net Investment Income Tax (NIIT) expansion



MFJ

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Individuals, Trusts & Estates

- Excess Business Loss Limitation
  - Section 461(l) limits pass-through business net losses which can offset non-business income to $250,000 (or $500,000 MFJ) (2021 limit)
  - This was added by the TCJA and set to sunset in 2025 (note, the CARES Act modified the effective date)
  - This legislation would permanently apply the limitation beyond 2025

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Individuals, Trusts & Estates

- High Income Taxpayer Surcharge
  - A surcharge equal to 5% of excessive Modified AGI
    - ➢ The AGI threshold is $10,000,000 ($5,000,000 MFS)
    - ➢ The AGI threshold is $200,000 for trusts & estates
  - A surcharge equal to 3% (8% total) of excessive Modified AGI
    - ➢ The AGI threshold is $25,000,000 ($12,500,000 MFS)
    - ➢ The AGI threshold is $500,000 for trusts & estates
  - Modifications to AGI include a reduction for investment interest
  - NO SUNSET date

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Individuals, Trusts & Estates

- Section 1202 Modifications
  - Limit gain exclusion to 50% for taxpayers with income in excess of $400,000
  - Note, there is also an AMT adjustment to contend with

This change would effectively eliminate the 100% exclusion.

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Tax Incentives for Equity Investments in Small Business Corporations

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Tax Incentives for Equity Investments in Small Business Corporations

- **IRC § 1244** - Ordinary losses
- **IRC § 1202** - Partial exclusion for gain
- **IRC § 1045** - Rollover of gain

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IRC § 1244
Ordinary Losses

- Available for individuals and partnerships to convert capital loss into ordinary loss
- Maximum amount for any taxable year:
  - $50,000
  - $100,000 for joint filers
- Losses in excess of income can be carried forward under § 172

26 U.S.C. § 1244

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Ordinary Losses

- 1244 Stock Definition
  - Additional requirements for stock issued before 11/6/78
  - Stock issued before 7/18/84 must be common stock; can be preferred stock thereafter as well
  - Stock in a domestic corporation
  - at the time such stock is issued, such corporation was a small business corporation
  - such stock was issued by such corporation for money or other property (other than stock and securities)
  - such corporation, during the period of its 5 most recent taxable years ending before the date the loss on such stock was sustained, derived more than 50 percent of its aggregate gross receipts from sources other than royalties, rents, dividends, interests, annuities, and sales or exchanges of stocks or securities

26 U.S.C. § 1244

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Ordinary Losses

- Small business corporation definition:
  - The aggregate amount of money and other property received by the corporation for stock, as a contribution to capital, and as paid-in surplus, does not exceed $1,000,000.
  - the amount taken into account with respect to any property other than money shall be the amount equal to the adjusted basis to the corporation of such property for determining gain, reduced by any liability to which the property was subject or which was assumed by the corporation

26 U.S.C. § 1244

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Ordinary Losses

- Individuals
  - Does not include trusts or estates
  - More restrictive than 1045 or 1202 in this respect
- Partnerships
  - Trusts & estates partners are not eligible; only individuals
  - Individuals must be partners at the time the stock is issued to the partnership to be eligible
  - Loss deduction limited to the partner's distributive share at the time the loss is sustained

26 U.S.C. § 1244

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IRC § 1202
Partial Exclusion For Gain

- Taxpayers (other than corporations) may be able to exclude certain percentages of gain on qualified small business stock provided the stock meets the following requirements:
  - Dollar limitation on the amount of gain
  - The stock must be issued after August 9, 1993
  - Must be a C corporation
  - Taxpayer must have acquired the stock at its original issue
  - The stock must be held for more than five years
  - The corporation must at all times have gross assets of $50 million or less
  - Must be an active business
  - Must be a qualified trade or business

26 U.S.C. § 1202

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Partial Exclusion For Gain

Acquisition Period	Exclusion Amount
Aug 9, 1993 - Feb. 17 2009	50%
Feb. 18, 2009 – Sept. 27, 2010	75%
Sept. 28, 2010 and after	100%

Note, there is a 60% exclusion for “empowerment zone businesses”

26 U.S.C. § 1202

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Partial Exclusion For Gain

Acquisition Period	AMT Add-Back Amount
Aug 9, 1993 - May 6, 2003	42%
May 6, 2003 – Sept. 27, 2010	7%
Sept. 28, 2010 and after	0%

26 U.S.C. § 1202

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Partial Exclusion For Gain

- The first time the exclusion is claimed it is capped to the greater of:
  - $10,000,000 ($5,000,000 for a married filing separately taxpayer)
  - **Ten times** the aggregated adjusted basis of the corporations qualified stock disposed by the taxpayer during the tax year
- The $10,000,000 limit is reduced in following years by the amount claimed in previous years
- Adjusted basis is determined without considering any additions to basis after the stock was issued

26 U.S.C. § 1202(b)

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Partial Exclusion For Gain

- The stock must be in a C corporation
  - "Must be a C corporation during substantially all of the taxpayer's holding period"

26 U.S.C. § 1202(c)

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Partial Exclusion For Gain

- Qualified small business
  - The corporation must at all times have aggregate gross assets of $50 million or less
  - the term "aggregate gross assets" means the amount of cash and the aggregate adjusted bases of other property held by the corporation
  - the adjusted basis of any property contributed to the corporation shall be determined as if the basis of the property contributed to the corporation were equal to its fair market value as of the time of such contribution
  - members of a parent-subsidiary controlled group (using a more-than-50% ownership test) are treated as a single corporation

26 U.S.C. § 1202(d)

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Partial Exclusion For Gain

- Active business requirement
  - at least 80 percent (by value) of the assets of such corporation are used by such corporation in the active conduct of 1 or more qualified trades or businesses

26 U.S.C. § 1202(e)

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Partial Exclusion For Gain

- Working capital
  - Assets held as part of the reasonable working capital needs of the business shall be treated as used in the active conduct of a trade or business
  - Assets held for investment and are reasonably expected to be used within 2 years to finance research and experimentation in a qualified trade or business shall be treated as used in the active conduct of a qualified trade or business
  - in no event may more than 50 percent of the assets of the corporation qualify as used in the active conduct of a qualified trade or business

26 U.S.C. § 1202(e)(6)

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Partial Exclusion For Gain

- Qualified trade or business requirement
  - any trade or business other than—

(A) any trade or business involving the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any trade or business where the principal asset of such trade or business is the reputation or skill of 1 or more of its employees,

(B) any banking, insurance, financing, leasing, investing, or similar business,

(C) any farming business (including the business of raising or harvesting trees),

(D) any business involving the production or extraction of products of a character with respect to which a deduction is allowable under section 613 or 613A, and

(E) any business of operating a hotel, motel, restaurant, or similar business.

26 U.S.C. § 1202(e)(3)

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Partial Exclusion For Gain

- Eligible corporations
  - any domestic corporation; except that such term shall not include—

(A) a DISC or former DISC,

(B) a corporation with respect to which an election under section 936 is in effect or which has a direct or indirect subsidiary with respect to which such an election is in effect,

(C) a regulated investment company, real estate investment trust, or REMIC, and

(D) A cooperative

26 U.S.C. § 1202(e)(4)

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Partial Exclusion For Gain

- Maximum real estate holdings
  - No more than 10 percent of the total value of its assets consists of real property which is not used in the active conduct of a qualified trade or business.
  - The ownership of, dealing in, or renting of real property shall not be treated as the active conduct of a qualified trade or business

26 U.S.C. § 1202(e)(7)

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IRC § 1045
Rollover of Gain

- Gain from the sale of qualified small business stock held by a taxpayer other than a corporation for more than six months is only recognized to the extent such sale exceeds the cost of any qualified small business stock purchased by the taxpayer within 60 days
- "Qualified small business stock" has the meaning given such term by section 1202(c).
- The taxpayer's basis in the replacement stock equals its purchase price less the amount of rollover gain

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Reporting Income from an Installment Sale

Reporting Income from an Installment Sale

- **IRC § 453** - Installment Method
  - Installment sale defined
    - ➢The term “installment sale” means a disposition of property where at least 1 payment is to be received after the close of the taxable year in which the disposition occurs.
    - ➢The term “installment sale” does not include dealer dispositions or a disposition of personal property of a kind which is required to be included in the inventory of the taxpayer if on hand at the close of the taxable year.

26 U.S.C. § 453(b)

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Reporting Income from an Installment Sale

- **IRC § 453** - Installment Method
  - Installment method defined
    - For purposes of this section, the term "installment method" means a method under which the income recognized for any taxable year from a disposition is that proportion of the payments received in that year which the gross profit (realized or to be realized when payment is completed) bears to the total contract price.

26 U.S.C. § 453(c)

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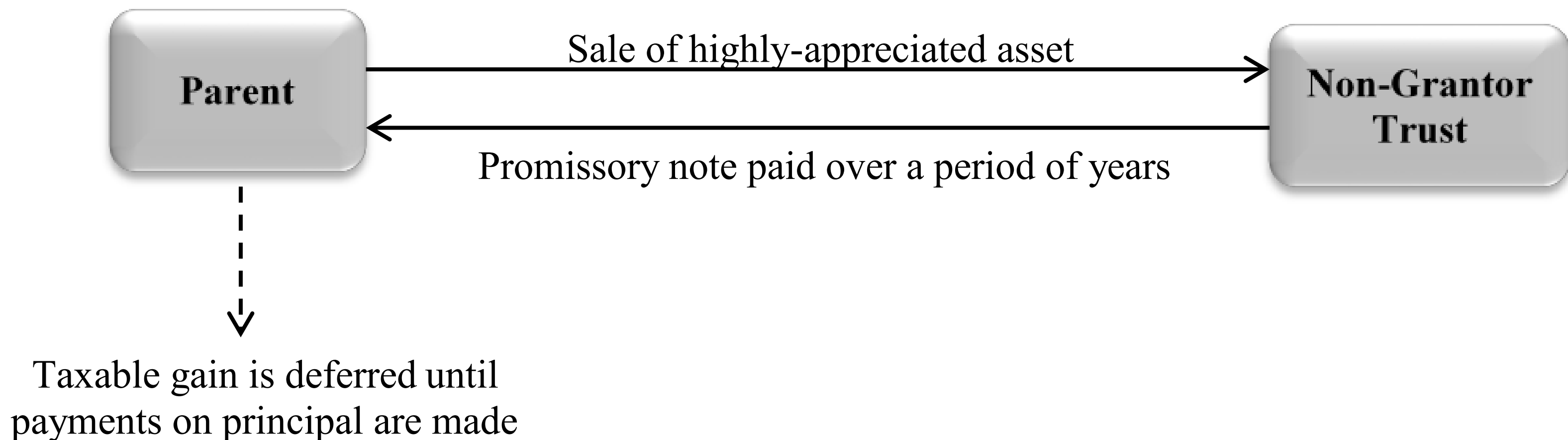
Reporting Income from an Installment Sale

- **IRC § 453** - Installment Method



26 U.S.C. § 453(c)

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Reporting Income from an Installment Sale

- **IRC § 453** - Installment Method
  - Election Out
    - Taxpayer can elect out of the installment method
    - Must be made on the return of the taxable year in which the disposition occurs
    - IRS must consent to revoking the election

26 U.S.C. § 453(d)

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Reporting Income from an Installment Sale

- **IRC § 453** - Installment Method
  - Second dispositions by related persons
    - ➢ Must be made on the return of the taxable year in which the disposition occurs
    - ➢ IRS must consent to revoking the election

26 U.S.C. § 453(e)

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Reporting Income from an Installment Sale

- **IRC § 453** - Installment Method
  - Second dispositions by related persons

Example 1. Parent (P) sells Greenacre, with a basis of $500,000 and FMV of $1,000,000 to a trust for P's children (CT). P takes back a 10-year note calling for 10 annual principal payments of $100,000 and adequate stated interest. CT's basis in Greenacre is $1,000,000, the amount of the note. In the first two years, CT makes payments of $100,000 to P and P recognizes $50,000 of gain on each payment. After making the second payment, T sells Greenacre to an unrelated party for $1,000,000 and recognizes no gain because CT's basis is equal to the selling price. CT has cashed out the full $1,000,000 value of Greenacre even though P has paid tax on only $100,000 of the gain. T will continue to pay off the note over the next eight years, gaining a substantial timing advantage.

26 U.S.C. § 453(e)

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Reporting Income from an Installment Sale

- **IRC § 453** - Installment Method
  - Interest on Deferred Tax Liability
    - ➢Interest is generally due on the deferred tax liability of outstanding installment agreements in excess of $5,000,000
    - ➢The deferred tax liability generally equals 20% x unrecognized gain
    - ➢The Underpayment Rate (currently 3%) applies

26 U.S.C. § 453A

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Reporting Income from an Installment Sale

Bracket Management

TOP OF EACH CAPITAL GAINS BRACKET					
	S	MFJ/QW	MFS	HOH	T&E
0%	$ 41,675	$ 83,350	$ 41,675	$ 55,800	$ 2,800
15%	$ 459,750	$ 517,200	$ 258,600	$ 488,500	$ 13,700
20%					

AMT	2021	2022
Single or Head of Household	$73,600	$75,900
Married Filing Jointly	$114,600	$118,100
Begin of Phaseout, Single or HoH	$523,600	$539,900
Begin of Phaseout, MFJ	$1,047,200	$1,079,800

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Reporting Income from an Installment Sale

Bracket Management

- Install sale benefits
  - Avoids a "spike" in income and allows it to be spread-out
  - **In the extreme, it can convert long-term capital gains taxed at 23.8% to 0%**

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Incomplete Gift
Non-Grantor Trusts

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Incomplete Gift Non-Grantor Trusts

- **Potential Opportunity:**
  - Resident of state with state income tax contributes low basis business equity interest to a Nevada Incomplete Gift Non-grantor (NING) Trust.
  - Trustee later sells the interest.
  - State income tax may be avoided.

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Incomplete Gift Non-Grantor Trusts

- **NING Trust**
  - Non-grantor trust for income tax purposes
    - Distribution Committee made up of adverse parties
  - Incomplete gift for gift tax purposes
    - Retained testamentary power of appointment
    - Retained non-fiduciary inter vivos power of appointment for HEMS
    - Chief Counsel Advice Memorandum 201208026

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Incomplete Gift Non-Grantor Trusts

- **The NING Trust doesn't work if you can't work around the resident's state income tax rules**
  - Source income
  - Non-source income
    - ➢ Grantor's residency?
    - ➢ Administered in state?
    - ➢ Resident trustee?
    - ➢ Resident beneficiary?

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Incomplete Gift Non-Grantor Trusts

- **Numerical Example – Low Basis Asset**
  - Example using round numbers
  - Assumptions
    - Business will be sold for $5,000,000
    - Income tax basis is $0
    - Federal capital gains rate is 20% plus 3.8% Obamacare
    - *State capital gains rate is 10%*
    - Disregard Federal income tax deduction for state income tax paid
  - Using NING Trust
    - $5,000,000 sales proceeds
    - $1,190,000 Federal income tax (i.e., $5,000,000 times 23.8% tax)
    - No state income tax (would have been $500,000 without the NING)
    - $3,810,000 after-tax proceeds (would have been $3,310,000 without the NING)

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Charitable Remainder Trusts

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Charitable Remainder Trusts

- **Potential Opportunity:**
  - Charitably inclined taxpayer contributes a low basis business equity interest to a CRT.
  - Trustee later sells the interest tax-free.
  - Grantor (or other beneficiary) receives a series of payments which are taxed as paid.
  - Income tax is deferred.
  - State income tax may be avoided.

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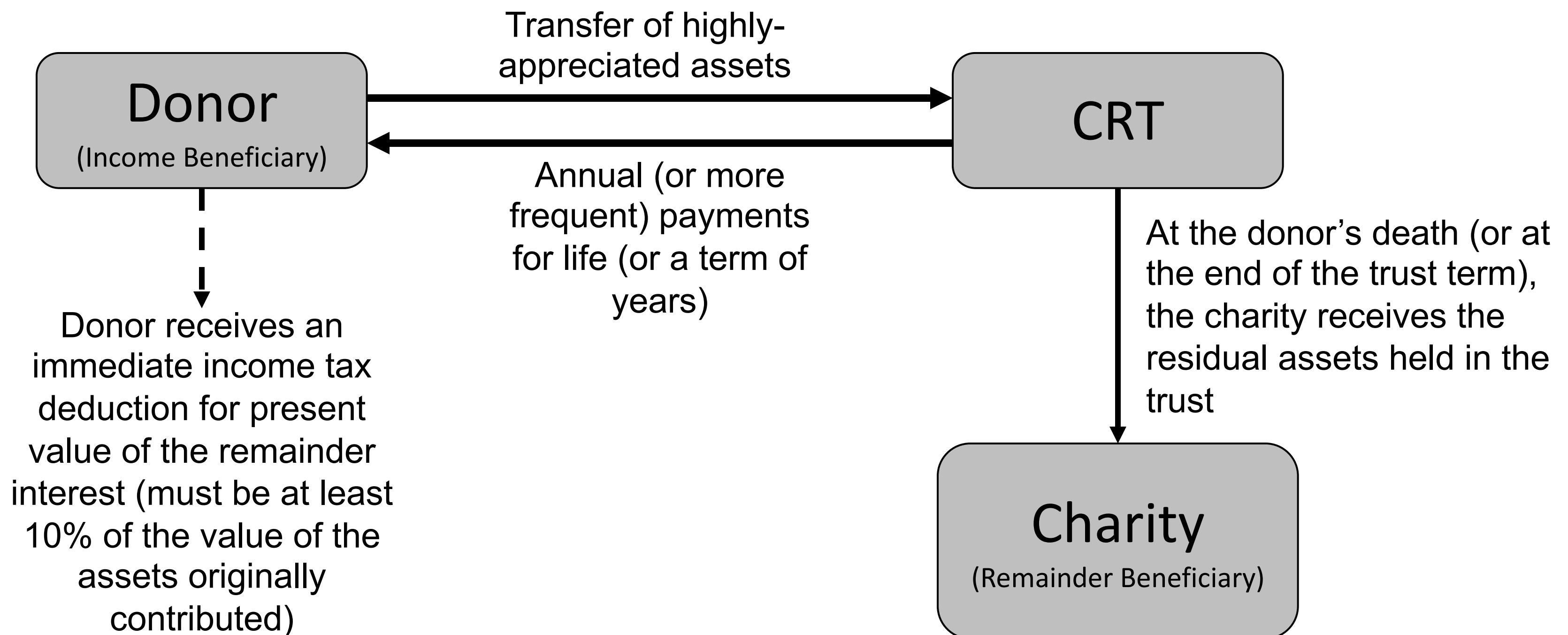
Charitable Remainder Trusts



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Charitable Remainder Trusts

- **Charitable Remainder Annuity Trust (CRAT)**
  - The beneficiaries receive a fixed percentage of the initial trust value or a stated amount annually or more frequently.
  - The amount paid doesn't change from year-to-year.
  - The annual payment must be 5-50% of the fair market value of the assets at the time of contribution.
  - The term of the annuity can be:
    - For a term up to 20 years,
    - Over the life of the annuitant(s),
    - Over the shorter of the two, or
    - Over the longer of the two.

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Charitable Remainder Trusts

- **Charitable Remainder Unitrust (CRUT)**
  - Income beneficiaries receive a stated percentage of the trust's assets revalued each year.
    - ➢ The distribution will vary from year-to-year depending on the investment performance of the trust assets and the amount withdrawn.

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Charitable Remainder Trusts

- **Taxation of the Donor & Trust**
  - Donor generally does not realize gain or loss when property is transferred to the trust
  - The donor generally will not realize gain or loss if and when the transferred assets are subsequently sold by the trustee of the CRT*
  - Distributions in kind are treated as a sale of the property distributed, resulting in gain recognition by the CRT. Treas. Reg. §1.664-1(d)(5).

*Need to consider the binding commitment issue. See Rev. Rul. 78-197.

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Charitable Remainder Trusts

- **Taxation of Distributions**
  - The character of income received by the recipient is subject to and controlled by the tier rules of IRC §664(b):
    - First, distributions are taxed as ordinary income
    - Second, distributions are taxed as capital gains
    - Third, distributions are taxed as tax-exempt income (e.g. municipal bond income)
    - Finally, distributions are assumed to be the non-taxable return of principal

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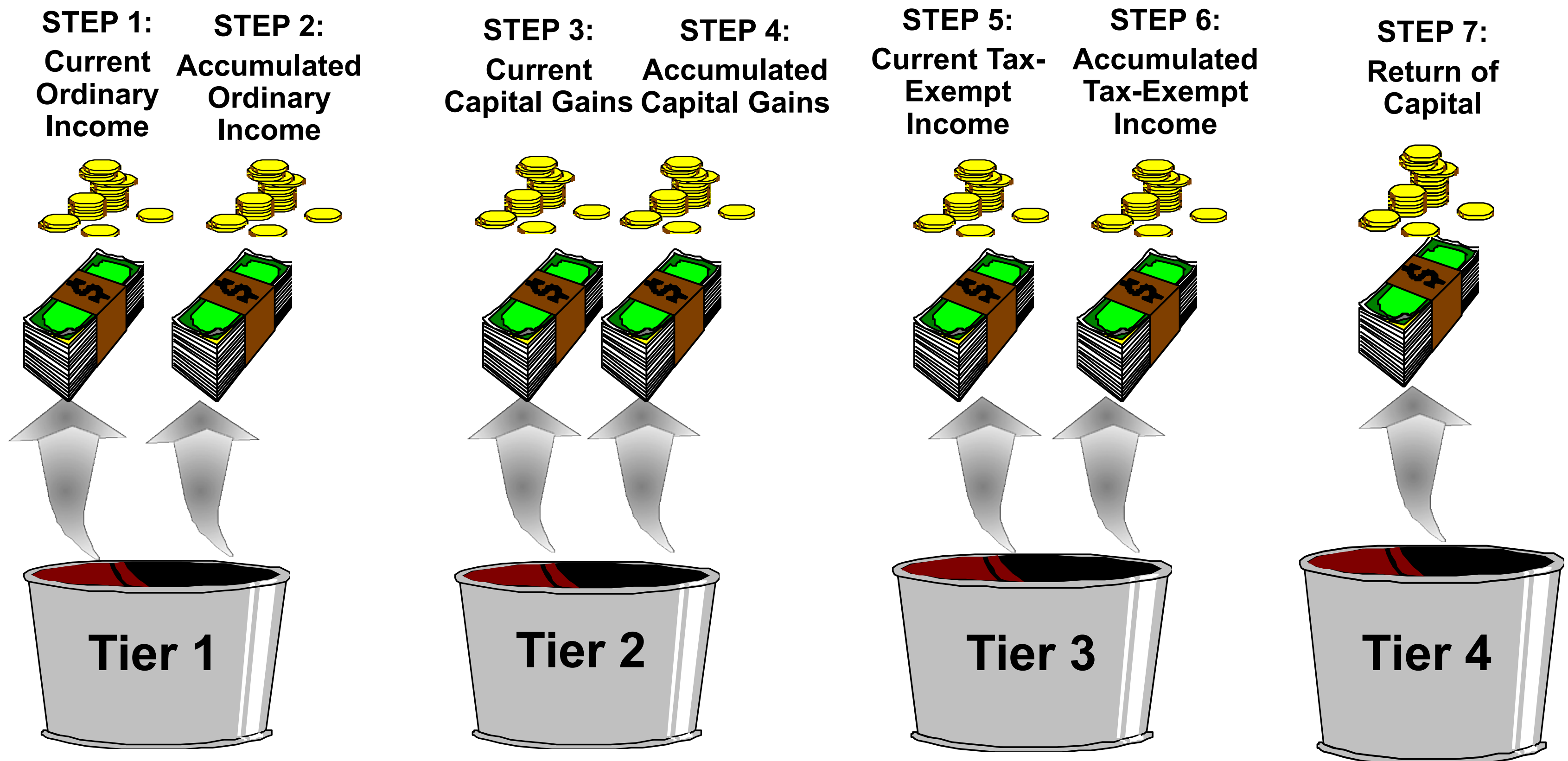
Charitable Remainder Trusts



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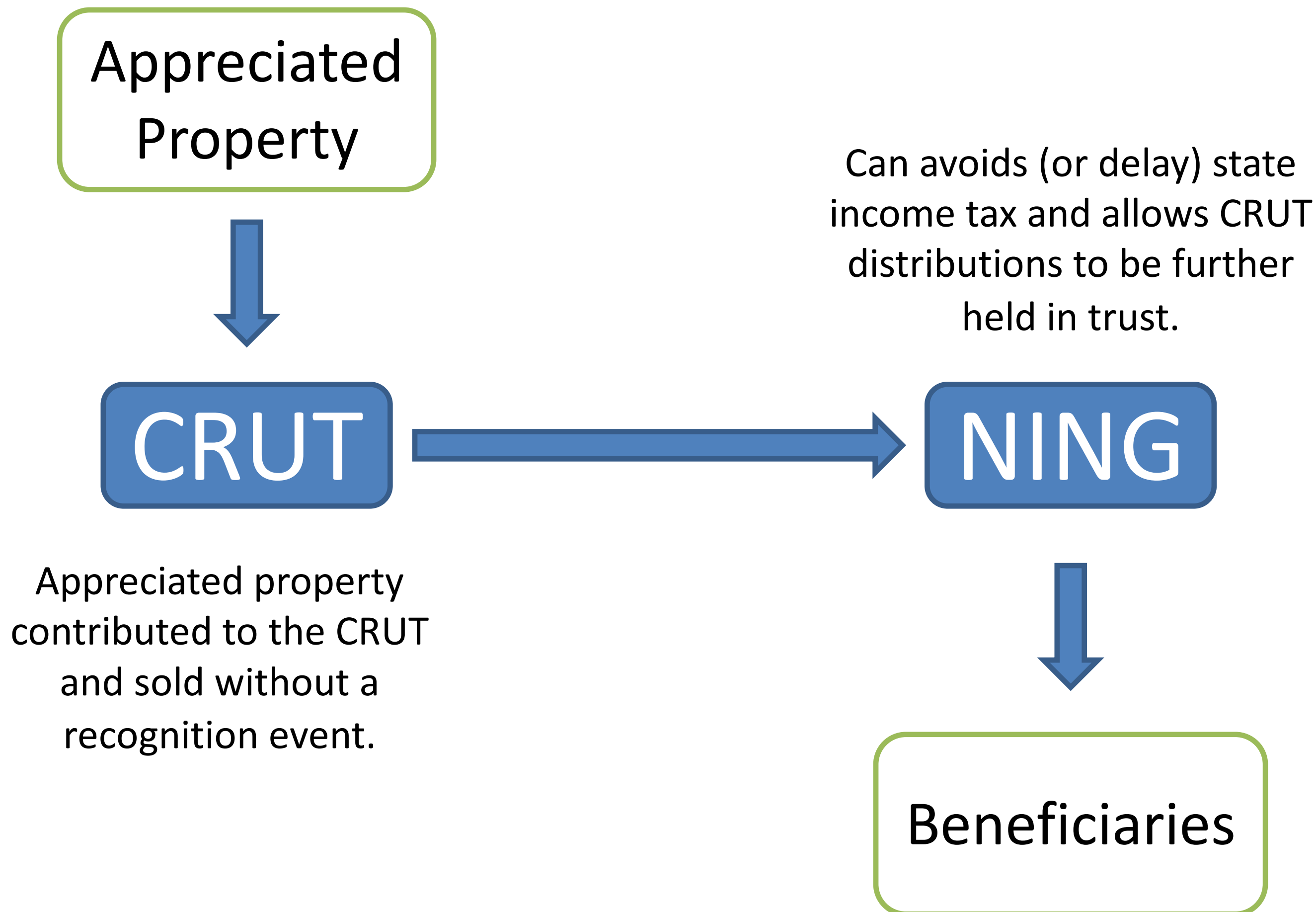
Combining Strategies



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Questions

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