Taxing Topics: Fundamental Income Tax Issues Every Advisor Should Know

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Taxes

"Anyone may arrange his affairs so that his taxes shall be as low as possible; he is not bound to choose that pattern which best pays the treasury. There is not even a patriotic duty to increase one's taxes. Over and over again the Courts have said that there is nothing sinister in so arranging affairs as to keep taxes as low as possible. Everyone does it, rich and poor alike and all do right, for nobody owes any public duty to pay more than the law demands."

Judge Learned Hand, Gregory v. Helvering, 69 F.2d 809 (2d Cir. 1934), aff'd, 293 U.S. 465 (1935)

“Just so you know, I’m taking all this with me into the afterlife.”

Factors for Income Tax & Basis Planning

- Federal Taxes
  - Estate taxes vs income taxes
  - Uncertainty
- State Taxes
  - State income taxes
  - State estate/inheritance taxes
- Whose income tax rate?
- Nature of asset
  - Real Estate
  - Closely-held Business
- How will benefits of basis adjustment be recaptured?
  - Will the property be sold?
  - Depreciated?

Basis Adjustments at Death - §1014

- §1014(a)(1) - the "basis of property in the hands of a person acquiring the property from a decedent or to whom the property passed from a decedent" is the "fair market value of the property at the date of the decedent's death."
  - Commonly known as the "Step-up" or "Step-down"
- General rule subject to §2032 (alternate valuation date) and §2032A (special use valuation), and exclusion under §2031(c) (conservation easement)
  - The alternate valuation election under §2032 is not available unless the election results in a lower value for the gross estate and a smaller combined estate and generation-skipping transfer tax liability (see §2032(c)).

Basis Adjustments at Death - §1014

- §1014(b) – What does it mean for property "to have been acquired from or to have passed from a decedent"?
- §1014(c) – Basis adjustment does not apply to "income in respect of a decedent."
  - Qualified retirement accounts
  - Annuities
  - Installment notes / completed contracts

Basis Adjustments at Death - §1014

- §1014(e)(1) provides that if "appreciated property was acquired by the decedent by gift during the 1-year period ending on the date of the decedent's death" and the property is "acquired from the decedent by (or passes from the decedent to) the donor of such property (or spouse of such donor)," then the property will not receive a step-up in basis, and it will have the basis in the hands of the decedent before the date of death.
- §1014(e)(2)(B) provides that carryover basis will apply to any appreciated property "sold by the estate of the donor or by a trust of which the decedent was the grantor," but only "to the extent the donor of such property (or the spouse of such donor) is entitled to the proceeds from such sale."
- PLR 200101021 - Section 1014(e) will apply to any trust property includible in the decedent's gross estate that is attributable to the surviving grantor's contribution to trust and that is acquired by the surviving grantor, either directly or indirectly, pursuant to the decedent's exercise, or failure to exercise, the general power of appointment

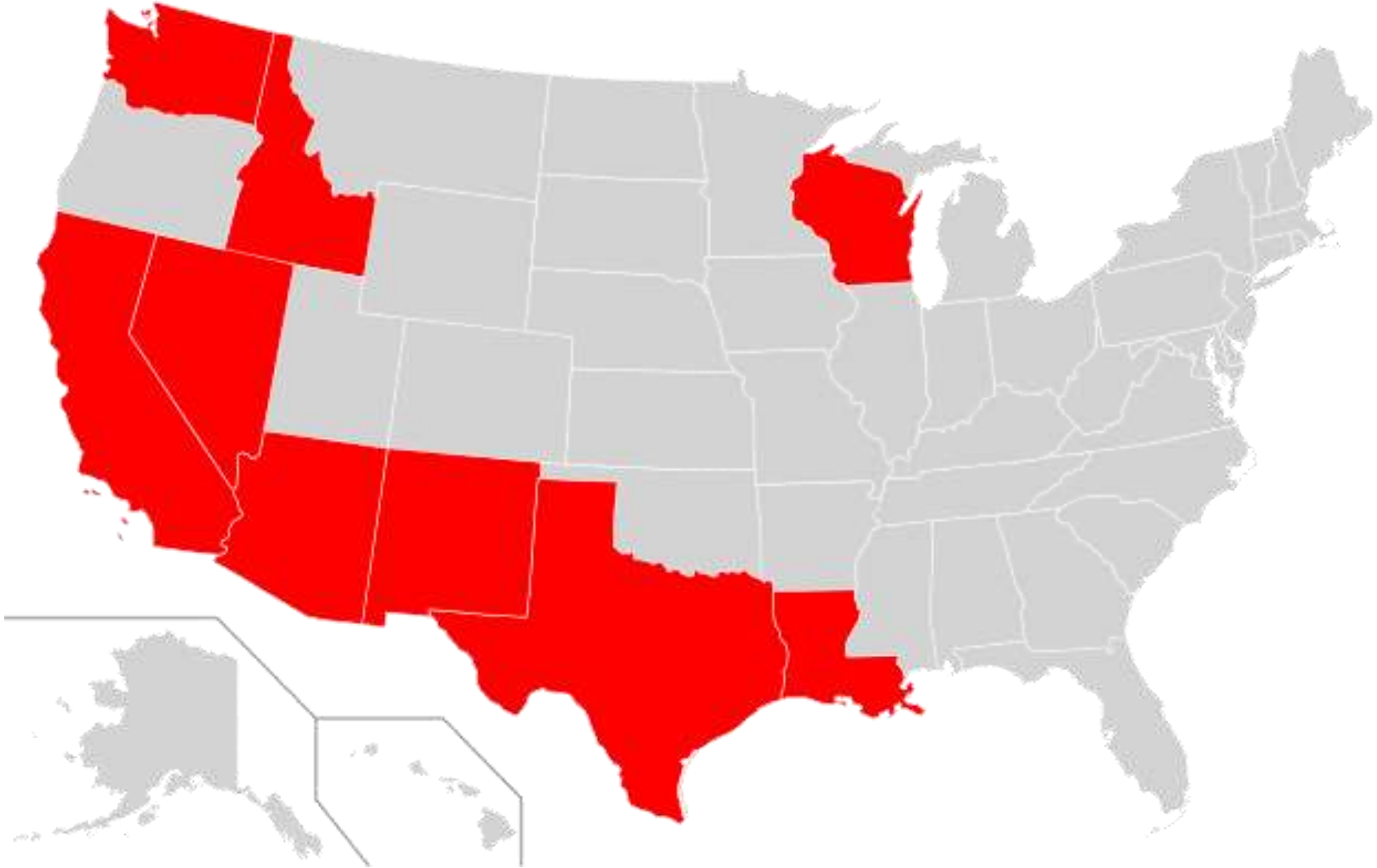
Community Property

- §1014(b)(6) - property which represents the surviving spouse's one-half share of community property held by the decedent and the surviving spouse under the community property laws of any State, or possession of the United States or any foreign country, if at least one-half of the whole of the community interest in such property was includible in determining the value of the decedent's gross estate constitutes property “acquired from a decedent.”
- Consequently, both the decedent’s one-half share of community property and the surviving spouse’s one-half share of community property receive a basis adjustment at the decedent’s death.

Community Property

- Whether property is community property and the interest of a spouse in any such community property is determined by state law.
- Community property states include Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, and Washington.
- Wisconsin also has a form of community property, and Alaska, South Dakota, and Tennessee have enacted a form of "opt-in" community property.
- Michigan recognizes community property from other states but cannot create more community property.

Community Property



Transmuting Marital Property – Separate Property to Community Property

- A strategy to obtain an increase in basis may be to transmute (i.e., convert) low-basis separate property into community property.
- Entering into a community property agreement ensures that no matter the order the spouses' deaths may occur, the surviving spouse will receive a new cost basis in all of the community property.
- Converting separate property into community property results in a gift for federal gift tax purposes. However, the gift qualifies for the marital deduction. Therefore, there will be no gift tax and no use of a spouse's lifetime gift tax exemption as a result of the conversion.

Transmuting Marital Property – Separate Property to Community Property

- Generally, absent an agreement controlling their rights, whether property is separate property or community property depends on not where the couple was married but rather where they lived when the property was acquired.
- Revenue Ruling 77-359, 1977-2 CB 24, discusses a scenario in which husband and wife, residing in Washington, enter into a community property agreement to convert their separate property to community property.
- The IRS holds that if such an agreement is valid under state law, then it will be given effect for federal income tax purposes.

Transmuting Marital Property – Separate Property to Community Property

- In Rev. Rul. 66-283, 1966-2 CB 297, a husband and wife transferred their California community property to a revocable trust.
- Upon the death of one of the spouses, one-half of the value of the community interest in the property held in the trust is includible under §§ 2033, 2036(a)(1) and 2038(a)(1) of the Code in determining the value of the decedent's gross estate.
- The property which represents the surviving spouse's one-half interest in the community property held in the revocable trust is considered under § 1014(b)(6) of the Code to have been acquired from or to have passed from the decedent and its basis is determined in accordance with the provisions of §1014(a) of the Code.

Transmuting Marital Property – Separate Property to Community Property

- In addition, as a general rule, marital rights in real property situated in another state are generally governed by the law of the real property's situs.
- However, real property located in another state that is subject to a community property agreement and/or owned by a joint revocable trust that states that the property of the trust is the community property of the spouses should be community property for federal income tax purposes for Arizona residents since it would be community property for state law purposes (see ARS §§ 25-211, 25-318(A), and 14-1201(9)) .
- If concerned, consider converting real property to personal property by transferring to an LLC or partnership.

Transmuting Marital Property – Separate Property to Community Property

- **Creditors** – If property is transmuted, all or part of the separate property being converted to community property may become subject to the liabilities of both spouses.
- **Management / Control during Lifetime** – In addition, all or part of the separate property being converted to community property may become subject to either the joint management, control, and disposition of both spouses or the sole management, control, and disposition of the other spouse alone (see ARS §25-214).
- **Death / Divorce** – When the marriage is subsequently terminated by the death of either spouse or by divorce, all or part of the separate property being converted to community property may become the sole property of the spouse or the spouse's heirs.

Transmuting Marital Property – Separate Property to Community Property

- Spouses do not have to transmute all property
- Spouses can transmute certain property to community property and keep certain property as separate property

Transmuting Marital Property – Community Property to Separate Property – §1015(e) and 1041(b)(2)

- Spouses can convert depreciated community property to separate property and make the spouse who is likely to survive the sole owner of such separate property.
- Doing so will avoid the loss in basis at the first spouse's death to the extent of the surviving spouse's separate interest in the property (see §§ 1015(e) and 1041(b)(2)).

Transmuting Marital Property – Community Property to Separate Property – §§ 1015(e) and 1041(b)(2)

- H has an individual brokerage account, and a joint brokerage account with W. The unrealized losses in H's individual account equal $80,000, while the unrealized losses in the joint account equal $150,000.
- If H dies without taking any action, the $80,000 unrealized capital loss in his individual account will disappear as the assets receive a step-down in basis. Similarly, the entire $150,000 unrealized loss in the couple's joint account would be eliminated via a step-down in basis.
- If W dies without taking any action, the $150,000 unrealized loss in the couple's joint account would be eliminated via a step-down in basis but the $80,000 would be preserved since it is H's separate property.
- Assuming H is more likely to die first, one strategy is for H to transfer (gift) the positions in the accounts (both his individual account and the joint account) with the unrealized losses to an account in W's own name while he's still alive.
- In doing so, W will retain H's basis in the investments. Thus, by making such a gift, H can avoid the step-down in basis upon his death, allowing W to 'hang on' to the unrealized losses for future use.

Marital / Community Property – Realized Losses & Death

- Sell to 3rd party instead of transmuting to separate property?
- See PLR 8510053 – Loss incurred by husband could be carried forward to joint return years, but could not be carried forward to separate year of spouse following husband's death.
- Rev. Rul. 74-175 – If a couple sell securities, property, or other capital assets held jointly at a loss, and the loss is not fully used in years before one spouse dies, half of the loss is allocated to the surviving spouse and can be carried over.
- Rev. Rul. 74-175 also specifically addressed NOL carryovers, providing that only the taxpayer who sustained the loss can use these carryovers.

Unrealized Losses & Gifting – §1015

- What about gifting property with a loss (i.e., FMV of property exceeds basis at time of gift)?
  - Donor buys stock for $12,000 and gives it to Donee when it's worth $8,000. Donee later sells it for $6,000. To **measure loss**, Donee's basis in the stock is $8,000, the value of the stock on the date of the gift. So, Donee has only a $2,000 loss on the sale.
  - Donee sells the stock for $15,000. To **measure gain**, Donee's basis is $12,000, the same basis Donor had. Thus, Donee's gain is $3,000.
  - Donee sells the stock for $10,000 (in between Donor's basis and FMV at time of gift). To measure Donee's loss, Donee's basis would be $8,000 (FMV at time of gift), so there's no loss on the sale for $10,000. To measure Donee's gain, Donee's basis would be $12,000, so there's no gain on a sale for $10,000. So, Donee would report no gain or loss.

Unrealized Losses & Sale to Related Party – §§ 267(a)(1) & (d)(1)

- What about selling to a related party?
  - No deduction shall be allowed in respect of any loss from the sale or exchange of property, directly or indirectly, between related parties.
  - Some related parties include (see § 267(b)):
    - Members of a family (i.e., family of an individual shall include only his brothers and sisters (whether by the whole or half blood), spouse, ancestors, and lineal descendants);
    - A grantor and a fiduciary of any trust;
    - A fiduciary of a trust and a fiduciary of another trust, if the same person is a grantor of both trusts;
    - A fiduciary of a trust and a beneficiary of such trust.
  - § 267(b) contains additional rules for when a business entity (e.g., corporation, partnership) is a related party.

Unrealized Losses & Sale to Related Party – §§ 267(a)(1) & (d)(1)

- If a loss was disallowed because the sale was to a related party, then the previously disallowed loss may reduce the related buyer's gain on a subsequent sale. However, if the related buyer subsequently sells the property for a loss, the loss disallowed on the original sale to the related party is never recognized.
- Example
  - Several years ago, B sold an asset to the Family Trust, of which he was the grantor, resulting in a realized, yet unrecognized, loss of $10,000 to B. In the current year, the trust sold the asset for a $15,000 profit (its basis was its purchase price when it bought the asset from B).
  - The trust recognizes a gain of $5,000 from the sale, which is the $15,000 realized gain reduced by the $10,000 loss to B disallowed in an earlier year under § 267.

Unrealized Losses & Sale to Related Party – §§ 267(a)(1) & (d)(1)

- Exceptions
  - If the loss sustained by the transferor is not allowable under the rules which relate to losses from wash sales of stock or securities; and
  - To the extent any loss sustained by the transferor (if allowed) would not be taken into account in determining the transferor’s income tax.
    - Basically, if the transferor was never going to be able to use the loss, then the transferee can’t use the loss.

Upstream Transfers of Appreciated Property - Methods & Risks

- Methods
  - Direct Gifting
  - Naked General Power of Appointment
  - In Trust with General Power of Appointment
  - In Trust with Limited Power of Appointment but trigger Delaware Tax Trap
- Risks
  - Disinheritance
  - Elder Abuse / Undue Influence
  - Mismanagement
  - Creditor Issues
  - Federal Estate Taxes
  - State Estate / Inheritance Taxes
  - §1014(e)

General Powers of Appointment – General

- §2041(a)(2) – The property subject to a powerholder's general power of appointment is included in the powerholder's estate for estate tax purposes.
- §2041(b)(1) – As a general rule, a general power of appointment means a power which is exercisable in favor of the powerholder, his estate, his creditors, or the creditors of his estate.
  - Exceptions
    - Limited to an ascertainable standard relating to the health, education, support, or maintenance;
    - Exercisable only in conjunction with the creator of the power;
    - Exercisable only in conjunction with a person having a substantial interest in the property, which is adverse to the exercise of the power

General Powers of Appointment – General

- The *existence* of the general power that gives rise to the basis adjustment – not its *exercise*.
- The IRS has historically had every incentive to recognize and give effect to general powers since they have traditionally produced more revenue from estate tax than they lost due to basis adjustments.
- Courts have found general powers to exist even where the holders of the powers didn't know they existed or couldn't actually exercise them due to incapacity. See Fish v. U.S., 432 F2d 1278 (9th Cir 1970); Est. of Alperstein v. Comm'r, 613 F2d 1213 (2nd Cir 1979); Williams v. U.S., 634 F2d 894 (5th Cir. 1981).
- See also Rev. Rul. 75-350 – H died on February 27, 1974, and H's will created trust for W. W was granted general POA over trust. W died December 10, 1974, and was incapacitated on and after death of husband. Held that W possessed a general POA.

General Powers of Appointment – Conditions

- Can be conditioned on consent of “non-adverse” party
  - An adverse party is a person with a substantial interest in the property, which is adverse to the exercise of the power (i.e., takers in default)
  - Multiple adverse parties / successors
- Can be limited in scope as to appointees
  - May limit the scope of eligible appointees so long as the creditors of the powerholder or creditors of the powerholder’s estate are included
- Can be limited in scope as to assets
  - Include specific assets or group of assets
  - General over all assets with carve outs for specific assets
  - Portions of one or more assets

General Powers of Appointment – Conditions

- Treas. Reg. § 20.2041-3(b) (Notice Requirements) – A power of appointment is considered to exist on the date of a decedent's death even though the exercise of the power is subject to the precedent of giving notice, or even though the exercise of the power takes effect only on the expiration of a stated period after its exercise, whether or not on or before the decedent's death notice has been given or the power has been exercised.
- Treas. Reg. § 20.2041-3(b) (Conditions Precedent) – A power which by its terms is exercisable only upon the occurrence during the decedent's lifetime of an event or a contingency which did not in fact take place or occur during such time is not a power in existence on the date of the decedent's death.
- Example: May condition on powerholder being solvent (see PLR 9110054)

General Powers of Appointment – Conditions

- Limit amount or value subject to power
- Ordering rules
  - Assets with greatest gain first, then next, etc.
  - Depreciable assets first, then assets with gain
- Exclusion of certain assets
  - Exclude assets with loss
  - Exclude income in respect of a decedent

General Powers of Appointment – Considerations

- Donee of power (powerholder) has legal capacity on the date of grant
  - If person already incapacitated, consider allowing an agent under a power of attorney or court appointed guardian/conservator to exercise power
- Give notice of grant of power
- If powerholder lives in state where surviving spouse has an elective share, then spouse asserting an elective share claim may (depending on the state) also reach property over which the other spouse held a general POA even if it has not been exercised.
- Creditor Issues
  - The common-law rule was that the donee's creditors could not reach appointive assets covered by an **unexercised** general power of appointment if the power had been created by a person other than the donee.
  - Now, as a general rule, appointive assets covered by an **unexercised** general power of appointment, created by a person other than the donee, can be subjected to payment of claims of creditors of the donee, or claims against the donee's estate, but only to the extent provided by statute.

Adding General Power of Appointment to Irrevocable Trust

- Common Candidates – Irrevocable trust with (i) appreciated assets or (ii) a GST Inclusion Ratio not equal to zero
  - Bypass / Credit Shelter Trust for Surviving Spouse
  - Spousal Limited Access Trust
  - Inter vivos / Testamentary Trust for Child, Grandchild, etc.
- Mechanisms
  - Decanting
  - Trust Protector
  - Nonjudicial Settlement Agreement
  - Court Order
- Statutory Authority for Trust Modification (ARS §§ 14-10410 to 10416)
  - ARS § 14-10412 (unanticipated circumstances)
  - ARS § 14-10416 (settlor’s tax objectives)

Adding General Power of Appointment to Irrevocable Trust

- Factors to Consider
  - Purpose of Trust
  - Family Situation
  - Beneficiary’s Personal Circumstances
  - Taxes (see slide 4)

Delaware Tax Trap

- Certain exercises of a testamentary power of appointment will cause estate tax inclusion of assets of an irrevocable trust under §2041(a)(3). Likewise, certain exercises of an *inter vivos* power of appointment will be treated as a gift under §2514(d).
- Example (Treas. Reg. §20.2041-3(e)(2)):
  - If a decedent has a power to appoint by will $100,000 to a group of persons consisting of his children and grandchildren and exercises the power by making an outright appointment of $75,000 and by giving one appointee a power to appoint $25,000, no more than $25,000 will be includible in the decedent's gross estate under §2041(a)(3).
  - If, however, the decedent appoints the income from the entire fund to a beneficiary for life with power in the beneficiary to appoint the remainder by will, the entire $100,000 will be includible in the decedent's gross estate under §2041(a)(3) if the exercise of the second power can validly postpone the vesting of any estate or interest in the property or can suspend the absolute ownership or power of alienation of the property for a period ascertainable without regard to the date of the creation of the first power.
- The triggering of estate tax inclusion (or a taxable gift) is known as the "Delaware Tax Trap" (DTT).

Delaware Tax Trap

- There are two fundamental types of powers of appointment that can be granted to spring the DTT to cause estate tax inclusion:
  - General power of appointment (GPA), and
  - Special (limited) power of appointment (SPA).
- A SPA is generally preferable for at least three reasons:
  - It continues to permit protection of trust property from the creditors of all beneficiaries,
  - Trust property does not have to be made available for the immediate taking by any beneficiary or other person, and
  - It will not require the trust assets to be included in new powerholder's estate for estate tax purposes or treated as a gift if appointed during his lifetime in whole or in part to others.

Delaware Tax Trap

- Under common law, the exercise of a SPA does not extend the original perpetuity period. Therefore, in almost all states the DTT can only be sprung by creation of a presently exercisable GPA (which allows for the extension of the perpetuity period).
- However, under the law of Arizona, the DTT can be sprung by exercising an initial SPA to create a second SPA (see ARS §§14-2901, 14-2902 and 14-2905).
  - ARS §14-2905 specifically allows the powerholder to extend the perpetuity period when exercising the SPA (thereby triggering the DTT).
- Verify governing instrument does not prohibit extending perpetuity period (saving clause to avoid the inadvertent triggering of the DTT).

Delaware Tax Trap vs. General Power of Appointment

- DTT
  - Never subject to powerholder’s creditors
  - Powerholder cannot vest property in self
  - SPA must actually be exercised
- General POA
  - Assets potentially subject to powerholder’s creditors
  - Powerholder can potentially vest property in self
  - Does not have to be exercised (existence of power sufficient)
- Sample Exercise of Formula Power of Appointment Triggering Delaware Tax Trap – See Mickey R. Davis and Melissa J. Willms, All About That Basis: How Income Taxes Have Reshaped Estate Planning, (2019)

Upstream Transfer of Appreciated Property to Irrevocable Trust

- Funding
  - Annual Exclusion Gifts
  - Taxable Gift
  - Sale to Grantor Trust
  - Combination
- Estate inclusion to be triggered by:
  - General power of appointment
  - Delaware tax trap

Upstream Transfer of Appreciated Property to Irrevocable Trust

- For estate tax purposes (and GST tax purposes), the beneficiary should be a new transferor.
- So long as the resulting trust is a typical irrevocable trust that limits the original grantor’s rights with respect to the trust (e.g., original grantor’s rights limited to an ascertainable standard, and allowing only limited powers of appointment), there should be no inclusion of the trust's assets in the original grantor’s estate at his/her death.
- See, Est. of Ford v. Comm'r, 53 TC 114 (1969); PLR 200210051; see also PLRs 200403094, 200604028.

Upstream Transfer of Appreciated Property to Irrevocable Trust – Sale to Grantor Trust

- Full Value vs Net Value
  - Suppose that the grantor sold assets to the trust for a note. If the asset is worth $100,000, but is subject to a debt of $90,000, then presumably only a net $10,000 is includable in the beneficiary’s estate. Nevertheless, the basis of the asset should be adjusted to its $100,000 value, and not just $10,000. See Crane v. Comm'r, 331 US 1 (1947).
  - Despite the holding in Crane, Treas. Reg. §20.2053-7 provides that a decedent's estate will include the full value of property for which the estate is liable for any indebtedness on the property, whereas only the net value of the property need be returned if the estate is not liable. Although the regulation appears to address a reporting position only and does not provide that the full value of the property may not be reported, it may be prudent to have the beneficiary personally guarantee the payment of the debt to ensure that all of the property and not just the net value will be reportable as part of his or her estate.

Upstream Transfer of Appreciated Property to Irrevocable Trust

- Depreciation
  - Note that if the general power of appointment is not exercised by the senior family member, the basis adjustment arises under §1014(b)(9) instead of §1014(b)(4). Unlike the other provisions of §1014, §1014(b)(9) limits the basis adjustment for depreciation taken by a taxpayer other than the decedent prior to the decedent's death.
  - Because the trust is a grantor trust, the grantor is presumably "the taxpayer" for this purpose. The §1014(b)(9) limitation would appear to apply to any depreciation deductions taken by the grantor prior to the death of the beneficiary. As a result, if the trust remains a grantor trust after the beneficiary’s death, then the amount of the basis adjustment might be reduced by the amount of the depreciation deductions allowed to the grantor prior to the beneficiary’s death. See Treas. Reg. § 1.1014-6.

Upstream Transfer of Appreciated Property to Irrevocable Trust

- Depreciation (continued) - Treas. Reg. § 1.1014-6(a)(3), Example 2.
  - On July 1, 1952, H purchased for $30,000 income-producing property which he conveyed to himself and W, his wife, as tenants by the entirety. Under local law each spouse was entitled to one-half of the income therefrom. H died on January 1, 1955, at which time the fair market value of the property was $40,000. The entire value of the property was included in H's gross estate. H and W filed joint income tax returns for the years 1952, 1953, and 1954. The total depreciation allowance for the year 1952 was $500 and for each of the other years 1953 and 1954 was $1,000. One-half of the $2,500 depreciation will be allocated to W. The adjusted basis of the property in W's hands of January 1, 1955, was $38,750 ($40,000, value on the date of H's death, less $1,250, depreciation allocated to W for periods before H's death). However, if, under local law, all of the income from the property was allocable to H, no adjustment under this paragraph would be required and W's basis for the property as of the date of H's death would be $40,000.

Swapping Assets of Grantor Trust

- If grantor created a grantor trust during grantor’s lifetime, grantor may consider transferring high basis assets to that trust in exchange for low basis assets of the same value owned by the trust.
- The effect of the exchange will be to place low basis assets into the grantor's estate, providing an opportunity to receive a step-up in basis of those assets at death.
- At the same time, if the grantor transfers assets with a basis in excess of fair market value to the trust, those assets will avoid being subject to a step-down in basis at death.
- Rev. Rul. 85-13 – The grantor trust status should prevent the exchange of these assets during the grantor's lifetime from being treated as a sale or exchange for federal income tax purposes.

Swapping Assets of Grantor Trust

- Hard to value assets create issues regarding what constitutes equivalent value and fair market value. Failure to utilize correct value creates fiduciary risk and potential negative transfer tax consequences.
- These risks can be mitigated by consent of all the parties in interest and the transfer tax consequences can be reduced through the use of a Wandry style valuation formula clause.

Swapping Assets of Grantor Trust – Installment Sales

- What are the income tax consequences if an installment note is used to purchase property from a grantor trust and the grantor dies before the note is paid in full?
  - The termination of the grantor's deemed ownership triggers a deemed transfer of the trust property to a newly-recognized nongrantor trust. If the grantor receives no consideration, the deemed transfer is generally treated as a nontaxable gift, and the trust property takes a carryover basis of the property in the hands of the nongrantor trust.
  - If the trust property is encumbered by liabilities in excess of the grantor's basis, however, the deemed transfer is treated as part gift, part sale, and the grantor may realize gain. See Crane v. Comm'r, 331 US 1 (1947); see also Rev. Rul. 77-402.

Swapping Assets of Grantor Trust – Installment Sales

- Rev. Rul. 2023-2 clarifies which assets transferred by a decedent to an irrevocable trust receive a basis adjustment to fair market value under §1014 and which do not.
- The IRS concluded that no basis adjustment is available for assets in an irrevocable trust where the individual creating the trust retains a power that causes the individual to be the owner of the entire trust for income tax purposes but does not cause the trust assets to be included in the individual's gross estate.

Distributing Assets

- Irrevocable trusts which benefit the dying client (such as classic bypass trusts) often have existing distribution standards which would permit a trustee to distribute property to the dying client.
- The potential trust standards of distribution range from health, education, maintenance and support (possibly considering the impact of other resources prior to making such a distribution) or to an independent trustee, trust director or trust protector having the discretion to make distributions for the dying client's best interests or any other broad-based purpose.

Estate Tax Inclusion under §2038

- §2038
  - A decedent's gross estate includes the value of any interest in property transferred by the decedent (except in case of a bona fide sale for an adequate and full consideration in money or money's worth), whether in trust or otherwise, if the enjoyment of the property transferred was subject to any change at the date of the decedent's death through the exercise by him of a power to alter, amend, revoke or terminate.
  - It doesn't matter whether the right was exercisable by the decedent alone or in conjunction with any other person.
- Modify trust instrument to allow the settlor to adjust beneficial interests.

Valuation Discounts

- Valuation discounts are not a magical artificial value reduction – they merely reflect proper valuation. In other words, valuation discounts are not optional.
- Although a discount might save estate taxes, it also causes a reduced income tax basis. Accordingly, for income tax purposes, a higher valuation is preferable to a lower valuation.
- Consideration should be given to when valuation discounts should be created and when they should be removed.

Valuation Discounts

- Generally, taxpayers are bound by the form of the transaction that they choose unless they can provide “strong proof” that the parties intended a different transaction in substance.
  - Schulz v. Commissioner, 294 F.2d 52, 55 (9th Cir. 1961), aff’g 34 T.C. 235 (1960).
- The courts and the IRS have held that the taxpayer cannot argue substance over form because the taxpayer selects the form of the transaction and cannot thereafter challenge it.
  - City of New York v. Comm’r, 103 T.C. 481 (1994), aff’d, 70 F.3d 142 (D.C. Cir. 1995)

Valuation Discounts

- Consider alteration of existing governing instruments in order to reduce the application and scope of valuation discounts on those business interests at the time of death.
  - Enhance management rights
  - Enhance voting rights
  - Grant put rights (i.e., right to require the business to purchase interest)
  - Remove or reduce transfer restrictions
- Reduce fractional ownership
- Any changes would need to be evaluated outside of the narrow confines of potential income tax savings (e.g., non-tax issues and estate tax issues).

Converting Non-Grantor Trust to Grantor Trust

- Conversion should not be a taxable event
  - PLR 201730017
    - Rev. Rul. 77-402 concludes that the lapse of grantor trust status during the grantor-owner's life may have income tax consequences, but does not impose such consequences on a non-grantor trust that becomes a grantor trust. Rev. Rul. 85-13 describes the income tax effects of a non-grantor trust becoming a grantor trust, which effects did not include the realization or recognition of any income by the grantor-owner by reason of the conversion. Given the lack of authority imposing such consequences, we conclude that the conversion of Trust from a non-grantor trust to a grantor trust will not be a transfer of property to Grantor from Trust under any income tax provision.
  - Rev. Rul. 85-13, 1985-1 C.B. 184
    - At the time the Grantor became the owner of the trust, the Grantor became the owner of the trust property. As a result, the transfer of trust assets to the Grantor was not a sale for federal income tax purposes and the Grantor did not acquire a cost basis in those assets.
  - Rev. Rul. 77-402, 1977-2 C.B. 222
    - Grantor realized an amount equal to the share of partnership liabilities that existed immediately before Trust converted from grantor to nongrantor status for federal income tax purposes. The gain or loss realized by Grantor is the difference between the amount realized from the reduction of the Grantor's share of partnership liabilities and the Grantor's adjusted basis in the partnership interest under § 705 of the Code immediately prior to the change in the trust's tax status. The gain or loss so realized must be recognized by the Grantor under § 741.

Converting Non-Grantor Trust to Grantor Trust

- Some Possible Benefits
  - Avoids compressed tax brackets for trusts
  - Capital gains taxable to beneficiary
  - Net Investment Income Tax (NIIT) – Easier to determine that beneficiary (rather than trustee) is actively involved in business to determine if business income is passive or active
  - Section 179 Expensing
  - Beneficiary can transact with trust
  - Can avoid filing separate tax return (see Treas. Reg. § 1.671-4)
  - Section 121 Exclusion

Converting Non-Grantor Trust to Grantor Trust

- Some Possible Benefits
  - S Corporation Ownership
    - vs. QSST Election
      - S corp distributions, which are accounting income, must be distributed from the trust
      - QSSTs are often set up as separate trusts from the other assets to avoid the mandatory income requirement applying to all the trust, requiring an additional tax return and accounting
      - Trust treated as non-grantor trust when S corp stock sold
      - Single beneficiary
      - QSST beneficiaries must sign the appropriate election, else risk disqualifying the S corporation (or forcing trustee to make an ESBT election)
    - vs. ESBT Election – Income taxable to beneficiary at beneficiary's rate rather than highest marginal tax rate

Converting Non-Grantor Trust to Grantor Trust

- Estate Tax Inclusion
  - Amounts of income (or principal) subject to withdrawal at death are included in beneficiary’s estate under § 2041.
  - For example, if, as of July 1 (date of death), a trust had $50,000 of income and the beneficiary had withdrawn $30,000 before death, leaving $20,000 of income available for withdrawal at death, then $20,000 would be includable.
- Toggling Tax Status
  - Should have a mechanism for converting from grantor trust status to non-grantor trust status
  - Trust protector most likely easiest method

Converting Non-Grantor Trust to Grantor Trust

- Creditor Issues
  - ARS §14-10505(B)(2) - Protects lapsed withdrawal rights without limitation:

    "B. For the purposes of this section:

    1. During the period the power may be exercised, the holder of a power of withdrawal is treated in the same manner as the settlor of a revocable trust to the extent of the property subject to the power.

    2. On the lapse, release or waiver of a power of withdrawal, the holder is not, by reason of any such power of withdrawal, treated as the settlor of the trust."

Taxing Topics: Fundamental Income Tax Issues Every Advisor Should Know

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