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PRACTICAL PLANNER®

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2021 INCOME TAX PLANNING

Note to Readers: We did not publish the Practical Planner in 2020 and apologize. We focused our educational and communication efforts in 2020 on webinars and created many planning webinars which appear in a growing library at www.shenkmanlaw.com/webinars. We also created short planning video which appear in a growing library at www.laweasy.com. In 2021 we will again publish our quarterly Practical Planning newsletter, but it will generally be disseminated by email. We will continue to add to the webinar and video planning libraries. We also will begin a periodic email with links to the many articles, webinars and other resources we create to make them more accessible. As always, we welcome any suggestions. Email us at shenkman@shenkmanlaw.com.

Summary: It is anticipated by tax pundits that the Biden Administration will raise income and estate taxes. There is still little certainty as to what those changes may be, or when they may be effective. Given the uncertainty should you wait and see? That might be like the old adage "you snooze, you lose." If you wait to know what the law will be it may be too late to plan. From an effective date perspective, it may be advisable to complete planning as quickly as possible. While that will not guarantee success, if the planning makes sense regardless of whether or how the law changes, rushing forward might be worthwhile.

■ Income tax rates may increase to 39.6% and capital gains for those with income over $1M may be taxed at ordinary income rates. That is tantamount to a doubling cap gain rates. Charitable Remainder Trusts ("CRTs") might be used to smooth income to keep you below that $1M threshold. If you are planning to exit a family business in a year or two, evaluate a sale now before rates rise. Roth IRA conversions might be advantageous before a change in law. Consider what charitable loss carryforwards or other tax benefits might offset the cost of a Roth conversion. Caution – if you plan on donating your regular IRA to charity do not convert it. If you have a taxable estate, you might benefit from conversion since the payment of the income tax on the conversion may reduce your estate.

■ Traditional income tax planning includes deferring income and accelerating deductions. The theory is a tax deferred is a taxed saved. But if you are on the cusp of a large tax increase you might do the opposite. It may pay to accelerate income with Roth IRA conversions, harvesting gains on appreciated security positions, etc. while rates are lower. You might actually defer business and other deductions to 2022 when rates may be higher (but see the 28% cap below).

■ The value of the remainder interests must be 10%. If you gift $1M to the CRT the value to the charity must be 10% = $100,000. Because the current interest rates are so low it may not be feasible to create a CRAT as that requires that you pay out 5% of the initial value, $50,000/year if the gift is $1M. Instead, a CRT unitrust may be necessary. If rates rise, you might use a CRT to shift income to children or grandchildren who may be in lower brackets. But you will have to address gift and GST tax issues. Another application of CRTs is to smooth out income. You put an appreciated asset in the CRT. When it is sold the income may be distributed back to you over 20 years smoothing it out and keeping you below the $1M threshold where capital gains might be taxed as ordinary income.

■ Social Security taxes may apply on all earned income. That would represent a large increase in tax on those earning large salaries. It might be possible to reorganize as an S corporation to cap the amount of salary paid, leaving the excess as an S corporation distribution not subject to Social Security taxes. But this planning technique might be closed.

■ State and local tax (SALT)

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CHECKLIST: TAX CHANGE

Summary: The Biden administration may reduce the exemption retroactively, perhaps even to 1/1/21! Protect against a retroactive tax change.

√ Retroactive tax changes sound unfair! Even Taylor Swift said: "It's hard to fight when the fight ain't fair. But we'll tell you how to fight that unfair tax fight! The law permits a retroactive tax change. See: Pension Benefit Guaranty Corporation v. R. A. Gray & Co., 467 U. S. 717 (1984); United States v. Carlton, 512 U.S. 26 (1994). The need for revenue, or the desire to reinforce the estate tax to reduce wealth disparity, might result in a retroactive tax change.

√ Example: You make a gift to use your $11.7M exemption and the exemption is reduced retroactively to $1M (yes, that is the proposal for the gift tax exemption in the Sanders tax proposal which may be a foundation for a Biden administration proposal) you could owe gift tax on a $10.7M gift. Ouch! Even if you view this as unlikely, you cannot say it's impossible, so take steps to integrate protection into your planning. Here's 3 approaches:

√ Disclaimer Approach: Make gift transfers to a trust for intended beneficiaries, not out right. Provide in the trust instrument that a particular beneficiary shall be treated as the primary beneficiary and shall have the right to dis-

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2021 Income Tax Planning

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deductions might be reinstated. That could be significant for those living in high tax states. But consider that this is a very regressive benefit (i.e., most benefit inures to the wealthy) so it may not be fully reinstated. To plan you might defer expenses, e.g., pay property taxes in January 2022 not in December 2021 in case there is a lifting of the SLAT limit.

■ Deductions might be capped at a 28% tax benefit. So, if tax rates are increased to 39.6% that differential will reduce the value of deductions. That reduction might even apply to retirement plan contributions. If that occurs, consider that you might get only 28% deduction on funding, but when you retire and take-out funds you may pay tax then at a 39.6% higher rate. Does the deferral make sense?

■ The 3% Pease limitation might be restored. If your income exceeds $400,000 this limitation might reduce your itemized deductions by 3% of your adjusted gross income (AGI) over the threshold, up to 80% of itemized deductions.

■ There is talk of eliminating the basis step up on death. Under current law if you die owning highly appreciated assets (e.g., Apple stock) the income tax basis in that stock gets stepped up to its fair market value at your death. That eliminates the capital gain inherent in that asst. That has driven many estate and income tax planning strategies. That step up might be eliminated under a Biden tax plan. Worse, a Biden plan may incorporate a Canadian-like estate tax system of tax unrealized appreciation on death. That would have profound impact on all planning. The incentive to hold appreciated assets until death may be eliminated. Life insurance might be purchased to address the liquidity needed to pay tax on appreciated assets at death, e.g., a family business or real estate.

■ Code Section 1031 exchanges have permitted real estate owners to exchange one investment property for another without triggering taxable gain. This benefit may be repealed.

■ Sale of appreciated assets to a non-grantor trust you create may enable you to lock in the current 20% capital gains tax rate without selling to a third party.

■ Use instalment sales to manage or smooth spikes in income. With an installment sale you can spread income out over the period of the note you receive on the sale. In 2021 you might instead opt out of installment sale treatment, so all gain is taxed as the current lower rates.

■ Family partnerships (FLPs) can be used to shift income to lower bracket family members if capital is a material income producing factor. You can create an FLP, contribute assets without gain recognition (watch out for negative basis property), as asset are sold children and others in lower brackets who own the interests will be allocated income. Under current law discounts on the valuation of the FLP interests given to trusts or lower bracket family members may leverage those gifts. Caution be wary of creating an investment company triggering gain on funding under Code Sec. 721.

■ Gain harvesting (matching and planning when you realize gains or losses on assets) may be more important. Should you sell appreciated assets now to avoid the future higher tax brackets? Will non-grantor (so-called complex trusts) trusts have a different limit before capital gains are taxed at the higher ordinary income rates? The rules might be very onerous, so be careful. Might it be beneficial to turn a non-grantor trust into a grantor trust to permit a higher threshold capital gains are taxed at higher ordinary rates?

■ Code Section 1202 exclusion for certain closely held business stock may be able to benefit from up to a $10M exclusion.

■ Intentionally non-grantor trusts (INGs) have been used to minimize or avoid state income taxation. Appreciated assets could be gifted to the trust, no exemption is used if structured as an incomplete gift trust, then the asset sold. Because the trust is a non-grantor trust and would be based in a no tax state, your high home state income tax (e.g., NY, NJ, CT, etc.) are arguably avoided. NY has adopted anti-ING legislation so that this technique will not be respected for incomplete gift trusts. CA has similar legislation. The IRS has also indicated it would no longer issue private letter rulings on INGs.

■ Charitable Lead Trusts may be used to provide, if structured as a grantor trust you may get a deduction up front to offset income from a large capital gain or Roth conversion.

■ Code Section 199A provides for a deduction for qualified busines income (QBI) may be subject to a new phaseout if income exceeds $400,000.

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Reviewer: *Andrew Wolfe, CPA, Esq.*
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...Checklist: Tax Change

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claim or renounce interests in any property given to the trust on behalf of herself and all beneficiaries. But, unlike typical disclaimers where the disclaimer results in assets passing to remaining beneficiaries, the trust provision could provide for disclaimed assets to revert back to you as the settlor. That would unwind the transfer so that the gift would arguably not have occurred. That way, if there is a retroactive tax change a spouse or other beneficiary could disclaim sufficient assets to avoid an unintended gift tax. It may be possible to give the trustee the right to disclaim but state law will have to permit that. If you are making a transfer to an existing trust that does not have a disclaimer provision, you might consider adding a disclaimer right in the transfer instrument (e.g., an assignment).

√ QTIP Approach: Make a gift to a marital (QTIP) like trust. Your spouse must be a US citizen, must get income at least annually, have the right to demand that any property held in the trust be made income producing, and no one other than your spouse can access assets in the trust during your spouse's lifetime. That trust might then qualify for the unlimited gift tax marital deduction (so no use of exemption) with one more step. You can then determine to what extent, if any, that you elect marital QTIP treatment on your 2021 gift tax return which can be filed as late as October 15, 2022. That is a long time and should suffice to know what the new laws will be. To the extent your exemption was reduced retroactively you might then elect QTIP treatment to avoid a current gift tax. The remainder would not be subject to a QTIP treatment and would use that amount of your exemption. Note that the Clayton QTIP technique that works for the estate tax purposes will not work for a lifetime transfer. Also, if one spouse will use this mechanism you might not wish to use this technique for the second spouse as the trusts will inherently be very similar and that might raise a reciprocal trust doctrine issue that could permit the IRS or creditors to unwind the trusts. If your plan will involve two such QTIP-like trusts, you might give different testamentary powers of appointment, the right to make one QTIP a unitrust, etc. Those differences might negate a reciprocal trust attack but be mindful of the risk.

√ Formula Gift Approach: Use a formula in the document assigning a gift to an irrevocable trust to transfer only assets worth your exemption amount as reduced by a retroactive tax change, if any. There is no law supporting this mechanism, but the risk of a retroactive tax change is so difficult and unique that for a taxpayer to try to avoid an unintended gift tax seems so reasonable that it is hoped the IRS and courts would accept this technique. The balance of the gift could pass to an incomplete gift trust or a marital trust to avoid gift tax. This could also be addressed in a manner like a so-called Wandry transfer formula wherein you transfer only the portion of the gift property that equals your remaining exemption (but as retroactively adjusted). If you transfer multiple assets, e.g., interests in 5 LLCs, you should include an ordering provision. It may be safer to have the spillover mechanism rather than limiting the amount actually transferred akin to a Wandry mechanism. Also, if your GST tax exemption might differ from the gift tax exemption you might create a QTIP'able trust that is a reverse GST exemption trust. You could transfer to a family trust your gift tax exemption amount as of the date of the instrument. The remaining value could pass to a QTIP type trust if you have GST exemption in excess of gift exemption. Any balance could pass back to you. PP

Recent Developments

Estate of Moore v. Commissioner, T.C. Memo. 2020-40: 88-year-old Moore developed health issues and was moved to hospice. He then created trusts and a family limited partnership (FLP) with the intent of reducing estate taxes. He documented reasons to support the planning which included maintaining control of his assets during his lifetime. The court found that kinda transparent as he was in hospice at the time. The Court also held the full value of his farm was included in his estate despite the planning efforts. Code Sec. 2036(a)(1). Moore contracted for the sale of the farm and the sale agreement authorized him to continue to live on and operate the farm until he died. Bad move. Moore sold an interest in the farm to an irrevocable trust taking a 53% discount for lack of control and lack of marketability. The Court gave him zip. Moore tapped FLP assets for his living expenses. That's a big no-no. After the initial FLP meeting the partners never met to address FLP management. Moore's children served as trustees and the trust was the general partner of the FLP. Despite that Moore exercised control over FLP assets.

No surprise that the taxpayer lost this one. With so many cases making it clear that many of the things that Moore did (or did not do) can torpedo a plan, why did Moore and his family not act more carefully? How was this planned conceived?

Taxpayers who wait to the last minute rarely can plan as effectively as they could if a plan is developed and implemented over a longer period of time. Entities set up as part of an estate plan must be carefully administered on a regular basis and with the guidance of professionals. If you have entities and trusts in your plan, unlike Moore, schedule regular review meetings with your advisor team and have the plan administered properly.

Finally, the same TLC you should give your FLP should also be given to trusts. Some have speculated that spousal lifetime access trusts (SLATs) may be the new FLP in terms of audit attacks. Set up those review meetings! PP

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Covid changes to make to your estate planning documents:

- **Be sure elderly parents have key documents in place. College-age children are legally adults so you cannot make decisions for them so be certain they have a health care proxy and financial power of attorney.**
- **Evaluate springing powers of attorney. Many powers become effective only if you are incapacitated and cannot manage your affairs. Evaluate changing that to a new power that lets the agent act immediately (i.e., not contingent on the principal being disabled) so that the agent can help you today. The restriction of only being effective when you are disabled might make your form useless in the current environment as the springing mechanism often requires two physicians to evaluate you and sign confirming letters. That might be tough to obtain in the current situation.**
- **In the current COVID-19 environment confirm whether your health care documents expressly prohibit intubation. With COVID intubation may be necessary to survive a bout of the virus. This should be distinguished from a statement that you may not want intubation if in a persistent vegetative state or terminally ill with a short time to live. This might require revising your documents.**
- **Another COVID-19 consideration is whether experimental medical treatments are permitted under your health care documents. This might be critical to survival. You might modify your documents to expressly permit experimental treatments.**
- **In the past, if your health care agent made medical decisions, he or she would been in the hospital speaking to your care providers, and perhaps signing documents. With COVID-19 being so contagious, and many hospitals overwhelmed, this is not practical. Consider modifying your documents to expressly authorize electronic communication of decisions by your agent: FaceTime, Zoom, electronically signed documents, etc.**
- **Sample Clause: "*I expressly authorize my Agent to communicate decisions to any medical provider verbally, in person, by telephone, via email, via web conference including but not limited such services as Skype, FaceTime, or in any other manner appropriate to the circumstances. Further, I expressly hold harmless any medical provider for relying on such communications of decisions and directions by my Agent. The express purpose of this provision is to foster decision making by my Agent in remote or indirect manners that may be necessary or advisable given whatever circumstances accompany such decision making.*" PP**

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