
Kenan v. Commissioner,
114 F.2d 217 (2d Cir. 1940).

Kenan v. Commissioner

- A testamentary trust satisfied a pecuniary (dollar amount) bequest with a mix of cash and securities.
- The issue was whether the distribution of securities required the trust to realize the unrecognized capital gains?
- The court agreed with the Service that the distribution required the trust to recognize capital gain.
- The appeals court affirmed, reasoning that there was never a chance that securities distributed would change in value between the date of death and the date of distribution.

Kenan v. Commissioner

- The basis “step-up” usually minimizes any difference between fair market value and basis, minimizing risk that the *Kenan Doctrine* will force an early recognition event for the family.
- However, in a volatile market, estates are much more likely to have unrecognized gains and losses.
- Therefore, estate planners and administrators must consider how best to avoid the issue.

Note, the *Kenan Doctrine*, generally applies to items of income in respect of a decedent (IRD).
This may include IRAs.

Kenan v. Commissioner

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- However, in a volatile market, estates are much more likely to have unrecognized gains and losses.
- Therefore, estate planners and administrators must consider how best to avoid the issue; ideas may include:
 - Using fractional and residuary bequests
 - Planning for liquidity
 - Careful allocation of assets amongst beneficiaries

Kenan Gains

- *Kenan* gains are undesirable for two reasons:
 1. Loss of deferral – the tax paid early reduces future compounded asset value growth
 2. Potential exposure to a higher marginal income tax rate at the fiduciary compared to the individual level

- *Kenan* gains are often frustrating because:
 1. They are difficult to understand and therefore lead to conflict amongst family members and with advisors.
 2. They are often entirely avoidable recognition events.

Kenan Losses

- If the assets used to satisfy a pecuniary bequest have basis greater than fair market value (Kenan Losses) special rules apply.
 - The rule that bars recognizing losses on sales or exchanges of property between related parties, specifically does not apply to an estate. That is, the estate will be able to claim the loss. IRC § 267(b)(13).
 - **There is no exemption to the related party rules if the distribution is from a trust.**
 - A loss cannot be claimed by a trust which uses built-in-loss property to satisfy a pecuniary bequest. The general rule of § 267 applies to block claiming a related party loss and unlike an estate there is no exception.
 - However, the loss does not simply disappear. Rather, the transferor can generally use the previously disallowed loss to offset gain at a future sale. IRC § 267(d).
 - A Section 645 Election is a useful tool which can solve this problem.

ESTATE TAX CONSIDERATIONS “INHERITED” IRA PLANNING

Estate Tax Considerations

- Funding a GST-Exempt Trust
 - Fractional formula on the beneficiary designation form (to avoid the *Kenan* issue)
 - Apportion estate tax to non-exempt property (to avoid using GST-exempt trust assets to pay estate tax)
 - Allocate GST exemption to the receiving trust

Estate Tax Considerations

- Note, the same amount GST exemption must be allocated for a Traditional IRA or a Roth IRA – the Roth is therefore much more efficient

		Traditional IRA	Roth IRA
Value of Assets		\$ 1,000,000	\$ 1,000,000
Less: Income Tax	37%	(370,000)	-
Net After Tax to Family		\$ 630,000	\$ 1,000,000
GST Allocation Required		\$ 1,000,000	\$ 1,000,000

Estate Tax Considerations

- “Missing” IRC § 691(c) deduction
 - When a taxpayer dies with an item of Income in Respect of a Decedent (IRD), such as a traditional IRA, in his/her taxable estate the estate (and/or its beneficiaries) must not only pay estate tax on the IRD but also pay income tax on the IRD
 - To prevent double-taxation of IRD, the federal income tax law allows an income tax deduction (on IRS Form 1040, Schedule A), for **federal** estate taxes paid on IRD
 - This is typically known as the “IRC § 691(c) deduction”

Estate Tax Considerations

- “Missing” IRC § 691(c) deduction
 - The dilemma with the IRC § 691(c) deduction is that it only is available for **federal** estate taxes paid on IRD, not state death/estate taxes
 - Thus, the state death/estate tax portion is subject to tax twice (i.e. “missing” IRC § 691(c) deduction)

Estate Tax Considerations

- “Missing” IRC § 691(c) deduction example

	Traditional IRA	Roth IRA
IRA balance	\$ 1,000,000	\$ 1,000,000
Less: Federal and state income taxes on Roth IRA conversion (40%)	-	(400,000)
Taxable Estate	<u>\$ 1,000,000</u>	<u>\$ 600,000</u>
Federal estate tax (40%)	\$ 336,000	\$ 201,600
State death tax (16%)	160,000	96,000
Total estate taxes	<u>\$ 496,000</u>	<u>\$ 297,600</u>
Post-death traditional IRA balance	\$ 1,000,000	
Less: IRC §691(c) deduction	(336,000)	
Post-death traditional IRA balance subject to income tax	<u>\$ 664,000</u>	
Federal and state income taxes on IRA distributions (40%)	\$ 265,600	\$ -
Net IRA balance to beneficiaries	<u>\$ 238,400</u>	<u>\$ 302,400</u>

Estate Tax Considerations

- “Fading” IRC § 691(c) deduction
 - Another dilemma with the IRC § 691(c) deduction is that it is only calculated on the value of the IRD at the time of death
 - Thus, post-death appreciation is not sheltered against income tax by the IRC § 691 deduction, resulting in additional income tax being incurred (i.e. “fading” IRC § 691(c) deduction)

Frozen-in-Time

Estate Tax Considerations

- “Fading” IRC § 691(c) deduction example

	No Planning	Roth IRA Conversion at Death
Traditional IRA balance at death	\$ 1,000,000	\$ 1,000,000
Less: IRC §691(c) deduction	-	(400,000)
Taxable portion of Roth IRA conversion	\$ 1,000,000	\$ 600,000
Federal and state income taxes on Roth IRA conversion (40%)	\$ -	\$ 240,000
IRA balance available for future distributions	<u>\$ 1,000,000</u>	<u>\$ 760,000</u>
Total future IRA distributions	\$ 2,000,000	\$ 1,520,000
Less: IRC §691(c) deduction	(400,000)	-
Less: Amounts not subject to income tax	-	(1,520,000)
Taxable portion of future IRA distributions	<u>\$ 1,600,000</u>	<u>\$ -</u>
Federal and state income taxes on future IRA distributions (40%)	\$ 640,000	\$ -
After-tax total future IRA distributions	<u>\$ 1,360,000</u>	<u>\$ 1,520,000</u>

Example

- Your favorite clients are considering estate planning for an IRA with \$1,000,000 of assets. They are newly retired, but these are accumulations beyond their expected lifetime needs. They are making “snowbird” plans but haven’t decided on a state and how to split their time.
- You calculate the tax consequences of undertaking a Roth conversion under various assumptions:
 - The IRA will grow 3.5x between now and the second death
 - Federal income tax rate: 37%
 - Federal estate tax rate: 40%
 - State income tax rate: 5%
 - State estate tax rate: 16%

Example

Net After Tax Wealth Transferred to Family



Example

Relative Benefit of Roth Conversion (Percent increase in wealth transfer)

