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The Adviser's Guide to

Financial and Estate Planning

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Use this guide and other PFP Section resources noted throughout these pages to help you stay current, communicate with your clients, and reinforce your role as trusted adviser during this time of uncertainty.

About the AICPA Personal Financial Planning Section

The AICPA's Personal Financial Planning (PFP) Section is the premier provider of content and tools to help you deliver the most valuable and competent advice to your clients in the areas of estate, tax, retirement, risk management, and investment planning. Visit our website for more information on many of the topics covered in this publication, such as COVID-19 planning strategies and client-facing resources, the Proactive Planning Toolkit (updated for the Setting Every Community Up for Retirement [SECURE] Act and the Coronavirus Aid, Relief, and Economic Security [CARES] Act), financial planning resources grouped by topic, substantive practice guides written by subject matter experts, PFP Learning Library with 24/7 on-demand access, Advanced PFP Conference recordings, and the AICPA PFP Section homepage at aicpa.org/pfp.

Long-term trends in client demographics, needs, and expectations are now compounded with valid concerns about the impact on financial plans related to the COVID-19 pandemic. With myriad questions and complexities, clients need the professional, objective, and trusted advice of a CPA Personal Financial Specialist (CPA/PFS) more than ever to sort things out. Learn more about the CPA/PFS credential at aicpa.org/pfs.

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The AICPA established the Sidney Kess Award for Excellence in Continuing Education to recognize individual CPAs who have made significant and outstanding contributions in tax and financial planning and whose public service exemplifies the CPA profession's values and ethics. Sidney Kess was the first recipient of this award. Mr. Kess was selected as one of "125 People of Impact in Accounting" by the *Journal of Accountancy* in its June 2012 issue celebrating the AICPA's 125th anniversary. Mr. Kess was inducted into the New York State Society of CPA's Hall of Fame. He recently received the New York State Society's Outstanding CPA in Education Award.

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Mr. Siegel is the author of many books, including *The Grantor Trust Answer Book* (2018 CCH); *The Adviser's Guide to Financial and Estate Planning* (AICPA 2020; formerly *The CPA's Guide to Financial and Estate Planning*); Co-author, *Income Taxation of Trusts and Estates* (Carolina Press 2020) *Federal Fiduciary Income Taxation* (Foxmoor 2020) and *Federal Estate and Gift Taxation* (Foxmoor 2016).

In conjunction with numerous tax planning lectures he has delivered for the National Law Foundation, Mr. Siegel has prepared extensive lecture materials on the following subjects: *Planning for the 99%; Understanding the SECURE Act; Planning for An Aging Population; Business Entities: Start to Finish*; *Preparing the Audit-Proof Federal Estate Tax Return*; *Business Acquisitions: Representing Buyers and Sellers in the Sale of a Business*; *Dynasty Trusts*; *Planning with Intentionally-Defective Grantor Trusts*; *Introduction to Estate Planning*; *Intermediate-Sized Estate Planning*; *Social Security, Medicare and Medicaid: Explanation and Planning Strategies*; *Subchapter S Corporations: Using Trusts as Shareholders*; *Divorce and Separation: Important Tax Planning Issues*; *The Portability Election*; and many other titles.

Mr. Siegel has delivered hundreds of lectures to thousands of attendees in live venues and via webinars throughout the United States on tax, business, and estate planning topics on behalf of numerous

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Contents

3530 Avoiding Loss of Social Security Benefits

3535 Social Security Planning Issues: Questions, Answers, and Case Studies

Chapter 20

Planning for the Partner

¶2001 Overview

Tax law changes in the late 1980s operated to make partnerships the preferred form for conducting many businesses that traditionally had been conducted in corporate form. These changes included the following:

- The reduction of the top rate of tax for individuals below that of the top rate for regular C corporations
- The repeal of the *General Utilities* doctrine and the resulting tax on corporate liquidations (by comparison, the liquidation of partnerships may be tax-free)
- A tough corporate alternative minimum tax (AMT)
- Limitations on the use of cash basis accounting by corporations

The 2017 Tax Cuts and Jobs Act (TCJA) has reversed many of these changes. Partnerships may no longer be the preferred form of doing business based solely on comparisons of tax rates because the top individual income rate of 37% plus the 3.8% tax on net investment income now exceeds the top corporate income tax rate of 21%. However, many persons owning interests in entities taxed as partnerships may be eligible for the new 20% qualified business income (QBI) deduction for pass-through entities, making the choice of entity a more complicated decision. See Volume 2, ¶1805 and

Volume 4, Appendix, for additional planning tips and discussion of the QBI deduction (new IRC Section 199A, as enacted by the TCJA).[1]

Planning Pointer.

Proactive Planning Toolkit

Legislation like the TCJA and the SECURE and CARES Acts have added more complexity to financial planning. Technical content, tools, and other resources are available to PFP Section members at aicpa.org/PFP/ProactivePlanning to help you get up to speed on all the intricacies, so that you can educate your clients and proactively help them meet their life goals and give them peace of mind while navigating the complex financial landscape.

The corporate AMT has been repealed. More corporations with under $25 million of annual average gross receipts are now permitted to use the cash basis of accounting. However, partnerships continue to offer some advantages over corporations, including the following:

- Under IRC Section 721, partners generally recognize no gain on the transfer of property to a partnership with no mandatory ownership interest requirement. Under IRC Section 351 pertaining to corporations, the transferors must own 80% of the corporate stock in order to be eligible for non-recognition of gain.

- The basis of the partner's interest includes the partner's share of the partnership liabilities even if they[2] are not personally liable for such debts (not so for shareholders in either a C or an S corporation).

- Special allocation is permitted for partnership items of income, gain, loss, deductions, or credits so long as there is a substantial economic effect for the allocation (not so in either an S or C corporation).[3]

- Partnership interests may reflect different economic interests, and partnerships may issue preferred units or different classes of units (not so in an S corporation, which is limited to one economic class of stock notwithstanding permitted differences in voting rights).

- Control of a partnership can be placed in a preferred group (in an S corporation, the only difference is between voting and nonvoting stock).

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[1] For more on the 20% tax deduction for qualified business income, found in IRC Section 199A and other changes brought about by the Tax Cuts and Jobs Act (TCJA) of 2017 ("Tax Reform"), visit the AICPA's Tax Reform Resource Center.

[2] IRC Sections 752(a) and 722.

[3] IRC Section 704.

- An S corporation cannot have more than 100 shareholders[4] (husband and wife counting as one under IRC Section 1361(c)(1)). Members of a family through six generations may be treated as one shareholder of an S corporation. A partnership is not so limited. Only certain types of trusts may qualify to be S shareholders. C corporations, partnerships, and nonresident alien individuals may not be S corporation shareholders. Partnerships are not so limited about who may be a partner.

- Partners may receive nontaxable distributions to the extent of their basis in the partnership.[5]

A partnership is not a taxpayer, but it is a pass-through entity under IRC Section 701. The partnership income is taxed, and the tax is paid at the partner level, even if it is not distributed, per IRC Section 702.

In any case, a partnership must file an income tax return (Form 1065).[6] It must also withhold and remit income, Federal Insurance Contributions Act (FICA) tax, Federal Unemployment Tax Act (FUTA) tax, and worker's compensation taxes and other amounts from the wages and salaries of its common law employees. Partners are jointly and severally liable for any deficiencies and penalties. However, the partners themselves are generally subject to self-employment tax, rather than FICA, income tax withholding, and FUTA.

The Bipartisan Budget Act of 2015 created new partnership audit rules that apply to partnership taxable years that begin after 2017. The general rule is that audits will occur and adjustments will be made at the partnership level. Taxes determined by audits will be paid by the partnership, not by the partners. Each partnership must designate a "partnership representative" with full authority to represent and bind the partnership. Individual partners may not participate in an audit. Any taxes, penalties, and interest that may be due are to be assessed and collected in the year adjustments become final, not the reviewed year that was audited. This can create a serious problem if the partnership had different partners in the possibly distant reviewed year versus the current adjustment year.

Certain partnerships may elect out of this new partnership audit rule, generally those with under 100 partners, but partnerships that include revocable trusts, grantor trusts, nongrantor trusts, charitable remainder trusts, or disregarded entities as partners may not elect out.

A partnership generally may not use a fiscal year as its tax year absent a valid business purpose[7] or the making of required payments under an IRC Section 444 election, discussed in ¶1945 in connection with S corporations.[8] The IRC Section 444 election works the same way for partnerships as it does for S corporations.

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[4] IRC Section 1361(b)(1).

[5] IRC Section 731(a).

[6] Regulation Section 1.6031-1(a)(1).

[7] IRC Section 706(b)(1).

[8] IRC Section 441(f)(3).

.01 Negative Aspects of Partnerships

The greatest disadvantage of a partnership is the potential liability exposure of the partners. The extent of this liability exposure depends in large part on the type of partnership form chosen (general partnerships, with unlimited liability of the general partners vs. limited partnerships, with one's liability limited to one's investment in the partnership) and the nature of the business operations. Insurance is generally available to cover the risk exposure. The partners can also take other steps to reduce the liability exposure.

Partners might also suffer in the area of employee benefits in comparison with corporate employees. Partners are not generally entitled to the tax-favored benefits accorded corporate employees, except for what may be the most important tax benefit of all: qualified retirement plans. Partners may be participants in a variety of qualified retirement plans (¶2105). Such plans enjoy essential parity with corporate plans. Partners (and all self-employed persons) are entitled to deduct 100% of their health insurance costs, including Medicare premiums as an adjustment from gross income to adjusted gross income (¶1715).[9]

.02 Planning Matters

The family partnership offers opportunities for family income splitting and estate and gift tax planning benefits. These benefits are explored in ¶2005.

One of the most important areas where the financial planner can help the partner is planning for the continuance or disposition of the partner's partnership interest on death, retirement, or disability. However, the tax provisions dealing with partnerships (subchapter K) are among the most complex in the entire IRC.

These areas, along with related questions affecting estate tax valuation of partnership interests and the concept of income in respect of a decedent (IRD),[10] as applied to partnership interests, are the main components of this chapter.

¶2005 The Family Partnership

A partnership can be an effective way of dividing income among family members (parents, children, grandchildren, and others). Income splitting can be accomplished either directly or through a trust that owns the partnership interest. (Trusts are favored where there are minor children involved or where asset protection is desired.) Gifts of partnership interests can also reduce the gross estate of the donor.

Usually, no problems arise with a family partnership in which each partner contributes services or capital to the business. Difficulties can arise, however, when a child or other relative who acquired a partnership interest by gift from a partner and who contributes little or nothing in the way of services is a partner. In these cases, if the business is a personal service business in which capital is not a material factor in producing income, the IRS and the courts, generally, refuse to recognize the partnership, or at least the participation of the non-contributor in the partnership. They look upon the arrangement as an

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[9] IRC Section 162(l).

[10] IRC Section 691(a).

attempt to assign income—to "separate the fruit from the tree," as the courts sometimes phrase it. The tax law generally does not allow assignment of income. The donor partner would be taxed on the income in such a case.

However, IRC Section 704(e)(1) specifically recognizes as a partner a person who owns a capital interest in a partnership in which capital is a material income-producing factor, regardless of whether that person purchased the interest or received it by gift. IRC Section 704(e)(2) states that an interest purchased by one member of a family from another is to be treated as created by gift from the seller, and the fair market value of a purchased interest is to be considered donated capital. IRC Section 704(e)(2) provides that the family of any individual includes the individual's spouse, ancestors, descendants, and any trusts for the primary benefit of such persons.

IRC Section 704(e)(1) states that when a partnership interest is created by gift, the donee includes the donee's distributive share of partnership income in gross income, less an allowance for reasonable compensation for services rendered to the partnership by the donor, if any.

IRC provisions clearly approve the use of family partnerships under certain terms and conditions. Nevertheless, the partnership must prove that it is genuine, that the partner, in fact, owns a partnership interest, that it is a capital interest, and that capital is a material income-producing factor.

.01 Trusts as Partners

IRC Section 704(e)(3) expressly includes trusts for family members as permissible partners for tax purposes. Still, the trust may not be recognized for tax purposes unless the trustee actually functions as a fiduciary and administers the trust solely for the beneficiary's best interest.

The state in which the partnership is to be set up must be one that permits a trust to be a partner in a business enterprise. Most states allow this arrangement.

For tax purposes, the same tests used for determining the bona fide nature of an individual partner's interest are applied, coupled with special trust factors. In one case, a sole proprietor executed partnership and trust agreements whereby he transferred 15% of the business assets to himself as sole trustee of a trust for the benefit of his 10-year-old daughter. The IRS determined, and the courts agreed, that the trust was not a bona fide partner.[11]

.02 Special Rules

Some special rules affecting family partnerships are discussed in the following paragraphs.

Contributions of property or money. A partner contributing property will be taxed on built-in gain or loss, determined as of the time of contribution, if the property is later disposed of by the partnership

[11] *L. Ginsberg*, 502 F.2d 965 (6th Cir. 1974), *aff'd* 32 T.C.M. 1019 (1973).

within seven years of being contributed.[12] Similar rules taxing the contributing partner apply to contributions by a cash-method partner of accounts payable and other accrued but unpaid items.[13]

Character of gain or loss on contributed property. Generally, the character (capital or ordinary) of any gain or loss on the disposition of property by a partnership is determined at the partnership level. However, there are some far-reaching exceptions to this rule involving contributions of unrealized receivables, inventory items, property subject to recapture and capital loss property to a partnership to prevent the conversion of ordinary income into capital gain, and capital losses into ordinary deductions.[14]

Disguised sales. At one time, taxes on the transfer of property to a partnership could be avoided or deferred, in some cases, if the transfer was accomplished through a contribution to a partnership followed by a tax-free distribution to the contributing partner to the extent of the partner's basis in the partnership. Now, however, a transfer of money or property by a partner to a partnership, when combined with a related transfer of money or property to the contributing partner or another partner, is outside the partnership non-recognition rules and is treated as a sale between the partner and partnership or two or more partners, as appropriate.[15]

"Mom-and-pop" partnerships. A qualified joint venture whose only members are spouses filing a joint return can elect not to be treated as a partnership for federal tax purposes. A *qualified joint venture* is a joint venture involving the conduct of a trade or business, if (1) the only members of the joint venture are spouses, (2) both spouses materially participate in the trade or business, and (3) both spouses elect out of partnership treatment. If this election is made, all items of income, gain, loss, deduction, and credit are divided between the spouses in accordance with their respective interests in the venture. Each spouse takes into account his or her respective share of these items as a sole proprietor. Thus, each spouse would account for his or her respective share on the appropriate form, such as Form 1040, Schedule C.[16]

.03 S Corporation as an Alternative

In many cases, a client can obtain the tax advantages of splitting income among family members by using an S corporation as an alternative to a family partnership (¶1945), but, as indicated in ¶2001, the partnership has numerous tax planning advantages over an S corporation. Nevertheless, the S corporation may offer more planning options in the context of the self-employment tax, the qualified business income deduction, and the 3.8% tax on net investment income if the S corporation shareholders are able to make appropriate allocations of reasonable compensation and income distributions.

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[12] IRC Section 704(c)(1).

[13] IRC Section 704(c)(3).

[14] IRC Sections 724, 751.

[15] IRC Section 707(a)(2)(B).

[16] IRC Section 761(f).

¶2010 Family Limited Partnerships

The family limited partnership (FLP) has had some success — and even more notoriety — in garnering estate, gift, and asset protection advantages. However, the IRS has been fighting the perceived abuses of FLPs. The IRS sees many of the tax breaks claimed in connection with FLPs, particularly discounting, as inappropriate.

Before suggesting a client use an FLP, the financial planner should exercise caution, become thoroughly familiar with the use of the FLP strategy, and be familiar with the most recent applicable decisions and rulings. How successful the IRS will be when challenging a particular case depends on its facts and circumstances. A bona fide business purpose, aside from simply tax savings, appears to be an essential element for the creation of a sustainable FLP. The financial planner should always advise clients about the possible advantages and dangers associated with the use of FLPs.

.01 Advantages

Reasons for setting up FLPs include the following:

- Favorable estate and gift tax treatment, primarily a result of valuation discounts claimed with respect to the transfer of minority partnership interests
- Protection from creditors of the limited partners for assets held in the FLP
- Ease of probate, including the possibility to avoid ancillary probate for out-of-state real property
- Ability of the transferors (who are typically parents) to retain control over the transferred assets

.02 Disadvantages

Reasons for not setting up FLPs include the following:

- High legal, accounting, and asset appraisal fees.
- Loss of stepped-up basis that would have been available had the transferors retained their property until death under IRC Section 1014(a) because in a typical FLP transaction, assets are transferred during a person's lifetime, rather than at death. With higher income tax rates on capital gains and the net investment income tax for wealthy taxpayers in 2020, addressing basis issues takes on increased importance.
- The advancement by the IRS of several legal challenges, particularly to "independent business purpose" or retained interests in the transferred property to defeat or lessen the claimed valuation discounts and other tax advantages of FLPs.[17]
- The risk to the general partner of the FLP of liability exposure.

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[17] *Powell* v. *Commissioner*, 148 T.C. 18 (2017); Estate of Moore v. Commissioner, T.C. Memo 2020-40

Discussing all the possible advantages and disadvantages of FLPs is beyond the scope of this chapter. Instead, this chapter will focus on the most important — and most contentious — claimed advantages relating to FLPs: the estate and gift tax breaks and the ability to put partnership assets beyond the reach of creditors.

.03 FLP Basics

Although there are different variations of the FLP, the FLP technique typically involves spouses contributing assets to a limited partnership in exchange for interests in the partnership. Each spouse might receive a very small general partnership interest (equal to 1% of the value of the transferred assets) and a larger limited partnership interest (valued at 49% for each spouse of the value of the transferred assets). They each retain their general partnership interests but transfer as gifts a large portion of the limited partnership interests to their children (each of whom typically receives only a minority interest).

Despite transferring most of the economic partnership interests, the parents' retention of the general partnership interests gives them control over the operation of the partnership. For asset protection purposes, it is not advisable to leave individuals as general partners. The persons serving as general partners typically form a corporation or LLC which they control to act as the general partner and gain liability protection.

.04 Estate and Gift Tax Advantages

Applying valuation principles generally applicable throughout the IRC, the limited partnership interests transferred to the children would be worth significantly less for estate and gift tax purposes than would the same proportionate interest in the underlying assets. The holder of the minority limited partnership interest cannot make decisions about how the partnership is run, demand distributions, or force a liquidation of the partnership. In addition, a minority interest in a family partnership might be far less marketable than an interest in the underlying assets of the business. Because of these limitations, minority interest and lack of marketability discounts have been allowed on the transfer of interests in an FLP. The combined discount for a minority interest and lack of marketability has been in the 20% to 40% range. (See, for example, *S. LeFrak Est.*[18] and *J. Barudin Est.*[19])

However, IRS Appeals Settlement Guidelines, issued in 2006, take the position that under certain circumstances, there should be a minimal, or no, discount from the pro rata value of the entity's underlying asset.[20] The Appeals Settlement Guidelines also take the position that the fair market value of transfers to an FLP should be includible in the transferor's gross estate under IRC Sections 2036 or 2038 when the facts and circumstances indicate that the decedent retained a sufficient interest in, or control over, the transferred property. Accordingly, the financial planner should not assume that the creation of an FLP is a guaranteed path to family transfer tax savings.

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[18] 66 T.C.M. 1297 (1993).

[19] 72 T.C.M. 488 (1996).

[20] Appeals Settlement Guidelines: Family Limited Partnerships and Family Limited Liability Corporations, October 20, 2006.

.05 The IRS Fights Back

When battling FLPs, the IRS has employed several arguments usually aimed at disallowing the claimed valuation discounts or forcing an outright inclusion in the estate of someone purportedly transferring a partnership interest. The following summaries are some legal theories that the IRS may raise in a dispute involving an FLP.

Swing vote premium. An FLP arrangement will normally involve one or more of the transferor's children holding minority limited partnership interests. Although this fact is central to the FLP's ability to generate a minority discount for such transferred interests, the IRS has raised the issue[21] that the children could combine their interests to create a "swing vote." If a swing vote is possible, the IRS believes the value of each of their limited partnership interests must reflect this power to control the partnership.

IRC Section 2701 issue. This IRC section applies if a person transfers a certain interest in a partnership to or for the benefit of a family member, and the transferor or an "applicable family member" retains a different interest in the same partnership. If IRC Section 2701 is applicable (generally addressing transferring "common" and retaining certain "preferred" interests in the partnership), the value of the partnership interest retained by the donor may be valued at zero, thereby charging the donor with a potentially substantial gift.

Planning Pointer. Fortunately, for FLPs, IRC Section 2701 includes an important exception. If the interest retained by the donor is proportionate to the transferred interest without regard to non-lapsing differences with respect to management and limitations on liability, the zero-value rule does not apply. Thus, an FLP agreement should give the same proportional rights to the transferors and the transferees with respect to income, gain, loss, and deductions, and make the right to distributions on the retained preferred interests cumulative.[22]

IRC Section 2703 and the sham transaction doctrine. In IRS Technical Advice Memorandum 9719006, the IRS launched a major attack on FLPs. This ruling involved a transferor who held assets in a revocable trust. When she died, the trust property, as well as the property in a marital trust established by her predeceased husband, was to be divided equally between her son and daughter. The property of both of these trusts would be included in the transferor's gross estate at her death.

An FLP was formed two days before the transferor's death when she was terminally ill and had been taken off life support. The transferor's son and daughter each contributed about $33,000 in cash for a 1% general partnership interest each. The transferor's revocable trust and her marital trust contributed over $2,259,000 to acquire the 98% limited partnership interests.

Immediately after formation of the partnership, the marital trust transferred two 30% limited partnership interests, one to each of the transferor's children, in exchange for $10,000 cash and a 30-year promissory note for $486,000.

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[21] IRS Technical Advice Memorandum 9436005, May 26, 1994.

[22] IRC Section 2701(a)(2).

On the deceased transferor's estate tax return, a 40% discount was applied to the promissory notes from the children. The partnership interests held by the transferor's trusts on the date of her death were valued at about 70% of the value of the underlying partnership assets. The result was that assets having a value of about $2,259,000 on one date were valued at only $1,177,000 two days later.

The IRS first disallowed the valuation discounts based on the sham transaction doctrine. Here, the IRS pointed out that because the son and daughter were the only beneficiaries under their mother's two trusts, they would have received all the assets transferred into the partnership. Likewise, their promissory notes would be distributed to them, as trust beneficiaries, in effect, canceling them. The IRS concluded that nothing of substance changed by reason of the FLP transaction. Thus, the FLP was to be disregarded for transfer tax purposes.

The second argument that the IRS invoked to disallow the claimed discounts was based on IRC Section 2703. This section provides that the value of property is determined without regard to any option, agreement, or other restriction on the right to sell or use such property. Within this context, the partnership agreement was deemed to be a restriction within the meaning of IRC Section 2703. Therefore, any reduction in value caused by the partnership agreement was to be disregarded unless the bona fide business arrangement exception of IRC Section 2703(b) applied.

Under IRC Section 2703(b), the general rule of IRC Section 2703 allowing the IRS to disregard a business valuation does not apply to any option, agreement, right, or restriction that (1) is a bona fide business arrangement, (2) is not a device to transfer property to members of the transferor's family for less than full and adequate consideration, and (3) has terms comparable to those in similar arrangements entered into by persons in arm's-length transactions.

Not surprisingly, the IRS ruled that the bona fide business arrangement exception did not apply to the facts in Technical Advice Memorandum 9719006. The IRS concluded that even if the taxpayer had a legitimate business purpose for the FLP transaction (such as creditor protection), the facts showed that the transaction was entered into primarily for the purpose of artificially reducing the value of the transferor's gross estate. Thus, it was to be regarded as a device to transfer property to members of the transferor's family for less than adequate consideration in money or money's worth.

Application of IRC Section 2704. The IRS has also raised objections to FLP valuation discounts based on Subsections (a) and (b) of IRC Section 2704. The IRC Section 2704(a) issue is the easier one for planners to avoid. Financial planners can avoid this issue by making sure that the partnership agreement does not contain any lapsing voting or liquidation rights. (If it does, the FLP-related transfers will be subject to transfer tax, if the transferor and members of the transferor's family control the partnership before and after the lapse.)

IRC Section 2704(b) provides that if a transfer of an interest in a partnership to a member of the transferor's family occurs, and immediately after the transfer, the transferor and members of the transferor's family control the entity, any applicable restriction is disregarded when determining the value of the transferred interest. For this purpose, an *applicable restriction* is defined as one that effectively limits the ability of the partnership to liquidate and with respect to which the transferor or any member of the transferor's family has the right after the transfer to remove, in whole or in part, the restriction.

The IRS applied IRC Section 2704(b) to deny FLP valuation discounts in IRS Technical Advice Memorandum 9725002 and Letter Ruling 9723009 when the applicable restriction was a partnership provision that restricted partners from withdrawing from the partnership. Application of IRC Section

2704(b) to such a situation turns on whether a limited partner's ability to liquidate his or her interest is to be equated with a partnership liquidation. The estates in the rulings argued "No." Rejecting their contentions, the IRS pointed to Regulation Section 25.2704-2(b), which defines an *applicable restriction* as a limitation on the ability to liquidate an entity in whole or in part. Citing example 5 of Regulation Section 25.2704-2(d), the IRS concluded that a restriction on the rights of individual partners to liquidate was a limitation on the entity to liquidate in part.

The IRS promulgated proposed regulations under IRC Section 2704 in August 2016 that would have significantly limited the ability of transferors of partnership interests to family members to claim valuation discounts for minority interest and lack of marketability. The regulations were criticized by many and withdrawn as "burdensome" in 2017.

Inclusion of interest in gross estate. Even if the FLP-related lifetime transfers withstand IRS scrutiny or attack, the IRS might still assert that the transferred interests should be included in the transferor's gross estate at death. IRC Section 2036(a) mandates inclusion in the donor's gross estate of lifetime transfers that are not made for full and adequate consideration in money or money's worth, in which the donor retains for life or for a period which does not, in fact, end before his or her death (1) the possession or enjoyment of, or the right to the income from, the property or (2) the right to designate the persons who are to possess or enjoy the property or the income therefrom.[23]

If structured properly, the donor in an FLP situation can be given a substantial amount of control over the partnership business without the donee's interests' being includible in the donor's gross estate at death. However, if the controls retained by the donor are not commonly found in normal business relationships, the donee's interests are at risk of being includible in the donor's gross estate under the rules of IRC Section 2036(a).

IRC Section 2036(a) will also apply if an express or implied understanding exists at the time of the transfer that the transferor will retain the economic benefits of the partnership property. A number of appellate courts have required inclusion of FLP assets in the donor's gross estate on the grounds that an implied agreement existed under which the donor retained lifetime enjoyment and economic benefit of the transferred assets.[24]

.06 Investment FLPs

The viability of FLPs funded by investment property, rather than by business property, is in doubt. Whether the valuation discounts that have been allowed with respect to FLPs containing business interests will also apply to investment FLPs is unclear. The investment FLP would also seem vulnerable to IRS attack based on its failing the business purpose test required for viable partnership treatment.

Transfers of business property to a partnership in exchange for partnership interests are generally tax-free.[25] However, if the partnership is such that it would be treated as an investment company under IRC

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[23] *A. Strangi Est.*, 115 T.C. 478 (2000), *aff'd in part, revs' in part*, 293 F.3d 279 (5th Cir. 2002); *Harper Est.*, 83 T.C.M. 1641 (2002); *D. A. Kimberly, Sr.* et al. 244 F. Supp. 2d 700 (D.C. ND Tex., 2003).

[24] *Est. of Thompson*, 417 F.3d 468 (3d Cir. 2004); *Gulag*, 293 F.3d 279 (5th Cir. 2005); *Est. of Abraham*, 408 F.3d 26 (1st Cir. 2005).

[25] IRC Section 721(a).

Section 351 if it were incorporated, gain or loss will be recognized on such transfers for partnership interests.[26]

All the other arguments discussed in ¶2010.05 would also apply to investment FLPs.

.07 Protection Against Creditors

Although the matter varies greatly with applicable local law, an FLP may impede a creditor's ability to reach the underlying partnership assets. At a minimum, the expected delays and legal fees might give the FLP partners the ability to negotiate a better deal with their creditors. When local partnership and debt collection provisions are particularly debtor-friendly, the creditor may never be able to reach the underlying partnership assets, at least not on terms that would be economically worthwhile. A creditor might be able to obtain only a charging order, which gives the creditor rights to any distributions made by the partnership to the limited partner. Because the IRS treats a creditor with a charging order as a substituted partner,[27] there is an argument that the holder of the charging order will receive a Schedule K-1 for the holder's distributive share of the partnership's income. Thus, the creditor would be taxed on income that the creditor might never receive, if the partnership does not make an actual distribution. A contrary position, however, is that the charging order is merely a lien; the holder may be an assignee, but not of the interest in the partnership or LLC but, rather, only of the claim on funds when made available. Practitioners who favor this position argue there is no "substituted partner," and there is no Form 1065 (Schedule K-1) for "phantom income" to be sent to the holder of a charging order.

The authors are not aware of any federal or state cases, or of IRS guidance, that verifies whether the creditor with a charging order or the debtor should be taxed for a distributive share of LLC profits. Because a charging order appears to be nothing more than a lien, a prudent suggestion would be for debtor-members to assume that they will continue to be allocated their usual distributive share of partnership or LLC profits, as well as the resulting income tax liability, even if a creditor obtains a charging order.

The shield of the FLP is certainly not complete, and the financial planner should warn clients already in financial distress about contributing assets to an FLP in hopes of avoiding creditor collections.[28] The financial planner must also check state law, as not every state allows a charging order to keep creditors "at bay."

¶2015 Death, Retirement, or Disability of a Partner and Disposition of Partnership Interest

The death of a partner or retirement because of age or disability will have important human and economic consequences, as well as profound legal and tax consequences. Under state law, unless the partnership agreement otherwise provides, the death or retirement of a partner terminates the partnership and requires a distribution of the partnership's assets to the partners or their successors in interest. This process of dissolution and liquidation of the partnership can result in a severe loss in values through

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[26] IRC Section 721(b).

[27] Revenue Ruling 77-137, 1977-1 CB 178, *D.L. Evans*, F.2d 547 (7th Cir. 0971), *aff'd* 54 T.C. 40 (1970).

[28] See *In re Tai*, BC-DC Fla., 96-2 USTC ¶50,547.

forced sales, dissipation of going-concern value and goodwill, and loss of jobs for the survivors. Dissolution of the partnership is clearly something that most clients will want to avoid. Accordingly, the partners may agree in advance to continue the partnership in the event of the death or retirement of a partner. A partnership agreement generally provides that the partnership will continue in the event of the death or retirement of a partner, unless there is affirmative action to dissolve the partnership.

The four basic alternatives on the death or retirement of a partner are as follows:

1. A sale of the deceased or retiring partner's interest to the remaining partners, allowing the partnership to continue.

2. A sale of the interest to a new partner.

3. A distribution to the deceased partner's estate (or successor in interest) or to the retiring partner in liquidation of the partnership interest. This really amounts to a sale to the partnership, but it has vastly different tax consequences.

4. The estate or successor in interest of a deceased partner may continue as a partner.

The partnership should consider certain practical factors when choosing among these alternatives. Can a new partner be found to buy the interest? Will a newcomer be able to handle a partner's responsibilities? Will the new partner fit in with the remaining partners? If the executor continues holding an interest in the partnership, similar questions of competency and assumption of responsibility apply. An heir or successor in interest who continues to hold a partnership interest involves additional difficult questions of competency, personality, and responsibility.

Some of the answers to these questions may hinge on the nature of the partnership business. If it is essentially passive (rental real estate, for example), family members may succeed to an interest with little disruption or concern. Alternatively, if the partnership business is active, requiring certain skills or expertise, successors must be chosen more carefully.

The financial planner must, of course, consider the tax implications, but should not overlook or minimize the practical considerations.

The planner must also consider estate tax consequences and income tax consequences. The following discussion treats estate tax consequences only incidentally, but they are examined in greater detail in ¶2020.

If the retiring partner, the estate, or the successor in interest of a deceased partner sells the partnership interest to the remaining partners, the tax law treats the sale as a sale of a capital asset.[29] The retiring partner receives capital gain or loss treatment on the sale of the partnership interest, except to the extent of required allocation of payments and ordinary income treatment for the selling partner's share of unrealized receivables, depreciation recapture, or inventory items.[30]

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[29] IRC Section 741.

[30] IRC Sections 741, 751

In case of death, the basis to the heir of the interest of the deceased partner is its fair market value at the partner's date of death (or the alternate valuation date).[31]

.01 Complete Liquidation of Interest of Retiring or Deceased Partner

A complete liquidation of the retiring or deceased partner's interest has special tax consequences under rules contained in IRC Section 736. Under IRC Section 736(a), payments made in liquidation of the interest of a partner who has retired or died are generally treated as a deductible distributive share of the partnership's income or as a guaranteed payment, which are items of ordinary income to the recipient. The payments are a distributive share of the partnership's income if they are determined with regard to the partnership's income. The payments are treated as guaranteed payments if the partnership determines the payments without regard to the income of the partnership. However, under IRC Section 736(b)(2), liquidation payments for goodwill and unrealized receivables generally are treated as made in exchange for the partner's interest in partnership property and not as a distributive share or guaranteed payment that could give rise to a partnership deduction or its equivalent. This rule does not apply to payments made to a general partner in a service-type partnership, such as a medical, legal, accounting, consulting, or architectural firm, and the rule does not affect the deductibility of compensation paid to a retiring partner for past services.[32]

Rules for unrealized receivables. Payments made for unrealized receivables (other than unbilled amounts and accounts receivable) are treated as made in exchange for the partner's interest in partnership property. Thus, for example, a payment for depreciation recapture is treated as made in exchange for an interest in partnership property and not as a distributive share or guaranteed payment that could give rise to a partnership deduction or its equivalent.[33] As discussed in ¶2015.02 that follows, payments attributable to depreciation recapture and unrealized receivables are treated as ordinary income to the recipient.

Planning Pointer. The special treatment of liquidation payments made for goodwill and unrealized receivables provides a great deal of planning flexibility for payments made to a general partner in a service partnership. In such situations, the parties can determine the extent to which payments are to be treated as ordinary income or as capital gain. If the remaining partners are in the top income tax bracket, they may prefer to have the payments treated as a share of profits or guaranteed payments, resulting in deductible ordinary income. On the other hand, departing partners might prefer to have payments specifically allocated to goodwill. Such payments would not be taxable as ordinary income to the retiree, a deceased partner's estate, or successor in interest, and would not be deductible by the partnership but would be taxed as capital gain to the recipient. For payments to an estate where the value of the deceased partner's interest has increased over his or her lifetime, the estate is able to take advantage of a basis step-up on the death of the departing partner.[34]

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[31] IRC Sections 1014, 2032).

[32] IRC Section 736(b)(3).

[33] IRC Sections 736(b)(2) and 751(c).

[34] IRC Section 1014(a).

.02 Gain or Loss Attributable to Unrealized Receivables and Inventory Items

Money or property received in exchange for all or part of a partnership interest attributable to the partnership's unrealized receivables or inventory items is treated as an amount realized from the sale or exchange of property that is not a capital asset. Thus, the sale or exchange of such property, sometimes called "hot assets," will result in ordinary income or loss under IRC Section 751(a). The value is measured by the difference between the amount realized for the partnership interest allocated to these items and the portion of the selling or liquidating partner's basis attributable to these partnership items.

Generally, the portion of the total amount realized that the parties allocate to these items in an arm's-length agreement will be regarded as presumptively correct.[35]

Unrealized receivables are rights to payment for goods or services delivered or rendered or to be delivered or rendered.[36] However, unrealized receivables also include depreciation on real and personal property subject to recapture under IRC Sections 1250 and 1245. Such amounts are treated as paid in exchange for the partner's interest in partnership property.[37] The term *inventory* includes not only stock in trade but also accounts receivable.[38]

.03 Fixing a Price for Sale or Liquidation

Valuing a partnership interest and fixing a price for a buy-sell agreement or partnership buyout by liquidation are difficult. Regulation Section 20.2031-3 says to look for the net amount a willing buyer would pay to a willing seller, both having reasonable knowledge of all relevant factors, including a fair appraisal of the assets, tangible and intangible, including goodwill, the economic outlook of the industry, proceeds of life insurance, earning capacity, and other items.

However, different partners can look at all the relevant factors, and each one may have a different opinion of value. Fixing the value or price among the partners becomes a matter of negotiation. The parties might negotiate one price on death, another on retirement, and still another on disability on the basis of different needs.

Buy-sell agreements may establish value for transfer tax purposes if they meet the rules contained in IRC Section 2703 (discussed in ¶2310). Agreements among family members are viewed skeptically by IRS examiners, but agreements among unrelated parties are given a presumption of validity.

Because of the possibility of wide-ranging fluctuations of value, the partners might give some thought to providing a disabled partner or a deceased partner's widow(er) with some participation in the recovery of earnings if cyclical low partnership earnings produce an unrealistically low price. These, and other considerations specially tailored for the particular firm, should be on the negotiating table. Provisions for

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[35] Regulation Section 1.751-1(a)(2).

[36] Regulation Section 1.751-1(c).

[37] Regulation Section 751(c).

[38] Regulation Section 1.751-1(d)(2)(ii).

periodic review of a stated value run the risk of delay by those satisfied with the last price fixed. The partners can supplement such provisions with an independent arbitration to decide any disagreement.

Planning Pointer. It is always best to encourage the partners to enter into a mutually satisfactory buy-sell agreement early in their relationship, when prospects for an agreement and cooperation may be at their highest level, and the bargaining power of the parties may be equivalent. Waiting until possible conflicts in the relationship develop or a partner becomes ill may make it difficult, if not impossible, for the partners to reach an equitable agreement.

.04 Disability

Any agreement among the partners themselves or with the partnership for the sale or liquidation of their interests on death or retirement should normally also provide for disposition of the partnership interest in the event of disability. Disability calls for special attention in the following key areas:

- Defining disability.
- When the transfer is to take place.
- Effect of recovery from and recurrence of the disability.
- Removal from management.
- Price — Price may be the same as on death or retirement. What is the date of valuation? When does disability begin? When does the transfer take place?
- Effect of death before completion of disability payments.
- Funding — If insurance is used, the funding will follow the pattern of the sale or liquidation on the death of a partner. It will either be a cross-purchase type of arrangement or an entity buy-out arrangement. If insurance is not used, how will the payments be structured — a lump-sum or an installment buyout?
- Death or disability of two or more partners — If the partnership is small and a key partner dies while another is out on disability, the partners should consider a dissolution of the partnership and suspension or cancellation of payments due to a deceased or disabled partner, which are not funded by insurance.

.05 Use of Insurance to Fund Agreement

Insurance funding will commonly play a part in whatever form of agreement is used to buy or liquidate a partnership interest. In some agreements, life insurance is employed simply to furnish funds to the remaining partners or the partnership to make the acquisition from the departed partner or his or her family. Any excess insurance may either be retained by the partnership or the remaining partners or be paid to the estates of the deceased partners. The agreement should address this point specifically. In some cases, the insurance proceeds are made payable to the estate or beneficiary of the deceased partner. Partners may own policies of insurance on each other's lives, so that they will have funds with which to purchase the deceased partner's interest. The comparison of planning alternatives at the end of this section describes and evaluates the effects of various common life insurance arrangements.

Financial planners should keep the following general considerations in mind when planning life insurance ownership and coverage:

- With a cross-purchase agreement, usually each partner buys a separate policy on the life of each of the other partners and pays the premiums, which are not tax deductible.[39] The younger members of the partnership bear a heavy premium burden to insure the older partners unless some adjustment in compensation of the younger partners is made.

- With a partnership buyout or liquidation agreement, the partnership usually buys a separate policy on the life of each partner and pays the premiums, which are not tax deductible.[40]

- The policy proceeds, in either case, are normally received free of income tax.[41]

- If the policy proceeds are made payable to the estate of the deceased partner, the financial planner should consider the matter of a possible excess or deficiency of the proceeds in relation to the fixed price for the interest to be acquired. Also, the financial planner should consider a possible attempt on the part of the IRS to include both the insurance proceeds and the value of the partnership interest in the gross estate of the deceased partner. Proper draftsmanship, making clear that the deceased partner had no incidents of ownership in the policy on his or her life, and that the insurance proceeds are in payment for the partnership interest under a binding agreement with lifetime restrictions on transfer, will prevent double inclusion.

- Prior to the TCJA, it was generally not advisable to have the insured own the policy on the insured's own life with the proceeds payable to the surviving partners or the partnership. In such a case, it would be difficult to prove that the insured is divested of all incidents of ownership in the policy to avoid having the proceeds includible in the insured's gross estate under IRC Section 2042.[42] With the increased estate tax exclusions available under the TCJA, owning a policy is far less likely to result in estate tax liability, suggesting the insured may want to retain ownership and control of the policy. This advice must be considered in connection with the sunset of the TCJA provisions after 2025, and the political risk of a change in the law sooner. Holding the policy "too long" could result in an estate inclusion. Attempting a "late" transfer still must satisfy the three-year rule (that is, the death of the insured within three years of the transfer of the policy results in the policy being included in the insured's estate).

- To reduce costs, term insurance and loans against cash policies can be used. If loans are to be used, the financial planner should be mindful of the rule barring deduction of interest payments

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[39] IRC Section 264.

[40] IRC Section 264.

[41] IRC Section 101(a).

[42] Regulation Section 20.2042-1(c), IRS Letter Ruling 8610068 (December 11, 1985), *B. L. Fuchs Est.*, 47 T.C. 199 (1966), *Noel Est.*, 380 U.S. 678 (1965).

generally[43] unless four of the first seven annual premiums are paid without borrowing.[44] Effective for contracts purchased after June 20, 1986, a taxpayer may deduct only the interest paid or accrued on the first $50,000 of coverage.[45] For modified endowment contracts[46]entered into after June 20, 1988, loans from the policy are treated as distributions taxable on a last-in-first-out basis[47]and generally subject to a 10% additional tax if made before age 59½.[48]

A trust might help to hold down a partner's cost of carrying insurance on the lives of the other partners. The partner could, for example, buy a policy on partner A's life and transfer it to a trust, along with sufficient income-producing property to generate enough income to pay the premiums. The purchasing partner should not be the insured or beneficiary of the policy, because IRC Section 677 would treat the trust's income as taxable to the purchasing partner.

.06 Provision for Payment of Shares of Postmortem Profits

Sometimes, an agreement will provide that the estate of a deceased partner be paid a share of the partnership's profits following death. This agreement might be the exclusive basis of payment for the partner's interest, or it might supplement other payments. Unless the agreement provides for the payment for goodwill, these payments would be taxable to the recipient as IRD.[49] These payments would also be includible in the gross estate of the deceased partner to the extent of their value on the date of the decedent's death.[50] If the payments are to be paid over a period of years, difficult valuation problems arise.

.07 Adjusting Basis of Partnership Assets

By making a special election under IRC Section 754, a partnership can adjust the "inside" basis of its assets (that is, the partnership's basis in its underlying assets as distinguished from a partner's "outside" basis, that is, the partner's basis in his or her partnership interest) when a change in partnership interests occurs. This adjustment will affect only the partner to whom an interest is transferred, not the other partners. The basis adjustments applicable to a Section 754 election apply to the acquisition of a partnership interest either by purchase or inheritance. If the election is in force, the adjusted basis of the

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[43] IRC Section 264(a).

[44] IRC Section 264(d).

[45] IRC Section 264(e)(1).

[46] IRC Section 7702A(a).

[47] IRC Section 72(e)(10).

[48] IRC Section 72(v).

[49] IRC Section 691(a).

[50] IRC Section 2031(a).

partnership assets is increased by any excess of the adjusted basis to the transferee of the partnership interest acquired over the partner's share of the adjusted basis of all partnership assets.[51]

> **Example 20.1.** Assume that Thomas pays $30,000 for Albert's 50% interest in a partnership, which has assets with a total basis of $40,000. Thomas has paid $10,000 [$30,000 − ($40,000 × 50%)] in excess of the partnership's inside basis for a share of partnership assets. If a Section 754 election is made, this $10,000 is added to the basis of partnership assets for the benefit of Thomas only. Similarly, if Albert had died and Thomas had inherited his interest, worth $30,000, a Section 754 election would give him a basis in the partnership assets of $30,000.

Note that the rule providing for a technical termination of a partnership on account of the sale of a 50% interest was repealed by the TCJA.[52]

If the Section 754 election is in effect and the adjusted basis of partnership property (inside basis) exceeds the transferee's basis for the partnership interest (outside basis), then inside basis is to be reduced in a similar manner.[53] Therefore, the partnership should make the special Section 754 election only after careful consideration of its potential advantages and disadvantages.

When confronted with a situation in which there are some partnership assets that have declined in value and some that have increased in value, consider separating the assets into two partnership (or LLC) entities. Then, choose an IRC Section 754 election for the entity that will result in an increased inside basis to a purchaser or heir.

It is the partnership, and not the affected individual partner, that makes the IRC Section 754 election. The advantage is the increased inside basis of partnership assets for the purchaser of a partnership interest or the heirs of a deceased partner. The potential disadvantage to the partnership is that each partner could have a different basis in each partnership asset, making for a very cumbersome recordkeeping requirement. If there are many partners and many assets, this administrative inconvenience could serve to reject the opportunity to make an IRC Section 754 election. If there is a small number of partners and a modest list of assets, the advantages of the IRC Section 754 election should outweigh any issues of inconvenience. In some situations, the partnership agreement may provide that the partner(s) benefitting from the Section 754 election agree to bear responsibility for the additional administrative costs of the Section 754 election.

¶2020 Alternatives for Planning Partnership Successions and Terminations

This chapter has examined the income tax considerations affecting planning for partnership successions by way of sale or liquidation of partnership interests and life insurance programs. However, this chapter has not discussed estate tax considerations to any considerable extent. Neither has this chapter discussed the alternatives to dissolution of the partnership or the continuance of the partnership by the executor or heir of a deceased partner.

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[51] IRC Section 743(b).

[52] IRC Section 708(b)(1).

[53] IRC Section 743(b).

These issues are discussed in the following text.

.01 Purchase of the Decedent's Interest by the Surviving Partners — Unfunded Agreement

The surviving partners logically provide the best market for acquiring the interest of a deceased partner. The agreement to address this should be made well in advance of the death of any partner for the best tax and practical results.

Estate tax consequences. The buy-sell agreement fixing the sale price should determine the estate tax value, provided the agreement contains a lifetime restriction on transfer and satisfies the rules contained in IRC Section 2703 (discussed in ¶2310).

Income tax consequences. The tax year of a partner terminates on the date that the partner's interest in the partnership terminates, whether by death, sale, or otherwise.[54] However, the partnership itself does not terminate unless the partnership no longer carries on a business. The TCJA repealed the rule providing that a partnership terminates if there is a sale or exchange of at least 50% or more of the total interests in the partnership within a 12-month period.[55]

The estate of the decedent will usually not realize any gain on the sale of the decedent's partnership interest to the surviving partners. The basis of the interest is equal to the date of death or the alternate valuation date estate tax valuation,[56]and the amount the estate receives generally will be the estate tax valuation of the interest. However, IRC Section 1014(c) does not allow the adjustment in basis for any property that represents IRD under IRC Section 691(a) (¶2025).

The survivors must use their own funds to purchase the decedent's interest. The amount they pay increases their basis in their partnership interests.[57] In addition, if the surviving partners' share of the partnership's liabilities increases, their bases in their respective partnership interests will likewise increase.[58] If the payment to the decedent's estate results in the estate's relinquishing its interest in appreciated assets, the survivors may elect, under IRC Sections 743(b) and 754, to increase the adjusted basis of the purchasers in the partnership property by the amount paid for the decedent's interest in excess of the decedent's proportionate share of the partnership's inside basis for its assets.

> **Example 20.2.** Assume that the Abel Baker Campo partnership has $10,000 in cash and an asset with a tax basis of $5,000, which is worth $20,000. Assume that Baker dies, and Abel and Campo pay Baker's estate $10,000 for Baker's interest, or $5,000 over the tax basis of the partnership assets. If the partnership makes the available IRC Section 754 election, Abel and Campo may increase the tax basis in their partnership assets by $5,000.

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[54] IRC Section 706(c)(2)(A).

[55] IRC Section 708(b)(1).

[56] IRC Section 1014(a).

[57] IRC Section 1012.

[58] IRC Section 722 and 752(a).

.02 Purchase of Decedent's Interest by the Surviving Partners — Funded Agreement

The buy-out agreement may be funded in various ways, but life or disability buy-out insurance is the preferred method. When the partners use insurance, a variety of alternatives exists regarding ownership of the policies, beneficiaries, and payment of premiums. Three possible variants are as follows.

Policy owned by surviving partners and proceeds payable to them. The estate tax consequences and income tax consequences discussed previously in connection with an unfunded buy-sell agreement apply here as well. The survivors increase the basis of their partnership interests by the amount paid to the deceased partner's estate and by any increase in their share of the partnership's liabilities assumed.[59] Only the value of the partnership interest should be includible in the decedent's gross estate, not any of the insurance proceeds.

Policy owned by the survivors and the estate is the policy beneficiary. The partnership agreement or cross-purchase agreement among the partners might provide that the partnership interest is to be transferred for the insurance proceeds, and no further payment is to be made.

One of the advantages of this approach is that the proceeds are payable directly to the decedent's estate without going through the survivor's hands, thus seemingly removing the risk of diversion of the funds to other purposes. Doubt exists whether the survivors can increase their income tax basis in their partnership interests this way. A concern here is that by paying the insurance proceeds to the decedent's estate, there will be an estate inclusion under IRC Section 2042. To avoid this result, the partnership agreement would have to provide that the insurance proceeds are received by the decedent's estate in full liquidation of the decedent's partnership interest.

Survivors own the policy with the proceeds payable to an heir. In this method, the insurance proceeds would be payable directly to the decedent's heir. Whether this approach would succeed in achieving a required sale or a basis adjustment remains undecided, and financial planners should carefully consider its consequences before recommending it to clients. It does not appear to provide any assurance that the partnership interest will be sold or that the policy proceeds will be applied toward a sale, hence, the reluctance to recommend this method. The payment of the policy proceeds needs to be tied to a buy-sell agreement stating that the proceeds are received in exchange for the decedent's partnership interest.

.03 Insurance Funding of Payments in Liquidation of a Deceased Partner's Interest

Example 20.3. Assume that a three-partner law firm carries $60,000 in term insurance on Jake Shaw's life payable to the partnership. If, on Shaw's death, his surviving spouse receives $35,000 for his interest, the partnership, instead of obtaining an after-tax cost of $35,000 on the payments made to Shaw's surviving spouse, would show a $25,000 "profit," less its investment in the insurance premiums. If the partnership agreement was to provide that the insurance proceeds were to be allocated to the capital accounts of the surviving partners, each of the two surviving partners would increase the basis of his or her partnership interest by $30,000. The partnership could also allocate a portion of the proceeds to the deceased partner's account, say one-third, or $20,000. This allocation would serve to decrease the IRC Section 736(a) payments

[59] IRC Section 1012.

and increase the IRC Section 736(b) payments. Furthermore, the partnership agreement could allow payment for goodwill, which would affect the allocations under IRC Section 736(a) and (b).

If the partnership owns the policy and the estate is the beneficiary, the decedent's gross estate might include both the insurance proceeds and the value of the partnership interest. However, this potential double inclusion should be avoided with a properly drawn agreement that clearly provides that the insurance proceeds are received by the estate in full liquidation of the decedent's partnership interest.

Other problems of this plan include determining whether the survivors' bases may be increased by their share of the insurance proceeds. If the premiums have all been charged to the decedent's capital account, then IRC Section 736 is completely avoided. The proceeds would be includible in the decedent's gross estate, but there would be no income tax. Then, the surviving partners would not be able to increase the bases of their interests. If the partnership allocated the premiums paid to the capital accounts of each partner, the survivors should be able to increase their bases by an allocable portion of the proceeds.

.04 Estate, Heir, or Successor Continuing as Partner

With this approach, no formula fixes the value of the decedent's interest. Thus, one can expect the IRS to argue for a high valuation for estate tax purposes if the deceased partner's estate will be taxable. The IRS would likely add goodwill to net asset value and value the business as a going concern, unless the interest is left to a surviving spouse and qualifies for the marital deduction. If the estate will not be taxable, the heirs should argue for the highest justifiable value for the partnership interest in order to secure the largest basis increase.

Furthermore, using this approach does not result in any income tax consequences for either the surviving partners, the estate, or other successors to the decedent's interest, except as the estate or other successors receive a stepped-up basis for the interest acquired.

.05 Dissolution of the Partnership

From an estate tax viewpoint, a financial planner might argue that, on dissolution, only the net asset value of the decedent's share should be valued. However, the IRS looks at the value of the business as a going concern, which is the price a willing buyer would pay and a willing seller would accept for the assets, goodwill, and demonstrated earning capacity of the interest.

From an income tax standpoint, enjoying the flexibility allowed by IRC Section 736 upon liquidation of the decedent's interest is not possible. Any excess over basis, received by the decedent's estate or other successor, is treated as capital gain under IRC Sections 731 and 732, except for unrealized receivables and inventory items, which are taxable as ordinary income under IRC Section 751. Under IRC Section 754, the partnership may elect to make the optional adjustments to basis permitted under IRC Section 743. This election permits the partnership to increase the basis of partnership property by the excess of the basis of the decedent's interest in the partnership (the outside basis) over the decedent's proportionate share of the adjusted basis of the partnership property (the inside basis), as described previously in ¶2015.07.

¶2025 IRD From a Deceased Partner's Interest

Because most individuals are on the cash basis method of accounting, they cannot report income until they have received it. If an individual dies before receiving income, the recipient of the income realized

by the decedent must include the amount in gross income as income in respect of a decedent (IRD) under IRC Section 691(a).

In a partnership setting, IRD includes payments considered as a distributive share or guaranteed payment in liquidation of a deceased partner's interest within the reach of IRC Section 736(a). IRD may also include payments for goodwill in such liquidations if no special allocation is made for goodwill, as well as payments for unrealized receivables and inventory items. IRD would also encompass a share in the partnership profits earned after the partner's death and payable under a pre-death agreement.

IRD is, thus, includible in the income tax return of the estate of the deceased partner or in the tax return of the eventual recipient of the deceased partner's partnership interest. If the decedent's estate is taxable, the IRD items are also includible in the decedent's estate tax return.[60] However, the recipient of this income is allowed an income tax deduction for the estate tax (if any is paid) attributable to the inclusion of the income in the decedent's gross estate.[61]

A financial planner can recommend a number of important steps to soften the impact of IRD:

- Consider the income tax position of the possible recipients of IRD. Consider allocating the IRD to family members in lower income tax brackets, spreading it among multiple beneficiaries.
- The choice of a charity as recipient of the IRD saves both estate taxes and income taxes.
- If the executor receives IRD, the decedent's will should allow the executor to distribute IRD to spread it among recipients in low income tax brackets.
- Consider making a specific bequest of the partnership interest and having the bequest distributed before the end of the estate's taxable year, or provide in the partnership agreement that specific beneficiaries, rather than the estate, are to succeed to the interest.
- If the IRD is payable to the estate, the estate's choice of a fiscal year can prevent bunching of income when the estate anticipates that certain IRD payments will be received in one month and other IRD payments in later months. IRD items can be distributed from the estate to individual beneficiaries in lower income tax brackets.

¶2030 Valuation of Partnership Interests for Estate Tax Purposes

Valuation of a partnership interest for the purpose of fixing a price for a buy-sell or buy-out agreement is difficult. If the agreement is binding on all parties, and they are not free to dispose of their interests during life, the price stated in the agreement should be used as the basis for estate tax valuation. Agreements entered into after October 8, 1990, must meet special IRC Section 2703 requirements in order to fix value. Where the agreement is among family members, strict IRS scrutiny should be anticipated. These requirements are discussed in ¶2310.

Absent an agreement fixing a price, the executor must determine the fair market value of the interest at the date of death or the alternate valuation date. The executor must weigh all relevant factors, such as the

[60] IRC Section 2031(a).

[61] IRC Section 691(c)(1) and (2).

nature of the business, general economic outlook in the industry, book value, financial condition, proven earning capacity, and intangibles such as goodwill.

If dissolution and discontinuance of the partnership business is the route chosen, one might think the IRS would look solely to net asset value, without regard to going-concern value or goodwill. However, the IRS wants to value the partnership interest at its fair market value or the price that a willing buyer would pay and a willing seller accept.[62]

The IRS has instructed its appeals officers that the appraisal of partnership interests does not vary greatly from the valuation of closely held stock (¶1940), except for certain accounting distinctions.

.01 Valuation of Business Real Estate

Under certain conditions, the executor may elect to value real property included in the decedent's gross estate, which is devoted to closely held business use, based on use of the property in the closely held business, rather than at its fair market value based on its highest and best use.[63] There is a limit on the aggregate decrease in the value of qualified real property from its highest and best use resulting from the election to use the special use valuation method.[64] For the estate of a 2020 decedent, the aggregate decrease in value may not exceed $1,180,000.[65] This number is indexed annually for inflation.

IRC Section 2032A requires that the owner or a member or members of the owner's family materially participate in the operation of the business for specified periods, both before and after the decedent's death. A surviving spouse's active participation in management will suffice.[66] As to the decedent, a partnership is a closely held business as defined in IRC Section 6166(b)(1), if 20% or more of the total capital interest in the partnership is included in the decedent's gross estate. In addition, a partnership that has no more than 45 partners is a closely held business for purposes of IRC Section 2032A and IRC Section 6166.

Regulations provide that when applying the requirement of material participation to partnerships, activities in the management and operation of the real estate component of the business as a whole are determinative.[67] The time and manner of making the special election are described in a Treasury regulation.[68]

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[62] IRC Section 2031(a) and Regulation Section 20.2031-3.

[63] IRC Section 2032A.

[64] IRC Section 2032A(a)(2) and (3).

[65] Revenue Procedure 2017-58.

[66] IRC Section 2032A(b)(1).

[67] Regulation Section 20.2032A-3(f)(2).

[68] Regulation Section 20.2032A-8.

For a discussion of how this provision should be applied when business real estate is held directly by the decedent and of the conditions attached to the special use valuation election, see ¶2110.

¶2035 Installment Payment of Estate Taxes

If the value of an interest in a closely held business exceeds 35% of the value of the decedent's adjusted gross estate (gross estate value reduced by allowable expenses, losses, and debts),[69] the executor may elect to pay the estate taxes attributable to the business interest in 2 or more, but not more than 10, annual installments with interest only due for the first 4 years. The installment payments must be equal. If the executor makes the election to pay such estate taxes in installments, the first installment payment of the tax is due no more than 5 years after the prescribed date for paying estate taxes. The maximum payment period is 14 years, rather than 15 years, because the due date for the last of the interest-only payments is the same date as the due date for the first installment payment of the tax.[70] This provision allows the estate to defer the estate taxes attributable to the business interest for up to 14 years with a special 2% interest rate applicable to the estate taxes on the first $1 million[71] (indexed for inflation) in taxable value of the closely held business. For the estate of a 2020 decedent, the annually inflation-adjusted amount is $1,570,000. In the case of a partnership interest, in addition to the 35% test, the partnership must have no more than 45 partners, or 20% or more of the total capital interest in the partnership must be included in the decedent's gross estate.[72] For the purpose of meeting the 20% requirement, interests in the partnership held by members of the decedent's family, as well as the decedent's own interest, are to be aggregated.[73] Family members are spouses, children, grandchildren, parents, and siblings.[74] These attribution rules are not applicable when determining the number of partners.

If the amount of the taxable value of the estate extended under IRC Section 6166 is greater than $1,570,000, only that amount qualifies for the special 2% rate.[75] Any amounts deferred that are in excess of the amount that qualifies for the 2% rate (called the 2% amount) are taxed at a rate equal to 45% of the rate that applies to underpayments of tax.[76] That amount of interest due will fluctuate each year as the IRS underpayment rate is adjusted from time to time. The interest

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[69] IRC Section 6166(b)(6).

[70] IRC Section 6166(a)(3) and (f)(1).

[71] IRC Section 6601(j)(1)(A).

[72] IRC Section 6166(b)(1)(B).

[73] IRC Section 6166(b)(2)(D).

[74] IRC Sections 6166(b)(2)(D) and 267(c)(4).

[75] IRC Section 6601(j)(2).

[76] IRC Section 6601(j)(1)(B).

payments made on the deferred tax under IRC Section 6166 are not deductible on the estate tax return[77] or on the estate's income tax return.[78]

If the estate has undistributed net income for any taxable year after its fourth taxable year, the executor must apply it to the unpaid estate taxes.[79]

The 14-year extension can help overcome a cash squeeze, at the small price of low interest rates. In situations in which an extension appears to be of possible use but there is some question about whether the estate can meet the percentage tests, the financial planner should consider strategies that will help satisfy the test. The client could either increase the size of the partnership interest, reduce the size of the other parts of the estate by making lifetime gifts of assets other than the partnership interest, or both.

The number of partners for purposes of the 45-partner limitation is to be determined immediately before the decedent's death.[80] A husband and wife holding an interest in any form are counted as one partner.[81] If a corporation or other partnership or trust is a partner, the shareholders, other partners, and beneficiaries of the trust are counted as partners.[82] The latter provision is designed to prevent circumvention of the 45-partner limitation through the use of these other entities.

The maximum estate tax deferrable is the amount of estate tax attributable to the partnership interest. This is determined by the ratio of the value of the partnership interest to the adjusted gross estate.[83] The balance of the estate tax is due at the regular time for paying the tax, that is, nine months after the date of the decedent's death. In addition, if after the election to pay tax in installments is made, one-half or more in value of the partnership interest is sold, or if aggregate withdrawals of the partnership interest are made that equal one-half of the value of the partnership interest, there is an immediate acceleration of the unpaid balance of the estate tax.[84] This rule suggests that the provision has practical value only in situations in which the executor or heirs will continue to hold the partnership interest.

The value of a partnership eligible for the Section 6166 deferral opportunity includes only assets used to carry on the business. Passive assets are not included.[85]

When the partnership business involves the management of investment assets, it does not qualify as a closely held business for purposes of IRC Section 6166. If additional services are performed, converting

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[77] IRC Section 6601(j)(1)(B).

[78] IRC Section 163(k).

[79] IRC Section 6166(g)(2)(A).

[80] IRC Section 166(b)(2)(A).

[81] IRC Section 6166(b)(2)(B).

[82] IRC Section 6166(b)(1)(C).

[83] IRC Section 6166(a)(2).

[84] IRC Section 6166(g)(1)(A).

[85] IRC Section 6166(g)(1)(A).

the activity to a service enterprise, a qualifying business interest will be found.[86] Revenue Ruling 2006-34 liberalized the availability of IRC Section 6166 for persons holding real estate investments and engaging in some active management of those investments.

¶2040 Limited Liability Companies

The LLC is another form of operation for conducting a small business available in all 50 states and in the District of Columbia. LLCs address many of the shortfalls of the other forms of business organizations.

LLCs are hybrid business entities that can provide their members with both the limited liability characteristics of corporations and the pass-through tax treatment of partnerships. LLCs, like limited partnerships and corporations, are creatures of statute. The members of an LLC enjoy the same freedom from personal liability for obligations of the business as shareholders of a corporation.

Pursuant to the check-the-box regulations,[87] an LLC with two or more members that is not required to be classified as a corporation generally can choose to be taxed as either a partnership or an association taxable as a corporation. In addition, a single-member LLC may be treated as an association (and taxed as a corporation) or disregarded as an entity separate from its owner (taxed as a sole proprietorship). An LLC can choose to be taxed as a C corporation or as an S corporation. An LLC makes the entity election under Regulation Section 301.7701-3(b)(1) by filing Form 8832, Entity Classification Election. If S Corporation treatment is desired, an S Corporation election is filed on Form 2553.

.01 Advantages of LLCs

Members of LLCs enjoy the same protections from personal liability for business obligations as do shareholders of a corporation or limited partners in a limited partnership. Unlike the limited partnership form, which requires at least one general partner who is personally liable for all the debts of the business, no such requirement exists for an LLC. The financial planner should recognize that this is a significant advantage recommending the use of an LLC.

An LLC with two or more members that is not required to be a corporation and makes no election to be treated as a corporation will be classified by default as a partnership for tax purposes.

One person may form and own an LLC. If the LLC is owned by only one person, the entity is generally ignored for federal tax purposes. It is often called a “disregarded entity.” If an individual owns an LLC, the individual will be treated as a sole proprietor and file Schedule C of Form 1040, absent an election to be taxed as a corporation. If a corporation owns an LLC, the LLC will be treated as a division of the corporation.

LLCs, S corporations, and partnerships all provide for the pass-through of income and loss to their owners. LLCs, however, can be used in a wider range of circumstances than S corporations. S

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[86] PLR 199929025.

[87] Regulation Section 301.7701-3(b)(1).

corporations may have no more than 100 shareholders.[88] (For this purpose, a husband and wife are treated as one shareholder. In addition, lineal members of a family through six generations may be treated as one shareholder of an S corporation.) With limited exceptions for certain trusts, shareholders in S corporations must be individuals. Other types of investors, such as corporations and partnerships, are not eligible to be S corporation shareholders. In addition, S corporations may issue only a single class of stock.[89] LLCs are not subject to any of these restrictions.

LLC members have flexibility to allocate income or loss on a basis other than each member's percentage interest in the LLC. Special allocations that have substantial economic effect are permitted. By contrast, in the case of an S corporation, all such allocations must be based strictly on each shareholder's stock ownership.[90]

An LLC treated as a partnership for tax purposes is eligible to elect under IRC Section 754 to adjust the inside tax basis of its assets after a change of ownership of a membership interest. In addition, such an LLC can use nonrecourse debt to increase a member's basis in the member's interest. Neither of these advantages is available to an S corporation. An LLC may be eligible for a Section 199A qualified business income deduction, depending on the taxable income of the member and whether the LLC is engaged in a specified service trade or business. Section 199A is discussed at length in the appendix.

.02 Disadvantages of LLCs

The most frequently cited disadvantage of LLCs has been uncertainty resulting from the lack of legal precedent for LLC disputes. Corporations, partnerships, and limited partnerships have been around for some time, whereas LLCs are relative newcomers. A Uniform Limited Liability Company Act has been adopted by an increasing number of states. However, LLC acts and taxation can differ materially from state to state.

The cost of forming an LLC may be more substantial than establishing a sole proprietorship or partnership. Proper formation and organization is likely to entail extensive paperwork that requires legal assistance.

State tax treatment of LLCs varies. Most state laws provide that the classification of LLCs will follow the federal tax classification. However, some states apply special entity-level taxes or gross receipts taxes, regardless of the federal tax classification of an LLC.

.03 Conversion of a Partnership into an LLC

A partnership may be converted into an LLC without adverse tax consequences, regardless of whether the LLC is formed in the same state as the partnership.[91] Converting a partnership into an LLC will not cause the partners to recognize gain or loss. The LLC is treated as a continuation of the partnership.

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[88] IRC Section 1361(b).

[89] IRC Section 1361(b)(1).

[90] IRC Section 1366(a).

[91] Revenue Ruling 95-37, 1995-1 CB 130.

Chapter 21

Planning for the Sole Proprietor

¶2101 Overview

The sole proprietor has the same basic financial problems as a businessperson operating through a closely held corporation or partnership, but the sole proprietor's problems are likely to be more severe. The sole proprietor has no partner to help shoulder the burden if disability strikes. Often, no one is standing in the immediate line of succession, ready to take over, run the business, and preserve its value upon the sole proprietor's death. When a sole proprietor dies or becomes disabled, without some contingency planning, virtually everything that the sole proprietor has built up in the business context can be wiped out in short order. That is the central problem.

¶2105 Alternatives Available to the Sole Proprietor

A sole proprietor should explore several alternative financial and estate planning methods.

.01 Business Entity

The first question the sole proprietor should ask is whether the sole proprietorship form of doing business makes sense over time. The sole proprietor may consider a change to the corporate form of business. A one-person corporation will not solve the successor problem immediately, but it can facilitate the solution by giving the sole proprietor incentives to recruit and retain successors and address liability concerns. At the same time, the corporate form can open up a whole new world of wealth-building possibilities not available to a sole proprietor: the world of executive benefits. In addition, the corporate form opens important wealth-transferring possibilities by transfers of stock to family members.

If the regular C corporation form is not practical, the sole proprietor might want to consider an S corporation, which in several respects is taxed similarly to a partnership, as discussed in ¶1945. Another possibility is to operate as a partnership or LLC. A partnership must have at least two members. A partnership can provide some measure of insurance against the hazards of disability and precipitous loss of value on death. However, finding a partner and maintaining a partnership relationship has its own problems. Perhaps the sole proprietor is not ready for a regular partnership. If so, a family partnership might be the answer. In this case, the sole proprietor does not form a partnership with a stranger but with family members. The sole proprietor can still be in control. The family members can be silent partners.

Trusts for minor members of the family may also be partners. The family partnership can produce immediate income tax savings by way of income splitting provided that capital is a material income-producing factor in the partnership, not just the personal services of the ex-sole proprietor. It will also serve to decrease the ex-sole proprietor's gross estate for estate tax purposes. In time, if not immediately, it may be the source of successor management and permit continuance of the business in the family or a sale at a better price than would otherwise be obtainable. The subject of family partnerships is discussed in ¶2005.

Operating as a single-member LLC will not address the succession issues but can protect the member from liability concerns. Single-member LLCs have limited liability and file Schedule C of Form 1040.

Many persons owning interests in entities taxed as sole proprietorships may be eligible for the new 20% qualified business income pass-through deduction, making the choice of entity a more complicated decision.[1]

.02 Tax Shelter

If the sole proprietor remains unconvinced of the need for a change in the form of doing business, the next item on the agenda should be how to obtain a business-related tax shelter.

If the sole proprietor does not already have one, a qualified retirement plan can serve to shelter retirement savings from income taxes. Sole proprietors and other self-employed individuals can enjoy essentially the same qualified plan benefits as corporate employees. The proprietor can contribute in 2020 the lesser of $57,000 or 100% of compensation to a defined contribution Keogh plan, a SEP-IRA, or a single participant 401k plan.

Under IRC Section 219(g)(3), participation in a qualified plan will deny the sole proprietor deductions for IRA contributions if his or her adjusted gross income (AGI) exceeds certain limits.

For 2020, if an individual who files a single or head-of-household return is covered by a qualified retirement plan, his or her IRA deduction begins to phase out when AGI reaches $65,000 and is completely eliminated once income reaches $75,000. For 2020, the phase-out begins for a married individual who is covered by a qualified plan when income reaches $104,000 on a joint return and is complete when income reaches $124,000. The phase-out range is higher for a married individual who is not covered by a qualified plan, but whose spouse is covered. The IRA contribution deduction opportunity for a married individual not covered by a qualified plan phases out if the AGI ranges from $196,000 and $206,000 on the couple's joint return for 2020. If the AGI on the joint return exceeds $206,000, there is no IRA contribution deduction allowed. For married individuals filing separately, the phase-out range is $0 to $10,000.[2]

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[1] IRC Section 199A.

[2] IRC Section 219(g)(3)(B).

However, even if AGI is above the IRA phase-out range, the sole proprietor can still make a nondeductible IRA contribution. If the sole proprietor is not an active participant in a qualified plan, IRA contributions would be deductible no matter how high AGI is. For a detailed discussion of the qualified plan and IRA rules, see ¶905 and ¶915, respectively.

.03 Disability Insurance

The sole proprietor should consider the possibility of disability. A business concentrating in something other than personal services may be able to maintain its operations for a while if the sole proprietor is disabled. The end result, however, is likely to be a shutdown. With a personal service business, the end result is the same, only it comes about more dramatically. When the sole proprietor is disabled, the business cannot provide services to realize earnings. The accounts receivable might carry the disabled service provider for a short time. However, unless the sole proprietor returns to work, the business is likely to fail.

In either case, the sole proprietor should consider disability income insurance protection and a certain amount of business interruption insurance. The proprietor of a personal service business is not going to close the office, terminate the lease, and fire employees the moment disability strikes, as long as there is a chance business will resume before too long. Even a proprietor who is convinced that the disability is permanent will want to stay open for a time, at least to collect the accounts receivable and arrange for the termination or possible succession of the business. If it is a capital-based business, the business might continue with employees running it for a short while. The sole proprietor will still want to think about business interruption insurance. The premiums on such insurance are tax deductible, but the proceeds are taxable. The premiums for disability income insurance are not tax deductible, but the proceeds of the disability income insurance are not taxable.

¶2110 Disposition of the Business upon Retirement or Death

The next question for the proprietor is: What is to be done with the business when the owner reaches retirement age or dies? Liquidation is the ultimate solution if the sole proprietor can find no other solution. However, the sole proprietor should avoid liquidation if at all possible because it means severe shrinkage in value. Liquidation typically means a sale of assets at forced-sale prices, sacrifice of goodwill, discounting accounts receivable, and elimination of what had been a continuing source of income. If this shrinkage takes place on the death of the owner, life insurance can be a means of making up the difference between going-concern and liquidation value.

.01 Control by Executor

As an alternative to liquidation, the sole proprietor might consider having the executor (or personal representative) maintain the business, but this is not a long-term, viable solution. The executor will rarely be in a position to be ready, able, and willing to undertake the job and assume personal liability and all that is entailed in running the business. The executor may lack the expertise or professional credentials necessary to continue the business. Even more important, all the assets of the estate will be exposed to the liabilities of the proprietorship. If an executor can be found to take on the job, the chances are, with the prospect of beneficiaries of the estate and their counsel second-guessing him or her, the executor will err on the side of ultra-conservatism. Alternatively, by the time the executor is able to obtain court authorization and be permitted to act, serious shrinkage in value might already have taken place, and the executor might feel pressured to be more aggressive, which could be even worse. This alternative is possibly better than liquidation, but it is rarely feasible and hardly a good choice.

If the sole proprietor chooses to have the executor carry on the business, the executor must decide what to do with the business interest. The executor should make an immediate survey of liability insurance coverage and obtain additional protection, if necessary. Then, the executor will have to determine whether the estate can sell the interest as a going concern at a value higher than its liquidation value. If the interest has going-concern value and the executor decides to keep it, the executor's job becomes more difficult than if the estate liquidated the interest. The executor will have to evaluate management and make any necessary changes. The executor will then want to consider the future ownership form of the business. Incorporation is the clear solution for the liability exposure that the estate and the fiduciary face by continued operation in an unincorporated form. Incorporation not only reduces liability, but it also facilitates transfer of the business. The double taxation inherent in a C corporation operation is a factor the executor should consider, along with the avoidance of double taxation available through the S corporation election. The executor might also consider operating the business as an LLC. The 21% tax rate of a C corporation and the 20% pass-through deduction if the business involves a qualified business interest are all opportunities to be considered.

If the executor decides to incorporate the business, the executor faces a decision about which assets to place in the corporation and which to keep out. The executor might find that it is advisable to keep ownership of the business real estate out of the corporation. Rather, the estate could own the real estate directly or place it into a separate LLC, and lease it to the corporation. When forming the corporation, the executor will have all the pre-incorporation opportunities for planning discussed in planning for closely held corporations (see chapter 18, "Closely Held Businesses — Choice of Business Form," and chapter 19, "Planning for the Owner of the Closely Held Corporation").

.02 Family

Another possibility, of course, is to give the business to a family member — a child or surviving spouse. Unless they have been in close touch with the business and understand it, they start out with two disadvantages: their inexperience and a serious difficulty establishing credit, leading to a cash crunch. This approach could be better or worse than having the executor try to run the business. Obviously, the decision will depend on the individuals involved, their background, experience, credibility, and their willingness to work. Additional problems finding a successor will be presented when the business owner must be a duly licensed professional.

If the business interest and other estate assets would subject the estate to federal estate taxes, the sole proprietor should consider a bequest of the business interest to the surviving spouse, rather than to a younger family member. A bequest of the business interest to the surviving spouse would shield the business interest from federal estate taxes because of the marital deduction.[3] The surviving spouse could then employ the younger family member(s) to operate the business. Another possibility the sole proprietor should consider is the use of a qualified terminable interest property (QTIP) trust to hold the business interest. The younger family member(s), as trustee or under a contract with an independent trustee, might operate the business during the surviving spouse's lifetime, and be entitled to reasonable compensation for doing so. The income from the business would be payable to the surviving spouse at least annually in accordance with the QTIP trust requirements. On the spouse's death, when federal estate tax may become due, the interest would pass to the younger family member.

[3] IRC Section 2056.

.03 Sale

The sole proprietor should consider forming a family partnership, or an LLC taxed as a partnership if a suitable co-venturer can be identified, especially if coupled with a sale of part of the partnership to someone capable of running the business. Key employees are the most likely candidates for a purchase agreement. This approach removes the threat of liquidation and makes possible a third-party purchase at lower cost than if the full interest were being sold. However, in the context of a possible sale of a portion of the business to third parties, consider the issue of control — will a prospective buyer be content to purchase a minority share in a business, especially if the decedent's family members are the other business owners? The likely answer may well be no.

If the business owner forms a family limited partnership during his or her lifetime, an easier transfer of leadership is possible, with standby assistance available for the new managers. Lifetime gifts of partnership interests to family members or gifts of the sale proceeds by the owner, or both, will reduce any estate tax liabilities, taking into account a combination of discounting, portability, the available unified credit, and the marital deduction. Consumption of sale proceeds also reduces the estate. In addition, gifts of partnership interests may reduce the owner's income tax liabilities. If the purchase is designed to take place at death, the agreement might establish the value of the interest for estate tax purposes. Agreements entered into after October 8, 1990 must meet special requirements under IRC Section 2703 in order to fix value, particularly when family members are involved. These requirements are discussed in ¶2310.

If the business owner does not desire this approach or if it is not feasible, a sale of the business to capable employees is another alternative. The business owner could arrange for the sale to take effect upon retirement, death, disability, or at some other time.

The chief problem when consummating a sale of the business to employees is often financing. If the purchase is to take place at death, then life insurance on the life of the sole proprietor can be used to fund the purchase. The sole proprietor must be insurable. The employees will own the policy or policies and pay the premiums. Premium payments could be a problem if a permanent life policy were to be used because of its relatively high cost. Term insurance premiums would cost less than the premiums for a permanent life policy, but the cost would become prohibitive should the owner live "too long," because term insurance premiums typically increase as the insured ages. In any case, the premiums paid are not tax deductible,[4] and one may anticipate some difficulty financing them.

Also, the owner might be called on to pay the premiums, with provisions for reimbursement to the estate upon the owner's death, using some form of a split-dollar financing arrangement. This plan raises a question about whether the premiums paid are to be regarded as a loan to the employees or as taxable compensation to them. (See the discussion of split-dollar life insurance in chapter 7.)

Insurance can also be used to fund a purchase that takes place on the owner's retirement. In such a case, the business owner would use some form of policy that would provide a sufficient cash surrender value when payment is to be made. Again, premium costs become a factor for the employees.

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[4] IRC Section 264(a).

If the proceeds are made payable to the employees, the business owner incurs a risk that the proceeds might never be applied to their intended purposes. If the proceeds are payable to the owner's executor, the owner incurs a possible risk that both the policy proceeds and the value of the interest to be purchased would be includible in the owner's gross estate. Payment of the proceeds to an irrevocable trust might be best. The financial planner should ascertain the fees and costs involved. Payment of the proceeds to a properly drafted trust would assure payment without delay, without reliance on the compliance of specific employees and the possible risk of double estate tax inclusion when life insurance is payable to the executor.

If the sole proprietor is uninsurable but holds policies obtained while insurable, the sole proprietor should consider selling these policies to the employees. Because of the insured's present uninsurability, the value of the policies could be open to dispute. They should be worth more than their current cash value. How much more might depend on an evaluation of the insured's health and actual life expectancy. The sole proprietor should evaluate the adverse income tax consequences resulting from a transfer of an insurance policy for value. Under IRC Section 101(a)(2), the proceeds in excess of the consideration paid by the employees, plus the subsequent premiums paid and other amounts subsequently paid will be taxable income to the employees under the transfer for value rule. However, IRC Section 101(a)(2) provides an exception from the transfer for value rule in the case of transfers to "partners" (but not to other stockholders) that might be worth exploring. Consider making key employees partners to take advantage of this exception to the transfer for value rule.

The sole proprietor should explore other means of financing apart from or in addition to insurance funding. For example, instead of selling the business intact, the sole proprietor might arrange to sell the operating part of the business only. The sole proprietor, the estate, or heirs would retain the property, plant, and equipment and lease it to the purchasers. Another possibility would be to sell the business for a down payment and a note. The seller could negotiate to retain a portion of the earnings in return for favorable financing terms. A possible downside of this approach is the necessity to rely on the ability of the purchasers to manage the business successfully to make certain the note payments are made as required.

A sole proprietor might desire to sell the business to his or her children. However, the children might not have sufficient cash to purchase the business. The sole proprietor could sell the business to the children for a self-canceling installment note. The business would provide the cash flow for the installment payments. If the seller dies before the note is paid in full, the children's liability on the note ends. Thus, the note has no estate tax value on the date of the seller's death, and the unpaid balance is not included in the seller's gross estate. The seller's estate might have to recognize the deferred capital gain on the note for income tax purposes.[5] In addition, the buyer may have to reduce the basis in property acquired by the note by the unpaid balance on the note but only if the transaction is treated as a cancellation of indebtedness.[6] The basis would not be reduced if the note cancellation is treated as properly bargained for in the transaction.

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[5] IRC Section 691(a)(5), *Frane v. Commissioner*, 998 F.2d 567 (8th Cir. 1993).

[6] IRC Section 108(e)(5).

Planning Pointer. Because the self-cancelling installment note involves a required premium (either principal payments in excess of the fair market value or an interest rate above market), this technique is best used when the seller's actual life expectancy due to health concerns is shorter than the seller's actuarial life expectancy and the duration of the note.

The IRS closely scrutinizes notes that are automatically canceled when the lender dies. That is because a bona fide self-canceling note is not subject to estate tax when the lender's interest is extinguished at death. Courts have held that such a note between family members is presumed to be a gift and not a bona fide transaction. However, this presumption can be rebutted if there is a clear showing that the parties intended to create a true debtor-creditor relationship. For example, one federal court of appeals upheld the validity of a self-canceling installment note used by a son to buy his father's business, even though the father's death canceled the note shortly after its execution. The court ruled that transaction was a bona fide self-cancelling note and should not be treated as a taxable gift.[7]

.04 Valuation for Estate Tax Purposes

A binding buy-sell agreement, negotiated at arm's length, may fix the valuation for estate tax purposes. Each asset should be valued on its own merits. For example, even though receivables are collectible, the time element involved in their collection may justify a discount. Obsolescence and deterioration can be important factors in inventory valuation. However, it is very difficult to fix a value for estate tax purposes when the transaction is between family members in light of the strict requirements of IRC Section 2703, as discussed in ¶2310.

.05 Valuation of Qualified Business Real Estate

The rules for special use valuation for closely held business property also apply to farm property. These rules are discussed in more detail in ¶2210.[8]

The mere passive renting of property will not qualify for special use valuation. However, the property will qualify when a related party leases the property and conducts farming or other business activities on the property. Leasing to a nonfamily member may qualify if the rental is substantially dependent on production.

When planning to take advantage of the special use valuation provision, the financial planner should take into account the possible effect the lower valuation can have on the tax basis of the property and the future income tax liability of the heirs. Use of the lower special use value for estate tax purposes will give the heirs a lower tax basis for income tax purposes than would a highest and best use value. The lower basis would ultimately result in a higher income tax on disposition of the property by the heirs. The financial planner should also consider the effect of a higher valuation on death tax costs. Consider the year of death and the exemptions from the estate tax available in such year, as well as the comparison between the tax rate that would be imposed on the decedent's estate as the result of death

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[7] IRC Section 108(e)(5); *Costanza v. Commissioner*, 320 F3d 595 (6th Cir. 2003)

[8] Revenue Ruling 87-122, 1987-2 CB 221.

and the income tax rate that might be imposed on the decedent's heirs if they decide to sell the property in the future, with or without the recapture concerns.

A sole proprietor may be married and eligible to take advantage of the unlimited marital deduction possibly in combination with the maximum use of portability or the available unified credit (or both). In such a case, the sole proprietor's estate should not have any federal estate tax liability, and special use valuation is not a factor. In such circumstances, a valuation based on highest and best use will provide a higher basis for the property passing from the decedent. A higher basis will usually produce better income tax results on a taxable disposition of the property. The comparison of potential estate tax liability and income tax basis is important.

If the sole proprietor is not sure about meeting the IRC Section 2032A 50% and 25% requirements and wants to take advantage of the special use provision, the proprietor should consider lifetime gifts of nonqualified property or gifts of the proceeds of the sale of such property. To be effective for purposes of applying the 50% test, the business owner must make the gifts more than three years before death.

.06 Joint Ownership of Business Realty and Personal Property with Spouse

If the sole proprietor and spouse own real estate and tangible personal property used in the business as joint tenants, 50% of the value of such property will be excluded from the gross estate of the first to die under IRC Section 2040(b) (¶315.02), regardless of the contribution of the survivor. The survivor's basis will be equal to one-half of the decedent's date of death value, plus one-half of the original cost of the property. If the business interest is considered community property, all of the property is deemed to have been acquired from the decedent under IRC Section 1014(b)(6). Accordingly, the entire value of the community property at the decedent spouse's death is the basis to the surviving spouse.

.07 Installment Payments of Estate Tax

If the value of the business interest includible in the proprietor's gross estate is equal to more than 35% of the adjusted gross estate, the executor may elect to pay all, or part, of the estate tax attributable to the business interest up to 10 equal annual installment payments.[9] The first installment payment is due no more than five years after the prescribed estate tax payment date.[10] The discussion of this topic in ¶2035 in connection with partnerships applies equally here.

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[9] IRC Section 6166(a).

[10] IRC Section 6166(a)(3).

Chapter 22

Planning for the Farmer and Rancher

¶2201 Overview

Farmers and ranchers differ in many ways, but they are generally grouped together for tax purposes. This chapter will follow the same pattern. Unless making a distinction is important, both are referred to as *farmers*. In addition, *farms* include ranches.

¶2205 Keeping the Property Intact

Farms represent a substantial investment in land, equipment, and buildings. Although a farmer's net worth can be substantial, the farmer's estate may be highly illiquid. The prices of things farmers buy can go up at a far faster rate than the prices of things farmers sell. Rising labor costs have made increased mechanization a competitive necessity, which further increases the farmer's debt and interest charges.

The farmer often wants to remain a farmer, involve the children in farm operations, keep the farm together, and pass it on to the family. However, taxes and agri-economics can make doing so very difficult without careful planning. Without the marital deduction, keeping a farm intact if the estate is without liquid assets to pay federal estate taxes is difficult. Under current rules for 2018 and beyond, estate taxes can be 40% of the market value of the farm in excess of the applicable exclusion amount. The increased federal estate tax exclusion amount ($11.58 million in 2020, indexed for inflation, through 2025, reverting back to the 2017 exclusion amount in 2026, indexed annually for inflation) may reduce the pressure on the farmer's potential estate tax liability. The farmer's liquidity problem is worse if the farm's value exceeds the applicable federal exclusion, and the farm is mortgaged.

One solution is to sell part of the farm to pay the death taxes. However, that solution might not be feasible with a ranch. Another problem is dealing fairly with the children who remain farmers and the

children who leave the farm. Often, the family can solve this problem only by the farming part of the family buying out the interests of the others. This solution can create difficulties for both buyers and sellers.

Against this background, the three things a financial planner should address when considering estate planning for a farmer are as follows:

1. Minimize death taxes.

2. Provide sufficient liquidity for the farm operation to continue.

3. Adjust in a satisfactory manner the interests of the heirs who remain and those who leave the farm.

IRC Section 2032A (discussed in ¶2210) provides some estate tax relief for farmers by permitting a reduced estate tax value for the actual use valuation of the farm, instead of valuation based on its highest and best use.

¶2210 Minimizing Death Taxes

Minimizing death taxes is a very broad subject addressed by much of this publication. Some techniques that might be especially useful when planning for the needs of the farmer are discussed in the following text.

.01 Valuation of Qualified Real Estate Used in Farming or Other Closely Held Business

Under IRC Section 2032A, if certain conditions are met, the executor may elect to value real property included in the decedent's estate used in a closely held business or as a farm on the basis of the property's value as a farm or its value in the closely held business, rather than its fair market value determined on the basis of its highest and best use. However, this special use valuation cannot reduce the decedent's gross estate by more than $1,180,000 for a decedent passing away in 2020.[1] This figure is indexed annually for inflation.[2]

To qualify for the special use valuation, the decedent must have been a citizen or resident of the United States at the time of death, and the following conditions must be met:

- The value of the farm or closely held business assets in the decedent's estate, including both real and personal property (but reduced by debts attributable thereto), must be at least 50% of the decedent's gross estate (less debts and expenses).

- At least 25% of the adjusted value of the gross estate must be qualified as farm or closely held business real property.

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[1] Revenue Procedure 2019-44, (November 6, 2019).

[2] IRC Section 2032A(a)(3).

- The real property qualifying for special use valuation must pass to a qualified heir (described).
- Such real property must have been owned by the decedent or a member of his or her family and used or held for use as a farm or closely held business for five of the last eight years prior to the decedent's death.
- The decedent or a member of his or her family must have materially participated in the operation of the farm or closely held business in five out of the eight years preceding the date the decedent died, became disabled, or retired.
- The executor must attach to a timely filed federal estate tax return (Form 706) a notice of election containing certain information specified in Regulation Section 20.2032A-8(b), including copies of written appraisals of the fair market value of the real property and an agreement signed by each person having an interest in the property consenting to the tax treatment provided for dispositions and the recapture rules for failure to use the property for qualified purposes (described below).

Active management by a surviving spouse satisfies the material participation requirement.

For purposes of the 50% and 25% tests, the value of property is determined without regard to its special use value. The term *qualified heir* means a member of the decedent's family, including his or her spouse, parents, brothers, sisters, children, stepchildren, and spouses and lineal descendants of those individuals.

Only property that has passed from a decedent is eligible for special use valuation. However, property purchased from a decedent's estate by a qualified heir, as well as property received by bequest, devise, or inheritance, or in satisfaction of a right to a pecuniary bequest, is considered to have so passed. Property passing to a qualified heir as a result of a qualified disclaimer is considered as passing from the decedent.[3]

In general, trust property is deemed to have passed to a qualified heir to the extent that the qualified heir has a present interest in the trust. Property that meets the other requirements for special use can be specially valued if it passes to a discretionary trust. No beneficiary of the trust can have a present interest because of discretion in the trustee to determine the amount to be received by any individual beneficiary. In addition, all potential beneficiaries of the trust must be qualified heirs.

The mere passive renting of property will not qualify. However, the property will qualify when a related party leases the property and conducts farming or other business activities on the property. Leasing to a nonfamily member may even qualify if the rental is substantially dependent on production.

A relevant question is whether the property is used as a "farm or for farming purposes." IRC Section 2032A(e) contains a long list of farming activities.

Salvaging special use valuation. IRC Section 2032A(d)(3) provides for "perfection" of elections of special use valuation within 90 days of a request by the IRS. Defective special use elections may be perfected without regard to whether the estate's original estate tax return evidenced "substantial

[3] Revenue Ruling 82-140, 1982-2 CB 208.

compliance" with the technical rules for making the election. If the executor submits a timely notice of election and recapture agreement, but the election does not contain all the required information or signatures, the executor may supply the missing information or signatures within 90 days of being notified by the IRS.

Special valuation methods. Under IRC Section 2032A(e)(7), if an estate and a farm or real estate used for farming qualifies for IRC Section 2032A special use valuation, their value is to be determined by dividing

1. the excess of the average annual gross cash rental (the use of net-share rentals is permitted if cash rentals for comparable land in the same locality are not available) for comparable land used for farming purposes and located in the locality of such farm over the average annual state and local real estate taxes for such comparable land by

2. the average annual effective interest rate for all new Federal Land Bank loans.

For the purposes of items 1 and 2, each average annual computation is to be made on the basis of the five most recent calendar years ending before the date of the decedent's death.

However, IRC Section 2032A(e)(7)(C) provides that this special farm valuation rule does not apply:

- When it is established that there is no comparable land from which the average annual gross rental may be determined.

- Where the executor elects to have the value of the farm determined by applying the following factors from IRC Section 2032A(e)(8) (these factors would also apply in the case of qualified closely held business real property other than property devoted to farming):

    — The capitalization of income that the property can be expected to yield for farming or closely held business purposes over a reasonable period of time under prudent management using traditional cropping patterns for the area, taking into account soil capacity, terrain configuration, and similar factors

    — The capitalization of the fair rental value of the land for farmland or closely held business purposes

    — Assessed land values in a state that provides a differential or use value assessment law for farmland or closely held businesses

    — Comparable sales of other farm or closely held business land in the same geographical area far enough removed from a metropolitan or resort area so that nonagricultural use is not a significant factor in the sales price

    — Any other factor that fairly values the farm or closely held business value of the property

See Regulation Section 20.2032A-4 for further details on the method of valuing farm realty.

Recapture rules. Under IRC Section 2032A(c)(1), if within 10 years after the decedent's death, but before the death of the qualified heir, the property is disposed of to nonfamily members or ceases to be used for the originally qualified use, then the estate tax benefits resulting from the special use valuation will be recaptured. IRC Section 2032A(c)(7) provides a 2-year grace period for nonuse. Also, certain

qualified heirs are treated as materially participating in the farm or other business operation during the recapture period when such heirs engage in the active management of the farm or business. Recapture does not apply if the disposition results from the death of the qualified heir.

Recapture is not triggered by a net cash rental of specially valued property by a surviving spouse or lineal descendants of the decedent to a member of the decedent's family.

The grant of a conservation easement in property subject to special use valuation is not considered to be a disposition of the property for purposes of the recapture tax.

Planning considerations. The use of portability, the marital deduction, and the available unified credit can avoid all estate taxes, at least upon the death of the first spouse. In such a case, valuation at fair market value based on the highest and best use might be preferable to special use valuation in order to obtain a higher income tax basis for the farm property. When planning to take advantage of the special use valuation provision, the financial planner should take into account the possible effect the lower valuation can have on the tax basis of the property and the future income tax liability of the heirs and compare that to the potential liability for the federal estate tax and the rate at which the federal estate tax may be imposed.

Taxpayers who are uncertain of meeting the 50% and 25% requirements but who want to take advantage of the special use valuation provision will want to consider making lifetime gifts of nonqualified property or the proceeds of the sale of such property to increase the likelihood that the special use property will meet the percentage tests. To be effective for this purpose, the gifts must be made more than 3 years before the death of the taxpayer purported to be eligible for the special use valuation election.[4]

No special use valuation applies to lifetime gifts of qualifying real estate. Thus, the client must consider retaining farm interests or closely held business real estate to take advantage of the special use provision at death. On the other hand, if the property has good appreciation potential, a lifetime gift of the property might be a good tax planning strategy aside from considerations involving the special use valuation opportunity. The gift tax based on current fair market value might be less than the estate tax at death based on appreciated value, even allowing for the special use discount.

The special use provision introduces complexities to both before- and after-death tax planning, the costs of which need to be taken into account. Preparing to meet the requirements of the special valuation methods calls for extensive record keeping.

Fundamentally, the purpose of the special use valuation provision is to reduce the estate tax burden of the decedent's estate and heirs. However, the reduction in estate taxes might be at the expense of higher income taxes at the time of the disposition of the property. Thus, the special use valuation provision does not guarantee an overall reduction in estate and income taxes when considered together.

The financial planner should consider the recapture potential for this special use valuation election arising from the possible early disposition of the property. The life expectancy of the qualified heir becomes a factor because the death of the qualified heir eliminates recapture. The heir can avoid personal liability for recapture by posting a bond that meets certain requirements. A procedure also

[4] IRC Section 2035(c)(1).

exists for subordinating the government's lien for recapture. This provision helps the heirs to obtain credit based on the value of the realty.

A transfer by a qualified heir to a member of the heir's family is not subject to recapture.[5] However, a transfer to an individual who is not a member of the qualified heir's family is subject to recapture, even though the transferee is a member of the decedent's family.[6] The law extends the statute of limitations for the assessment and collection of any recaptured tax. A special lien also continues for as long as the potential recapture liability may exist. However, the IRS may waive the lien if it finds that the interests of the United States are adequately protected.

.02 Joint Ownership With Spouse

Under IRC Section 2040(b), generally only one-half of the jointly held property with a right of survivorship in the surviving spouse is includible in the gross estate of the first spouse to die. This rule applies regardless of the contribution, or lack of contribution, by either spouse (see ¶315.02 for a detailed discussion of this provision). The half that passes to the survivor qualifies for the marital deduction under IRC Section 2056 and receives a date-of-death value as its basis under IRC Section 1014. The other half, already possessed by the survivor, generally receives no date-of-death value as its basis. Rather, the other half carries over or continues its original basis. This rule can be an important factor working against the use of joint ownership of highly appreciated property, when the spouse who is expected to die first holds or can be given sole ownership. However, if the couple owned the property as community property, all the property is deemed to have been acquired from the decedent.[7] Therefore, all the community property would receive a basis equal to fair market value at the death of the first spouse to die.[8]

.03 Management Powers

The financial planner will want to think about giving the surviving spouse or trustee certain powers to facilitate management. For example, the financial planner might consider the power to lease for a period extending beyond the surviving spouse's lifetime, the power to deal with mineral interests in the land, and the power to make soil conservation improvements and enter into any necessary arrangements with the Department of Agriculture.

.04 Form of Operation

A trust is not usually a good vehicle for operating a farm. Therefore, for this and other reasons, a financial planner should recommend a corporation, partnership, or limited liability company as the entity to be used for holding the farm assets.

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[5] IRC Section 2032A(c)(1)(A).

[6] Revenue Ruling 89-22, 1989-2 CB 276.

[7] IRC Section 1014(b)(6).

[8] IRC Section 1014(a).

.05 Lifetime Gifts

Lifetime gifts of nonfarm assets are one way of minimizing the size of the gross estate. The opportunity in 2020 to use the gift tax lifetime exclusion of $11.58 million per donor (adjusted annually for inflation), along with the annual exclusion gift of $15,000 (for 2020, and adjusted annually for inflation) per donee per year, as well as gift splitting with a spouse to double these amounts, makes possible a fairly rapid reduction of an estate. Is the farm client willing to make significant gifts? If so, the opportunity in 2020 may be too attractive to ignore. The financial planner should encourage consideration of gifting opportunities while the current law exclusion remains in effect.

.06 Incorporation

Incorporation of the farm might prove of great value for estate planning purposes. A corporation lends itself to planning for the reduction of estate tax values by gifts of minority stock interests, while at the same time, permitting retention of operational control. The operation of the farm can remain uninterrupted by the probate process. Redemptions of stock at death under IRC Section 303 become possible. The redemption is treated as a sale or exchange and not as a dividend. Gain is realized only to the extent that the redemption proceeds exceed the recipient's basis. If the decedent's shares receive a basis of the date-of-death value under the rules of IRC Section 1014 (¶1005), there will be little or no gain or loss to the estate when an IRC Section 303 redemption takes place. However, an IRC Section 303 redemption to pay death taxes can have an adverse effect on special use valuation because it will be viewed as a disposition of some or all of the qualified stock interest.[9]

Corporate stock can be used to make gifts to the family. If gifts are made over a span of years in amounts within the annual gift tax exclusion or through the use of the lifetime gifting exclusion, estate tax values can be greatly lowered without transfer tax consequences. If the senior family member's stock ownership is reduced to the point that stock holdings represent a minority interest in terms of control, the value of the holdings will be further decreased for estate tax purposes because a discount for minority interest may then be claimed by the decedent's estate. In addition, the special use farm valuation method, discussed previously, will be available (assuming all the requirements are satisfied), even though the farm is held in corporate form.[10]

A farmer can operate a farm as a C corporation or as an S corporation (¶1945). An S corporation may have both voting and nonvoting stock without violating the S corporation single class-of-stock rule, as long as there is no difference in economic preferences between the classes. An S corporation may also have a form of safe harbor debt that will not be deemed a second class of stock.

When the farmer uses the C corporation form, the shareholder-employees may enjoy fringe benefits not available to partners, sole proprietors, or S corporation shareholders. However, parity exists between corporate and non-corporate retirement plans. As a result of the TCJA, the C corporation now has a flat income tax rate of 21%. However, many persons owning interests in entities taxed as S corporations, sole proprietorships and partnerships may be eligible for the new 20% qualified business income (QBI) pass-through deduction of IRC Section 199A, making the choice of entity a more complicated decision.

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[9] Revenue Ruling 85-73, 1985-1 CB 325.

[10] Regulation Section 20.2032(A)-(3)(b).

One corporate fringe benefit that might be of special value to the farmer or rancher is meals and lodging for the convenience of the employer. Under IRC Section 119, an employee may exclude meals and lodging from gross income if furnished for the convenience of the employer.

The U.S. Tax Court applied the IRC Section 119 exclusion in a case involving a dairy farm.[11] The issue in the case was whether meals and lodging furnished to shareholder-employees were excludable from gross income. When determining whether the lodging was excluded from gross income, the court concluded that "dairy farming is simply not a nine-to-five business." It pointed to the possibility of escaped cattle, broken-down milk coolers, calf-birth, and bleeding udders as events requiring personnel on hand at all times.

The cost of gas and electricity furnished to the residence would also be excluded from the gross income of the shareholder-employees as part of the lodging expenses. Telephone service might also be excluded if an allocation were made to business use.

The U.S. Tax Court has allowed the IRC Section 119 convenience of the employer exclusion in other cases in which the taxpayer was required to reside on the farm as a condition of employment, and the taxpayer had to be available for duty at all times.[12] In one case, the U.S. Tax Court did not allow the exclusion. However, the U.S. Court of Appeals for the Ninth Circuit reversed the decision and allowed the exclusion because taxpayers were required to be available for duty at all times.[13]

Any farming operation involving the care and maintenance of livestock or the storage of farm produce, especially if refrigeration or heat is required, and other operations calling for nighttime supervision, may qualify. This exclusion can provide a substantial benefit to shareholder-employees.

Whether a partnership may receive the benefits of IRC Section 119 is the subject of conflicting opinions. The IRS does not consider a sole proprietor his or her own employee for purposes of IRC Sections 119 or 162.

In short, corporate operation seems the safest route to ensure the availability of many of the tax benefits for the farming client. However, the double taxation requirement of a C corporation may weigh against use of the corporate form, despite the favorable 21% rate, unless all or nearly all corporate income is paid out currently in the form of salary and benefits, or is not paid out and is reinvested with a view to a future sale.

.07 Family Partnership

The family partnership discussed in ¶2005 can also be valuable in estate planning for a farmer who is unwilling or unable to incorporate.

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[11] *J. Harrison*, 41 T.C.M. 1384 (1981).

[12] *J. Grant Farms, Inc.*, 49 T.C.M. 1197 (1985), and *D.L. Johnson*, 49 T.C.M. 1203 (1985).

[13] *M. Caratan*, 442 F.2d 606 (9th Cir. 1971), *rev'g* 52 T.C. 960 (1969).

¶2215 Liquidity

If one individual owns all the stock of a farming corporation, the stock is highly illiquid. Moreover, the stated objective of keeping the farm in the family could obviously not be attained by selling the stock to outsiders. The economics of farm operation, in general, serves to decrease liquidity. The use of portability and the marital deduction is one way of solving the liquidity problem insofar as funds to pay estate taxes might otherwise be needed. Life insurance is another method of addressing this problem, providing funds not only for the payment of any taxes but also to pay cash legacies, debts and expenses, living, and operating expenses. Also, if the farmer used qualified retirement plans, incidental insurance benefits might also be available. Those individuals covered by qualified plans may also make contributions to their own individual retirement accounts (although deductions for such contributions are subject to phase-out and elimination based on the level of the taxpayer's AGI) (¶915).

Liquidity can also be secured by the development of investment programs. Even if the farm is to be operated as a sole proprietorship, the farmer should consider a qualified plan and an IRA in conjunction with a qualified plan. The financial planner should pay attention to the special methods of computing self-employment income and timing of payment of estimated income taxes and tax return filings of farmers. Special rules apply to dealing with government payments, farm rentals, and share-farmers.

Crops and livestock are other sources of liquidity, but developing a savings or investment program is preferable.

¶2220 Income Averaging for Farmers

An individual engaged in a farming business may elect to average farm income over three years.[14] The tax imposed in any tax year will equal the sum of the tax computed on taxable income reduced by elected farm income, plus the increase in tax that would result if taxable income for each of the three prior tax years were increased by an amount equal to one-third of the elected farm income.[15]

Elected farm income means the amount of taxable income attributable to any farming business that is specifically subject to this three-year averaging election.[16] Gain from the sale or disposition of property, other than land, regularly used by the farmer for a substantial period in such a farming business is treated as attributable to a "farming business."[17]

The averaging provision is not available to trusts or estates.[18] In addition, it does not apply for employment tax or AMT purposes.[19]

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[14] IRC Section 1301(a).

[15] IRC Section 1301(a).

[16] IRC Section 1301(b)(1)(A).

[17] IRC Section 1301(b)(1)(B).

[18] IRC Section 1301(b)(2).

[19] Conference Committee Report to the Taxpayer Relief Act of 1997 (P.L. 105-34).

¶2225 Providing Equality for Heirs Who Have Left the Farm

The farmer has three basic choices if the farm is to remain intact and operational while continuing to treat heirs who remain involved with the farming operation in the same manner as those who have moved on to other pursuits:

1. Provide cash legacies or life insurance proceeds in an amount which, if invested, would give the absent legatees roughly as much as those operating the farm could expect to receive on their investment.

2. Give the absentees an interest in the farm or in the stock of the farm corporation, but give the farm operators operational and management control and an option to purchase the interest of the absentees at a fair price.

3. Find some way in which the absentees could participate in the farm profits either as landlords, debtors, or security holders. The financial planner should address these possibilities with the farming client, being sensitive not only to the tax and estate planning issues involved, but also to the personal issues. The client's concerns about addressing these potentially difficult personal issues may outweigh the client's concerns about the financial issues involved.

¶2230 Consider the Creation of a Conservation Easement

Property owners who donate a qualifying conservation easement to a qualified land protection organization under the regulations set forth in IRC Section 170(h) may be eligible for a federal income tax deduction equal to the value of their donation. The value of the easement donation must be determined by a qualified appraiser. The charitable tax deduction equals the difference between the fair market value of the donated property before and after the conservation easement takes effect.

Several criteria must be established if a taxpayer is to qualify for this income tax deduction. The easement granted must be: (*a*) perpetual; (*b*) held by a qualified governmental or non-profit organization; and (*c*) serve a valid "conservation purpose," meaning the property must have an appreciable natural, scenic, historic, scientific, recreational, or open space value. The laws permit the donation of a farm and/or ranch property (or a portion thereof) or a perpetual restriction on the use of the property, to qualify for the deduction. Farming, ranching, and residential activities can continue on the property, as long as development is restricted and open space and/or natural habitats for wildlife are preserved.

The general rule addressing gifts of conservation easements permits donors to deduct the value of their gift up to 50% of their AGI per year. A special enhancement directed toward farmers and ranchers permits landowners that earn 50% or more of their income from agriculture to deduct the donation up to 100% of their AGI. Any amount of the donation remaining unused as a tax deduction after the first year may be carried forward for 15 additional years (effectively allowing a maximum of 16 years within which the deduction may be utilized) or until the amount of the deduction has been fully utilized, whichever comes first. This law was made permanent by the PATH Act of 2015.

The IRS has focused on conservation easements, especially those that are marketed by syndications, as a potentially abusive tax shelter. The IRS declared the following:

In recognition of our need to preserve our heritage, Congress allowed an income tax deduction for owners of significant property who give up certain rights of ownership to preserve their land or buildings for future generations.

The IRS has seen abuses of this tax provision that compromise the policy Congress intended to promote. We have seen taxpayers, often encouraged by promoters and armed with questionable appraisals, take inappropriately large deductions for easements. In some cases, taxpayers claim deductions when they are not entitled to any deduction at all (for example, when taxpayers fail to comply with the law and regulations governing deductions for contributions of conservation easements). Also, taxpayers have sometimes used or developed these properties in a manner inconsistent with section 501(c)(3). In other cases, the charity has allowed property owners to modify the easement or develop the land in a manner inconsistent with the easement's restrictions.

Another problem arises in connection with historic easements, particularly façade easements. Here again, some taxpayers are taking improperly large deductions. They agree not to modify the façade of their historic house and they give an easement to this effect to a charity. However, if the façade was already subject to restrictions under local zoning ordinances, the taxpayers may, in fact, be giving up nothing, or very little. A taxpayer cannot give up a right that he or she does not have.[20]

¶2235 Ten Useful Tax Tips for Farmers and Ranchers

Farmers and ranchers should pay particular attention to the 10 tax tips contained in the following checklist.

1. **Crop Insurance**

   Insurance payments from crop damage count as income. Generally, report these payments in the year they are received.

2. **Sale of Items Purchased for Resale**

   If livestock or items that are bought for resale are sold, the sale must be reported. The profit or loss is the difference between the selling price and the taxpayer's basis in the item. Basis is usually the cost of the item. The cost may also include other expenses such as sales tax and freight. Like-kind exchange treatment is no longer available for personal property after 2017 as the result of the TCJA.

3. **Weather-Related Sales**

   Bad weather, such as a drought or flood, may force the sale of more livestock than would normally be sold in a year. If so, the taxpayer may defer tax on the gain from the sale of the extra animals.

[20] https://www.irs.gov/charities-non-profits/conservation-easements

4. **Farm Expenses**

Farmers can deduct ordinary and necessary expenses they paid in connection with their business. An ordinary expense is a common and accepted cost for that type of business. A necessary expense means a cost that is proper for that business.

5. **Employee Wages**

The wages paid to the farm's full- and part-time workers are deductible expenses. The employer must withhold Social Security, Medicare, and income taxes from the workers' wages. Payment of W-2 wages may be helpful if the qualified business income deduction of IRC Section 199A is available to the farmer.

6. **Loan Repayment**

A borrower can deduct the interest paid on a loan only if the loan is used for the farming or ranching business. Interest paid on a personal loan is not deductible.

7. **Net Operating Losses**

If the business expenses are more than the business income for the year, there may be a net operating loss (NOL). That loss can be carried back or over to other tax years and deducted. The taxpayer may get a refund of part or all of the income tax paid in prior years. If carried forward, the loss may also be able to lower taxes in future years. The TCJA made several changes in the availability of farming loss deductions. Unlike the TCJA rules for most other taxpayers that prohibited NOL carrybacks, farm NOLs were allowed to be carried back two years (instead of five under prior law) and may be carried forward indefinitely. The losses were limited in that only 80% of taxable income may be offset by the NOL carryforward in any given year. The CARES Act of 2020 revised the NOL rules to permit five-year carrybacks of losses sustained in 2018–2020 and allows 100% of taxable income to be offset by the NOL.

A farming loss is the lesser of

- the amount which would be the net operating loss (NOL) for the tax year if only income and deductions attributable to farming businesses were taken into account, or
- the NOL for the tax year.

A taxpayer can choose to treat a farming loss as if it were not a farming loss. If this choice is made, the loss is subject to the revised NOL rules as enacted by the CARES Act. For more information, see IRS Publication 536.

8. **Farm Income Averaging**

A farmer may be able to average some or all of the current year's farm income by spreading it out over the last three years. This may reduce taxes if farm income is high in the current year and low in the prior three years.

9. **Tax Credit or Refund**

A farmer or rancher may be able to claim a tax credit or refund of excise taxes paid on fuel used on the farm or ranch for farming or ranching purposes.

10. Farmer's Tax Guide

A useful publication on this topic is IRS Publication 225, Farmer's Tax Guide, available on www.IRS.gov/forms-pubs. Farmers may be eligible for the new 20% QBI pass-through deduction of IRC Section 199A, making the choice of entity a more complicated decision. Farming and ranching activities are not designated as "specified service trades or businesses," so they are potentially eligible for the IRC Section 199A QBI deduction at all levels of taxable income. If taxable income does not exceed $326,600 on a joint return or $163,300 on all other returns (2020 numbers, to be indexed for inflation), the QBI deduction is available without dealing with the more complex issues of W-2 wages and depreciable property that arise when taxable income is in excess of these thresholds.

The 2017 TCJA lowered income tax rates for corporate farms to 21%. IRC Section 199A was developed to provide an income tax deduction for unincorporated farms. Farmers marketing through a cooperative, however, may only qualify for a modified deduction. Income tax laws consider cooperatives as extensions of a farmer's own operations. IRC Section 199A allows cooperatives to deduct up to 9% of their income from their corporate income tax liability, to a maximum value of 50% of the co-op's wages paid for marketing activities. Farmers benefit from this deduction by virtue of potentially increased patronage allocations (made either in cash or non-cash allocations).The deduction allows the cooperative to pass through more income to the farmer than otherwise. IRC Section 199A is written in a way that reduces the farm income tax portion of the IRC Section 199A deduction to potentially reduce a farmer's ability to "double-dip" the IRC Section 199A deduction's benefits.

Planning Pointer.

Proactive Planning Toolkit

Legislation like the TCJA and the SECURE and CARES Acts have added more complexity to financial planning. Technical content, tools, and other resources are available to PFP Section members at aicpa.org/PFP/ProactivePlanning to help you get up to speed on all the intricacies, so that you can educate your clients and proactively help them meet their life goals and give them peace of mind while navigating the complex financial landscape.

Chapter 23

Impact of Estate Freeze Rules on Intrafamily Transfers

¶2301 Overview

A traditional estate tax freeze was a technique used to limit the value of business interests in a decedent's gross estate. The technique worked by passing on property representing any appreciation in the value of the business to the next generation. In the typical estate tax freeze, a parent would cause a closely held corporation to recapitalize its stock into two classes. The parent would keep a class of preferred stock that was limited in value using a fixed dividend preference. The children would receive common stock that would grow in value as the value of the corporation grew. In another type of estate tax freeze, the parent would retain an interest for a term of years or a life estate in a trust or property for the ultimate benefit of the children. This technique would effectively shift future appreciation in the property to the children. Under a third type of estate freeze technique, a corporate buy-sell agreement, a parent would grant to a child an option to purchase property at a fixed price or a formula price on the parent's death.

The typical business freeze involved a parent retaining preferred stock and making a gift of common stock. Over the years, Congress wrestled with legislation to curb the abuses arising from estate freezes and sought to limit their tax-saving impact. It enacted a cumbersome rule under which the value of the common stock was brought back into the donor's gross estate. However, Congress retroactively repealed that rule in 1990 (former IRC Section 2036(c)) as though it had never been enacted. Congress replaced it with four separate IRC sections, which are discussed in the balance of this chapter. These sections deal with valuation of preferred interests in corporations and partnerships (¶2305), options in buy-sell agreements (¶2310), interests in trusts (¶2315), and lapsing rights and restrictions (¶2320). They are sometimes referred to collectively as the "Chapter 14 Rules."

¶2305 Business Valuation Rules

Special rules contained in IRC Section 2701 and the regulations thereunder can come into play when an individual transfers an interest in a corporation or partnership to a family member and retains certain rights (or an applicable family member possesses such rights). These rules determine whether and to what extent the transfer is a gift. The underlying premise behind these rules is that the value of a residual interest in a corporation or partnership is determined by subtracting the value of the retained interest

from the value of the entire entity, with an adjustment to reflect the actual fragmented ownership.[1] Only the value of the transferred residual interest would be viewed as a gift.

Specific and *extremely* complex rules apply for determining the value of retained rights. Under these rules, retained rights might have no or low value, thereby pushing up the value of the transferred residual interest. This result is contrasted with the traditional recapitalization. In a traditional recapitalization, most of the value of the company is loaded into the retained preferred interest and very little value assigned to the transferred residual common interest. This "traditional" result is no longer possible for family transfers found to be subject to the IRC Section 2701 rules.

.01 Transfers Subject to the Rules

The rules apply to the transfer of a residual interest to or for the benefit of a member of the transferor's family. A member of the family is, with respect to the transferor, the transferor's spouse, a lineal descendant of the transferor or the transferor's spouse, and the spouse of any such descendant.[2]

Transfer defined. For purposes of the special valuation rules, the term *transfer* has a specific meaning. A transfer for full and adequate consideration is a transfer for purposes of these rules, although such a transfer is not a taxable gift for gift tax purposes. Any redemption, recapitalization, contribution to capital, or other change in the capital structure of a corporation or partnership is treated as a transfer of an interest in the entity if the transferor or applicable family member:

- receives a retained right affected by these provisions;
- surrenders a junior equity interest and receives property other than an applicable retained interest; or
- surrenders a senior equity interest and the fair market value of an applicable retained interest already held by that individual increases.[3]

An applicable retained interest is an interest in a family-controlled entity with respect to which there is a distribution right.[4] A subordinate interest is an interest to which an applicable retained interest is a senior interest.

A termination of an interest held through a corporation, partnership, estate, trust, or other entity, or a contribution to capital by an entity to the extent an individual indirectly holds an interest in the entity, is also treated as a transfer if the indirectly held property either (1) would have been includible in the gross estate of the individual if the individual had died at the time of the termination or (2) is in a grantor trust of which the indirect holder is treated as the owner.[5]

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[1] Regulation Section 25.2701-1(a)(2).

[2] IRC Section 2701(e)(1).

[3] IRC Section 2701(e)(5) and Regulation Section 25.2701-1(b).

[4] Regulation Section 25.2701-2(b)(1)(ii).

[5] Regulation Section 25.2701-1(b)(2)(C)(1); described in Section 2305.02.

Exceptions. The rules of IRC Section 2701 do not apply in the following circumstances:

- To any right conferred by a retained interest for which market quotations are readily available on an established securities market.
- To a retained interest that is of the same class as the transferred interest.
- When the rights in the retained interest are of a class that is proportionally the same as all of the rights in the transferred interests in the business, other than non-lapsing differences in voting power. In the case of a partnership, the rules do not apply to non-lapsing differences with respect to management and limitations on liability, including differences between classes attributable to non-lapsing provisions necessary to comply with partnership allocation requirements.
- To rights to convert into a fixed number or a fixed percentage of the shares of the same class as the transferred stock if the rights are non-lapsing, subject to proportionate adjustment for splits, combinations, reclassifications, and similar changes in the capital stock, and adjusted for accumulated dividends not paid on a timely basis (a similar exception applies to rights in partnerships).
- A transfer to a member of the transferor's family to the extent the transfer results in a proportionate reduction in each class of interest held by the transferor and all applicable family members in the aggregate.[6]

.02 Retained Rights Generally

Valuation rules apply to two types of retained rights. The first kind of right is an *extraordinary payment right*, which is defined as any liquidation, put, call, or conversion right, any right to compel liquidation or similar right, the exercise or non-exercise of which affects the value of the transferred interest.[7] A call right includes any option, warrant, or other right to acquire an equity interest. An extraordinary payment right is valued at zero, unless the holder of that right must exercise it at a specific time and amount.

The other type of right is a *retained distribution right*. A retained distribution right that is noncumulative or lacks a preference upon liquidation is valued at zero if, immediately before the transfer creating the right, the transferor and applicable family members control the entity.

A distribution right generally is a right to distributions with respect to stock of a corporation or a partnership interest. A distribution right does not include any right to receive distributions with respect to an interest that is either of the same class as, or a class that is subordinate to, the transferred interest. A distribution right also does not include any right in a junior equity interest; any liquidation, put, call, or conversion right; or a guaranteed payment determined without regard to income.[8]

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[6] IRC Section 2701(a)(2) and 2701(c)(2)(C); and Regulation Section 25.2701-1(c).

[7] Regulation Section 25.2701-2(b)(2).

[8] Regulation Section 25.2701-2(b)(3).

A retained distribution right that consists of a *qualified payment right* is not valued at zero under these rules.[9] A qualified payment right is a dividend payable on cumulative preferred stock, or a comparable cumulative payment right under a partnership interest, to the extent the payment is determined at a fixed rate.[10]

> **Example 23.1.** Brenda Harris holds all the voting common stock of a corporation and all the Series 1, 3, and 4 Class A preferred stock. The Series 2 Class A preferred stock is owned by a trust, the beneficiaries of which are Brenda's children. Brenda transfers all of the Series 3 and 4 Class A preferred stock to the trust. The Series 1 Class A stock is entitled to cumulative dividends at a fixed rate. The Series 1 Class A preferred stock is an applicable retained interest, but it is valued at its fair market value, rather than at zero because it carries a distribution right that is a qualified payment right.

Applicable family member. An *applicable family member* is, with respect to any transferor, the transferor's spouse, ancestors of the transferor and the spouse, lineal descendants and spouses of such ancestors, and lineal descendants.

Control. For a corporation, *control* is defined as holding, before the transfer, at least 50%, by vote or value, of the stock of the corporation. For a partnership, control generally means holding at least 50% of either the capital or profits interest in the partnership. In addition, any general partner in a limited partnership is deemed to have control. When determining control, attribution rules apply, that is, the interests of the transferor, applicable family members, and lineal descendants of the parent transferor or the transferor's spouse are all included in the determination of control.[11] In addition, individuals are treated as holding interests held indirectly through corporations, partnerships, estates, trusts, or other entities.[12]

Excluded rights. Rights expressly excluded from application of the IRC Section 2701 valuation rules are mandatory payment rights, liquidation participation rights, rights of a partner to guaranteed payments of a fixed amount, and non-lapsing conversion rights. Mandatory payment rights include the right to receive a specific amount payable at death and a mandatory redemption right in preferred stock requiring that the stock be redeemed at a specified date at par value. Liquidation participation rights are valued either without regard to the ability to compel liquidation or under a rule requiring that all rights are exercised in a manner that results in the lowest value for all the rights.

.03 Extraordinary Payment Rights Combined With Distribution Rights

A retained interest that confers both (1) a liquidation, put, call, or conversion right and (2) a distribution right that consists of the right to receive a qualified payment, is valued on the assumption that each right is exercised in a manner resulting in the lowest total value for all of these rights.[13] A *qualified payment* is

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[9] Regulation Section 25.2701-2(a)(2).

[10] Regulation Section 25.2701-2(b)(6).

[11] IRC Section 2701(b)(2)(C).

[12] Regulation Section 25.2701-6.

[13] Regulation Section 25.2701-2(a)(3).

defined as a dividend payable on a periodic basis at a fixed rate, including a rate that bears a fixed relationship to a specified market interest rate, under cumulative preferred stock or a comparable payment under a partnership agreement.

> **Example 23.2.** Frank Anderson is a father who retains cumulative preferred stock in a transfer to which these valuation rules apply. The cumulative dividend is $100 per year, and the stock may be redeemed at any time after two years for $1,000. The value of the cumulative preferred stock is the lesser of (1) the present value of 2 years of $100 in dividends plus the present value of the redemption for $1,000 in year 2 or (2) the present value of $100 paid every year in perpetuity.

> **Example 23.3.** Edward Davis holds all 1,000 shares of Ex Corporation's preferred stock bearing an annual cumulative dividend of $100 per share, and all 1,000 shares of Ex's voting common stock. Edward has the right to put all the preferred stock to Ex at any time for $900,000. Edward transfers the common stock to his daughter Leah, while holding the preferred stock. Assume that the fair market value of Ex at the time of the transfer is $1.5 million, and the fair market value of the dividend right is $1 million. The preferred stock confers both an extraordinary payment right (the put right) and a qualified payment right (the right to receive cumulative dividends). Therefore, the value of these rights is determined as if the put right will be exercised in a manner that results in the lowest total value being determined for the rights, that is, by assuming that the put will be exercised immediately. The value of Davis's preferred stock is $900,000 (the lower of $1 million or $900,000).

A transferor or applicable family member may elect not to treat all rights of the same class to dividends, or comparable payments, as qualified payment rights. In addition, a transferor or applicable family member may elect to treat a distribution right as a qualified payment right to be paid in the amounts and at the times specified in the election.[14]

> **Example 23.4.** Tim West and his daughter, Debra Kale, are partners in a partnership to which West contributes an existing business. West is entitled to 80% of the net cash receipts of the partnership until he receives $1 million, after which he and Kale will each receive 50% of the partnership's cash flow. West's liquidation preference equals $1 million. The retained right to $1 million is valued at zero unless West elects to treat it as a right to receive qualified payments in the amounts and at the times specified in the election. Amounts not paid at the times specified in the election are subject to the rules regarding the transfer tax treatment of accumulated distributions.

Applicable family members subject to special rule. Applicable family members holding qualified payment rights are subject to these valuation rules, even though they have not made a transfer. As a result, these individuals would be subject to a compounding rule for missed payments (as discussed in the text that follows), which could increase their future estate and gift tax liability. To avoid this result, any qualified payment made to an applicable family member is treated as a nonqualified payment unless the family member elects to treat the payment, or consistent portion thereof, as a qualified payment.

Making elections. The elections to treat payments as qualified or nonqualified payments must be made by attaching a statement to the Form 709, Federal Gift Tax Return, filed by the transferor. Regulations

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[14] IRC Section 2701(c)(3)(C).

set forth the information to be provided on the statement. Once made, these elections are revocable only with the consent of the IRS.

.04 Subtraction Method

The amount of the gift resulting from a transfer to which the special valuation rules apply is determined using a subtraction method of valuation. Generally, the amount of the gift is determined by subtracting the values of all family-held senior equity interests from the value of all family-held interests in the entity immediately before the transfer. The balance is then allocated among the transferred interests and other family-held subordinate equity interests. Family-held interests are interests held by the transferor, applicable family members, and lineal descendants of the parents of the transferor or his or her spouse. A *senior equity interest* is an equity interest that has a right to income or principal distributions that is preferred as compared to the transferred interest. A *subordinate equity interest* is an interest about which the retained interest is senior. The regulations prescribe a four-step subtraction method.[15]

.05 Transfer Tax Treatment of Accumulated Distributions

If a transferor retains cumulative preferred stock valued under the rule pertaining to the treatment of distribution rights combined with liquidation rights, the amount of the transferor's taxable gifts or taxable estate is increased by a certain amount. The amount of the increase is determined by:

- the value of the distributions payable during the period beginning on the date of the transfer and ending on the date the interest of the prior interest holder terminated, determined as if all such distributions were paid on the date payment was due, and all such distributions were reinvested by the transferor as of the date of payment at a yield equal to the discount rate used in determining the value of the applicable retained interest, over

- the value of the distributions paid during such period computed on the basis of the time when such distributions were actually paid, including the earnings on the payments determined as if each payment were reinvested as of the date paid at a yield equal to the discount rate used in determining the value of the distribution right, and to the extent required to prevent double tax, including any amount otherwise included in the gift or estate tax base.

This increase is intended to compensate for late or unpaid qualified payments that could have been reinvested by the recipient had the payments been made as due.

For purposes of this computation, a qualified payment includes payment in the form of a debt instrument, the term of which does not exceed four years, that bears compound interest at a rate no less than the appropriate discount rate payable from the due date of the qualified payment.[16]

The amount of the increase determined under this provision, however, is limited to an amount equal to:

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[15] Regulation Section 25.2701-3.

[16] Regulation Section 25.2701-4(c).

- the excess of the fair market values of equity interests that are junior to any retained preferred interests at the date of the later transfer plus any amounts paid to redeem a subordinate equity interest, over those values as of the date of the prior transfer of the junior interest, multiplied by
- a fraction (determined immediately before the later transfer), the numerator of which is the number of shares of preferred interests held by the transferor, and the denominator of which is the number of all shares of the same class of preferred interest.[17]

.06 Minimum Value of a Junior Equity Interest

A minimum value is established for a junior equity interest in a corporation or partnership. The minimum value is no less than a pro rata portion of 10% of the sum of the total equity in the corporation or partnership, plus any debt that the corporation or partnership owes to the transferor or members of his or her family. Debt does not include the following:

- Short-term indebtedness incurred to conduct the entity's trade or business, such as amounts payable for current services
- Loan guarantees by the transferor or an applicable family member
- Amounts permanently set aside in a qualified deferred compensation arrangement
- A lease of property if the lease payments represent full and adequate consideration for the use of the property

This minimum value is intended to reflect the option value of the right of the residual interest to future appreciation.[18]

.07 Adjustments to Mitigate Double Taxation

In the case of retained rights valued pursuant to these special valuation rules, the possibility exists that rights given a zero value will be subject to double taxation on a subsequent transfer or inclusion in the gross estate of the transferor. To avoid this result, final regulations generally allow an adjustment in the computation of the transferor's gift tax if either the transferor or an applicable family member transfers an applicable retained interest to or for the benefit of an individual other than the transferor or applicable family member.[19] In addition, if the applicable retained interest had not been so transferred before the death of the transferor, the executor of his or her estate is entitled to make the adjustment when computing the transferor's estate tax. However, the executor must be able to demonstrate the fair market value of the applicable retained interest as of the date of death of the transferor.

The actual adjustment mechanism is complicated and difficult to describe. Nevertheless, the following example should serve to demonstrate how the adjustment works for a lifetime transfer of an applicable retained interest.

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[17] Regulation Section 25.2701-4(c)(6).

[18] IRC Section 2701(a)(4).

[19] Regulation Section 25.2701-5.

Example 23.5. Donald Smith holds 1,500 shares of $1,000 par value preferred stock of Widget, Inc. (bearing an annual noncumulative dividend of $100 per share that may be put to Widget at any time for par value) and all 1,000 shares of voting common stock of Widget. On January 15, 2017, when the total fair market value of the preferred stock was $1.5 million, and the total fair market value of the common stock is $500,000, Donald transferred all the common stock to his daughter, Jill Jones. Under IRC Section 2701, the value of the preferred stock was zero, and the gift of the common stock is valued at $2 million. On October 1, 2020, at a time when the value of Donald's preferred stock is $1.4 million, Donald transfers all of it to Jones.

Under the adjustment mechanism, Donald reduces the amount on which his tentative gift tax is computed under IRC Section 2502 by $1.4 million so that no gift tax is paid on the 2020 transfer. The $1.4 million is the lesser of $1.5 million (the amount by which the initial gift of the common stock was increased as a result of IRC Section 2701) or $1.4 million (the duplicated amount). The duplicated amount is 100% (the portion of the IRC Section 2701 property subsequently transferred) times $1.4 million, the amount by which the gift tax value of the preferred stock exceeds zero (the IRC Section 2701 value of the preferred stock at the time of the initial transfer).

The financial planner needs to recognize that these attempted preferred stock "freezes" are exceptionally complex transactions. The IRS Regulations appear to be an attempt to make addressing these transactions so complicated and uncertain about their result that entering into them is discouraged. If a client wants to use such a transaction in planning, the financial planner must be very careful to ascertain the planner's own comfort level as an adviser in these circumstances. If uncertain how to proceed, the financial planner is encouraged to engage persons who are experts in this field to guide the client.

¶2310 Options and Buy-Sell Agreements

When valuing any property for estate, gift, and generation-skipping transfer tax purposes, the value is determined without regard to any option, agreement, or other right to acquire or use the property at less than fair market value, or any restriction on the right to sell or use such property, unless the option, agreement, right, or restriction meets three requirements.[20] These requirements are that the option, agreement, right, or restriction (1) is a bona fide business arrangement, (2) is not a device to transfer such property to members of the decedent's family for less than full and adequate consideration in money or money's worth, and (3) is comparable to similar arrangements entered into by persons in an arm's-length transaction.

Also, although not specifically included in the language of IRC Section 2703, under long-standing principles that continue to apply according to applicable Congressional Committee reports, an agreement must contain lifetime restrictions in order to be binding upon death. Under the IRC Section 2703 rules, the mere showing that the agreement is a bona fide business arrangement does not establish that the agreement is not a device to transfer property to members of the decedent's family for less than full and adequate consideration.

[20] IRC Section 2703.

The requirements to allow a restriction to be recognized are considered to be met if more than 50% by value of the property subject to the right or restriction is owned by persons who are not members of the transferor's family. Family members include the transferor, applicable family members (as discussed in ¶2305 in connection with the rules for business interests), any lineal descendants of the parents of the transferor or the transferor's spouse, and any other individual who is the natural object of the transferor's bounty.[21]

These requirements apply to any restriction, however created. For example, they apply to restrictions implicit in the capital structure of a partnership or contained in a partnership agreement, as well as those found in articles of incorporation, corporate bylaws, or a shareholder's agreement. A lease is a right or restriction that is subject to these requirements. These requirements do not, however, apply to perpetual restrictions on the use of real property that qualified for either the gift or estate tax charitable deduction.[22]

The requirements of IRC Section 2703 apply to agreements, options, rights, or restrictions entered into or granted after October 8, 1990, and those created before but that are substantially modified after October 8, 1990.[23] A right or restriction that is substantially modified is treated as being created on the date of the modification. A modification resulting in other than a *de minimis* change in the quality, value, or timing of the rights of any party with respect to property subject to a right or restriction is a substantial modification. The addition of a family member as a party to the right or restriction in a generation no lower than the lowest generation occupied by persons already party to the right or restriction is not a substantial modification. However, the IRS held in Letter Ruling 9620017[24] that a pre-October 8, 1990, shareholder agreement was substantially modified when a proposed change to the agreement allowed the controlling shareholder to transfer stock to members of his family.

A substantial modification does not include mandatory changes under a right or restriction, or a change to a right or restriction, to approximate the fair market value of the subject property more closely. Thus, the IRS has ruled that a grandfathered buy-sell agreement was not substantially modified by changing the strike price to fair market value or by providing a reciprocal arrangement so that at the death of one of three shareholders, the remaining two would have equal buy-out rights.[25] A substantial modification also does not include amendments to a corporation's articles of incorporation and bylaws that change the number of directors and the indemnity and immunity provisions for directors and officers and increase the number of shares to effectuate a stock split.[26]

Family limited partnerships. The IRS has taken the position that valuation discounts on the creation of a family limited partnership and the transfer of interests in the partnership just before a decedent's death could be denied. The IRS has ruled that it could deny the valuation discounts on the theory that the steps to accomplish the transfer should be disregarded for estate tax valuation purposes either as a sham

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[21] Regulation Section 25.2703-1(b)(3).

[22] IRC Sections 2522 and 2055.

[23] Regulation Section 25.2703-2.

[24] February 15, 1996.

[25] IRS Letter Ruling 9417007, January 13, 1994.

[26] Regulation Section 25.2703-1(c).

transaction or under the rules of IRC Section 2703.[27] (The IRS may also seek to include the transferred interest in the decedent's gross estate under IRC Section 2036. In such cases, the IRS may argue that the decedent made the transfer for less than full or adequate consideration in money or money's worth and retained rights of use of the property or of the income from it, or retained some element of control, however small).[28]

According to the IRS, under the circumstances of the transaction in question in Technical Advice Memorandum (TAM) 9719006, the children of the transferor really received the underlying partnership assets, subject to the partnership agreement. Thus, the partnership agreement itself was an agreement within the meaning of IRC Section 2703, and any reduction in value caused by the terms of the partnership agreement could be disregarded.

Even if the steps of the transaction were not collapsed and the partnership interests, rather than the underlying assets, were treated as the subject of the transfers, the IRS argued in the TAM that IRC Section 2703 would still apply. It pointed out that, under Regulation Section 25.2703-1(a)(3), a restriction could either be contained in a partnership agreement or implicit in the capital structure of the partnership. Under the facts of the ruling, the partnership agreement and state law implicitly imposed several restrictions on the ability of the beneficiaries to sell their interests. The IRS said that these restrictions could be disregarded in valuing the partnership interests. More discussion about family limited partnerships and the special valuation rules appears at ¶2010.

The financial planner should be aware of how difficult it is to persuade the IRS to accept a value in a buy-sell agreement between or among related parties. The IRS uses IRC Section 2703 to establish an almost irrefutable presumption that the value set forth in such an agreement is at best questionable; and at worst invalid. Accordingly, the financial planner should advise the client that the value chosen by the client in a family buy-sell agreement is not necessarily "set in stone," and that there is very likely to be some negotiation with the IRS about the fair market value of the property that is the subject of the agreement. It is a good idea to have this discussion not only with the senior family members who are the likely sellers in the buy-sell context, but also with the junior family members who are the likely buyers or beneficiaries, so that all necessary parties are involved and are aware that some negotiation and possible compromise may be required before the value contained in a buy-sell agreement is finally settled.

Note that when a decedent's estate is likely to have a total value of less than $11.58 million (in 2020, indexed annually for inflation) a discount may not be advantageous, as a reduced valuation will give the decedent's heirs a reduced basis in the inherited property for income tax purposes. Consider in such circumstances avoiding any discounting claims.

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[27] IRS Technical Advice Memorandum 9719006, January 14, 1997.

[28] *A. Strangi Est.*, 115 T.C. 478 (2000), *aff'd in part, rev'd in part, and rem'd in part*, 293 F.3d 279 (5th Cir. 2002); *Harper Est.*, 83 T.C.M. 1641 (2002); *D.A. Kimbell, Sr.*, et al., 371 F.3d 257 (D.C. N. Tex. 2003); *Estate of Powell v. Commissioner*, 148 T.C. No. 18 (May 18, 2017); *Estate of Cahill*, T.C. Memo 2018-84; *Estate of Moore*, T.C. Memo 2020-40. The taxpayer has a significant victory in *Bongard v. Commissioner*, 124 T.C. 95 (2005).

¶2315 Transfers of Trust Interests (GRATs, GRUTs, and QPRTs)

IRC Section 2702 provides special valuation rules for transfers of interests in trusts to or for the benefit of members of the transferor's family made after October 8, 1990.

Family members are broadly defined to include the transferor's spouse, lineal descendants of the transferor or his or her spouse, spouses of those descendants, the transferor's ancestors, siblings, and the spouses of any of them.[29] As broad as this definition is, it omits nieces, nephews, and cousins. Thus, a taxpayer could form a grantor retained income trust (GRIT) with these extended family members and other nonfamily members, including a civil union partner or live-in companion. If a taxpayer is going to make a transfer to a trust for a family member, IRC Section 2702, with certain exceptions, provides that for gift tax purposes any retained interest other than a "qualified retained interest", that is, a grantor retained annuity or unitrust (a GRAT or a GRUT), is valued at zero. Consequently, any gift of a remainder interest would be valued at the full value of the property transferred to the trust absent the presence of a qualified retained interest.

Exceptions. IRC Section 2702 contains two express exceptions:

- Incomplete gifts
- Transfers of an interest in trust if all the property in the trust consists of a residence to be used as a personal residence by persons holding term interests in the trust (primarily a qualified personal residence trust [QPRT])[30]

An incomplete gift means any transfer that would not be treated as a gift, regardless of whether consideration was received for the transfer. A transfer to a revocable trust, for example, would be treated as an incomplete gift.

The exception for transfers of an interest in a personal residence is discussed in ¶2315.03.

In addition to these two express exceptions, the law also provides an implicit exception for transfers to trusts for nonfamily members, which may take the form of GRITs, as discussed in ¶2315.02. Further, special rules apply to transfers of certain tangible property and undeveloped land. These rules are discussed in ¶2315.04 in connection with the treatment of non-trust property.

The IRC Section 2702 rules also apply to joint purchases of property, as discussed in ¶2315.05.

.01 The General Rule

IRC Section 2702 is concerned with the valuation for gift tax purposes of transfers in trust to or for the benefit of a member of the transferor's family and the valuation of retained interests of the transferor or any applicable family member.

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[29] IRC Section 2702(e), which picks up the family definition in IRC Section 2704(c)(2).

[30] IRC Section 2702(a)(3).

IRC Section 2702 provides that any retained interest that is not a qualified interest and not subject to an exception is valued at zero. This requires the entire transfer to be treated as a taxable gift. If the retained interest is a qualified interest, its value generally is to be determined under IRC Section 7520 and the applicable IRS tables.

IRC Section 2702 further provides that a *qualified interest* is (1) a right to receive fixed amounts payable at least annually, or (2) a right to receive amounts payable at least annually, which are a fixed percentage of the value of the trust's assets determined annually, or (3) a non-contingent remainder interest if all the other interests in the trust consist of interests described in (1) and (2).

A trust of the first type can be likened to an annuity, although it is typically created for a term of years and not for life. For that reason, it has come to be known as a grantor retained annuity trust, or GRAT. The second type can be likened to a unitrust, and for that reason, it has come to be known as a grantor retained unitrust, or GRUT.

With a common law GRIT, which generally is no longer allowed except for transfers to nonfamily members and trusts that take advantage of the personal residence exception, use of the IRS valuation tables frequently results in the retained income or use interest being overvalued (to the taxpayer's advantage) and the remainder interest (the gifted portion) being undervalued. For example, if low dividend, high-growth stock is transferred to the trust, use of the valuation table causes the retained interest to be valued on the basis of an assumed income or interest rate. Use of the table can result in a much higher valuation of the retained interest for a GRIT than if the actual yield were used, with the resulting low valuation of the remainder interest (the gift portion) to the taxpayer's advantage.

The qualified interest rules of IRC Section 2702 preclude the use of the GRIT technique where family members are involved. The annuity or unitrust amount must be paid regardless of the actual yield of the trust assets. Because the trust is a grantor trust, the grantor will be taxed on all of the trust's income,[31] even if it exceeds the amount needed to pay the annuity or unitrust amount. The grantor can be the trustee of this trust. This result is better for the grantor than having the trust income taxed under the highly compressed brackets that apply for trusts. The greater the value of the qualified interest retained by the grantor, the lower the value of the gift of the remainder interest.

It is possible to retain enough of an interest in the trust to allow the value of the gift of the remainder interest to be zero, possibly allowing subsequent appreciation in the value of the property used to fund the trust to pass transfer and income tax-free to the beneficiaries of the trust.[32] This popular planning technique using the "Walton GRAT" is referred to as the *zeroed-out GRAT*. Short-term trusts (typically two years) are used to return all of the initially transferred property to the grantor and to try to capture appreciation on that property tax-free for the trust beneficiaries. When the IRS-required interest rate used in the calculation of a qualified interest under IRC Section 7520 (the applicable federal rate [AFR]) is low, that favors the creation of GRATs and GRUTs because the low rate increases the actuarial value of the retained interest, which is the portion of the trust not subject to gift tax. Conversely, as interest rates rise, that causes the retained interest to receive a lower actuarial value and the remainder interest a

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[31] IRC Section 671.

[32] *Walton v. Commissioner*, 115 T.C. 589 (2000); acq. Notice 2003-72, 2003-44 IRB 964; Regulation Section 25.2702-3(e), Examples 5 and 6.

higher value, making the GRAT and GRUT techniques less attractive as transfer tax planning techniques in a rising interest rate environment.

If the property transferred to the GRAT or GRUT appreciates faster than the AFR (sometimes referred to as the *hurdle rate*), that appreciation does not return to the grantor. Instead, it is not subject to any transfer tax and stays in the trust and passes to the beneficiaries. If the appreciation does not exceed the AFR, then no benefit is left for the beneficiaries as the grantor gets back everything in the trust (or less, if the property declines in value).

GRATs and GRUTs are not limited regarding duration. The longer the term interest, the lower the value of the remainder for gift tax purposes. However, if the transferor dies before the expiration of the term, the value of the property needed to produce the required remaining annuity would be includible in the transferor's gross estate under IRC Section 2036(a)(1). This rule operates as a practical limitation on the duration of the trust. It should be significantly shorter than the transferor's life expectancy under mortality tables or, more importantly, the transferor's actual life expectancy based on his or her medical condition. Mortality risk is one of the more serious concerns for the financial planner when advising the creation of one of these trusts.

Nevertheless, some practitioners favor a 99-year GRAT on the assumption that the amount includible in a decedent's estate (the amount required to produce the remaining annuity) will, by definition, be less than the initial value of the gifted remainder interest, so the grantor will always be "ahead" in the tax-planning sense. The 99-year GRAT is viewed as a "sure win," with the level of success dependent on how long the grantor lives.

The IRS has taken the position that a GRAT established with a revocable spousal interest, which gives the spouse a contingent right to receive the property if the grantor died prematurely, was not a qualified interest.[33] Accordingly, the value of such a spousal interest could not be taken into account when valuing the property transferred to the GRAT.

.02 Common Law GRITs

IRC Section 2702 leaves little room for common law GRITs because the retained interest in a GRIT would generally be valued at zero under the provision. However, IRC Section 2702 is concerned only with transfers in trust to or for the benefit of a member of the transferor's family. A member of the family is rather broadly defined by IRC Section 2704(c)(2) (picked up in IRC Section 2702) as an individual's (1) spouse, (2) ancestor or lineal descendant of the individual or his spouse, (3) brother or sister, or (4) any spouse of an individual in (2) or (3). Broad as it is, this definition leaves out many others, some of whom may be close family members. For example, nieces and nephews and others with no blood or legally recognized relationship, such as a friend or companion, are not included. Common law GRITs may be set up for individuals outside the definition of a "member of the family." Such GRITs generally have an advantage over GRATs and GRUTs because a "qualified interest" is not required, the retained interest might be legally overvalued, resulting in the remainder interest being undervalued. For example, a GRIT may be funded with low dividend paying, high-growth stocks. The stock might produce dividends, for example, of only one or two percent of the value of the stock. Yet, the retained interest might be valued on the assumption that it will provide the grantor with a yield of six

[33] IRS Technical Advice Memorandum 9707001, October 25, 1996.

percent or so annually. Unlike the GRAT or GRUT, which requires the determined yield to be paid annually to the grantor, the GRIT is not so restricted. The result is a higher value for the retained interest than the actual yield may warrant, resulting in a reduced reportable gift by the grantor. Also, the low yield makes for less annual income taxable to the grantor.

These common law GRITs have no fixed period of duration. Thus, with longer durations, the value of a gift of a remainder interest can be kept lower. However, as a practical matter, duration should be safely short of the grantor's life expectancy, because if the grantor dies during the term of the GRIT , the entire corpus of the trust will be includible in his or her gross estate at its fair market value on the date of death.

IRC Section 2702 also expressly exempts personal residences from its reach. This exception is separately discussed in ¶2315.03.

.03 The Exception for Residences

IRC Section 2702 exempts personal residences from the general rule valuing retained interests in certain transferred property at zero unless the retained interest is a qualified interest. This exception creates important opportunities for tax-saving, intrafamily wealth transfers.

As an intrafamily wealth transfer vehicle, the exception is most useful when the family home is expected to appreciate significantly in value over the term of the trust. The IRC Section 2702 zero-value rules do not apply to a transfer of an interest in a personal residence trust or a qualified personal residence trust.[34] The latter was created by the Treasury regulations to address certain practical problems. However, it involves a tradeoff, as explained in the text that follows.

Personal residence trust. A *personal residence trust* is a trust, the governing instrument of which prohibits, for the original duration of the term interest, the holding of any asset other than one residence used or held for use as a term holder's personal residence and certain qualified proceeds. A *personal residence* is either the term holder's principal residence, one other residence, or an undivided fractional interest in either. A co-op qualifies as a personal residence.[35] The residence must not be occupied by anyone other than the term holder or his or her spouse and dependents, and must be available at all times for use as a personal residence by the term holder.

A personal residence may include appropriate structures used for residential purposes and adjacent land that is reasonably appropriate for residential purposes. The IRS has allowed a tract of land as large as 43 acres to be considered as reasonably appropriate for residential purposes.[36] However, financial planners should exercise caution in similar cases because the result depends on all the facts and circumstances of a particular case. Further, a personal residence may be subject to a mortgage. Ideally, mortgaged property should not be used in a personal residence trust because a portion of the principal component of each mortgage payment is an additional gift to the trust beneficiaries, requiring additional calculations and possibly additional gift tax return filings. The term holder may use a portion of the residence for

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[34] IRC Section 2702(a)(3) and Regulation Section 25.2702-5.

[35] IRS Letter Ruling 9448035, September 2, 1994.

[36] IRS Letter Ruling 9639064, June 27, 1996.

business purposes, (such as a home office or day care center) but may not provide transient lodging, such as a hotel or bed-and-breakfast, or provide substantial services in connection with lodging.

The trust may not hold personal property, such as household furnishings. *Qualified proceeds*, which may be held by the trust, are amounts held by the trust for no longer than two years that were received as a result of damage, destruction, or involuntary conversion of the personal residence.

A spouse who holds an interest in the same residence may transfer his or her interest to the same personal residence trust, but only if the governing instrument of the trust prohibits anyone other than a spouse from holding a concurrent term interest.[37]

Qualified personal residence trust. A QPRT is similar to a personal residence trust, except that a QPRT may also hold limited amounts of cash for payment of trust expenses, sale proceeds, payment of insurance costs on the residence, and insurance proceeds. The governing instrument of a QPRT must prohibit distribution of trust income to anyone other than the term holder. The trust instrument must also provide that any income of the trust be distributed to the term holder no less than annually. In addition, the governing instrument must provide that on cessation of use of the residence as a personal residence, either the trust terminates, and all trust assets are distributed to the term holder, or the term interest is converted to a qualified annuity interest, such as a GRAT. The trustee may be given sole discretion to choose either option. The grantor may be the trustee of a QPRT. The distribution of assets or conversion to a qualified annuity interest must occur within 30 days of the date on which the trust ceases to be a QPRT. If the residence is sold, excess sale proceeds that are not reinvested in a new personal residence may be converted to a qualified annuity interest.[38] The IRS has provided an annotated sample declaration of a qualified personal residence trust and alternate provisions that meet the requirements of IRC Section 2702(a)(3)(A) and Regulation Section 25.2702-5(c).[39]

If the grantor outlives the trust term, the value of the property in the QPRT passes to the remainder beneficiaries and is excluded from the grantor's estate. If the grantor dies during the term of the QPRT, the full fair market value of the residential property is included in the grantor's estate. Once again, as with the cases of the GRAT and GRUT, the financial planner must consider the mortality risk of the client and advise accordingly. Many QPRTs include provisions allowing the grantor to continue occupying the residence as a fair market value rent-paying tenant beyond the designated trust term if the grantor outlives the term to avoid forcing an undesired relocation.

The Treasury regulations provide additional guidance on the tax treatment of QPRTs. Regulation Section 25.2702-5(c)(9) requires that the governing instrument of the trust include a provision prohibiting the trust from selling or transferring the residence (whether directly or indirectly) to the grantor, the grantor's spouse, or an entity controlled by either. This prohibition would have to apply during the original term interest of the trust and to any time after the original term interest that the trust was a grantor trust. For purposes of this requirement, a sale or transfer to another grantor trust of the grantor or the grantor's spouse is considered a sale or transfer to the grantor or the grantor's spouse.

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[37] Regulation Section 25.2702-5(b).

[38] Regulation Section 25.2702-5(c).

[39] Revenue Procedure 2003-42, Internal Revenue Bulletin 2003-23 (June 9, 2003).

This requirement prohibiting a sale or transfer prevents families using personal residence trusts or QPRTs from realizing large income tax savings. If the grantor leaves the residence in trust until the expiration of the trust's term, the remainder beneficiaries will acquire the property with a carryover basis [40] from the grantor, often leaving them with a large built-in gain. On the other hand, if the grantor was allowed to repurchase the residence just before the end of the trust term, more favorable tax results could be obtained. No gain would be recognized to the grantor on the repurchase,[41] and at the end of the trust term, the beneficiaries would receive flat-basis cash. Further, the residence would return to the grantor, and if retained until death, be included in the grantor's gross estate and receive a fair market value at death (hopefully stepped-up basis) under IRC Section 1014. The prohibited sale rule of Regulation Section 25.2702-5(c)(9) does not apply to a distribution for no consideration after the grantor's death and before expiration of the term interest to any person pursuant to the provisions of the trust or pursuant to the exercise of a power retained by the grantor under the trust provisions. Nor does it apply to a distribution for no consideration to the grantor's spouse after the expiration of the trust term pursuant to the language of the trust.

Regulation Section 25.2702-5(a)(2) provides that a trust that failed to qualify for the regulatory requirements of a personal residence trust or a QPRT may be modified to bring it into compliance. Such a modification must be commenced within 90 days after the due date (including extensions) for filing the gift tax return reporting the transfer of the residence and must be completed within a reasonable time thereafter. If the reformation is not completed by the due date (including extensions) for filing the gift tax return, the grantor or the grantor's spouse must attach a statement to the gift tax return stating that the reformation has been commenced or will be commenced within the 90-day period.

Planning Pointer. When a personal residence is owned by spouses as joint tenants with right of survivorship or as tenants by the entirety, consider transferring the residence to the spouses as tenants in common, giving each an undivided 50% interest in the residential property. Then, instead of doing a single QPRT, do a separate QPRT for each spouse. Not only will this possibly hedge against the mortality risk of an early death, it will also allow each of the QPRTs to claim a discount for transfer of a minority interest — because neither spouse can control the disposition of the property — and lack of marketability. In the case of *Ludwick v. Commissioner*, TCM 2010-104, the Tax Court allowed a discount of 17% of the value of the residential property in such a situation.

For those taxpayers who created QPRTs years before the enhanced federal transfer tax exclusions, current planning suggests violating the terms of a "successful" QPRT (the grantor outlived the term of the trust) and allowing the grantor to demonstrate a retained interest in the property so that the fair market value of the residence will be included in the grantor's estate at death. Where no estate tax will be due from the parents, passing the fair market value at death basis to heirs is a valuable tax benefit. Some practitioners question this suggestion on the basis that the grantor had no legal right to "retain" an interest, so that the retained interest claim is illusory, while other practitioners believe that the use and occupancy by the grantor beyond the designated term is sufficient control to require an estate inclusion.

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[40] IRC Section 1015.

[41] Revenue Ruling 85-13, 1985-1 CB 184.

.04 Treatment of Property Not Held in Trust

Under IRC Section 2702(c), the transfer of a term interest in property not held in trust is treated like the retention of an interest in trust. Thus, for example, if a parent gives a remainder interest in stock to a child, the parent is deemed to make a gift of 100% of the value of the stock, not merely the actuarial value of the remainder interest.

However, IRC Section 2702(d) provides a special rule for the valuation of a term interest in certain tangible property. This section provides that if the non-exercise of rights in tangible property would not have a substantial effect on the valuation of the remainder interest in such property, the value of such term interest would not be zero under the general rule. In this case, the value would be the amount that the holder establishes an unrelated person would pay for such interest in an arm's-length transaction.

The Senate Finance Committee, when discussing the special rules for tangible property, makes reference to a joint purchase of paintings and undeveloped land as within the ambit of these special rules. Joint purchases are discussed in ¶2315.05.

.05 Joint Purchases

Intrafamily joint purchases of property had been popular estate planning devices before the enactment of IRC Section 2702. A parent and child would purchase income-producing property from a third person. The parent would receive a life income or term interest, and the child would receive a remainder interest. Each would pay the actuarial value for each interest, computed under IRS tables. The goal was to buy property with good appreciation potential. No gift tax would be due on the acquisition of the property because each party paid the full value of the interest acquired. Nothing would be includible in the parent's gross estate on his or her death, even though the parent held a life income interest. IRC Section 2036(a), which drew into the gross estate of a decedent property that the parent had transferred during his or her lifetime in which the parent retained a life income interest or an interest that did not, in fact, end until death, did not apply. The reason was that the parent had not made a lifetime transfer and had not retained a remainder interest in the property transferred.

Now, a joint purchase of property is treated as the acquisition of the entire property by the holder of the term interest followed by a transfer of the remainder interest. The Senate Finance Committee stated, "Thus, for purposes of determining the amount of the gift, the bill [the law] effectively treats the purchaser of a life estate pursuant to a joint purchase as making a transfer of the entire property less the consideration paid by the remainderman." If no consideration is paid by the remainderman, the purchaser of the life interest is treated as having made a gift of 100% of the value of the property to the remainderman, which would not be considered a present interest gift eligible for the gift tax annual exclusion ($15,000 in 2020, indexed annually for inflation) because the annual exclusion is available only for gifts of present interests.

¶2320 Lapsing Rights and Restrictions

IRC Section 2704 deals with the tax treatment of certain restrictions and lapsing rights upon the value of an interest in a partnership or corporation. It is intended to prevent results similar to those in *D. Harrison*

Est.,[42] in which the lapse of Harrison's unexercised right to liquidate his interest in a partnership with his sons upon his death resulted in a drastic reduction in the value of his partnership interest at death by over $20 million.

IRC Section 2704(a) provides that the lapse of voting or liquidation rights in a family-controlled corporation or partnership results in a transfer by gift or an inclusion in the gross estate. The amount of the transfer is the value of all the interests in the entity held by the transferor immediately before the lapse (assuming the right was non-lapsing) over the value of the interests immediately after the lapse.

IRC Section 2704(b) provides that any restriction that effectively limits the ability of a corporation or partnership to liquidate is ignored when valuing a transfer among family members if (1) the transferor and family members control the corporation or partnership immediately before the transfer, and (2) the restriction either lapses after the transfer or can be removed by the transferor or members of his or her family, either alone or collectively.

For purposes of IRC Section 2704, the definition of a family-controlled business is a broad one, and family members include the transferor's (1) spouse; (2) ancestors, lineal descendants, or the spouse of such persons; (3) brothers and sisters; and (4) any spouse of individuals in (2) and (3).

These rules apply to restrictions or rights (or limitations on rights) created after October 8, 1990.

The IRS has applied IRC Section 2704 to the valuation of interests transferred in family limited partnerships (FLPs). For example, IRS Letter Ruling 9723009[43] involved the transfer of an interest in an FLP whose partnership agreement provided that no partner could withdraw from the partnership. Under applicable state law, however, absent the restriction in the partnership agreement, the transferee could have withdrawn and liquidated the partnership with six months' notice. Because the prohibition on the decedent's right to liquidate her interest was more restrictive than state law, it was an applicable restriction and was disregarded for purposes of valuing the transferred stock.

The IRS issued proposed regulations under IRC Section 2704 on August 2, 2016. The regulations tried to prevent the creation of intrafamily transfer restrictions that reduce value for transfer tax purposes without really restricting the interest of family members.[44] The goal was to deny or eliminate valuation discounts in the context of family business transfers. The regulations were extremely unpopular when they were proposed. They were never finalized and were withdrawn as burdensome in 2017. They still serve as a strong indication, however, of the IRS' view of valuation discounts in the family business transfer context and could certainly return in a different political context.

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[42] 52 T.C.M. 1306 (1987).

[43] February 24, 1997.

[44] IRC Sections 2704(a)(3); (b)(4); 2701(e)(6).

Chapter 24

Planning for Marriage, Divorce, or Separation

¶2401 Overview

Preparing financially for marriage, divorce, or separation requires careful planning and full consideration of the options available. Issues involving taxes and tax planning are not typically at the forefront of the parties' thinking — if they are given any consideration at all. The financial planner can make an important difference here by making certain that tax and other financial issues are at least raised — and then addressed in the appropriate circumstances. The emotions involved in marriage and divorce may relegate tax issues to the background, but long after the emotional highs and lows of the clients' situation have subsided, the tax decisions they made — or did not make — may linger many years into the future. The financial planner needs to be the person able to address these issues and make certain that the clients give them appropriate attention and consideration.

The TCJA has made a significant change in the way taxation of divorce will be addressed after 2018. For matrimonial arrangements entered into after 2018, alimony will no longer be deductible by the payer nor includable in income by the payee.

¶2405 The Premarital Agreement

A financial planner should consider the use of premarital agreements (also known as *prenuptial agreements* or *antenuptial agreements*) whenever one of the parties is contemplating making a substantial gift to the other in consideration of the marriage. Another use of a prenuptial agreement is to limit the statutory, common law, or community property rights of each party to the other party's property or to limit or eliminate other claims of one against the other. Couples often use this type of agreement when there is a substantial disparity in the wealth of the parties, one or both parties stand to receive a substantial inheritance from family members, or one or both parties holds a professional license. A couple might also use a prenuptial agreement when each party has substantial wealth, and the parties wish to maintain their financial independence. Another situation in which couples often use a prenuptial agreement is when one or both of the parties have had prior marriages that confer on them continuing rights or impose on them continuing duties involving former spouses or children (¶2410).

In its common form, the prenuptial agreement involves a transfer, or the promise of a transfer, of property from the more affluent individual to the other. The transaction is either outright or in trust, in exchange for a release of all rights and claims the other individual might have for support or against the transferor's property or estate.

The National Conference of Commissioners on Uniform State Laws adopted the Uniform Premarital Agreement Act in 1983. This act provides assistance for couples who want to make agreements before marriage regarding such things as alimony and property dispositions in the event of separation, divorce, or death. The District of Columbia and at least the following 28 states have adopted some form of this act:

Arizona	Montana
Arkansas	Nebraska
California	Nevada
Colorado	New Jersey
Connecticut	New Mexico
Delaware	North Carolina
District of Columbia	North Dakota
Florida	Oregon
Hawaii	Rhode Island
Idaho	South Dakota
Illinois	Texas
Indiana	Utah
Iowa	Virginia
Kansas	Wisconsin
Maine	

States that have not adopted this act often have their own version of similar laws. Its enactment has been proposed in Mississippi, Missouri, South Carolina, and West Virginia. However, the laws may vary somewhat among the states. A financial planner should urge a couple considering a premarital agreement to consult a competent attorney in the state where they plan to live. A revised Uniform Act,

known as the Uniform Premarital and Marital Agreements Act, was approved by the Uniform Law Commission in 2012. If adopted, it will replace the 1983 Uniform Premarital Agreement Act. The revised Act is touted as correcting the "flaws" of the 1983 Uniform Act. The jurisdictions listed above have adopted some version of one or the other Uniform Acts.

A financial planner should consider a prenuptial agreement as part of the financial plan of both parties. The planner should evaluate it in terms of its estate, gift, and income tax consequences; legal considerations; and other matters as discussed in the text that follows.

.01 Validity in General

As a general rule, for a premarital agreement involving property rights to be valid under state law, it must be fair, reasonable, and equitable. In order to meet this test, both parties must make a full and fair disclosure of all their income and property. No disclosure should be omitted. Each party must be represented by separate and independent counsel. Even if the parties are willing to waive conflict of interest issues and use the same attorney, this should not be done. It could be grounds to invalidate a premarital agreement in the future.

.02 Release of Support Obligations

Most states adhere to the view that a prenuptial agreement cannot relieve a spouse of his or her support obligation. The U.S. Supreme Court held that a statute that provides that husbands, but not wives, can be required to pay alimony on divorce is unconstitutional because alimony rests on need, and need is gender neutral.[1] Thus, if the marriage fails, an individual might remain liable for support unless relieved of this obligation by a legal separation agreement, divorce decree, or the subsequent remarriage of his or her divorced spouse. All states prohibit couples from making binding agreements about obligations for child support payments. Such obligations and payments always remain subject to court jurisdiction and modification while a child is a minor.

.03 Alimony Rights

An individual may challenge the validity of alimony provisions in a premarital agreement in many states as against public policy. However, under the current trend of authority, many states will not deem such provisions to be contrary to public policy if they take into account the adequacy of the spouse's means of support or if the support obligation is subject to increase or decrease under changed conditions. As a result of the TCJA, prenuptial agreements prepared before the TCJA addressing alimony obligations included assumptions about tax consequences which will no longer be accurate after 2018. It is unclear (but unlikely) as of the writing of this book whether prenuptial agreements entered into before the TCJA will somehow be "grandfathered" to allow pre-TCJA laws to apply, or will have to bear the consequences of the new law provisions unless they are modified by the parties. The AICPA is monitoring tax reform closely and the latest on IRS guidance can be found in the Tax Reform Resource Center (aicpa.org/taxreform.)

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[1] *N. Orr*, 440 US 268, 99 S.Ct. 1102 (1979).

.04 Governing Law

If the possibility exists that the parties might change their domicile and move to another jurisdiction, the prenuptial agreement should address the governing state law. Addressing the governing law is particularly important if the change is from or to states with conflicting public policy views (paragraph .03) or involves moving from common law to community property states or vice versa.

.05 Community Property Law

If the parties are residents of a community property state or might become residents of a community property state, the agreement should address their community and separate property rights and obligations. Persons contemplating a premarital agreement should be careful when they consider converting separate property to community property and vice versa because distinct legal obligations apply to each type of property.

.06 Income Tax Consequences

If an individual transfers property to a spouse or former spouse incident to a divorce as part of a premarital settlement in consideration of the release of the support obligation, the transferor recognizes no gain or loss.[2] The transferee's adjusted basis in the property is the same as the transferor's adjusted basis.[3]

.07 Gift Tax Consequences

A transfer of property to a current spouse (assuming the spouse is a United States citizen) is not subject to gift tax because of the unlimited gift tax marital deduction.[4] A transfer of property to a former spouse in satisfaction of marital or property rights could be interpreted as a taxable gift to the extent that the value of the property transferred exceeds the actuarial value of any support obligation or other consideration in money or money's worth.[5] The gift is subject to the $15,000 annual exclusion (for 2020),[6] which is indexed annually for inflation.[7] However, the transfer will not be a taxable gift if it complies with the requirements of IRC Section 2516.[8] IRC Section 2516 applies when spouses enter into a written agreement concerning their marital and property rights, and they divorce within the three-year period beginning on the date one year before they make the agreement. A transfer of property pursuant to the agreement in settlement of marital rights, property rights, or support for minor children is not subject to gift tax. Such transfers are considered made for a full and adequate consideration in money or

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[2] IRC Section 1041(a) and Temporary Regulation Section 1.1041-1T(a).

[3] IRC Section 1041(b).

[4] IRC Section 2523(a).

[5] IRC Section 2043(b) and Revenue Ruling 68-379, 1968-2 CB 414.

[6] IRC Section 2503(b)(1).

[7] IRC Section 2503(b)(2).

[8] House Committee Report on P.L. 98-369 (Deficit Reduction Act of 1984).

money's worth. Transfers pursuant to marital settlement agreements that fall outside of the timing issues of IRC Section 2516 may still avoid gift tax when the marital agreement is subject to ongoing court jurisdiction.

Timing can be important here. A transfer made prior to marriage pursuant to a premarital agreement can be viewed as a taxable gift. The parties are not yet married, so there is no protection provided by the gift tax marital deduction, and a transfer in exchange for the release of marital rights is not considered a transfer made for valuable consideration, hence, it is viewed as a gift. Planning might suggest having the parties enter into the desired premarital agreement, arrange for the transfer of the agreed-upon property, but have all the transfers held in escrow, conditioned on the completion of a legal marriage ceremony. Once that has occurred, the condition of marriage has been satisfied, and the property can be released from escrow. No gift tax issue exists because the parties are now married, and the unlimited marital deduction for gifting between United States citizen spouses applies.

.08 Estate Tax Consequences

A lifetime transfer made by an individual can be includible in his or her gross estate under IRC Sections 2035–2038, except in the case of a bona fide sale for adequate and full consideration in money or money's worth. IRC Section 2043(a) governs transfers for a consideration in money or money's worth when the consideration is less than adequate and full. In such a case, the decedent's gross estate includes only the fair market value at the time of death of the transferred property exceeding the value of the consideration received by the decedent. IRC Section 2043(b) also provides that a relinquishment of marital rights in the decedent's property or estate is not to be regarded in any degree as a consideration in money or money's worth unless the transfer complies with the requirements of IRC Section 2516 (discussed in .07).

Therefore, the prenuptial agreement must first be tested against several IRC sections. IRC Section 2035, dealing with transfers within three years of death and their includibility in the gross estate of the transferor, should pose no problem unless the transfer is of a life insurance policy on the life of the transferor. IRC Section 2036 applies only if the donor retains a life estate in transferred property, or the use and enjoyment of the transferred property. IRC Section 2037 can be more troublesome. If a transfer is to take effect at death, the transfer must not provide for the retention of a reversionary interest in the transferor exceeding 5% of the value of the property transferred. To avoid attack under IRC Section 2038, the transfer must not be subject to revocation, alteration, termination, or amendment.

Assuming the parties can structure the transfer under the prenuptial agreement to avoid inclusion under these sections, whether the transfer is for full and adequate consideration in money or money's worth becomes immaterial for estate tax purposes. The transfer is not includible in the transferor's gross estate.

Even though the transaction may be within reach of one of these sections, the value of the transferred property will not be includible in the transferor's gross estate to the extent that the transfer is made in release of support rights. This result occurs because the IRS and the courts distinguish between support rights and marital property or inheritance rights. The renunciation of support rights is deemed to be consideration in money or money's worth, whereas renunciation of inheritance rights is not.[9]

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[9] Revenue Ruling 68-379, 1968-2 CB 414.

Another estate tax consideration that should be raised in a prenuptial agreement is portability. It is recommended that the prenuptial agreement require the executor of the first spouse to die to file Form 706 to make a portability election, even if filing Form 706 is not otherwise required for the estate of the first spouse to die.

.09 Claims Against the Transferor's Estate

Whether the decedent's estate may deduct a claim against the estate[10] based on a premarital agreement depends primarily on whether the claim is supported by consideration. If the claim is based on giving up the transferee's marital rights, it generally will not be deductible because marital rights are generally not viewed as consideration in money or money's worth.[11] However, the estate may deduct property transferred in satisfaction of a claim pursuant to an agreement that complies with the provisions of IRC Section 2516 (discussed in .07). Thus, if a transferor dies before completing the transfers under a written divorce or separation agreement that meets the requirements of IRC Section 2516, the estate may deduct the value of the property actually transferred in satisfaction of the claim.[12]

If a transfer or payment was to be made under a prenuptial agreement in consideration of the release of support rights, the claim made against the decedent's estate should be deductible.

An issue may arise when the decedent's debt for the payment of marital or support rights is unpaid when the federal estate tax return is to be filed. The IRS could deny the deduction for the "estimated" payments and require either an amended return or a refund claim to establish the deduction when the payment is actually made.[13] If there is a substantial payment due but unpaid, it may be necessary for the estate to file a protective refund claim if the statute of limitations for claiming refunds for payment of the federal estate tax is about to expire. The federal estate tax return (Form 706) includes a Schedule PC to be used for making protective claims when the entitlement to a deduction exceeding $500,000 cannot be fully established at the time the Form 706 is filed. The IRS regulations require proof of actual payment in order for the estate tax deduction to be granted without controversy. When the payment may be conditioned on uncertain future events that may occur beyond the three-year period of the statute of limitations for refund claims, a protective claim should be filed and will be honored if an appropriate payment is made in the future, even beyond the statutory period.

.10 Claims Against the Transferee's Estate

If the surviving spouse is given a greater interest than provided for in the prenuptial agreement, to the detriment of a descendant, and subsequently dies, the payment of any claim made by the descendant against the estate of the surviving spouse may be deductible by the surviving spouse's estate.[14]

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[10] IRC Section 2053(a)(3).

[11] IRC Section 2043(b).

[12] House Committee Report on P.L. 98-369 (Tax Reform Act of 1984).

[13] IRC Section 2053.

[14] *M.K. Patterson Est.*, 46 T.C.M. 618 (1983).

.11 Release of Right to Retirement Benefits

A married individual has a legal, enforceable right under federal law in the qualified retirement plan benefits (but not in IRAs) belonging to his or her spouse. Nevertheless, matrimonial claims may be made against the funds in another spouse's IRA.

.12 Structuring the Agreement

When setting up a prenuptial agreement, using a trust instead of an outright transfer is often advisable. With an irrevocable trust, the property will generally be kept out of the grantor's gross estate even if the trust is set up within three years of death. A transferor might give his or her spouse a life interest in a trust, with the possible right to invade the principal for the spouse's benefit in accordance with a defined standard, with the remainder going to the children of the marriage or other properly designated beneficiaries. In such a case, the trust property will be kept out of the surviving spouse's gross estate as well. In general, a trust arrangement has all of its usual advantages (management, asset protection, control by the trustees, control of ultimate beneficiaries by the settlor, and so on).

The prenuptial agreement does not have to be in any particular form. It should be in writing, name the parties; and describe the property to be transferred and the time at which the transfer is to take place (that is, before marriage, after marriage, or on the death of the transferor spouse). It should also recite the promises to marry, the considerations for the transfer(s), the rights relinquished, and special provisions to be included in wills or trusts of one or both parties. The agreement should recite that each party was represented by independent counsel (naming such counsel is a good idea) and should have each party's asset disclosure statement as an attachment.

.13 Breach of Agreement

A party might decide to terminate the agreement and call off the wedding. The agreement should provide that the parties are then restored to the status quo before the agreement. Because the parties might have undertaken obligations in connection with the marriage (such as wedding plan expenses, apartment rental, and gifts to each other and from third parties), the agreement might also specify who keeps what gifts and who provides for payment or reimbursement of expenses, or both.

¶2410 Special Planning for Subsequent Marriages

In a subsequent marriage, special considerations apply when one or both parties to the subsequent marriage have children by a prior marriage, a "blended family." The situation is further complicated when the couple plans to have children of their own. In these situations, the financial planner may suggest more sophisticated planning arrangements, such as a qualified terminable interest property (QTIP) trust that can be designed to provide for the comfortable support of the surviving spouse while allowing each spouse to control the ultimate disposition of property to his or her chosen heirs.

.01 Termination of a Prior Marriage

Whether a prior marriage has been legally terminated can pose problems. No problem occurs if the termination is by death, and there is actual proof of death. However, in the rare situation when termination by death is to be established on the basis of a presumption of death through prolonged absence without communication or other evidence of survival, problems can arise. The more common problem involves the validity of a prior divorce. The court that granted the divorce might subsequently declare it invalid. A problem can arise in which a divorce obtained in one state or in a foreign country is later declared invalid in another jurisdiction.

The validity or invalidity of a prior divorce (and common law marriage) can affect the parties' eligibility to file joint income tax returns, their estate and gift tax marital deduction, and their Social Security benefits. In those states that recognize a common law marriage, the couple may file a joint income tax return.[15] The Social Security Act (SSA) recognizes a common law marriage if it is valid under state law for payment of widow's (and widower) benefits. The SSA also recognizes an invalid ceremonial marriage for payment of benefits, but it does not recognize an invalid common law marriage.

The IRS will not generally question the validity of any divorce decree until a court of competent jurisdiction has declared it to be invalid. However, when a state court declares the prior divorce to be invalid, the IRS will usually follow the later court decision, rather than the prior divorce decree.[16]

.02 Children of a Prior Marriage

If either or both parties to a marriage have children by a prior marriage, protection of the children requires special attention. The parties can provide such protection by a premarital agreement, outright gifts to the children, living trusts, custodial accounts, testamentary bequests, and testamentary trusts. A QTIP trust merits special consideration because it provides for the protection and support of the surviving spouse while allowing the first spouse to die to control the ultimate disposition of the trust property — all while preserving the benefit of the unlimited marital deduction. The portability election should be used carefully here. The "simplicity" of leaving all assets to a surviving spouse may not take into account more complex considerations of asset control and ultimate disposition. Portability is discussed in detail in chapter 37.

The parties should also consider the acquisition of additional life insurance by the parent or by the (adult) child on the parent's life, naming the child as beneficiary. The child might also be named as beneficiary of existing policies. New policies might be obtained to provide added coverage for the new spouse or that individual's children by a prior marriage, or both. Generally, the adult child should purchase life insurance policies on the life of a parent, rather than the parent purchasing the policy. In the latter case, the policy would be an asset of the parent, and the policy proceeds would be includible in the parent's gross estate.[17] If the child is not old enough to purchase insurance, the purchase could be made by a trustee of an irrevocable life insurance trust created by the parent for the benefit of the child.

The trust is the preferred method of providing for children of a prior marriage when the parent has sufficient assets with which to fund the trust. If the trust is created before marriage, the property transferred to it will generally not be included in determining the common law, statutory, or other interest of the transferor spouse upon a subsequent marriage. However, state law differs about the effect of the creation of a premarital revocable trust on the interests created by state law in favor of a spouse. Therefore, the financial planner should check applicable state law.

.03 Prenuptial Agreements

Couples use prenuptial agreements more frequently when one or both parties have been previously married. Prenuptial agreements are especially common when one or both parties have children from

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[15] Revenue Ruling 83-183, 1983-2 CB 220.

[16] Revenue Ruling 67-442, 1967-2 CB 65.

[17] IRC Section 2042(2).

prior marriages. Such agreements can also play a special role when two elderly individuals plan to marry. In such a case, family members of one or both parties might fear that the legal rights and obligations flowing from what may well be a short-term relationship might operate to the family members' disadvantage. This concern is particularly true when the assets of one of the parties include a family business. Family anxieties can also exist when there is a great disparity in the ages of the parties to the contemplated marriage, or significant disparity in the wealth of the parties to the contemplated marriage. Exercise caution if Medicaid is an issue and the assets of the spouses must be combined to determine eligibility.

.04 Tax Consequences

The tax consequences of a prenuptial agreement in connection with a second or subsequent marriage involving a transfer of property in consideration of a release of marital or support rights are the same as those for a first marriage (¶2405), except for any possible factual differences in the two situations.

.05 Will Provisions

The couple and financial planner should consider emotional factors when providing for the disposition of property by will if one or both parties was previously married to someone else. Personal items may have special significance. These factors may not be present in the same manner in connection with a first marriage. This consideration is particularly important when the prior marriage ended in divorce. The couple must consider the children — his, hers, and theirs. A will that bequeaths everything to the survivor might be inappropriate, even if the couple has no children or provisions for the children have already been made. Siblings, parents, and other related parties might be potential beneficiaries. Even an ex-spouse might merit consideration or demand recognition by virtue of a property settlement or court decree.

In many cases, the bequest to the surviving spouse will be limited to the statutory, common law, or other interest required by law.

As suggested in preceding paragraph .02, in connection with the discussion of children, a QTIP bequest merits special consideration from the standpoint of providing for a surviving spouse and deferring payment of any required estate taxes, while at the same time protecting other intended beneficiaries after the death of the surviving spouse. Use of the QTIP trust also provides the opportunity for the use of the portability election along with a potentially stepped-up income-tax basis at the death of each spouse.

¶2415 Marriage Versus Living Together Outside of Marriage

The practice of couples living together outside of marriage is not unusual. The financial planner whose client is an individual cohabiting with another outside of marriage should advise the client of the probable legal and financial consequences (see also chapter 25, "Planning for Same-Sex Couples"). Unless the relationship establishes a common law or informal marriage in a state that recognizes such marriages, the relationship by itself does not create marital rights similar to those of spouses under federal law. However, a contractual agreement concerning property rights between the parties may be enforceable.

Although a written contract might not be essential, prudence suggests the need for a written contract to avoid the difficulties involved in proving an oral contract. If a written contract does not appear to be feasible, then a financial planner should consider advising the client to keep a diary in which he or she

would record any oral agreement(s) or conversations that might result in an enforceable contract. A financial planner should refer any legal questions involving such a contract to a competent attorney.

Many difficult issues can arise here, including claims of "palimony" by a survivor of a relationship requesting lifetime support that may be resisted by the decedent's family. As a general rule, oral contracts for the transfer of real estate are not enforceable. The financial planner should do everything in the planner's power to encourage the parties to enter into a written agreement addressing their relationship and their legal expectations. Attempting to prove or resist claims of oral contracts will only bring substantial aggravation to both sides, not to mention extensive legal costs.

Various tax factors can affect a decision to marry or live together outside of marriage. A two-earner couple in the higher tax brackets may pay more in income taxes if they are married than if they are living together and filing as single individuals. This phenomenon is known as the *marriage penalty*. This penalty has become even more severe with the 3.8% tax on net investment income because this tax applies to married couples with AGI over $250,000, to single persons and heads of households with over $200,000 of AGI, and to married persons filing separately with over $125,000 of AGI. These numbers are not adjusted for inflation. The relief from the marriage penalty involving disparate income tax rates below the 24% tax bracket on single and married filers was made permanent, but at upper income tax brackets, two single persons will pay less tax than a married couple with the same combined income.

.01 Passive Activity Losses

Generally, a taxpayer may use losses from passive activities to offset income from passive activities only.[18] A taxpayer may not use losses from passive activities to offset portfolio income, such as interest, dividends, or capital gains[19] or active income from employment and business activities in which the taxpayer materially participates.[20] A taxpayer carries forward any unused passive activity loss indefinitely.[21] A taxpayer may deduct any unused passive activity loss against portfolio income or active income, or both, when the taxpayer disposes of the passive activity property in a fully taxable transaction.[22] If a taxpayer disposes of a passive activity as the result of death, the unused passive activity loss, beyond any increase in basis under IRC Section 1014(a), is allowed as a deduction against income from other activities for the year of death on the decedent's final income tax return.[23] A special rule permits a taxpayer to use up to $25,000 of losses from real estate activities in which the investor actively participates to offset active income and portfolio income.[24] The active participation threshold is

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[18] IRC Sections 469(d)(1) and 469(a).

[19] IRC Section 469(e)(1)(A).

[20] IRC Sections 469(e)(2)(B) and 469(e)(3).

[21] IRC Section 469(b).

[22] IRC Section 469(g)(1).

[23] IRC Section 469(g)(2)(A).

[24] IRC Section 469(i).

lower than the material participation standard.[25] The $25,000 ceiling applies to single taxpayers and married couples. Also, the $25,000 is phased out by $1 for every $2 that AGI exceeds $100,000.[26] Thus, the ceiling is fully phased out at an AGI of $150,000. These figures apply to single taxpayers and married couples, as well as to the estate of a decedent in the first two years of the estate's administration. These amounts are not indexed for inflation.

.02 Personal and Dependency Exemptions

The deduction for personal exemptions has been repealed through 2025 by the TCJA beginning in 2018. The standard deduction has been increased to $24,800 MFJ and $12,400 for single filers for 2020, indexed annually for inflation. Because the personal exemption has been suspended until 2026, the rules providing for its phase-out have also been similarly suspended.

.03 Repeal of the Limitation on Itemized Deductions

The rule which required that many itemized deductions be reduced by 3% of AGI in excess of a threshold amount,[27] the so-called "Pease limitation," is suspended for tax years after 2017 through 2025 by the TCJA. Although this sounds like good news for taxpayers, the repeal or limitation of many itemized deductions will force most taxpayers to claim the standard deduction for 2018 and beyond.

.04 Standard Deduction

For 2019, the basic standard deduction is $12,400 for single taxpayers, $18,650 for heads of household, $24,800 for married couples filing jointly, and $12,400 for a married taxpayer filing separately.[28] For 2020, the additional standard deduction for blindness or being age 65 or over is $1,300 for each married taxpayer and $1,650 for a single taxpayer or head of household.[29] The basic standard deduction and the additional standard deduction are indexed for inflation.[30]

.05 Transfers Between Parties

In general, gain or loss is not recognized on an outright transfer of property from one spouse to another, and the recipient spouse does not recognize income as a result of the transfer. The recipient spouse takes a basis in the transferred property equal to the basis of the transferor spouse, that is, a "carryover" basis.[31] Furthermore, the transfer is made free of gift tax by virtue of the unlimited marital deduction.[32]

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[25] IRC Section 469(i)(6).

[26] IRC Section 469(i)(3)(A).

[27] IRC Section 68(a).

[28] IRC Section 63(c)(2).

[29] IRC Sections 63(c)(3) and 63(f).

[30] IRC Section 63(c)(4).

[31] IRC Section 1041.

[32] IRC Section 2523(a).

The foregoing does not apply to transfers to nonresident alien spouses; gain may be recognized with respect to such transfers.[33] However, the transferor would not recognize any loss realized because it would be a sale or exchange to a related party.[34]

If the parties are not married and property is transferred between them, the transferor will recognize gain or loss, unless the transfer qualifies as a gift under IRC Section 102 or a transfer pursuant to a divorce decree or a court supervised divorce transfer. If the transfer is compensation for any services rendered, the transferor will recognize gain on any appreciated property transferred, but the transferor may be entitled to a deduction under IRC Section 162(a) if the compensation represents an ordinary and necessary business expense. The transferee would recognize gross income for any property received as compensation to the extent of the property's fair market value.[35] Gifts in excess of the amount of the $15,000 annual exclusion[36] (for 2020) would be subject to gift tax. The annual exclusion may be indexed annually for inflation but is adjusted only in increments of $1,000.[37]

.06 Deductible IRA Contributions

An individual will not be considered to be an active participant in an employer-sponsored retirement plan merely because his or her spouse is a participant. However, the ability of a nonparticipant spouse to claim an IRA deduction begins to be phased out when the couple's combined AGI exceeds $196,000 (for 2020).[38] The deduction is denied in full when their AGI exceeds $206,000 (for 2020).[39] These amounts are annually indexed to inflation.

Planning Pointer. Thinking of transfers from a pure tax planning viewpoint, in order to provide security to the less wealthy of the parties and ensure that the payment will be excluded from the recipient's gross income, the parties may consider entering into a prenuptial-type agreement, even though they might not plan to get married. However, the wealthier party would be making a potentially taxable gift on any transfer. Of course, the transferor may use any available unified credit[40] to reduce or avoid any gift tax. Such use of the unified credit might be at the expense of later estate and gift taxes. For gifts made in 2020, the applicable exclusion amount for gift tax purposes is $11,580,000. This amount is indexed annually for inflation, but sunsets after 2025. Such planning has obvious emotional and nontax issue limitations. The financial planner may want to raise the issue to cover the tax aspects and see if there is any receptivity from the parties involved.

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[33] IRC Section 1041(d).

[34] IRC Sections 267(a)(1), 267(b)(1), and 267(c)(4).

[35] IRC Section 61(a) and Regulation Section 1.61-2(d).

[36] IRC Section 2503(b)(1).

[37] IRC Section 2503(b)(2).

[38] IRC Section 219(g)(7)(A).

[39] IRC Section 219(g)(7)(B).

[40] IRC Section 2505.

¶2420 Divorce and Separation

Few individuals contemplate divorce or separation when they get married. However, many marriages end in divorce. A financial planner must carefully consider the financial results of a potential separation or divorce. Alimony, child support, and property settlements all have tax consequences that a financial planner should consider when advising a married couple contemplating divorce or an unmarried couple contemplating marriage.

Tax factors and state laws affect alimony, child support, and property settlements in divorce. Most states have enacted equitable distribution laws under which all assets acquired during a marriage by either spouse, other than those acquired through inheritance, personal injury settlements, or a gift from someone other than the spouse, are to be divided equitably, not necessarily equally, by settlement or by the divorce court.

The court may take into account many factors when determining an equitable distribution of assets, including the length of the marriage, the contributions of both spouses, the future earning capacities of each spouse, the presence of children and the responsibility for their support.

The equitable distribution laws increase the responsibilities of matrimonial advisers. They must carefully evaluate all assets in a marriage, including pensions, business assets, stocks and bonds, real estate, savings accounts, and marital gifts. A license to practice a profession (such as public accounting, medicine, law, and architecture) and an academic degree might be considered marital property under state law. Lottery winnings might also be subject to equitable distribution. The matrimonial adviser must attempt to discover hidden assets. Accountants, appraisers, and attorneys might become part of the process.

The increased responsibilities of divorce attorneys result in longer trials when issues are contested. Couples often negotiate the settlement of contested issues because of cost factors and the uncertainty in predicting how a court might decide the issues.

Division of retirement benefits is separately discussed in ¶2445.

.01 Community Income of Separated Spouses

IRC Section 66 provides rules for the tax treatment of certain types of community income when the spouses live apart during the entire calendar year and do not file a joint return for the year. In such a case, each spouse is entitled to treat his or her income separately.

For the IRC Section 66 rule to apply, one or both spouses must have earned income for the calendar year that is community income, no portion of which has been transferred directly or indirectly between the spouses, except for *de minimis* amounts and payments made solely to satisfy support obligations for dependent children.

If the couple qualifies, earned income (other than trade or business income or a partner's distributive share of partnership income) is treated as the income of the spouse who earned it for federal income tax purposes. Trade or business income (other than partnership income) is treated as the income of the spouse who owns the business, unless the other spouse exercises substantially all the management and

control of the trade or business.[41] In the case of a partnership, the income is taxed to the spouse who has a distributive share of the partnership profits.[42]

The IRC Section 66 rule also applies to situations in which a spouse establishes that he or she did not know, or have reason to know, of an item of community income, and including the item in that spouse's taxable income would be inequitable. In addition, the IRS has the power to disallow the benefits of any community property law to a taxpayer if the taxpayer acts as if he or she is solely entitled to the income, and the taxpayer failed to notify his or her spouse of that income.[43]

.02 Kiddie Tax

As the result of the TCJA, beginning in 2018, the unearned income of a child in excess of a threshold amount ($2,100 for 2019) was taxed at the rates applicable to trusts and estates, no longer at the parent's marginal tax rate (this subject is dealt with in detail in ¶3205).[44] However, this law was changed retroactively as the result of the 2019 SECURE Act. The kiddie tax rule returns to the rule that unearned income subject to the kiddie tax (above $2,200 for 2020) is again taxed at the marginal rates of the parents of the child. The kiddie tax applies to children who are (1) younger than age 19 or (2) full-time students over age 18 but under age 24. The rule applies only to children whose earned income does not exceed one-half of the amount of their support.[45]

.03 Joint Return Considerations

A financial planner advising a separated couple or couple contemplating divorce must deal with the issue of whether the couple will file a joint income tax return. Consider an indemnification agreement, particularly when the client is concerned about whether the spouse has declared all of his or her income or overstated deductions. Often, when a divorce is imminent, the parties will want to file separate returns. Both parties are jointly and severally liable for the tax due on a joint return, including any deficiencies assessed later.[46] A spouse can avoid liability for the tax assessed on a joint return only if the spouse proves that he or she is an innocent spouse.[47] The spouse claiming to be "innocent" has the burden of proof here. If the spouse has lived and enjoyed a lifestyle without prior complaint that does not match the income reported, the IRS will typically deny innocent spouse claims. If the parties are no longer married, are legally separated, or are no longer living together, then a party may elect to limit liability to his or her allocable share of the income.[48] In addition, a joint filer may seek relief from

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[41] IRC Section 1402(a)(5)(A), incorporated by reference.

[42] IRC Section 1402(a)(5)(B).

[43] IRC Section 66(b).

[44] IRC Section 1(g).

[45] IRC Section 1(g)(2).

[46] IRC Section 6013(d)(3).

[47] IRC Section 6015.

[48] IRC Sections 6015(a)(2) and 6015(c).

liability if he or she did not know, or have reason to know, of an understatement in tax and holding the innocent individual liable for the additional tax would be inequitable.[49]

Often, the higher income spouse will want the other spouse to sign the joint return. A spouse is entitled to refuse to sign a joint return. No one can be forced to sign a joint return.

In one case, the U.S. Tax Court considered a return as a joint return, even though neither spouse signed the return; it contained only the typed names of the spouses and the signature of the tax return preparer. However, evidence indicated that the wife had intended to file a joint return but had refused to sign the return in an attempt to extract concessions in the midst of a divorce proceeding.[50] If the other spouse files a separate return, nothing can be done.[51]

In addition, if one spouse signs the other spouse's name to a joint return, the IRS might deem the other spouse to have consented to the joint return unless the other spouse files a separate return. In case a divorce appears imminent, a financial planner should advise the client of the joint and several liability associated with a joint return and the potential adverse consequences of not filing a return. In most of these cases, the spouses should file separate returns. The timing of the divorce decree is important because for filing purposes, the marital status of the parties is determined on the last day of the tax year.[52]

A spouse who believes the other joint filing spouse has understated income or otherwise misrepresented items on the joint return may file for innocent spouse relief. Form 8857 should be filed as soon as the "innocent" spouse is aware of a problem, but generally not more than two years after receipt of an IRS notice trying to collect tax from an innocent spouse (there are some equitable exceptions for abused spouses and other situations noted in the instructions for Form 8857). See *Wilson v. Commissioner*, 705 F.3d 980 (9th Cir. 2013); *Cutler v. Commissioner*, T.C. Memo 2013-119; Rev. Proc. 2003-61; and Notice 2012-8 for the factors to be weighed in making the innocent spouse determination.

¶2425 Alimony

For tax purposes, *alimony* is generally a payment made by an individual to or on behalf of a former spouse under a divorce or separation instrument.[53] Alimony can have income, estate, and gift tax consequences.

As the result of the TCJA, major changes were made to the alimony rules. Going forward, there will be two distinct sets of rules addressing alimony. For divorce or separation instruments executed or modified before 2019, the following "traditional" rules described will continue to apply. However, new and very different rules will apply for divorce or separation instruments executed after December 31,

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[49] IRC Section 6015(b).

[50] *Riportella*, 42 T.C.M. 869 (1981).

[51] *Springmann*, 54 T.C.M. 592 (1987).

[52] IRC Section 7701(a)(3).

[53] IRC Section 71(b)(1).

2018, and those executed before January 1, 2019, and modified after 2018 with the modification expressly providing that the new rules becoming effective in 2019 are to apply.

The TCJA repeals the deduction of qualified alimony and separate maintenance payments by a payor, the inclusion of the payments in the gross income by the payee, and the special rules for alimony trusts (taxing the trust income to the trust beneficiary and not to the grantor of the trust) effective, as stated, for divorce or separation instruments executed in 2019 or later, or those instruments modified after 2018 to have these rules apply. For the rules repealing the deduction, IRC Sections 71 and 215 are repealed. For the rules repealing the special trust rule, IRC Section 682 is repealed.

For divorce and separation instruments still subject to the pre-TCJA rules, IRC Sections 71 and 215 permit payments to a divorced spouse either to be made taxable to the recipient[54] and deductible by the payer[55] in computing AGI[56] or to be tax-free to the recipient and nondeductible by the payer.[57] The tax consequences will turn on the characterization of the payments, as either alimony, child support, or a property settlement payment. The payer will tend to choose the alimony alternative (taxable to the recipient and deductible by the payer) because the payer is often in a higher income tax bracket than the recipient. In these circumstances, the payer can pay more at lower after-tax costs. If the payer is in a relatively low tax bracket or has no taxable income, but expects to make the payments out of capital, the tax deduction is of little value. Moreover, the fact that the recipient, if in a low tax bracket, can receive minimally taxed or tax-free payments characterized as child support normally allows that individual to accept smaller payments with the same after-tax result as higher payments made taxable to the recipient.

The financial planner should analyze suggested alimony payments from both the pretax and after-tax perspective of both parties.

.01 Requirements for Alimony Treatment

A number of specific requirements must be met in order for a payment to be properly characterized as a payment of alimony. These requirements include the following:

Cash. Payments must be in cash and be received by, or on behalf of, the payee spouse.[58] Transfers of services or property, the execution of a promissory note or other debt instrument, or allowing the payee to use property of the payer do not qualify as cash payments of alimony. Delivery of a third party's debt instrument or an annuity contract does not constitute a cash payment of alimony.[59]

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[54] IRC Section 71(a).

[55] IRC Section 215(a).

[56] IRC Section 62(a)(10).

[57] IRC Section 71(b)(1)(B).

[58] IRC Section 71(b)(1)(A).

[59] Regulation Section 1.71-1T(b) Q&A 5.

Divorce or separation instrument. Payments must be made under a decree of divorce or separate maintenance or under a written instrument incident to the divorce, a written separation agreement, or a decree requiring support or maintenance payments.[60]

Living apart. When the parties are divorced or legally separated, they may not be members of the same household at the time payments are made, subject to some limited exceptions.[61]

Death of payee. The payer must have no liability to make any payment for any period after the death of the payee.[62] The divorce decree should, but might not, address the issue of whether the payments cease after the death of the payee. If the decree is silent, state law determines whether the payments cease on the death of the payee.[63] Although most states provide that payments cease on the death of the payee, good practice suggests making certain that this provision is contained in every matrimonial agreement or divorce decree.

Treatment by parties. The parties must not designate the payments as not being alimony. The option to designate payments as not being alimony, and the related planning considerations, are separately discussed in the text that follows.[64]

Front-loading deduction as alimony denied or limited — Alimony recapture rules. Alimony payments are subjected to a three-year "test period" to determine whether they are truly alimony or a disguised property settlement. If the alimony payments in the first year that payments are made exceed the average payments in the second and third year by more than $15,000, the excess amounts are recaptured in the third year by requiring the payer to include the excess payment in income and allowing the payee, who previously included the payment designated as alimony in income, to claim a deduction for that amount in computing AGI.[65] A similar rule applies to the extent that the payments in the second year exceed the payments made in the third year by more than $15,000.[66] (See the two-step calculation and examples 24.1 and 24.2 that follow.) This rule is intended generally to avoid disguising an upfront property settlement payment as a deductible payment of alimony and also to prevent individuals whose divorce occurs near the end of the year from making a property settlement payment disguised as an alimony payment at the beginning of the next year. Recapture is not required if either party dies or if the payee spouse remarries by the end of the calendar year, which is two years after the payments began and if the payments cease by reason of that event.[67] Also, the rule does not apply to temporary support payments or payments that fluctuate as a result of a continuing liability to pay, for at least three years, a

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[60] IRC Section 71(b)(2).

[61] IRC Section 71(b)(1)(C).

[62] IRC Section 71(b)(1)(D).

[63] *A.R. Zinsmeister*, 80 T.C.M. 774 (2000) *aff'd* CA-8 (unpublished opinion) 2001-2 USTC ¶ 50,717.

[64] IRC Section 71(b)(1)(B).

[65] IRC Section 71(f).

[66] IRC Section 71(f)(1).

[67] IRC Section 71(f)(5).

fixed portion or portions of income derived by the payer spouse from the earnings of a business, property, or services.[68]

A Two-Step Process to Determine "Excess Alimony Payments":

1. **Step One**: Compare the aggregate amount of alimony payments in the third post-separation year to the aggregate alimony payments made in the second post-separation year. If the payments in the second post-separation year exceed the aggregate payments in the third post-separation year by more than $15,000, the excess over $15,000 is subject to recapture in the third post-separation year.[69]

2. **Step Two**: Compare the aggregate amount of alimony payments made in the first post-separation year to the average of the aggregate amount of the non-excessive alimony payments made in the second post-separation year and the alimony payments made in the third post-separation year. If the payments in the first post-separation year exceed the average of the non-excessive payments in the second post-separation year plus the payments made in the third post-separation year by more than $15,000, the excess over $15,000 is subject to recapture in the third post-separation year.[70]

   Example 24.1. Assume the alimony payer makes payments of $50,000 in the first post-separation year, $20,000 in the second post-separation year, and nothing in the third post-separation year. As the payments are made in the first and second post-separation years, they are deducted by the payer and included in the income of the payee. In these years, no recapture calculation is made, and nothing is, in fact, recaptured. Recall the requirement that recapture of excess alimony works on a three-calendar-year basis.[71]

   In the third post-separation year, the test is made to determine if recapture is applicable. In the preceding example, recapture is applicable. Applying step one, the amount of the second post-separation year payment subject to recapture is $5,000. This is the amount by which the second post-separation year payment ($20,000) exceeds $15,000 plus the amount of the third post-separation year payment (zero).

   Applying step two (also in the third post-separation year), the recapture amount with respect to the payment made in the first post-separation year is $27,500. This is the amount by which the first post-separation year payment ($50,000) exceeds $15,000 plus the average of the non-recaptured payments made in the second and third post-separation years (that is, $7,500, representing the average of $15,000 [the amount of the second post-separation year payment not previously recaptured] and zero). Accordingly, $50,000 less $15,000 less $7,500 results in a recapture amount in the third post-separation year of $27,500.

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[68] IRC Section 71(f)(5)(C).

[69] IRC Section 71(f)(4).

[70] IRC Section 71(f)(3).

[71] IRC Section 71(f).

The result of the application of the alimony recapture rules as illustrated by this example is that out of $70,000 paid by the payer ($50,000 + $20,000), only $37,500 is deductible ($22,500 year 1 amount; $15,000 year 2 amount).

Example 24.2. Assume that Bill West makes alimony payments to his former wife, Jean West, of $50,000 in the first year and no payments in the second or third year. He must recapture $35,000, assuming none of the exceptions apply.

.02 Reduced Payments Geared to Contingency Involving a Child

If alimony payments are to be reduced on the happening of a contingency relating to a child, then an amount equal to the amount of the reduction will be treated from the outset as child support, rather than as alimony, and therefore not deductible.[72] For example, if alimony payments are to be reduced by $100 a month when a child reaches age 18, then $100 of each monthly payment from the commencement of the alimony payments will be treated instead as child support.

Other examples of contingencies relating to a child include the child marrying, dying, or leaving school.[73] The rule will also apply when payments are reduced at any time that can clearly be associated with such a contingency relating to the child.[74]

Temporary Regulation Section 1.71-1T Q&A-18 states that there are only two situations in which payments that would otherwise qualify as alimony will be presumed to be reduced "at a time clearly associated with the happening of a contingency relating to a child of the payer." The first situation is when the payments are to be reduced no more than 6 months before or after the date the child is to attain the age of 18, 21, or local age of majority. The second situation is when the payments are to be reduced on 2 or more occasions that occur not more than 1 year before or after a different child of the payer spouse attains a certain age (which must be the same age for each such child) between the ages of 18 and 24, inclusive. The presumptions created by the regulation are rebuttable.

In all other situations, reductions in alimony payments will not be treated as clearly associated with the happening of a contingency relating to a child of the payer, so that it is possible the parties will contest the distinction between claims of alimony and claims of child support.

Planning Pointer. A financial planner might be able to avoid the specific facts of the first of the two preceding situations and provide the payer client with a tax deduction for what are in substance child support payments.

Example 24.3. Assume that Donald McElroy proposes to pay Claire McElroy additional deductible alimony intended to be used by Claire for the eventual college education of their 14-year-old child, Nell. The divorce instrument could reduce alimony at a fixed time that occurs more than 6 months after Nell attains age 21, carefully avoiding any specific mention of Nell's age or needs. Claire might not use the added alimony, less the tax liability incurred, for the

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[72] IRC Section 71(c)(2).

[73] IRC Section 71(c)(2)(A).

[74] IRC Section 71(c)(2)(B).

intended purpose. In addition, Nell may not attend college. Donald must weigh these risks before providing extra alimony. If Donald finds the risks acceptable, the benefits of an income tax deduction to Donald might make the suggested approach attractive, assuming, of course, that the pre-TCJA law applied in this situation.

.03 Nonalimony Treatment by Agreement

The parties can agree to have payments not treated as alimony and, thus, as not taxable to the payee or deductible by the payer.[75] Such an agreement must be clear, unequivocal, and unambiguous.

Planning Pointer. In some cases, this rule may afford tax savings opportunities for the payee spouse. As a practical matter, the payee spouse would be required to share the savings with the payer spouse in the form of reduced payments. For example, assume that for the next two years, the payer spouse will have little or no taxable income, and the payee spouse will be in the 45% (combined federal and state) income tax bracket. If the payments are $1,000 a month and the parties choose nonalimony treatment, the payee spouse will save $10,800 ($24,000 × 45%) in taxes over two years. The payee spouse could share the savings with the payer to persuade the payer to agree to nonalimony treatment.

.04 Compliance

The payee must furnish the payer with his or her Social Security number, and the payer must furnish the name and Social Security number of the payee to the IRS,[76] subject in either case to a $50 penalty for failure to comply.[77]

.05 Divorce Trusts

A financial planner might have considered using an IRC Section 682 trust (before the 2019 law changes brought about by the TCJA) to address the alimony obligations between the parties.

Example 24.4. Assume that Pablo Estrada transfers income-producing property to an IRC Section 682 trust. The payments of income from the trust made to his former wife, Teresa Estrada, are taxable to her under the usual income taxation trust rules. Pablo may not deduct the payments to Teresa, but they are not taxable to him even though they might otherwise appear to be deemed taxable to him under the grantor trust rules of IRC Sections 671-677 because they are used to satisfy his support obligations. The trust gives Teresa a measure of security that she might be willing to pay for in terms of lower alimony payments because once the trust is funded, she will not have to rely on Pablo to make regular payments of alimony. If Pablo retains a reversionary interest or creates a remainder interest in the trust to take effect on termination of alimony obligations, the transfer of legal title may be regarded as temporary. If he retains a reversionary interest, the trust property will be includible in his gross estate under IRC Section 2037. If Pablo creates a remainder interest in a third party (such as a child), he might have a gift tax liability. If the reversionary interest is in favor of persons other than his estate, however, it

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[75] IRC Section 71(b)(1)(B) and Regulation Section 1.71-1T(b) Q-A-8.

[76] IRC Section 215(c) and Temporary Regulation Section 1.215-1T.

[77] IRC Section 6723.

will not be includible in his gross estate. If some of the income of the trust is used to pay for child support, rather than for the support of Teresa, the portion of the trust income used to pay for child support will be taxed to Pablo.

IRC Section 682 was repealed by the TCJA, effective beginning in 2019, so that trusts created in 2019 and later providing payments to satisfy a spouse's obligations in connection with divorce will be treated as grantor trusts, with all the income taxable to the grantor and not to the recipient spouse.

¶2430 Child Support

Child support payments are excluded from the gross income of the recipient[78] and are not deductible by the payer.[79] If payments called "alimony" are to be reduced on the happening of a contingency involving a child, a portion of the payments will not qualify as alimony and will be recharacterized as nondeductible child support (¶2425).[80] Child support payments should clearly state that they are in fact for the support of the child of the marriage. They should be fixed and determinative. If there is ambiguity regarding the intent of the payments, they will not be deemed for child support.

Prior to the TCJA, before the repeal of personal exemptions, special rules applied for claiming the exemption for a dependent child whose parents are divorced or separated. The parent having custody for the greater portion of the year was entitled to the exemption,[81] unless that parent waived the right to claim the exemption in a written declaration, and the noncustodial parent attached the declaration to his or her income tax return,[82]using Form 8332, "Release/Revocation of Release of Claim to Exemption for Child by Custodial Parent." The waiver could have been an annual decision or a long-term one. In some cases, the parents agreed to alternate the years in which they claimed the dependency exemption. The IRS has been very strict in requiring a signed Form 8332 to waive the dependency exemption and would not accept a copy of the divorce decree.

The test to determine which parent was entitled to claim the dependency exemption was based on the number of nights that the child resided with each parent. It was *not* determined by the amount of support contributed by each parent.

These rules applied to persons divorced or separated under a written separation agreement.[83] The parent claiming the child as a dependent for income tax purposes was responsible for providing health insurance for that dependent under the Affordable Care Act.

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[78] IRC Section 71(c)(1).

[79] Temporary Regulation Section 1.71-1T.

[80] IRC Section 71(c)(2); Biddle v. Commissioner, T.C. Memo 2020-39 (April 6, 2020)

[81] IRC Section 152(e)(1).

[82] IRC Section 152(e)(2).

[83] IRC Section 152(e)(1)(A).

The TCJA does not change the definition of *dependent* for all other situations in which claiming a dependent has tax consequences (such as the child tax credit, the dependent care credit, and so on).

Any agreement or decree dealing with child support should state the specific age of the child at which the obligation is to terminate, instead of using a general term such as the *age of majority*. Payments made to the child after the child reaches the age of majority might be considered gifts to the child, rather than a discharge of a support obligation.

The repeal of the personal exemptions may have significant consequences beyond the 2017 TCJA. Many matrimonial agreements were negotiated with the right to claim the personal exemption as a central issue. Now it has become an empty right and we may see instances in which the disadvantaged party attempts to seek a renegotiation of an agreement or relief from a court.

The IRS may seize an income tax refund to pay a parent's delinquent child support obligation.[84] If the parent files a joint return with a new spouse, the non-obligated spouse may file a claim as an injured spouse to avoid having the portion of the refund attributable to his or her income from being seized. To do so, the non-obligated spouse must write "injured spouse" in the upper left corner of Form 1040 and attach Form 8379, "Injured Spouse Allocation." The IRS will determine the amount of the refund to which the non-obligated spouse is entitled.[85]

.01 Medical Expense Deductions

A child's medical expenses are potentially deductible (subject to applicable AGI thresholds) by the parent who paid them, regardless of eligibility for dependent claims.[86]

.02 Disabled Individual

Qualification for a dependency exemption was determined without regard to any income received by a permanently and totally disabled individual for services performed at a sheltered workshop school operated by a charity or the government.[87]

.03 Trusts

Trusts for child support are not tax-favored because trust income used for support would be taxable to the settlor-parent under the grantor trust rules of IRC Section 677(b). The now-repealed IRC Section 682 (effective after 2018) only protected the trust grantor from income tax on payments to the divorced spouse, not for payments to or on behalf of a child.

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[84] IRC Sections 6305 and 6402(c) and Regulation Section 301.6305-1(b)(4)(iii).

[85] Revenue Ruling 80-7, 1980-1 CB 296.

[86] IRC Section 213(d)(5).

[87] IRC Section 151(c)(5).

¶2435 Property Settlements

Matrimonial settlements can include partition of co-owned property, property exchanges, and property settlements, either made independently of equitable distribution statutory provisions or under such provisions as noted in ¶2420. These transactions might have income, estate, and gift tax consequences. If the obligor files for bankruptcy, serious questions arise about dischargeability (see the discussion in Section 2435.04 that follows).

.01 Income Tax Aspects

A transfer of property between spouses incident to a divorce in settlement of their marital rights is a nontaxable transaction, subject to certain exceptions.[88] The transfer is treated in the same manner as a gift for income tax purposes, with the transferee receiving a carryover of the transferor's adjusted basis.[89] Tax-free treatment is accorded whether the transfer is for cash, property, relinquishment of marital rights, or other consideration. The party receiving the property does not get a basis adjustment even if he or she contributes consideration for the property, assumes liabilities, and so on. There is simply a carryover basis from the transferor to the transferee spouse. The parties generally have up to one year after a divorce to make the transfer.[90] Certain circumstances (such as uncertain business or property valuations) may permit a longer time to transfer the property and still qualify for the rules of IRC Section 1041. IRC Section 1041 does not apply if the transferee spouse is a nonresident alien.[91]

Annuity. A transferee of an annuity is taxed under the usual annuity rules[92] and recovers the transferor's investment in the contract,[93] notwithstanding that the annuity is transferred in discharge of a support obligation.

Life insurance. A transferee of a life insurance contract will not be taxed on the life insurance proceeds under the transfer for value rule.[94]

Series EE, and Series I bonds. IRC Section 1041 does not apply to Series EE, or I bonds. Thus, the transferor must include the deferred, accrued interest in gross income in the year of the transfer.[95] The transferee spouse takes the transferor's adjusted basis, which reflects the basis increase for the interest includible in the transferor's gross income. Note that the accrued interest on savings bonds is income

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[88] IRC Section 1041(a).

[89] IRC Section 1041(b).

[90] IRC Section 1041(c).

[91] IRC Section 1041(d).

[92] IRC Section 72.

[93] IRC Section 1041(b).

[94] IRC Sections 1041(b), 101(a)(1), and 101(a)(2)(A).

[95] Revenue Ruling 87-112, 1987-2 CB 207, IRC Section 454(c), and Regulation 1.454-1(a).

and is not protected from gain realization under IRC Section 1041, which is intended to apply to property transfers, not transfers of income.

Transfers to trusts. IRC Section 1041(a) does not apply to transfers to trusts of installment obligations and property with liabilities in excess of basis.[96] Such transfers are taxable to the transferor if there is any realization of gain. The transferee's adjusted basis is increased for any gain recognized by the transferor.

Planning Pointer. Property settlements generally do not trigger gain to the transferor. However, tax considerations can play an important role in the selection of the properties to be transferred because of the carryover basis rules.

Example 24.5. Assume that David is negotiating a property settlement incident to a divorce from his wife Sara. David owns stock of X Corporation worth $100,000 and having an adjusted basis of $20,000. David also owns stock of Y Corporation worth $100,000 and having an adjusted basis of $80,000. Assume that both spouses agree that each is entitled to $100,000 worth of stock. A transfer of the X stock would be highly advantageous to David because the X stock has a built-in gain of $80,000, and the Y stock David retains has a built-in gain of only $20,000. A more equitable approach would be for each spouse to take $50,000 worth of each of the two stocks.

The financial planner should pay close attention to this income tax basis issue. Receiving valuable property with a large built-in gain is certainly less valuable than originally believed if the property is sold by the transferee with a large capital gain to recognize, when the capital gain rate may be 20% for the taxpayer depending upon taxable income, and the 3.8% tax on net investment income may be applicable to the taxpayer depending upon AGI. The financial planner paying attention to the tax basis issue may be able to gain an advantage for the client through knowledge of the IRC Section 1041 basis rules.

Dividing properties with equal bases is not always possible. For example, spouse A might want, or be awarded, the residence, which might have a lower adjusted basis than property spouse B will receive. In such a case, the parties might agree to provide spouse A with additional property to compensate for the greater tax liability that will arise on a sale of the residence that spouse A will face versus a sale of the property received by spouse B. However, if a sale of the principal residence by spouse A would qualify for the $250,000 exclusion of gain under IRC Section 121, perhaps no adjustment would be warranted, or possibly an adjustment to spouse B would be appropriate. Thus, although the parties can select property for division without concern for immediate income tax consequences, the parties should carefully consider future income tax consequences — who will bear them and how much will be involved.

There are two special rules applicable to separated or divorced taxpayers selling a former principal residence,[97] namely,

1. if the selling spouse is holding property obtained from a spouse or former spouse that was transferred in a transaction qualifying under IRC Section 1041, the period of ownership for such

[96] IRC Section 1041(e).

[97] IRC Section 121(d)(3) as revised by the TCJA.

seller includes the period during which his or her spouse or former spouse owned the property,[98] and

2. if a spouse or former spouse is granted use of the home under a divorce instrument described in IRC Section 71(b)(2), (a decree of divorce or separate maintenance or a written separation agreement), such spouse's use of the property as his or her principal residence during the period of occupancy allowed by the divorce instrument is imputed to the other spouse.[99]

   Note: These provisions, imputing *principal residence* qualification to a spouse who has moved out of the residence (without relinquishing an ownership interest) while the remaining spouse is granted use of the principal residence under the divorce or separation instrument, allow the "out of the house" spouse to enjoy IRC Section 121 treatment on an eventual sale in situations such as when the remaining spouse and children are permitted to occupy the residence while the children attain majority and finish education.

   Example 24.6. H and W agree in their separation agreement to allow W to remain in their jointly owned home for five years until their child completes high school. Thereafter, the home will be sold, and the net proceeds divided equally between H and W. In this situation, W's use of the home during the five-year period will be attributed to H, so that both spouses will satisfy the use requirement for the IRC Section 121 exclusion upon the sale of the house. Both can therefore be deemed to be selling their principal residence, and each will then presumably qualify for the $250,000 income tax exclusion.

If the spouses own the residence jointly following the divorce and the spouse who used the home as a principal residence is required to share the proceeds from the sale with the other spouse, then each spouse will be taxed on half the gain realized on the sale, regardless of how much of the proceeds each person received, even if all the sale proceeds were allocated to one spouse.[100]

If the spouses own the residence as tenants in common after the divorce, and the spouse who uses the home as a principal residence is required to share the proceeds from the sale with the other spouse, then the other spouse will be taxed on gain attributable to the percentage interest he or she owns, regardless of how much of the proceeds are received.

If one spouse owns the residence in his or her own name after the divorce and uses the residence as a principal residence, then if that spouse is obligated to share the proceeds from the eventual sale of the home with the other spouse, any gain on the sale will be taxed to the owner spouse. The owner spouse may not claim a basis increase for any part of the proceeds paid to the other spouse.

Annulments or marriages treated as void from the beginning are considered as divorces for purposes of IRC Section 1041.[101]

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[98] IRC Section 121(d)(3)(A).

[99] IRC Section 121(d)(3)(B).

[100] *Rosen v. Commissioner*, 67 TCM 2082 (1994); *Ward v. Commissioner*, 44 TCM 1299 (1982).

[101] Temporary Regulation Section 1.1041-1T Q&A 8.

If a shareholder in an S corporation transfers stock in the S corporation to his or her spouse or former spouse incident to a divorce, any suspended losses due to the shareholder's insufficient adjusted basis in the S corporation's stock and debt are treated as having been incurred by the transferee.[102] The transferor recognizes no gain or loss on the transfer of the stock in the S corporation to his or her spouse or former spouse incident to a divorce.[103] IRC Sections 1041 and 1366(d)(2) apply to a transfer to a spouse, regardless of whether a divorce occurs.[104]

> **Example 24.7.** Harmon was a shareholder in Crown Wholesale, Inc., which is an S corporation. Harmon has $24,000 in suspended losses from the S corporation because the losses exceed his basis in his S corporation stock. Harmon and his wife Wanda are divorced. As a part of the divorce settlement, Harmon transfers his stock in Crown Wholesale, Inc. to Wanda. The law treats the $24,000 in suspended losses as having been incurred by Wanda, so that they are now available to be used by her.

The law does not specifically state what happens to suspended losses when a shareholder transfers some, but not all, the shares owned in an S corporation to a spouse or former spouse incident to a divorce. Shareholders of an S corporation take items of income, deduction, credit, and loss into account on a pro rata basis.[105] Therefore, allocating the suspended loss between the shareholder and the transferee based on the number of shares owned after the transfer would be a reasonable way to handle the suspended losses.

If a shareholder of an S corporation has enough basis to deduct a loss but does not have enough amount at risk, the shareholder may not deduct the loss.[106] The shareholder carries forward the loss indefinitely until the shareholder has enough amount at risk.[107]

Amendments to IRC Section 1366 did not state what happens to losses suspended because of insufficient amount at risk. Under prior law, if the taxpayer transferred his or her shares in a transaction in which the transferee determined his or her basis, in whole or in part, by reference to the adjusted basis of the transferor, the suspended loss due to the taxpayer's insufficient amount at risk was added to the transferee taxpayer's adjusted basis in the activity solely for the purpose of the transferee determining his or her adjusted basis.[108] In a transfer to a spouse or former spouse incident to a divorce, the transferee determines his or her adjusted basis in the shares by reference to the basis of the transferor.[109] A financial planner can reasonably assume that prior law still applies. Thus, the transferor's suspended loss

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[102] IRC Section 1366(d)(2).

[103] IRC Section 1041(a).

[104] Temporary Regulation Section 1.1041-1T Q&A 2.

[105] IRC Section 1366(a)(1).

[106] IRC Section 465(a)(1).

[107] IRC Section 465(a)(2).

[108] Proposed Regulation Section 1.465-67.

[109] IRC Section 1041(b).

due to insufficient amount at risk would be added to the transferee's adjusted basis in the shares of the S corporation.

If the suspended loss is a passive activity loss, the shareholder may deduct the loss only to the extent of passive income.[110] The shareholder carries over any losses allocated to the shareholder that the shareholder may not deduct in the current year.[111]

Amendments to IRC Section 1366 do not address what happens to losses suspended because of the passive activity loss rules when a shareholder in an S corporation transfers shares to a spouse or former spouse incident to a divorce. Assuming that the prior law continues to apply, the suspended disallowed passive loss would increase the adjusted basis of the stock in the hands of the transferor immediately before the transfer.[112] The increase in the basis of the stock in the hands of the transferor increases the basis of the transferee in a transfer to a spouse or former spouse incident to a divorce because the adjusted basis of the transferor becomes the adjusted basis of the transferee.[113]

If the transferor could not deduct the loss because of insufficient basis in the S corporation stock, the transferee must have sufficient basis in the S corporation stock and debt and sufficient amounts at risk to deduct the loss.[114] If the loss is a loss from a passive activity, the transferee will also need sufficient passive income to be able to deduct the otherwise suspended passive loss.[115]

.02 Estate Tax Aspects

In general, IRC Sections 2036–2038 and 2043, discussed at the beginning of this chapter in connection with prenuptial agreements, can also have a substantial impact on property settlements. The property settlement must be measured against the basic requisites for inclusion in a decedent's estate under the cited sections, which generally require a transfer of property with a retained interest by the transferor. If the transfer falls within one of these sections, then the financial planner must ask whether the transfer meets the exception to estate tax inclusion for bona fide sales or exchanges for adequate and full consideration in money and money's worth. If the transfer meets the exception, it will not be included in the decedent's gross estate. If the transfer is for a consideration in money or money's worth that is less than adequate and full, the amount included in the decedent's gross estate is the value at the time of death of the property transferred in excess of the consideration received.[116] Relinquishment of marital rights in the particular property or in the assets of the decedent's estate is not to be treated as

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[110] IRC Sections 469(a)(1) and (d)(1).

[111] IRC Section 469(b).

[112] IRC Section 469(j)(6).

[113] IRC Section 1041(b).

[114] IRC Sections 465(a)(1) and 1366(d).

[115] IRC Section 469(a)(1).

[116] IRC Section 2043(a).

consideration in money or money's worth unless the relinquishment complies with the requirements of IRC Section 2516 discussed in section 2435.03 that follows, or is made subject to court supervision.

In this connection, the distinction between marital property rights and support rights comes into play. A relinquishment of support rights is deemed to be consideration in money or money's worth to the extent of the value of the rights released. A relinquishment of marital rights or property rights is not deemed to be consideration in money or money's worth[117] unless it meets the requirements of IRC Section 2516.[118] If the transfer does not satisfy the IRC Section 2516 requirements, the parties may rely on a U.S. Supreme Court decision that ruled that a transfer of property in exchange for a release of marital property rights is deemed to be for full and adequate consideration when the exchange has been approved by, and made part of, a court decree.[119] The IRS says that to come within the boundaries of this decision, the court that approves the settlement must also have the power to change it.[120] The U.S. Court of Appeals for the Second Circuit has rejected this notion, holding that it was sufficient that the court merely had the power to approve it.[121]

.03 Gift Tax Aspects

IRC Section 2516 provides that transfers of property made under the terms of a written agreement between spouses in settlement of their marital or property rights incident to divorce are deemed to be for an adequate and full consideration in money or money's worth (and, thus, are exempt from gift tax), if the spouses obtain a final decree of divorce within the three-year period beginning on the date one year before the written settlement agreement is entered into. If the transfer is treated as a gift but is completed while the parties remain married, the unlimited gift tax marital deduction is available.[122]

.04 Bankruptcy of Obligor

Obligations for alimony or child support are not dischargeable in bankruptcy.[123] In addition, bankruptcy does not relieve a debtor of any nonsupport obligation to a spouse, former spouse, or child incurred in the course of a divorce or separation.[124]

.05 Redemption of Stock in a Closely Held Business

IRC Section 1041 regulations (1.1041-2) provide clear rules that someone must recognize taxable income on the distribution of funds in connection with a corporate stock redemption pursuant to a divorce.

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[117] IRC Section 2043(b)(1) and Revenue Ruling 68-379, 1968-2 CB 414.

[118] IRC Section 2043(b)(2).

[119] *C. Harris*, 340 U.S. 106 (1950).

[120] Revenue Ruling 60-160, 1960-1 CB 374.

[121] *D. Natchez*, 705 F.2d 671 (1983).

[122] IRC Section 2523(a).

[123] 11 USC 523(a)(5).

[124] 11 USC 523(a)(15).

The rule of Regulation 1.1041-2(a)(1) prevents the application of IRC Section 1041 to the spouse whose stock interest is redeemed (assume W). This provision applies when the other spouse (assume H) does *not* have a primary and unconditional obligation to purchase the stock of the redeeming spouse. When this is the case, the form of the stock redemption will be respected for income tax purposes, and IRC Section 1041 will not apply. In such a situation, the redeeming spouse (W) will be subject to the rules of IRC Section 302 applicable to distributions by a corporation in redemption of its stock, which could result in dividend income or capital gain.

Another rule of Regulation 1.1041-2(a)(2) applies the non-recognition rules of IRC Section 1041 to the redeeming spouse (W) and applies the constructive distribution rules to the other spouse (H). When the other spouse (H) has a primary and unconditional obligation to purchase the redeeming spouse's (W's) interest in the corporation, and the corporation furnishes the consideration for the redemption, the other spouse (H) will be deemed to have received the distribution from the corporation and then to have transferred the distribution to the redeeming spouse (W). Here, the redeeming spouse (W) will not be subject to income tax on the redemption, IRC Section 1041 will be applied, but the other spouse (H) will be subject to IRC Sections 301 and 302 to determine the tax consequences of the deemed distribution, which could result in dividend income or capital gain. The regulation provides that any property actually received by the redeeming spouse from the corporation in respect of the redeemed stock is first deemed to be transferred by the corporation to the other spouse in redemption of that spouse's stock and then transferred by that spouse to the redeeming spouse.

The key determination of whether one spouse has a primary and unconditional obligation to purchase the ownership interest of the other spouse is a question of fact. When this is established clearly in the divorce agreement, there will be no issue about the tax consequences. However, Regulation 1.1041-2(c) permits the parties to elect which of them will be subject to tax on the redemption. The parties may elect to have the redeeming spouse be subject to a redemption distribution or have the other spouse be subject to a constructive dividend distribution. This determination could turn on the respective tax brackets of the parties, or on other items included in the property settlement agreement.

Ideally, a number of planning opportunities arise here because the agreement about the tax consequences can be separate from the divorce agreement. It can be executed as late as the timely filing due date, including extensions, of the tax return of the spouse recognizing the distribution for the tax year that includes the date of the stock redemption.[125] This gives the parties the opportunity to address the tax benefits and burdens to each party. Less than ideally, these regulations require the spouses to be aware of this potential tax issue and address it through negotiations about which of them will be subject to taxation — something that may be a great deal to expect in the context of a divorce.

Planning Pointer. To avoid some of the uncertainty surrounding the tax treatment of divorce-related stock redemptions, consider having one spouse purchase the stock held by the other spouse directly. (Avoid an actual corporate redemption.) Under IRC Section 1041, the selling (transferor) spouse will recognize no gain. The purchasing (transferee) spouse acquires the seller's basis in the shares, and any gain is deferred until the stock is sold. When they determine the purchase price for the shares, the parties can take into account the eventual tax consequences to the purchasing spouse, and make other property transfer adjustments, if appropriate.

[125] Regulation Section 1.1041-2(c)(3).

¶2440 Legal Expenses

A person generally cannot deduct his or her personal legal expenses, or those of a spouse, incurred to obtain a divorce because these expenses are considered to be nondeductible personal expenses.[126] Prior to the TCJA, however, an individual could deduct the fees paid for personal tax advice[127] incident to the divorce only as miscellaneous itemized deductions[128] subject to the 2% of AGI floor.[129] The TCJA repealed the deduction for miscellaneous itemized deductions effective beginning in 2018. If the tax advice relates to a business, the fees for such tax advice would be deductible in arriving at AGI[130] as a business expense.[131] Case law and IRS revenue rulings which permitted various methods to gain the benefit of the miscellaneous itemized deductions are no longer relevant, at least until the end of 2025, when this aspect of the TCJA is scheduled to sunset.

¶2445 Division of Retirement Benefits

The IRC permits qualified retirement plan and IRC Section 403(b) annuity benefits to be transferred for the purpose of meeting alimony, property division, and child support obligations, provided the transfers are pursuant to a qualified domestic relations order (QDRO).[132]

A QDRO is an order, judgment, or decree that relates to child support, alimony, or property rights of a spouse or former spouse, child, or dependent of the participant made pursuant to a state domestic relations law.[133]

The order must clearly specify the amount or percentage of the participant's retirement plan benefits to be paid to the "alternate payee" (a spouse or child, other than the participant) and the number of payments or the period for which the payments are to be made.[134]

For income tax purposes, the basic rule is that if the alternate payee is the spouse of the participant, the spouse is treated as a distributee of plan benefits, and accordingly, taxed on the income.[135] Payments to

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[126] IRC Section 262(a).

[127] IRC Section 212.

[128] IRC Section 67(b).

[129] IRC Section 67(a).

[130] IRC Section 62(a)(1).

[131] IRC Section 162(a).

[132] IRC Sections 401(a)(13)(B), 402(e)(1), and 414(p).

[133] IRC Section 414(p).

[134] IRC Section 414(p)(2).

[135] IRC Sections 72(m)(10) and 402(e).

an alternate payee under a QDRO before the plan participant attains age 59½ are not subject to the 10% additional excise tax that might otherwise apply.[136]

Payments made to a child as an alternate payee are taxable to the plan participant for income tax purposes.

Special rules apply for certain distributions to alternate payees who are spouses or former spouses of the participant. In particular, if a distribution of the plan balance to the credit of the participant would constitute a lump-sum distribution, then a distribution of the plan balance to the credit of the alternative payee also constitutes a lump-sum distribution.

Any portion of a total distribution to a spouse as the alternate payee may be rolled over by such spouse tax-free to a traditional IRA. Amounts not rolled over are taxed to the payee under the annuities rules of IRC Section 72.

The transfer of an IRA to a spouse pursuant to a divorce decree or a written instrument incident to a divorce is not a taxable transfer by the transferor.[137]

Transfers of interests in an IRA to a spouse or former spouse are treated as nontaxable transfers, provided that the transfer is pursuant to a decree of divorce or separate maintenance or a written instrument incident to such a decree.[138] Note that a transfer in accordance with a written separation agreement is *not* sufficient to achieve a nontaxable transfer of an IRA.[139] Once transferred under a divorce or separation agreement, the participant's interest in the IRA is treated as owned by, and taxable to, the transferee spouse.[140] When one spouse takes a distribution from an IRA and pays it to the other spouse pursuant to a divorce, such a transfer has been held to not constitute the transfer of an "interest" in the IRA, so that the withdrawal is taxable to the IRA owner, the transferor.[141] (One must transfer an interest in an IRA itself, not just the proceeds, to shift the tax burden).[142]

Planning Pointer. In order to avoid income taxation on the transferor when some, but not all, of the value of the IRA must be transferred, consider dividing one large IRA into two or more smaller ones and then transferring the entire interest in one or more IRAs to satisfy the transferor's obligation to the transferee spouse. Make certain that the transfer occurs after the divorce is final in order to avoid being "caught" in the written separation agreement versus final decree controversy.

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[136] IRC Section 72(t)(2)(C).

[137] IRC Section 408(d)(6).

[138] IRC Section 71(b)(2)(A).

[139] FSA 199935005; PLR 9344027.

[140] IRC Section 408(d)(6); Regulation 1.408-4(g)(1).

[141] *Bunney v. Commissioner*, 114 TC 259 (2000); *Kirkpatrick v. Commissioner*, T.C. Memo 2018-20.

[142] *Czepiel v. Commissioner*, TC Memo 1999-289; *aff'd* 86 AFTR2d 2000-7304 (1st Cir. 2000); *Rosenberg v. Commissioner*, T.C. Memo 2019-24.

Planning Pointer. A divorce may occur wherein there is no QDRO, but simply an agreement by the nonparticipant spouse to relinquish his or her interest in the participant's retirement plan. It is imperative that the participant spouse immediately change the plan beneficiary from the divorced spouse to another desired beneficiary. Failure to do so will leave the divorced spouse as the designated plan beneficiary. In the event of the death of the participant spouse, the divorced spouse will be awarded the plan proceeds, notwithstanding the agreement to relinquish the plan benefits. The person named as beneficiary in the plan documents is the person who receives the benefits.[143]

¶2450 Income Tax Return Filing Alternatives

In the context of divorce, the filing status of an individual is subject to a number of rules that will determine which filing status may or may not be available.

.01 Married Filing Jointly

A joint return may be filed only by those taxpayers who are married at the close of a tax year.[144] Taxpayers living together in a common law marriage that is recognized by the state law of their domicile or the state where the marriage began are treated as married.[145] Taxpayers are not considered to be married when they are legally separated under a decree of divorce or separate maintenance.[146] A joint return may be filed by married persons living apart from each other, so long as they are not legally separated.[147]

Joint return filing subjects both filers to joint and several liability for all taxes, interest, and penalties due in connection with the return, regardless of each spouse's share of the taxable income. Spouses unsure of the other spouse's veracity may choose to file as married filing separately to avoid participating in a joint return and possibly incurring liability. The IRS may attempt to collect all of any balance due from either spouse, notwithstanding any agreement between the spouses about who will be responsible for IRS obligations.[148] The collection efforts and success of the IRS with one taxpayer must be disclosed to the other taxpayer. In the context of an impending divorce, the parties should be cautious when taking the risk of subjecting themselves to a joint liability that may be difficult to resolve in the future when their lives and assets have become separated. Signing returns and receiving and disposing of refunds

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[143] *Kennedy v. Plan Administrator for DuPont Savings & Investment Plan*, 555 U.S. 285 (2009).

[144] IRC Section 6013(a).

[145] Revenue Ruling 58-66, 1958-1 CB 60.

[146] IRC Section 6013(d)(2).

[147] Regulation 1.6013-4(a).

[148] IRC Section 6013(d)(3); *Pesch v. Commissioner*, 78 TC 100 (1982).

may also pose practical problems. The filing of a joint return does not have the effect of converting the income of one spouse into the income of the other.[149]

Joint return filing precludes deducting a payment to the recipient as alimony and permits the recipient to not include the payment as income.[150] The parties should evaluate their relative marginal tax brackets to determine the advantages and disadvantages of inclusion and deduction in the absence of a joint return versus a joint return filing. For divorces that occur after 2018, alimony will no longer be deductible by the payer or includable in income by the recipient as the result of the changes made by the TCJA.

A spouse who believes the other joint filing spouse has understated income or otherwise misrepresented items on the joint return may file for innocent spouse relief by filing Form 8857. The form should be filed as soon as the "innocent" spouse is aware of a problem, but in any event, not more than two years after an IRS Notice trying to collect tax from an innocent spouse. In these situations, the spouse must be truly "innocent" to win the sympathy of the IRS. There are many cases denying relief to a spouse who claims to be innocent, but who lived a lifestyle well beyond the income reported on a joint tax return. Where this is the case, the IRS may deny relief on the basis that the spouse should have known there was more income based on the lifestyle being enjoyed.

.02 Married Filing Separately

If persons are legally married and do not file a joint return, and if neither of them qualifies as unmarried, each of the spouses must file a separate return and use the married filing separately tax rates.[151] This filing status becomes more costly to the parties as the disparity in their incomes increases. Spouses who file their returns as married filing separately are not responsible for the tax liabilities of the other spouse.[152] A spouse who makes an alimony payment prior to divorce must file a separate return to deduct the alimony payments made during the year, assuming the divorce occurred before 2019, so that the alimony payment would be deductible.[153] If one spouse filing as married filing separately itemizes deductions, the other must do so as well, unless the non-itemizer qualifies for head-of-household status, in which case, the standard deduction may be claimed. When separate returns are filed, each spouse is entitled to deduct the state income tax, property tax, and mortgage interest that he or she alone paid. If a casualty loss is suffered on property owned jointly, each spouse can deduct half the loss. Neither may deduct the entire loss.[154] Beginning in 2018, deductions for state and local tax payments are capped at $10,000 per year ($5,000 for each spouse filing as married filing separately), the mortgage interest deduction can be claimed only on post-December 15, 2017 qualifying debt of up to $750,000 ($375,000 for each spouse filing as married filing separately), and casualty losses can be claimed only if there is a presidentially declared disaster, all as a result of the TCJA.

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[149] *Dolan v. Commissioner*, 44 TC 420 (1965).

[150] IRC Section 71(e).

[151] IRC Section 1(d).

[152] IRC Section 6013(d)(3).

[153] IRC Sections 71(e) and 215.

[154] IRS Publication 504.

.03 Head of Household

A taxpayer who is unmarried must file either as an unmarried (single) individual or as a head of household. Persons filing as head of household are subject to tax rates that are lower than those paid by single taxpayers and by married persons filing separately, but higher than those imposed upon filers of joint returns. The persons eligible to file as head of household are generally divorced or single parents or persons who are still legally married but who are separated and awaiting a final divorce determination and who have minor children or an adult child in care at home. In addition to the advantage of lower marginal rates than single filers, the head-of-household filer is allowed to claim a larger standard deduction than single filers or married persons filing separately. The head-of-household filer is permitted to either itemize or claim the standard deduction, regardless of what his or her spouse elects to do.[155] A person filing as head of household may be able to claim earned income credits and child care credits unavailable on the return of a married person filing separately.

In order to claim head-of-household status, the person must be a U.S. citizen or resident for the entire year and must be considered not married or be living apart from a spouse on the last day of his or her taxable year.[156] This will result if he or she

- is single or legally divorced or separated under a decree of divorce or separation;
- is married but lives apart from his or her spouse during the last six months of the taxable year; or
- files a separate tax return, and the taxpayer maintains a household (that is, furnishes over half the cost of the household) during the entire taxable year that was the principal place of abode of a child (for whom the taxpayer is entitled to claim a dependency deduction, even if the right to actually claim the deduction has been transferred to the other spouse) for more than one-half of the taxable year.[157]

The taxpayer must furnish over half the cost of maintaining the household for the year, and a "qualifying person" (for example, an unmarried child, grandchild, foster child, or adopted child, who need not be the taxpayer's dependent) must have lived with the taxpayer for more than one-half of the year. If the taxpayer receives alimony payments from his or her spouse and uses such payments to maintain the household, the taxpayer spouse (the alimony recipient), not the alimony payer spouse, will be considered as having furnished this amount. The costs of maintaining the home include such items as rent, mortgage interest, property taxes, utility charges, maintenance and repairs, property insurance, and food. Items such as education expenses, clothing, vacations, medical expenses, life insurance, and transportation are not included as such home maintenance costs.[158]

The taxpayer claiming head-of-household status is not required to have legal custody of a child to be eligible to claim this filing status. Nevertheless, the time spent by a child at the parent's home is relevant

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[155] IRC Sections 63(c)(2)(B), 63(c)(6) and 63(g).

[156] IRC Sections 2(b)(1) and 7703(b); Regulation 1.2-2(b)(1).

[157] IRC Sections 2(b)(1), (c), and 7703(b).

[158] Regulation Section 1.2-2(d).

to determine whether such home constitutes the principal residence of the child for more than one-half of the taxable year. It is helpful for the parent seeking to claim or maintain head-of-household status to maintain a log indicating the presence of the child in the parent's residence. Temporary absences may be relevant in making this determination but should not be an issue when they are routine and not an indication of another place of permanent residence of the child.[159]

Note that the manner in which payments are made by one spouse to, or on behalf of, another may affect the ability of the payee spouse to claim head-of-household status. In light of the requirement that a person must furnish more than one-half of the cost of maintaining the household, consider having the payer spouse pay housing costs directly to the payee as either alimony or child support payments. This will enable the payee to pay such costs and count them as household expense payments. If the payer pays such expenses directly to third parties, these costs may not be added to the payee's costs of maintaining the household and could jeopardize the claim for head-of-household status.

The TCJA increased the burden on a tax preparer to exercise due diligence to verify the circumstances when a client is making a claim of head-of-household status on his or her income tax return.

[159] Regulation Section 1.2-2(c)(1).

Chapter 25

Planning for Same-Sex and Unmarried Couples

¶2501 Overview

In recent years, living together outside of marriage and domestic partnerships has become increasingly common. Alternatively, couples have entered into same-sex marriages, now legal throughout the United States as the result of the Supreme Court decision in *Obergefell v. Hodges*, 135 S.Ct. 2584 (2015) (June 26, 2015), and in jurisdictions outside the United States that permit such marriages. Financial planners must focus on the special challenges that unmarried relationships create in order to develop a successful plan for the client. Individuals involved in such arrangements are very concerned about their rights and asserting such rights at the times of death, separation, disability, and retirement. Married persons of the same sex now enjoy the full protection of the law. This is not necessarily the case when unmarried persons cohabit in a relationship.

The decision of the United States Supreme Court in *Windsor v. United States*, 570 U.S. 12 (June 26, 2013), holding that legally married persons of the same sex are entitled to receive the same federal law rights and obligations (including tax benefits and rules) as married persons of opposite sex, has resulted in the favorable rules discussed in this chapter to be applicable to many persons not previously affected by them. The *Windsor* holding was expanded to all same-sex marriages in the United States on June 26, 2015, when the United States Supreme Court issued its opinion in *Obergefell v. Hodges*, 135 S.Ct. 2584 (2015). The court held that same-sex married couples are entitled to equal protection under the laws and that their marriages must be recognized nationwide. State laws prohibiting same-sex marriages were declared invalid as unconstitutional. The *Obergefell* opinion resolved the following important issues:

- The 14th Amendment requires states to issue marriage licenses to individuals of the same gender.
- The 14th Amendment requires states to formally recognize same-sex marriages of that state's residents, when those residents entered into a same-sex marriage in another state where the marriage was legally valid.

Writing for the court, Justice Kennedy declared that:

> The right of same-sex couples to marry that is part of the liberty promised by the 14th Amendment is derived, too, from that Amendment's guarantee of the equal protection of the laws. It is now clear that the challenged laws burden the liberty of same-sex couples, and it must be further acknowledged that they abridge central precepts of equality. Here the marriage laws enforced by the respondents [i.e. states where same-sex marriage was not legal] are in essence

> unequal: same-sex couples are denied all the benefits afforded to opposite-sex couples and are barred from exercising a fundamental right. The Equal Protection Clause, like the Due Process Clause, prohibits this unjustified infringement of the fundamental right to marry.

The court further declared that there is no lawful basis for a state to refuse to recognize a lawful same-sex marriage performed in another state on the ground of that marriage's same-sex character.

¶2505 Married and Unmarried Couples

Each relationship has its special issues, and financial strategies that may be appropriate for one relationship may not be appropriate for another. For instance, the needs of a retired, unmarried couple living together differ considerably from a young couple living together. The older couple may be concerned about the loss of Social Security benefits, negotiating a marital agreement, addressing long-term care decisions, and dealing with family problems brought on by a possible remarriage.

.01 Role of the Financial Planner

The financial planner should take an active role in obtaining information from the unmarried couples clients in the same manner that the planner obtains such information from traditional married couples or from singles that live alone. As in the case of planning for married couples, the financial planner may want to interview both parties in the non-marital situation. Each of the parties may or may not want to have separate attorneys advising them about their respective rights. At a minimum, the financial planner should provide full disclosure of potential conflicts of interest.

.02 Legal Background

Every jurisdiction has extensive laws governing the marital relationship. However, until recently, few states had laws governing the rights and responsibilities of couples in nontraditional relationships, with the exception of those states that recognize common law marriages. Moreover, even in those states, simply living together does not mean the couple has a common law marriage. Couples must satisfy state law requirements regarding residence and holding themselves out to the public as married.

In specific instances, so-called palimony cases have imposed obligations on unmarried couples terminating relationships. The common law of contracts, rather than statutes, is the foundation for these cases. One party asserts a claim for support from the other party in return for having provided care, services or some other form of consideration.

A number of states (Colorado, Hawaii, Illinois, New Jersey, Oregon, and Wisconsin) have enacted legislation that permits same-sex couples (and, in some cases, opposite-sex couples) to enter into civil unions or domestic partnerships. Civil unions typically confer the same rights and responsibilities as marriage for state law purposes, whereas domestic partners may have equal or lesser rights than traditionally recognized married couples. Rhode Island and Vermont converted all civil unions to legal marriages. California, Nevada, and the District of Columbia offer domestic partnerships that include nearly all the rights and responsibilities of marriage.

The Supreme Court decision in *Obergefell* makes same-sex marriage a constitutional right, so state laws to the contrary are overturned, and it is not necessary for a state to enact legislation to permit same-sex marriages specifically now that it is a federally protected right.

Same-sex marriage became legal in Canada on July 20, 2005, with the enactment of the Civil Marriage Act (Bill C-38). Same-sex marriage was already legal in many of the provinces based on court decisions. Same-sex marriage is also legal in a number of countries around the world, with many more being added to this list each year. Countries allowing same-sex marriage now include Argentina, Australia, Austria, Belgium, Brazil, Canada, Colombia, Costa Rica, Denmark, Ecuador, Finland, France, Germany, Greenland, Iceland, Ireland, Luxembourg, Malta, Mexico, the Netherlands, New Zealand, Norway, Portugal, South Africa, Spain, Sweden, the United Kingdom, the United States, and Uruguay. It is also legal in parts of Mexico and other parts of the world. Some countries recognize same-sex marriages performed elsewhere (Israel). Other countries are considering legalization of same-sex marriages.

The legal rights of unmarried same-sex couples may vary depending on state law. Some state domestic partnership laws confer inheritance rights on domestic partners, whereas others do not. Civil unions generally provide for inheritance rights and state tax benefits equivalent to those for spouses. However, there is a catch.

Under the federal Defense of Marriage Act (P.L. 104-199) (DOMA),[1] signed into law by President Clinton, the federal government did not recognize same-sex marriages, and states did not have to recognize same-sex relationships formed in other states, despite the full faith and credit clause of the U.S. Constitution. In addition, 31 states passed constitutional amendments or enacted "mini-DOMA" laws barring state recognition of same-sex relationships.

Currently, those states that have enacted civil union or domestic partnership legislation recognize civil unions or domestic partnerships entered into elsewhere. Even after *Obergefell*, persons whose relationships are characterized as civil unions or domestic partnerships are not considered legally married, so they may not be treated as married persons for federal law purposes. A same-sex married couple will now be entitled to file a joint tax return for both federal and state income tax purposes, whereas prior to *Obergefell* they may have been denied married filing status if they resided in a state that did not recognize same-sex marriages. *Obergefell* ended that distinction.

.03 Wills and Intestacy

A surviving marital or civil union partner (whether same- or opposite sex) generally has no automatic rights to property owned by a deceased partner. As a result, a decedent must transfer property to the partner by will, trust, lifetime gift, or joint ownership. Moreover, property acquired by one partner (absent a legal marriage) on the other partner's death, whether by will, trust, or inheritance rights, may be subject to federal estate tax. The surviving spouse of a legally married same-sex couple will be able to take advantage of portability of the unused estate tax exemption amount of his or her deceased spouse, in the same manner as an opposite-sex couple (see chapter 37, "Portability, An Estate Planning Game Changer," for a discussion of portability).[2]

After *Obergefell*, all states that have a statute providing for a spousal election against the will of a deceased spouse must extend this right of election to all married persons.

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[1] 1 USC 7.

[2] IRC Section 2056(a).

Note: The tax treatment of property acquired by a partner for state law purposes will depend on whether the partners entered into a domestic partnership, civil union, or marriage. For example, New Jersey's estate tax law generally provides that property is treated the same for state law purposes as it is for federal estate tax purposes. However, an exception applies for partners in a civil union: Property passing from the deceased partner to the surviving partner of a civil union is entitled to an unlimited marital deduction for state tax purposes, even though no marital deduction is allowed for civil union participants for federal tax purposes.

Because a testator may revoke a will provision at any time before death, a provision in a will might not be entirely satisfactory to the partner-beneficiary.

Property that unmarried partners held as joint tenants with right of survivorship will pass to the surviving partner by operation of law. However, property held by such persons as joint tenants with right of survivorship will be included in full in the decedent's gross estate, unless the survivor can prove that the property belonged to the survivor or the survivor acquired the property for adequate consideration in money or money's worth because the surviving unmarried partner is not recognized as a "surviving spouse" under federal law.[3]

Unless the partners have entered into a domestic partnership, civil union, or marriage, the partners can easily terminate the relationship at any time. Therefore, the testator might want to provide that a bequest or devise is effective only if the parties are living together at the time of the testator's death. Similarly, if the testator nominates the partner as a fiduciary (executor or trustee), the testator might want to provide that the nomination is contingent upon the parties living together at the date of the testator's death. The testator should nominate a contingent fiduciary in the event the parties are not living together at that time.

.04 Lifetime Arrangements

A revocable trust can be an effective financial and estate planning tool in situations involving unmarried couples. If the partner is a beneficiary of the trust, the partner can enjoy benefits currently and receive the property in the trust upon the grantor's death. The grantor maintains control of the property and its disposition and can revoke the trust at any time. The grantor could use an irrevocable trust, but then the grantor might want the partner's enjoyment conditioned on the parties' continued relationship. In that event, the trust would have to provide for an alternative beneficiary. Gift tax considerations may arise here. Accordingly, the irrevocable trust is probably not a useful planning device in a non-formalized relationship.

Other forms of lifetime arrangements include outright gifts and the creation of co-ownership interests in property. These transfers involve potential federal gift tax liability. If one partner owns property or purchases property and then conveys title of the property to each partner as joint tenants, the donor has made a taxable gift equal to half the value of the property.[4] However, the donor may reduce or avoid the

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[3] IRC Section 2040(a).

[4] Regulation Section 25.2511-1(h)(5).

gift tax by the use of the annual gift tax exclusion[5] and the applicable gift tax lifetime exclusion amount.[6] An unmarried partner may not transfer an unlimited amount of property to the other partner free of federal gift tax as can a married couple.[7]

Planning Pointer. With the federal gift tax lifetime exclusion at $11.58 million for a donor in 2020, indexed annually for inflation, this is an ideal time for all persons, and especially those unmarried couples, to make gifts to the persons they care about and wish to benefit. Significant amounts of property and wealth can pass without transfer tax. With this level of exemption, concerns about the unavailability of the unlimited marital deduction for persons not legally married should not be a factor for most persons.

Co-ownership of property can either be designated as joint tenants with right of survivorship or as tenants in common. *Joint tenants with right of survivorship* means that upon the death of one joint tenant, the property goes to the survivor. With respect to bank accounts, the joint owner can withdraw the funds at any time (¶315.01). The creation of a joint bank account does not result in any gift tax because the gift is not complete (the creator of the account can revoke the transfer by withdrawing the funds) until the recipient withdraws the funds.[8]

Life insurance may be useful in several respects. It provides a benefit to the partner at a modest cost and is a transfer outside of probate. To avoid estate and gift tax on the life insurance, the financial planner could suggest that the client create an irrevocable life insurance trust or have the beneficiary be the owner of a new policy.

The partner could also be designated as the beneficiary of IRAs and qualified retirement plans. The value of IRAs and retirement plans will be included in the decedent's gross estate.[9] In addition, the beneficiary will be subject to income tax on distributed amounts as income in respect of a decedent.[10] Under long-standing rules, a non-spouse beneficiary of an IRA is not required to receive an immediate lump-sum distribution. Instead, the beneficiary can defer tax under the minimum distribution rules for inherited IRAs. However, unlike a spouse, a partner cannot roll the decedent's IRA into his or her own IRA.[11] The plan beneficiary will be subject to the 10-year required minimum distribution (RMD) withdrawal requirement as the result of the SECURE Act. In the case of a non-spouse beneficiary of an employer-sponsored qualified retirement plan, the plan may require a lump-sum distribution. If not, the law permits IRA rollovers of qualified plan benefits by non-spouse beneficiaries. The IRA receiving the

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[5] IRC Section 2503(b).

[6] IRC Sections 2505(a) and 2010.

[7] IRC Section 2523(a).

[8] Regulation Section 25.2511-1(h)(4).

[9] IRC Section 2031(a).

[10] IRC Section 691(a).

[11] IRC Section 401(a)(9); IRC Section 408(d)(3)(c).

rollover is treated as an inherited IRA.[12] To achieve this result, the rollover must be made as a trustee-to-trustee rollover. No check should be sent to the beneficiary prior to the rollover.

Planning Pointer. Situations sometimes arise in which family members who object to a same-sex or other partnership relationship attempt to block inheritances left to a decedent's partner on the grounds that the survivor is not a family member or part of a legally acknowledged relationship. If the surviving partner's only inheritance is through a will, family members of the decedent may try to argue undue influence or lack of capacity and seek to have the will voided, resulting in the decedent's property passing by intestacy. The laws of intestacy recognize family relationships, not partner relationships, so this could be a way for family members to attempt to defeat a partner's opportunity to be an heir. Marriage will protect an heir's relationship; other partner relationship statuses generally will not. The financial planner may suggest that various lifetime transfers be adopted so that less property is left to pass by a will. The use of revocable trusts, retirement plans, and life insurance policy beneficiary designations can accomplish this end. The person in control of property is not giving it up and can change designations, if appropriate, but if a death occurs and these designations are in place, it will be much harder for other family members to challenge their validity.

.05 Children

The existence of children complicates the problems of couples living together outside of marriage. The parent, whether natural or adoptive, may want to make provisions for children. The financial and estate planning process will be more complex if the children are from a prior relationship.

The legal problems of parenting can be acute when the relationship between the parents dissolves. For instance, when a couple breaks up, is a non-biological parent entitled to visitation or even custody of the children? Courts and legislatures will have to contend with the handling of these matters with a view to redefining the term *parent* so as not to deny rights to one who acted as a de facto parent. Technical advances in the fields of in vitro fertilization and artificial insemination pose additional complicating factors if the donors and surrogates assert rights to the children.

The U.S. Supreme Court ruled that a Washington state court erred when it granted extensive visitation rights to a child's paternal grandparents over the objections of the child's mother.[13] The Supreme Court noted that the state of Washington's statute allowing anyone to petition for visitation rights at any time was "breathtakingly broad." The court did not address the issue of whether all non-parental visitation laws had to show harm or potential harm to a child to satisfy a parent's constitutional rights. Although this decision does not nullify state laws granting visitation rights to third parties, it might influence decisions involving custody and visitation claims of third parties. This decision adds even more weight to the need for careful planning for couples who live together with children of which only one partner is a legal parent.

The financial planner can suggest having wills prepared that name guardians of minor children to protect the interests of the child and the non-biological parent, especially if there are concerns that other family members who may object to the relationship between the partners may try to interfere if there is a death

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[12] IRC Section 402(c)(11).

[13] *Troxel et vir. v. Granville*, 527 U.S. 1069 (1999), *aff'g* 137 Wash. 2d 1, 969 P.2d 21.

of a partner and a surviving minor child. Consider the possibility of having the non-biological parent legally adopt the child.

.06 Agreement Between the Parties

Partners who live together may want to sign a written agreement that sets forth their respective rights and obligations. The agreement could include provisions relating to household, vacation, and other living expenses, as well as ownership of cars, furniture, and household assets. The agreement could be more extensive and include matters usually covered in a marital agreement. The purpose of such an agreement would be to avoid the expensive litigation encountered in a palimony suit and possibly provide protection from claims of disapproving family members as discussed previously. Such an agreement is sometimes referred to as a *cohabitation agreement*. The essential elements to address in a cohabitation agreement are as follows:

- Both parties should have separate counsel.
- Describe how the party with fewer assets will (or will not) be made whole in the event the relationship ends.
- Address custody of pets.
- Each party should be protected against the other person's debts.
- Determine whether the parties will serve as the health care proxy for each other and who will have power of attorney.
- Decide who gets which assets in the event of a break-up or death.
- Make appropriate revisions in the wills or trusts used for estate planning to be consistent with the agreement.
- Consider designated beneficiaries of life insurance policies and retirement plans to be consistent with the agreement.
- Make full disclosure of each party's assets.

In those states that recognize same-sex domestic partnerships or civil unions, state law confers certain rights and obligations on the partners. However, those rights and obligations may not be recognized by other states. Moreover, private agreements between unmarried partners may not be recognized under state law. For example, the state of Virginia prohibits private contracts that confer marital benefits on same-sex partners and denies recognition to marital contractual arrangements entered into in other states. *Obergefell* will eliminate this issue where persons are married, but not if they are unmarried. Therefore, financial planners should carefully research state law when planning for unmarried partners. Note also that evolving court decisions, societal standards, and attitudes may suggest changes in these laws as time goes on.

.07 Powers of Attorney and Health Care Directives

Partners might want to execute durable powers of attorney that give the other partner the power to act on his or her behalf in the event of the individual's incapacity. A divorce usually terminates a durable power

of attorney in which the spouse is the attorney-in-fact. However, the power would not automatically terminate when a relationship ends if an unmarried partner serves as the attorney-in-fact. Making the power of attorney contingent upon the couple's living together at the time of its exercise might seem wise. However, third parties would not want to investigate the living status of the couple before relying on the power. Thus, a better strategy is to actually revoke the power upon a separation. The unmarried principal should also name a successor or contingent attorney-in-fact in case the partner is unable or unwilling to serve.

Financial planners should alert partners to the need for preparing for medical emergencies and incapacity. Advise the couple about the need for living wills, durable powers of attorney for health care, and health care proxies (¶2905). This can be a particularly important issue when there is no established legal relationship between persons who, nevertheless, live as partners. The well partner will not be able to make decisions on behalf of an ill partner absent an appropriate health care proxy and directive, which may result in the wishes of the parties not being met. Situations have existed in which only family is allowed to visit, be advised of health conditions, and so on, and the partner may not be classified as a member of the "family" in these circumstances. It is imperative that the partners address these issues (if they wish to do so) with appropriate written documents before any unfortunate circumstances occur.

In states that recognize domestic partnerships or civil unions, one partner may have the legal right to make medical decisions when the other partner becomes incapacitated. However, those rights may not be recognized by other states absent a medical power of attorney or health care directive. *Obergefell* resolved the medical directive issue for persons who are married — all spouses, regardless of sex, now have spouses' rights of visitation, information, and so on. There is no longer an issue regarding whether a spouse — same or opposite sex — is a "family member," as may have arisen before the *Obergefell* decision.

.08 What If the Couple Separates?

Financial planners should advise unmarried couples to consider how they would divide their property upon a separation. Married couples are subject to the divorce laws; unmarried couples are not. If the couple maintains separate ownership of various items of property, the division of property upon separation should be relatively easy. Each partner would take his or her own property. However, if the couple owns property as joint tenants with the right of survivorship or as tenants in common, the division of property on separation becomes more problematic. The laws describing "equitable distributions" do not necessarily apply to unmarried persons.

Another factor that unmarried partners should consider is that they cannot avoid tax on a distribution from a qualified plan as can a married couple using a qualified domestic relations order (QDRO).[14] Exchanges of property upon separation are not tax-free as they are in a divorce of a married couple under IRC Section 1041.[15] Losses on sales of property can be recognized because unmarried couples are not considered "related persons" under IRC Section 267. The couple might make an agreement that sets forth their property rights upon a separation. The financial planner will usually advise the couple to seek assistance of an attorney with expertise in family law, matrimonial law, and property law. Couples might

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[14] IRC Sections 401(a)(13) and 414(p).

[15] IRC Section 1041.

not want to contemplate a separation because of emotional factors. Therefore, the financial planner will need to approach the issue of possible separation delicately.

.09 Tax Return Filing Status

An unmarried couple may not file a joint federal income tax return. In addition, if one partner is not the legal parent of a child in the household, that partner may not file as head of household unless he or she can claim the child as a dependent.[16] A partner with a child may file as head of household if that partner provides more than half the cost of maintaining the household.[17]

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[16] IRC Section 2(b)(1)(A)(ii).

[17] IRC Section 2(b)(1)(A)(i).

Chapter 26

Planning for the Elderly and Disabled

¶2601 Overview

Laws regarding the elderly and disabled have become increasingly complex in recent years, and developments in this area demand the attention of financial planners and their clients. As with most problems in the broad area of financial planning, advance planning can alleviate, if not completely solve, many of the financial difficulties confronting elderly and disabled clients.

With the aging of a significant part of the population, the large number of baby boomers reaching age 60 and beyond, and the longevity of people increasing, the financial planner can certainly recognize that understanding and addressing the issues affecting elderly clients will be an important part of the financial planner's practice. Coupled with the complexities and likely changes over the coming years of the core programs of Social Security, Medicare, and Medicaid (discussed in detail in chapter 35), addressing the concerns of elderly clients should be viewed as a prime growth area of the financial planner's practice.

¶2605 The Elderly and Disabled

Financial planners have a number of tools at their disposal for developing financial plans for clients who are elderly or disabled:

- A durable power of attorney can give the designated agent authority to manage the financial affairs of an elderly or disabled client and eliminate the need for the appointment of a guardian, committee, or conservator.

- Financial planners can use a springing durable power of attorney to establish authority when needed, as determined by one or more triggering events, such as disability as certified by one or more physicians.

- A revocable living trust can also provide for management of financial affairs, including investments and payment of bills.

- In certain circumstances, financial planners can use an irrevocable trust to protect assets. In appropriate cases, financial planners can use an irrevocable trust to help an individual qualify for

Medicaid. At one time, there were rules that appeared to criminalize Medicaid planning (¶3515). However, in *New York State Bar Association v. Janet Reno, et al.*,[1] the U.S. District Court declared unconstitutional the law that made the knowing and willful counsel of an individual, for a fee, to dispose of assets to become eligible for Medicaid, to be a criminal act.[2]

- In some cases, the financial planner can suggest joint bank accounts, payable on death accounts ("p.o.d." accounts), or accounts in trust for another (Totten trusts).

- Life insurance assignments and irrevocable trusts may be useful in some situations.

- Address the status of retirement plan savings and distributions and the possible need for annuity investments.

- Lifetime gifts may also be appropriate, but attention should be paid to the income tax basis of proposed gifts.

- Long-term care insurance may be suitable for the elderly and any disabled individuals who are insurable, but issuance of these policies is subject to underwriting. Nursing home care can easily cost well over $100,000 a year. Exercise caution here, however, because many companies have left the long-term care business, stopped writing new policies, and dramatically increased premiums for those policies still in effect.

.01 Dealing with Limitations on the Use of Planning Tools

Implementation of these tools depends on the client's being mentally competent to authorize their use at the time they are needed. It would be wise to have expert witnesses and disinterested lay witnesses on hand at the time the required documents are executed. These witnesses can attest to and document the client's competency. Some states may require that a notary public attest to certain documents.

Durable powers. All states now recognize durable powers of attorney that survive the principal's incapacity. Clients must observe state formalities when creating the power. The client who grants the power is the *principal*, and the individual to whom the principal grants the power is the *holder* or *attorney-in-fact*. A durable power of attorney ends upon the death of the principal. In addition, the principal may revoke the durable power of attorney. If one's spouse is the attorney-in-fact, a divorce automatically terminates the durable power of attorney in some states. The durable power of attorney also terminates if the attorney-in-fact is unable or unwilling to serve. Principals should name successor attorneys-in-fact in case the designated attorney-in-fact predeceases the principal or is unable or unwilling to serve.

An attorney should draft the power in explicit terms broad enough to accomplish the client's desired objectives, including those related to financial planning. Although no one may delegate the authority to make or revoke a will, the principal may want to delegate the following powers:

- The power to make gifts in defined amounts to persons specified or to named charities. In several states, including New York and Florida, a gifting provision must be stated separately from the

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[1] 999 F. Supp. 710 (N.D.N.Y. 1998).

[2] Section 1128B(a)(6) of the Social Security Act, 42 USC Sec. 1320-7(b)(a)(6).

rest of the durable power and must be separately executed by the principal to be effective. Absent a specific gifting provision, the IRS may view gifts made late in the principal's life by the person acting as attorney-in-fact as invalid to reduce the estate of the principal.

- The power to deal with retirement plans, IRAs, life insurance policies, and buy-sell agreements.
- The power to fund living trusts and address investments.

Springing powers. Springing powers are now widely sanctioned under either the statutory or judicial law of many states. Some states may not approve springing powers. The financial planner should check the state law. The power must carefully define the triggering event, which "springs" or activates the power of attorney. The event typically used is incompetency, along with procedures for establishing its existence. Written certification by one or more physicians who have examined the principal will ordinarily be sufficient. The triggering event could conceivably be temporary physical disability or absence from the country, as standby trusts sometimes provide, with provisions for termination of the power upon completion of the event. The springing power should carefully define the power granted considering the objectives sought, including those related to financial planning. The advantage of a springing power is that it is not effective absent the occurrence of a specific event or condition, so that it cannot be used by an attorney-in-fact without establishing that the triggering event has occurred.

The disadvantage of the springing power is that it may take some time to be activated to assemble the needed proof that the triggering event to activate the power has, in fact, occurred, and time to act may be of the essence. Third parties to whom a springing power is presented may be reluctant to accept the power without evidence it has been "triggered." This evidence may be difficult to obtain immediately, and persuasion of the third party to accept the power may be difficult. This may be viewed as the most serious drawback of a springing power of attorney. In the case of the COVID-19 pandemic of 2020, the difficulty of finding one or more physicians to provide examinations and letters before a springing power could be activated illustrated the major drawback of this planning alternative.

Revocable living trusts. A revocable living trust can provide a great deal of flexibility. The settlor may revoke or amend a revocable living trust as long as he or she is competent. Initially, the settlor may only nominally fund the trust, but the settlor can fund the trust for any amount desired. The settlor may serve as beneficiary and trustee. Upon determination of the settlor's incompetency, the trust will become irrevocable for the benefit of the incompetent and ultimately the designated beneficiaries. The named successor trustee will take over the trust administration. A durable power of attorney can be used to pour all of the settlor's property into the trust upon the settlor's incompetency. The trust must contain provisions for determining incompetency, preferably a determination made by two physicians. The trust should give the trustee the authority to do things that the settlor would be disposed to do if the settlor were not disabled.

While the settlor remains competent, the income, estate, and gift tax consequences will be the same as with any revocable trust. The settlor will be taxable on the income, have no gift tax liability for funding the trust, be responsible for gifts made from the trust, and the value of the trust property will be includible in the settlor's gross estate at death. Upon disability, if the settlor retains an income interest,

as will normally be the case, the settlor will be taxable on the income, and the value of the trust property will be includible in the settlor's gross estate.[3]

The revocable trust is used in many states as the centerpiece of a person's estate plan when probate issues and privacy concerns are burdensome or costly, or both. In other states where probate is not a problem, fewer living trusts are generally used. In any event, regardless of a state's probate practices, a revocable living trust can be viewed as an excellent management vehicle, especially for an elderly client. A spouse or child can serve as a trustee or successor trustee, able to step in and manage and administer the trust funds and address the affairs of the trust creator should assistance be required. When a client owns property in multiple states, a living trust holding title to such properties can be used to avoid probate in the states where the client does not reside.

Irrevocable living trusts. An irrevocable living trust ordinarily will involve gift tax issues for the transfer to the beneficiaries. The settlor can use the unified credit to offset any gift tax liability to the extent that the settlor has any remaining unified credit. With proper planning, an irrevocable living trust can be useful in enabling the settlor to provide for significant family benefits without forfeiting qualification for Medicaid. The trust may be a short-term irrevocable trust to provide income to the settlor for a period of five years. Alternatively, the trust may be created as a supplemental needs trust or special needs trust. The funds for these trusts can come from a third party, such as a parent or grandparent or from the individual's own funds. The source of the funds and the term and details of the trust may affect issues of Medicaid eligibility. The laws governing these trusts vary among the states. Financial planners would be wise to consult an attorney with expertise in elder law to discuss the creation of these trusts.

Living wills and health care proxies. Living wills and health care durable powers and proxies (¶2905) can be extremely useful in carrying out an individual's desires with respect to medical decisions when he or she is unable to make them. Generally, an individual may refuse extraordinary medical care to prolong life when competent. If the individual is incompetent, the attorney-in-fact or proxy may likewise refuse extraordinary medical care for the grantor of the power. Living wills and health care powers of attorney and proxies are virtually universally recognized under state laws. Several states have adopted a "Death with Dignity" assisted suicide law. These include at present California, Colorado, the District of Columbia, Hawaii, Maine, Montana, New Jersey, Oregon, Vermont, and Washington. Other states are reportedly considering similar laws. The laws of these states should be consulted to determine exactly what a person must do to come within them.

Other planning tools. The elderly and disabled can use the financial planning tools generally used for young and healthy individuals. These tools include joint bank accounts, assignment of life insurance policies, lifetime giving, and other financial planning tools. The only prerequisite is that the elderly or disabled person must take action at a time when competent to act either directly in the use of these tools or by the appointment of surrogates with full authority to carry out the individual's directions.

The financial planner should be cautious, however, when recommending joint bank accounts for the bulk of an elderly person's assets. If the elderly person dies, the surviving joint owner is the owner of all

[3] IRC Section 2036(a).

the funds in the account. If that person is one of several children, the use of a significant joint bank account may inadvertently disinherit the other children. Also, placing the elderly person's funds in a joint account with another person may subject those funds to the claims of the creditors of the joint account holder. These risks of joint accounts suggest keeping only modest amounts of the elderly person's funds in such accounts and possibly considering use of a revocable management trust as a better planning alternative because it leaves the elderly person, via the trust document, in control of the ultimate disposition of the trust funds and limits claims of creditors to only the creditors of the elderly person.

The financial planner should also exercise caution with respect to advising an elderly person to gift appreciated assets that have a low income-tax basis. Allowing such assets to pass at death will give the heir a stepped-up income-tax basis, rather than the carryover basis that a donee of a gift would receive. If the elderly person will not have an estate subject to estate taxation at death, income tax planning for heirs takes on primary importance. Holding the elderly person's property until death in such a case is often the best tax plan.

Alternatively, consider making gifts of low-basis assets to an elderly person who will not have a taxable estate at death. If the donee lives beyond one year, dies, and returns the gifted property to the donor, the donor's basis is the fair market value of the property as of the donee's date of death — presumably stepped up from when the donor transferred the property. If the donee fails to live beyond one year and the property is returned to the donor, the basis to the donor is restored to the donor's original basis — no step-up occurs. In this situation, the plan might be to have the elderly person sign a will or trust with conditions — if the person holds the gifted property beyond one year, it returns to the original donor. If the one-year holding period is not satisfied, it is left to other relatives. Because they were not the donors, they should receive a basis equal to the fair market value at the death of the elderly person. This type of planning is sometimes referred to as *upstream planning*.[4]

.02 When Financial Planning Opportunities Are Neglected

Not everyone is foresighted enough to use the planning tools discussed previously. In some cases, a wholly unforeseen accident or medical condition that totally incapacitates an individual may occur before the individual planned for it. Consequently, a need may arise for the appointment of a guardian, committee, or conservator.

The financial planner will want to be acquainted with the basics of these forms of surrogacy. Guardianships, for example, have been around for centuries. In many cases, guardianships have become encrusted with cumbersome rules designed to protect the ward, but which, in their complexity, may act to deplete the ward's assets. Typically, bonding requirements of the guardian, accountings to be prepared and filed, court supervision, medical competency reports, and separate legal counsel are required for all the parties involved.

States originally enacted conservatorships to provide a simplified method of securing authority to manage the financial affairs of incompetent persons. Since their institution, many states have expanded conservatorships to some degree to assume the functions of a guardian of the ward.

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[4] IRC Section 1014(e).

Questions may arise under various laws about whether a guardian or conservator can make health care decisions or engage in what amounts to financial planning for the client. The Uniform Probate Code (UPC), which has been adopted in a number of states, gives the conservator the authority to do financial planning.

The bottom line from the standpoint of both the financial planner and the client is to consider the advantages and opportunities of the financial planning discussed previously before more extreme measures become necessary.

¶2610 The Mentally Disabled

Five important planning devices by which one person can hold and manage property for the benefit of another individual who is disabled or otherwise unable to manage his or her property are as follows:

1. Trusts
2. Guardianships
3. Conservatorships
4. Custodianships
5. Powers of attorney

The main concern in this chapter is whether those who hold or manage property for another individual can engage in some forms of financial planning for the ward or principal. For example, can such an individual make gifts of property of the ward to achieve financial planning objectives?

The sections that follow examine this question under two conditions: (1) under the UPC, which has been enacted in 18 states and accepted, in part, in most of the remaining states, and (2) independently of the UPC.

.01 Under the Probate Code

Under the UPC, guardians are without specific power to engage in financial planning for their wards. One can assume that they are also without implied powers in view of the specific powers conferred on conservators. The law specifically authorizes conservators to make gifts, such as the ward would make, not to exceed 20% of the annual income of the ward. In addition to the specific statutory powers that the UPC confers on the conservator, the court may confer such powers as the court itself could exercise.

The UPC specifically provides that the conservator and the court, in exercising any powers, should take into account any known financial plan of the ward. The known financial plan of the ward includes the ward’s will, any revocable trust, and any contract, transfer, or joint ownership arrangement which the ward may have originated.

.02 Independently of the Probate Code

An elementary principle of law is that a donor must have donative intent to make an effective gift. A comatose individual obviously lacks donative intent. Yet, under the doctrine of substituted judgment, courts have been willing to allow guardians acting on behalf of comatose individuals or other severely mentally impaired individuals to make gifts.

Two premises serve as the foundation for this doctrine:

1. The individual must have adequate funds so that the gifts will not adversely affect the donor's maintenance and support. The court looks to the assets of the individual and projected income requirements.

2. A likelihood exists that the disabled individual would have made the gifts if capable of doing so. The court looks to prior actions with respect to gifts and financial planning strategies.

.03 Durable Power of Attorney

When incapacity occurs, an attorney-in-fact may make gifts on behalf of the principal without court intervention, provided the principal executed a properly drawn durable power of attorney. Generally, the durable power of attorney should specifically authorize the attorney-in-fact to make gifts according to the principal's instructions.

In addition to authorizing gifts, the financial planner should consider these possible limitations on the authority of the attorney-in-fact:

- Restricting gifts to the annual exclusion to ensure that transfers are free of gift tax and to preclude any use of the unified credit. The annual exclusion is $15,000 per donee in 2020, but the amount is annually indexed for inflation.[5]

- Specifying to whom the attorney-in-fact can make gifts or cannot make gifts. For example, can the attorney-in-fact make gifts to himself or herself and his or her family or to charities?

- Requiring equal or unequal gifts to grandchildren.

If a holder of a durable power of attorney makes gifts not specifically authorized, the gifts may be includible in the gross estate of the principal as revocable transfers.[6] However, an exception may apply if applicable state law authorizes holders of durable powers to make gifts in accordance with their principal's personal history of gift giving. Gifts made by the power holder in conformance with such history have been held not includible in the decedent's gross estate.[7]

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[5] IRC Section 2503(b).

[6] IRC Section 2038, *O. Casey Est.*, 948 F.2d 895 (4th Cir. 1991).

[7] *J. Ridenour Est.*, 36 F.2d 332 (4th Cir. 1994).

Planning Pointer. How to Address Elder Planning with Your Clients.

CPA financial planners are in the business of helping clients address life transitions, whether it is joining the workforce, starting a business, starting a family, planning for college, or making the decision on when to retire. These transitions do not stop at retirement. Elder planning sometimes conjures images of complicated health and housing issues that CPAs are not as equipped to address. But if we break them down into the different types of transitions and decisions, it becomes clear that the skills and knowledge brought by the CPA financial planner complement other professionals to best serve their clients. Visit aicpa.org/pfpguides to find The Adviser's Guide to Retirement and Elder Planning. You may also find value in the Broadridge Advisor Life Events Center (aicpa.org/pfp/broadridge), available to PFP/PFS members.

¶2615 Growing Concerns About Elder Abuse and Suggested Solutions

Reports throughout the media suggest growing concerns about elderly clients being financially victimized, so-called "elder abuse." Increased dependency due to illness, disability, or cognitive impairments can make seniors susceptible to financial abuse. Nest eggs accumulated over decades also often make seniors attractive targets for predators, whether the predator is a care provider who sees an opportunity to be paid more than an hourly wage, an unscrupulous relative, or a marketed scheme that looks dangerously appealing.

Many states have passed Civil Financial Exploitation Acts and Civil Elder Abuse Acts to address concerns about these issues.[8]

Perhaps the strongest protection against elder abuse is making loved ones aware of one's circumstances and sharing information and experiences. If others are aware of the senior's finances, either possible predators will see that no opportunity exists to take advantage of the senior or the family members or professionals can step in to keep any fraud from occurring. Social involvement between seniors and trusted relatives or friends is an excellent way to combat possible elder abuse. Isolation is perhaps the greatest danger. Use of a revocable (or even better, an irrevocable) living trust with a person (typically a child) as a trustee or co-trustee can provide important protection for the elderly family member.

[8] See also, AICPA's three-part series: Elder Financial Abuse: *How CPAs Can Help* — Part 1, Part 2, Part 3.

Chapter 27

Planning for Generation-Skipping Transfers

¶2701 Overview

This chapter reviews the generation-skipping transfer (GST) tax and its technical requirements. This chapter also suggests planning techniques the financial planner may use to minimize GST tax exposure and take advantage of generation-skipping exemptions and exclusions.

The financial planner should recognize the opportunity presented in 2020 with the GST tax exemption now at $11,580,000, indexed annually for inflation. This exemption sunsets after 2025 and reverts to the 2017 exemption, indexed for inflation, and political risk suggests it could be reduced sooner. For clients desiring to use the GST exemption, the planner should recommend using it sooner rather than later. The Joint Committee Explanation of the TCJA (page 89, FTN 372) indicated that it would be permissible to allocate the GST exclusion currently to transfers previously made in which GST exclusion was not allocated, either because it was believed to be unavailable or erroneously omitted. This can be very helpful with respect to trusts that may continue in existence and pass ultimately to skip persons — to which little or no GST exemption was previously allocated.

¶2705 Generation-Skipping Transfers

Every individual has a substantial lifetime GST tax exemption under IRC Section 2631, but this does not mean that planning for the GST tax must be limited to the very wealthy. For 2004–2009, the GST tax exemption was equal to the estate tax applicable exclusion amount.[1] The GST tax exemption was $2 million in 2008 and $3.5 million in 2009.[2] The GST tax exemption was $5 million for 2010 and 2011 and $5,120,000 for 2012. Although the GST tax exemption for 2010 transfers was $5 million, the GST tax rate for 2010 was zero, but only for 2010. The GST tax exemption was $5,430,000 for 2015, $5,450,000 for 2016, $5,490,000 for 2017, $11,180,000 for 2018, $11,400,000 for 2019, and $11,580,000 for 2020, indexed annually for inflation. The GST tax rate in 2020 is 40%.

[1] IRC Section 2631(c).

[2] IRC Section 2010(c).

Financial planners should address GST tax planning not only for the very wealthy but also for individuals of more modest means who desire to make "skip persons" (that is, persons two or more generations younger than the transferor, typically grandchildren) their beneficiaries.

.01 Flat-Rate Tax

The GST tax rate is equal to the product of the maximum federal estate tax rate and the inclusion ratio for the transfer.[3] The maximum federal estate tax rate under current law is 40% in 2020 and subsequent years. The inclusion ratio for GST tax purposes is equal to 1 minus the applicable fraction.[4] The numerator of the applicable fraction is the amount of the GST tax exemption allocated to the property being transferred, regardless of whether it is transferred directly to a beneficiary in a direct skip or to a trust for the benefit of a skip person. The denominator of the applicable fraction is the value of the property transferred minus any federal estate tax or state death tax recovered from the trust.

> **Example 27.1**. If a taxpayer who has never used a GST exemption transfers $700,000 to a skip person, the numerator of the fraction is the $700,000 exemption available to the taxpayer. The denominator is the value of the transferred property. $700,000/$700,000 = 1, (this is the "applicable fraction") and 1 – 1 = 0. (one minus the applicable fraction is the "inclusion ratio"). The transfer in this example has an inclusion ratio of 0, and no GST tax is applicable.

.02 When and How the Tax Is Levied

The GST tax is levied on direct skips, taxable terminations, and taxable distributions[5] to "skip" persons.[6] A *skip person* is an individual who is two or more generations below the generation of the transferor.[7]

.03 Generation Assignment

Spouses are always considered to be in the same generation, regardless of age differences. Children of the spouses are one generation younger. Grandchildren are two generations younger. More "distant" relationships are determined as indicated in the text that follows.

A generation is determined along family lines as follows:

- When the beneficiary is a lineal descendant of a grandparent of the transferor (for example, the donor's cousin, niece, nephew, and so on), the number of generations between the transferor and the descendant is determined by subtracting the number of generations between the grandparent and the transferor from the number of generations between the grandparent and the descendant.

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[3] IRC Section 2641(a).

[4] IRC Section 2642(a).

[5] IRC Section 2611(a).

[6] IRC Section 2613(a).

[7] IRC Section 2613(a)(1).

- When the beneficiary is the lineal descendant of a grandparent of a spouse (or former spouse) of the transferor, the number of generations between the transferor and the descendant is determined by subtracting the number of generations between the grandparent and the spouse (or former spouse) from the number of generations between the grandparent and the descendant.
- For this purpose, a relationship by adoption is considered a blood relationship. A relationship by half-blood is considered a relationship by whole blood.
- The spouse or former spouse of a transferor or lineal descendant is considered to belong to the same generation as the transferor or lineal descendant, as the case may be.

A person who is not assigned to a generation according to the preceding rules is assigned to a generation based on his or her birth date as follows:

- A person who was born not more than 12½ years after the transferor is in the transferor's generation.
- A person born more than 12½ years, but not more than 37½ years, after the transferor is in the first generation younger than the transferor.
- Similar rules apply for a new generation every 25 years.

The GST tax rules generally apply to transfers made after October 22, 1986. However, certain transfers coming from wills and trusts that were irrevocable before that date are not subject to the GST tax. If the financial planner is confronted with such a "grandfathered" trust, the planner must take great care to comply with the complex and detailed exceptions to the general effective date, lest exemption from the GST be lost.[8] As a general rule, trusts grandfathered from the GST rules should not be extended in duration, have additional beneficiaries added, or have new assets contributed to them. Such modifications will cost the trust its grandfathered status and make it subject to the GST rules and limitations. Making administrative changes to a grandfathered trust, such as replacing a trustee or replacing one investment with another, is an acceptable modification that does not jeopardize the grandfathered status of the trust.

For a direct skip to a skip person (described in the text that follows) that does not come from a trust, the transferor is liable for any applicable GST tax.[9] The GST tax on a direct skip is determined on a tax-exclusive basis (that is, the tax base does not include the GST tax to be paid). A transferor computes the GST tax on a direct skip in a manner similar to that used to compute the gift tax.

In the event of a taxable distribution (described in the text that follows), the base for any GST tax is the value of the property received by the transferee minus expenses incurred by the transferee with respect to the determination of the GST tax.[10] The transferee is liable for any applicable GST tax.[11] If a GST taxable distribution consists of income for trust income tax purposes, there is a "double tax event" (that is, the GST tax and income tax arise from the same property distribution), and the transferee may deduct the GST tax paid in computing his or her taxable income. However, the amount of the GST tax that the

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[8] See Regulation Section 26.2601-(b).

[9] IRC Section 2603(a)(3).

[10] IRC Section 2621(a).

[11] IRC Section 2603(a)(1).

transferee may deduct cannot exceed the amount of the distribution included in gross income.[12] If the trust that made the taxable distribution pays any of the GST tax, the law treats the tax payment as an additional taxable distribution to the beneficiary.[13] The GST tax on a taxable distribution is determined on a tax-inclusive basis because the GST tax is to be paid out of the distributed property unless the governing instrument specifically directs otherwise.[14]

For a taxable termination (described in the text that follows) or a direct skip from a trust, the trustee is liable for the GST tax.[15] On a taxable termination, the base for the GST tax is the value of the property transferred to the skip person minus a deduction for expenses, indebtedness, and taxes attributable to the transferred property.[16] The GST tax on a taxable termination is determined on a tax-inclusive basis because the GST tax is to be paid out of the distributed property unless the governing instrument specifically directs otherwise.[17]

Direct skips. A direct skip is a transfer to a skip person who is subject to estate or gift tax.[18] For example, a direct skip will occur if a grandparent makes a gift or leaves a legacy to a grandchild. The transfer may, depending upon the applicable exemption in the year of the transfer and the transferor's history of cumulative lifetime transfers, be subject to both gift or estate tax and the GST tax, or possibly none of these taxes. The GST tax on direct skips is computed by multiplying the full value of the property[19] by the applicable rate.[20] The applicable rate is computed by multiplying the maximum federal estate tax rate[21] by the inclusion ratio.[22] The inclusion ratio is equal to 1 minus the applicable fraction.[23] The applicable fraction for a direct skip is determined as follows: The numerator is the amount of the GST tax exemption allocated to the property transferred in the direct skip. Its denominator is the value of the property involved in the direct skip reduced by the value of the property transferred, if any, that is a nontaxable gift.[24] A nontaxable gift is the portion of the gift not subject to gift tax because of the

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[12] IRC Section 164.

[13] IRC Section 2621(b).

[14] IRC Section 2603(b).

[15] IRC Section 2603(a)(2).

[16] IRC Section 2622.

[17] IRC Section 2603(b).

[18] IRC Section 2612(c)(1).

[19] IRC Section 2623.

[20] IRC Section 2602.

[21] IRC Section 2001(c)(1).

[22] IRC Section 2641(a).

[23] IRC Section 2642(a)(1).

[24] Regulation Section 26.2642-1(c)(1).

annual exclusion or the exclusion for certain transfers for educational expenses or medical expenses.[25] The inclusion ratio for a direct skip becomes final when no additional GST tax can be assessed with respect to the direct skip.[26]

When the inclusion ratio is zero, there is no GST tax due. When the inclusion ratio is one, GST tax is due on the full amount of the transfer. When the inclusion ratio is more than zero and less than one, GST tax is due on a portion of the transfer. Given the GST exemption allowed for 2020 of $11,580,000 per transferor, planning to avoid GST liability for most taxpayers, at least until the scheduled sunset after 2025, should not be difficult.

Taxable terminations. A *taxable termination* occurs when an interest in property held in trust terminates.[27] However, a taxable termination does not occur if (1) a non-skip person (that is, a person who is not two or more generations younger than the transferor) has an interest in the trust property immediately after the termination,[28] or (2) no distribution can be made, in accordance with the terms of the trust, at any time after the termination from the trust to a skip person.[29] For example, if a parent has created a trust for the benefit of a child, with the remainder to a grandchild, a taxable termination will occur on the death of the child. The GST tax on taxable terminations is levied (after deduction of certain expenses) on the full value of the property transferred, and the GST tax is payable by the trustee.[30] The applicable fraction for a taxable termination is determined by dividing the GST tax exemption allocated to the property by the value of the property transferred reduced by any estate tax or state death tax recovered from the trust with respect to the property and any deduction for charitable contributions allowed with respect to the property.[31]

Taxable distributions. A *taxable distribution* is a distribution of income or principal from a trust to a skip person, unless the distribution is a taxable termination or a direct skip.[32] For example, a taxable distribution occurs when the trustee of a trust created by a grandparent that permits distributions of income and principal to any descendant of the grandparent during the lifetime of his or her child makes a distribution of income to a grandchild. In such a case, the GST tax (if applicable after taking into account the available exemption) on taxable distributions is levied (after deduction of certain expenses) on the full value of property received by the transferee (the grandchild, in this example) and is payable by the beneficiary who receives the distribution (again, the grandchild).[33] If the trust pays the GST tax,

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[25] Regulation Section 26.2642-1(c)(3).

[26] Regulation Section 26.2642-5(a).

[27] IRC Section 2612(a).

[28] IRC Section 2612(a)(1)(A).

[29] IRC Section 2612(a)(1)(B).

[30] IRC Section 2622.

[31] IRC Section 2642(a)(2).

[32] IRC Section 2612(b).

[33] IRC Section 2621(a).

the payment will be treated as an additional taxable distribution to the grandchild.[34] The applicable fraction for a taxable distribution is determined by dividing the GST tax exemption allocated to the property by the value of the property transferred reduced by any estate tax or state death tax recovered from the trust with respect to the property and any deduction for charitable contributions allowed with respect to the property.[35]

.03 Avoiding a Direct Skip

The GST tax is imposed on every direct skip, subject, of course, to the use of any available GST exemption to avoid liability for the tax. An example of a direct skip is a transfer directly to, or in trust for, a grandchild while the parent of the grandchild is living. Assuming the transferor has used all of his or her available GST tax exemption, one way to avoid the immediate imposition of the GST tax is to have an interest in the transferred property held by a non-skip person.[36] For example, a parent could transfer a life income interest in trust to a child and a remainder interest to grandchildren. That would not be a direct skip, and any imposition of GST tax would await the termination of the child's interest and then be treated as a taxable termination to the grandchild at that time. Planners sometimes insert a charity as a trust beneficiary. Because a charity is a non-skip entity, the trust may never make a generation-skipping transfer.

.04 Gross Up of Taxable Gifts for the GST Tax

Under IRC Section 2515, persons who make lifetime direct skips will be liable for gift tax that is grossed up by the amount of the GST tax, if any.

> **Example 27.2.** Assume that Juan Cruz has exhausted his lifetime GST tax exemption. He makes a gift of $1 million in 2020 to his grandson Mario Rodriguez. He is allowed the $15,000 per-donee annual exclusion. The GST tax on this gift is $394,000 [($1,000,000 – $15,000) × 40%] making the total taxable gift $1,379,000 ($1,000,000 – $15,000 + $394,000), on which the gift tax (assuming the donor has no available unified credit and assuming that the entire value of the gift is taxed in the 40% bracket) is $551,600 ($1,379,000 × 40%). Accordingly, the total transfer taxes on the gift of $1 million are $945,600 ($394,000 + $551,600).

Given this tax liability, the financial planner needs to alert clients about the potential cost of the GST tax and encourage transfers that may reach, but do not exceed, the available GST tax exemption.

.05 GST Lifetime Exemption

The GST tax exemption for 2020 of $11,580,000 indexed annually for inflation, is equal to the gift tax and the estate tax applicable exclusion amounts.[37] Married couples may elect to split the use of their

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[34] IRC Section 2621(b).

[35] IRC Section 2642(a)(2).

[36] IRC Section 2621(a)(1)(A).

[37] IRC Section 2631(c).

GST tax exemptions for lifetime gifts[38] if they also elect gift splitting in computing the gift tax.[39] The use of the GST tax exemption will reduce the inclusion ratio of property subject to tax. A complicated set of rules governs the election of property to be covered by the GST exemption, allocation of the GST exemption if the transferor does not elect to apply it, and the taxation of property only partially covered by the GST exemption.

Strategic use of the lifetime GST exemption will permit potentially large sums to escape transfer taxation. Once a transferor elects the exemption, the property covered by the exemption will be exempt from generation-skipping taxation, regardless of its appreciated value, even during multiple future generation skips.[40] Thus, a taxpayer should use assets with the greatest potential for appreciation to fund GST tax-exempt transfers.

As with the estate and gift tax unified credit, individuals seeking maximum GST tax savings should arrange their assets to make full use of the GST tax exemption. A married individual, with greater wealth than his or her spouse, should consider giving assets to the spouse sufficient to permit use of that spouse's GST exemption as well as his or her own. Such gifts ensure that the opportunity to exclude an amount equal to twice the statutory GST tax exemption will not be lost if the less wealthy spouse dies first.

> **Note:** This is a "use it or lose it" planning situation. Unlike the gift tax and estate tax exclusions, the GST exclusion is *not* portable to the surviving spouse. See the discussion of portability in chapter 37. Each spouse must use his or her own GST tax exemption.

.06 Inclusion Ratio

If a GST transfer consists of exempt and nonexempt property, computing the GST tax requires a calculation of the inclusion ratio with respect to such property. This ratio is the difference between "1" and the applicable fraction.[41] For individuals faced with potential liability for the GST tax, using multiple trusts with each trust either totally exempt or totally subject to GST tax would be best. This would result in having distributions from the exempt trust (with the inclusion ratio of zero) bearing no GST tax and distributions from the taxable trust (with the inclusion ratio of 1) being fully taxed — instead of having every trust distribution partially subject to tax (with an inclusion ratio greater than zero and less than 1).

Under Regulation Section 26.2663-2, the GST tax can apply to lifetime and testamentary direct skips by nonresident aliens, but only to the extent that such transfers are subject to U.S. estate or gift tax. The GST tax will generally not apply to transferred property that does not have a situs in the United States.

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[38] IRC Section 2652(a)(2).

[39] IRC Section 2513.

[40] Committee Reports on P.L. 99-514 (Tax Reform Act of 1986) 1986-3 CB (Vol. 2) 826.

[41] IRC Section 2642.

.07 Annual Per-Donee Exclusion and Gifts for Educational and Medical Expenses

Excluded from the GST tax are any amounts paid on behalf of an individual for educational and medical expenses directly to the education or medical care provider.[42] This exclusion is the same one that applies for gift tax purposes under IRC Section 2503(e). Similarly, the annual present interest gift tax exclusion of $15,000 per donee in 2020, indexed annually for inflation, may also apply for the GST tax when the transfer is made outright to a skip person.[43]

These transfers are referred to as *nontaxable gifts* in IRC Section 2642(c). Under IRC Section 2642(c)(1), a direct skip that is a nontaxable gift would not be subject to GST tax because such gifts always have an inclusion ratio of zero.

In the case of a gift to a trust, a special rule applies for GST purposes if the annual GST exclusion for gifts to the trust is to be available. Here, the interest of the beneficiary must be vested to be eligible for the annual exclusion from GST tax. To accomplish vesting, two conditions must be satisfied: (1) No part of the principal or income may be distributed to or for the benefit of any person other than the beneficiary (that is, the trust must have just a single beneficiary), and (2) The trust must provide that if the trust does not terminate before the death of the beneficiary, the trust assets will be included in the beneficiary's gross estate.[44]

Planning Pointer. To receive the maximum GST tax exemption benefit for educational and medical expenses, a nonexempt (that is, subject to GST tax) trust for a child and the descendants of the child should contain broad powers of invasion for educational and medical expenses for the child's offspring to be paid directly to the education or medical care provider. Because such GST payments are nontaxable gifts with a zero-inclusion ratio, such payments convert nonexempt property into GST exempt property.

If an individual uses the annual gift tax exclusion for a grandchild or great-grandchild through contributions to a trust, the interest of the beneficiary must be vested, as noted previously. The trust should be a totally GST tax-exempt trust. If a trust with multiple beneficiaries is used, and the beneficiaries do not have separate shares in the trust, no GST annual exclusion will be allowed, and the donor's lifetime GST tax exclusion must then be used to avoid GST tax liability. There must be a single beneficiary of each trust to use the annual GST exclusion in accordance with the rules discussed previously.

.08 Reverse QTIP (Qualified Terminable Interest Property) Election

Qualified terminable interest property (QTIP) is property that passes from a donor or decedent to a spouse who receives all the income from the property for life. The income must be payable at least annually, and no person may appoint any of the property to anyone other than the spouse during the spouse's lifetime. The property in the QTIP trust is included in the spouse's gross estate upon his or her death.[45]

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[42] IRC Section 2611(b)(1).

[43] IRC Section 2642(c)(3).

[44] IRC Section 2642(c)(2) and Committee Reports on P.L. 100-647 (Technical and Miscellaneous Revenue Act of 1988).

[45] IRC Section 2044.

Property a decedent or donor transfers that is qualified terminable interest property is treated as the surviving spouse's property for purposes of the GST tax. That is, the surviving spouse becomes the deemed transferor of the property to future heirs for GST purposes. This treatment could result in a potential waste of a significant amount of the GST tax exemption if the first decedent's allowable GST exemption is not utilized. IRC Section 2652(a)(3) allows the estate of the first decedent for the purposes of the GST tax (only) to elect to treat all property in a QTIP trust as though the QTIP election had not been made. In addition, for the purposes of the GST tax, a donee spouse may elect to treat a life estate received from a spouse for which a QTIP election has been made as though the QTIP election had not been made. The election is irrevocable.[46] If the estate of the first decedent or the donee spouse makes the election, it must apply to all property in the trust subject to the QTIP election.[47]

The purpose of this election (called the "reverse QTIP election") is to treat the decedent (or donor spouse) instead of the surviving spouse (or the donee spouse) as the transferor of the QTIP trust. This will use the available GST exemption of the decedent (or donor spouse) at the first death (or at the time of the gift) and leave the surviving spouse (or donee spouse) with the full GST tax exemption still available to be used in his or her own financial plan.

Even when portability is being elected, it is still possible (and recommended for wealthy families) to use the reverse QTIP election because the GST exclusion is *not* portable. Even if portability is not used, consider filing Form 706 in any event to take advantage of the reverse QTIP opportunity to use the GST exclusion of the first decedent. (See chapter 37 for a more detailed explanation of portability.)

For purposes of the GST tax, the portions of a trust resulting from transfers from different transferors are treated as separate trusts.[48] Similar and independent shares of different beneficiaries in a trust are also treated as separate trusts for purposes of the GST tax.[49] In addition, if a trust is included in a decedent's gross estate or is created by the decedent's will, the severance of the trust into two or more trusts will be recognized for GST tax purposes if the severance is based on a provision in the will or trust that directs that the trust be severed on the death of the transferor, or the trust is severed by the executor or trustee based on discretion granted by the governing instrument or local law. If the trusts are severed, the terms of the new trusts must provide for the same succession of interests and beneficiaries in the aggregate as under the old trust. The severance must occur before the due date for filing the estate tax return, including extensions allowed. The severance must occur on a fractional basis or if the governing instrument requires severance on the basis of a pecuniary amount, the separate share requirements for individuals must be met.[50] However, if the trusts are severed using fractional amounts, the new trusts do not have to receive a pro rata portion of each asset. The new trusts could receive assets that reflect the fair market value of all the assets in the old trust. If court action to sever a trust is required, and if a court has not ordered a trust to be severed by the time the executor files the estate tax return, the executor must attach a statement describing any proceeding commenced to sever a trust and attach a copy of the

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[46] Regulation Section 26.2652-2(a).

[47] Regulation Section 26.2652-2(a).

[48] IRC Section 2654(b)(1).

[49] IRC Section 2654(b)(2).

[50] Regulation Section 26.2654-1(b)(1).

severance petition.[51] The executor or trustee may allocate the individual's GST tax exemption to the separate trusts based on the fiduciary's discretion.[52]

To minimize total transfer taxes, a will or trust should include a provision that allows the executor the discretion to sever a trust into two or more trusts in accordance with Regulation Section 26.2654-1(b)(1). The will or trust could also direct the executor to pay any estate taxes due from trusts that are not exempt from the GST tax. When an executor severs a trust, the executor should place sufficient funds in a separate trust to use the remaining amount of the decedent's GST exemption and give that trust an inclusion ratio of zero. If the executor does not sever the trust, the executor must either (1) make a reverse QTIP election for an amount larger than necessary with the result that upon the death of the surviving spouse, the executor of his or her estate will not necessarily be able to take full advantage of the maximum GST tax benefit that could have resulted over the deaths of both spouses, or (2) not make a reverse QTIP election and lose some of the decedent's otherwise available GST tax exemption.

.09 Personal and Family Considerations

Planning for GST tax savings can present personal and family problems. Clients might wish to give their children outright use of funds, rather than limit their interest to those of lifetime trust beneficiaries, even at the cost of extra estate taxes on the death of the children. The financial planner should identify possible GST tax savings, explain the pros and cons of long-term exempt multi-generational trusts (so-called "dynasty trusts") to achieve such savings, and let the client make an informed decision. The planning decision involves consideration of whether each generation should be a transfer taxpayer or whether, under current law, transfer taxes can be avoided as one generation succeeds the other.

Planning Pointer. With the GST exemption at $11,580,000 per transferor in 2020, indexed annually for inflation, and with the gift tax exemption also at $11,580,000 for 2020, also indexed annually for inflation, this "window of opportunity" suggests that if financial planners are ever going to suggest multi-generational planning for their clients, now is the time. Consider the creation and funding of a multi-generational dynasty trust in one of the states that has repealed the rule against perpetuities so that the trust qualifies for the GST tax exemption and has perpetual duration, thereby avoiding future generations being subject to transfer taxes as they die, and their interests in the trust expire.

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[51] Regulation Section 26.2654-1(b)(1).

[52] Regulation Section 26.2654-1(b)(1)(C)(3).

Chapter 28

Planning for a Personal Residence

¶2801 Overview

A client's ownership of one or more residences suggests the financial planner should consider a number of tax and nontax factors. A list of some of the key factors follows, with cross-references to a more detailed discussion of particular factors, where applicable:

- **Purchasing a home.** An individual or family that is purchasing a home should consider several important factors. These factors include the structural integrity of the home, commuting, appreciation potential, quality of neighborhood schools, crime rate, transportation, legal considerations, use of a real estate agent, and financing.

- **Home financing and refinancing.** Understanding the various types of financing available to purchase or improve a residence is an important consideration for any prospective home buyer. Existing homeowners may want to know about refinancing options, including home equity loans and home equity lines of credit. Deductibility of mortgage interest paid should be of prime concern (¶2810). The 2017 TCJA made significant changes in this area, reducing the amount of acquisition debt on which mortgage interest can be deducted, and limiting the deduction of interest on home equity loans to loans incurred for the acquisition and improvement of a residence.

- **Exclusion of gain.** IRC Section 121 allows each taxpayer to exclude up to $250,000 of gain from the sale of a principal residence (¶2820). On a joint return, a couple may exclude up to

$500,000 of gain on the sale of a principal residence.[1] The taxpayer must meet certain ownership and use requirements, discussed in the text that follows.

- **Business and rental use of home.** Certain expenses are allowed and others disallowed in connection with the business use of a home and the rental of vacation homes (see ¶2825 and ¶2830, respectively).

- **Joint ownership by spouses.** A variety of special rules involving both gift and estate tax consequences become applicable when a residence is jointly owned by spouses (see chapter 3, "The Co-ownership of Property," for discussion of co-ownership generally).

- **Joint ownership by unmarried individuals.** The pros and cons of joint ownership of a residence by unmarried individuals require careful consideration (see chapter 3 for discussion of co-ownership generally).

- **Ownership in community property jurisdictions.** There are special rules to be considered if the residence is situated in a community property jurisdiction (see ¶325 for a discussion of community property generally).

- **Placing residence in trust.** One of the options open to an individual owning a residence is to place it in trust and permit a spouse or others to use it on terms provided in the trust (see chapter 6, "The Use of Trusts," for discussion of trusts generally). A qualified personal residence trust (QPRT) can be funded with one's residence and achieve special tax and financial planning benefits under an exception to the IRC Section 2702 rules that normally limit the benefits of transfers with retained interests (¶2315). A residence placed in a trust for one's spouse may qualify for the marital deduction if the trust is set up to meet the requirements of a qualified terminable interest property (QTIP) or general power of appointment trust (¶1225).

- **Gift of a residence.** A gift of a residence, in some circumstances, may provide favorable financial planning results and possibly other practical benefits (¶410). However, the potential detriment of carryover basis considerations should be weighed against the benefits of a lifetime gift.

- **Charitable contribution deduction.** A charitable contribution deduction is available for a gift of a remainder interest in a personal residence or farm (¶515.03). A charitable contribution deduction may also be available for a gift of a conservation easement appurtenant to a residence (¶535).

- **Title insurance.** Title insurance operates to protect a buyer and a lender against unforeseen or unknown title defects.

- **Special use valuation.** If a decedent's estate includes farm or business property that qualifies for a reduced special use valuation, residential buildings thereon may be so valued (¶2210).

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[1] IRC Section 121(b)(2).

- **Purchases from nonresident alien.** A purchase of a residence from a nonresident alien may trigger a withholding obligation.

- **Casualty losses.** As a result of the TCJA, losses for casualties and thefts are no longer deductible unless there is a presidentially declared disaster.

- **Casualty gains.** When a taxpayer's property is damaged or destroyed as a result of a casualty, the taxpayer must recognize gain to the extent that any amount received from insurance exceeds the basis of the property. In this connection, IRC Section 1033(h) provides relief provisions for people whose principal residences (and contents) are involuntarily converted as a result of a federally declared disaster. Under this provision, a taxpayer does not recognize any gain from the receipt of insurance proceeds for the loss of personal property unless the property was "scheduled property" on the taxpayer's insurance policy. The owner may avoid recognizing any casualty-related gain on the home if the taxpayer incurs costs for similar replacement property, equal to the amount realized, within four years of the end of the tax year in which the taxpayer realized the gain.[2]

- **Real estate taxes.** Real estate taxes are generally deductible only as an itemized deduction unless they are incurred in connection with a rental or business property.[3] As the result of the TCJA, beginning in 2018, all state and local itemized deduction taxes (including real estate taxes) are limited to a deduction of $10,000 for a single person or a joint return filer, and $5,000 for a married person filing separately.

- **Two or more homes.** For the individual who has two or more residences, there are special considerations:

  — Which home is to be the individual's principal residence? This issue becomes important in terms of meeting the $250,000 ($500,000 on a joint return) gain exclusion rule. It may also be important in terms of establishing domicile and governing state law for purposes of the individual's financial plan.

  — If the individual has more than two residences, the mortgage interest deduction is limited to interest expenses for two residences.[4]

  — If the residences are situated in different states, some consideration must be given to the requirement of ancillary administration of a decedent's estate and what steps, if any, might be taken to eliminate that problem, such as the use of a living trust or limited liability company to hold title to the multiple properties.

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[2] IRC Sections 1033(h)(1) and 1033(a)(2)(B).

[3] IRC Section 164(a).

[4] IRC Section 163(h)(4)(A).

¶2805 Purchasing a Home

Owning a home is sometimes considered part of the "American dream." Owning a home provides an individual or family with a place to live, a valuable asset, tax benefits, and pride of ownership. A home is the largest investment that many people will make. Before purchasing a home, an individual or family should consider several important factors.

.01 Structural Integrity

A purchaser should ensure that the home is structurally sound, with particular attention being paid to the foundation and roof as well as electrical and plumbing systems. A financial planner would be wise to recommend that a client have the home inspected by a well-qualified inspector. Issues such as the presence of asbestos, underground oil tanks, a septic system, wells, radon, and termites should be among the subjects of inspection. The commitment to complete the purchase of a home should be conditioned on a satisfactory home inspection and agreement between the parties that any home inspection issues have been resolved. New homes may come with a warranty. The purchaser should understand the terms of the warranty. Often, the warranty will cover some things for one year, but cover the foundation or roof, or both, for as long as 10 years. Purchasers might want to have the home inspected again before the warranty coverage expires.

.02 Appreciation Potential

Although the tax law considers a home as a personal use asset, a client often treats his or her home as an investment. On average, people move approximately every 5 to 10 years. A financial planner should advise a client to consider the appreciation potential of the home. This consideration is especially important because the tax law provides a generous exclusion for the gain realized on the sale or exchange of one's principal residence. (¶2820)

The financial planner should suggest that the clients be realistic in their expectations of home appreciation and view a home purchase as selecting a home as the place in which they want to reside perhaps more than as a financial investment.

.03 Quality of Neighborhood Schools

If the purchaser has children who are in school, the purchaser should consider the quality of the neighborhood schools the children would attend. The financial planner should advise the client to obtain information on the quality of the schools. Visiting the schools before a purchase decision might be enlightening.

.04 Crime Rate

The purchaser would be wise to investigate the crime rate of a neighborhood before purchasing a home. Also, the purchaser should learn if the neighborhood has a citizens' crime watch program.

.05 Transportation

The purchaser should check the roads that serve the neighborhood. If the area is a new area, the purchaser should learn what plans the local government has for expanding access. Of particular concern to many clients will be the ease of commuting to and from the place where the client works. Ease of

transportation to shopping areas, public services, hospitals, and schools would also be important to many purchasers.

.06 Legal Considerations

Under the statute of frauds, a contract to purchase real estate must be in writing to be enforceable. Although real estate agents often have standard contracts that one can use to make an offer on a home, the purchaser does not have to use these standard contracts. The purchaser may modify the standard contracts. A purchaser would be wise to have an offer to purchase real estate reviewed by an attorney. Purchasers should be aware of restrictive covenants and easements. Have a survey of the property performed by a registered land surveyor. A purchaser would also be wise to have an attorney present at closing to review all documents. The new homeowner should have the title to the property reviewed by an attorney and title company and obtain title insurance, or both.

.07 Use of a Real Estate Agent

Although some purchasers buy a home without using a real estate agent, the use of a real estate agent is common. Purchasers should remember that real estate agents who list the home for sale represent the seller and owe a fiduciary duty to the seller. In many areas, buyer's agents are available who represent the buyer. Purchasers should give serious consideration to employing a buyer's agent. Real estate agents are often aware of local issues such as permit requirements, buried oil tank concerns, certificates of occupancy, etc., that are essential considerations when purchasing a residence.

.08 Financing

Financing is a most important aspect of purchasing a home because few people pay for a home entirely out of their available funds. The next paragraph discusses home financing and interest deductions in detail.

¶2810 Home Financing and Interest Deductions

The focus of this section is on financing. Deductions for interest are separately considered in ¶2815.

The two basic types of mortgages are fixed rate mortgages and adjustable rate mortgages. Variations of both types are separately considered in the following text.

.01 Fixed Rate Mortgages

As the name implies, a *fixed rate mortgage* carries an interest rate that is fixed (generally at the loan closing) and remains constant until the loan is retired. Virtually all fixed rate home mortgages require level monthly payments and are self-amortizing (that is, at the end of the loan term, the principal balance will be zero). The total amount of interest paid on the mortgage increases with its term, which generally ranges from 15 to 30 years. A lender may retain the loan in its portfolio or sell it on the secondary mortgage market and continue to earn servicing fees on the outstanding loan balance.

The outstanding feature of a fixed rate mortgage, from the borrower's standpoint, is the certainty that payments will not increase over the life of the loan, even if interest rates increase substantially. There is the possibility of making payments over time in cheaper dollars due to inflation. If interest rates decline during ownership, the loan may be refinanced to take advantage of the lower rate, which may involve the payment of additional fees, generally referred to as *points*.

.02 Adjustable Rate Mortgages

Adjustable rate mortgages (ARMs) are designed to transfer to borrowers some or all the risk that lenders may encounter in connection with long-term mortgage loans in a climate of rising interest rates. The ARM may be presented to the borrower at a low interest rate "teaser" when mortgage interest rates are high as a means of passing along some of the benefits of a possible interest rate decline or to induce the borrower to take the loan. ARMs, at least in their initial year, typically feature lower interest rates than fixed rates, in part, to compensate the borrower for accepting more risk of future uncertainty. In general, the greater the risk the borrower finds acceptable, the lower the interest rate. A typical ARM will include most, and possibly all, of the following features.

Index. This rate is the benchmark that the lender uses to adjust the rate. Common indexes are the rate on U.S. Treasury securities (six-month, one-, three- or five-year maturities) and the average cost of funds for savings institutions insured by the Savings Association Insurance Fund.

Margin. The *margin*, also known as the *spread*, is the amount that the lender may add to the index value used in the agreement.

Initial rate and adjusted effective rate. The *initial rate* is the interest rate upon which the borrower's initial payments are based. Typically, the rate is lower than the amount that would be payable on a fixed rate mortgage. If the initial rate is much lower, it is said to be a *teaser*, an artificially low rate designed to induce the borrower to enter into the arrangement. An easy way to see if the initial rate is artificially low in the first year is to determine what the rate would be under the then applicable index, plus the margin, and compare this rate with the initial rate.

When rate adjustments occur, the adjusted effective rate is the index value used plus the margin. For example, if the index value is 4% and the margin is 2%, the adjusted effective rate is 6%. The effective rate is not to be confused with the annual percentage rate or APR, which takes into account the points (that is, additional charges to the buyer calculated as a percentage of the loan amount) levied (if any) when the loan is closed.

Adjustment period. This period is simply the time when payments or interest rates can change. For example, they may change every six months, every year, or every three or more years.

Caps. Several caps may apply, including the following:

- **Payment cap.** This cap limits the increase in monthly payments at each adjustment period. For example, payment increases may be capped at 7.5%.

- **Interest adjustment cap.** The interest rate that monthly payments are based on cannot increase (or decrease) by more than a set percentage at each adjustment period. The cap is usually one or 2% for shorter adjustment periods and higher caps for longer adjustment periods.

- **Lifetime caps.** There may be one or several ceilings specified in the note. An ARM must, by law, carry an interest rate ceiling that limits the maximum interest that the lender may charge during the life of the loan. Lifetime interest caps usually are 5 or 6 percentage points higher than the initial rate. For example, if the initial effective rate is 5.5%, the rate can go no higher than 11.5% during the loan term if the lifetime interest cap is 6%. A lifetime payment cap places a percentage limit on the amount by which principal and interest payments can increase during the loan term. The note also may carry a cap on negative amortization.

Negative amortization. This condition occurs when the borrower's monthly payments are less than the amount necessary to pay interest on the outstanding debt. As a result, the lender adds the unpaid interest to the loan principal. This may occur in the early years of an ARM, when the initial interest rate is artificially low.

.03 Other Kinds of Mortgages

Variations of the basic fixed rate and adjustable rate mortgages discussed previously include the following.

Seven-year balloon mortgage. A 7-year balloon mortgage calls for fixed monthly payments based on a 30-year amortization of the mortgage. At the end of 7 years, the borrower must pay the balance due on the loan. However, if the borrower meets certain conditions, the borrower may refinance the loan at maturity with a 23-year fixed rate mortgage.

Graduated-payment mortgage (GPM). With a GPM, payments begin at a lower level than with a conventional mortgage and increase in fixed steps over the first several years. The borrower may usually choose between different rates of increase and different periods of increase. For example, the borrower may choose to have payments increase 5% each year or 2.5% each year for 10 years.

The major disadvantage of a GPM is that the borrower pays substantially more interest and less principal than under a conventional mortgage because of the slower amortization. If the home is resold before monthly payments have caught up with those under a conventional mortgage, the mortgage principal due will have grown. As a result, the owner will have a smaller equity for the next home than at the inception of the mortgage if the appreciation of the home is less than the increase in the mortgage principal.

Graduated-payment adjustable mortgage (GPAM). This form of mortgage is a combination variable rate mortgage (VRM) and GPM. It starts out as a GPM, with lower payments increasing by steps, and, when payments reach the point when they would level off under a GPM, interest rates may move up or down as under a VRM. The complexity of the GPAM explains its less frequent use than VRMs or GPMs.

Price level adjusted mortgage (PLAM). With a PLAM, the lender sets the initial rate of interest at the prevailing real rate of interest (rate without any adjustment for inflation). At the end of each year, the principal balance is adjusted to keep pace with inflation (or deflation), so that it reflects the real purchasing power of the dollars initially borrowed. PLAMs involve many trade-offs for the borrower, the main one of which is negative amortization.

Another concern is that equity increases will not significantly increase the homeowner's ability to use the home as a source of additional borrowing. If inflation outpaces the borrower's income, the borrower may find keeping up with the monthly payments is difficult.

Renegotiable-rate mortgage (RRM). The RRM is a series of short-term loans of possibly 3, 4, or 5 years secured by a long-term mortgage of perhaps 25 or 30 years. Each time the short-term loan is renewed, the interest rate changes in accordance with the formula fixed in the agreement. Federally chartered savings institutions create RRMs using the Federal Housing Finance Board interest rate index, which is published monthly.

Lenders are required to renew the loan at the end of each short-term period, but the borrower may pay it off without penalty.

Shared-appreciation mortgage (SAM). With a SAM, the borrower gets a below-market interest rate for a designated period in exchange for giving the lender a share of the appreciation of the home's value over the period designated or on resale, whichever comes first.

If the borrower does not sell the home, the borrower must pay the lender what is designated as "contingent interest," equal to the lender's share of the appreciation as determined by an independent appraisal. To protect the owner against the possibility of having to pay the lender a large sum at the time specified, the lender ordinarily guarantees to refinance at the interest rate then prevailing.

The SAM is more speculative for both parties than the other types of mortgages discussed previously. If, for example, inflation were to continue at a rate of 7.2% per year for an indefinite period, the value of the house would double in 10 years. The owner, even though guaranteed refinancing, might find carrying the home with the much greater mortgage difficult, if not impossible. The lender, on the other hand, would receive an excellent return. The exact amount of cost to one and benefit to the other would depend on their relative shares in the appreciation. The relative shares in the appreciation would be affected by the extent to which the interest rate is below market. Typically, the interest rate will be one-third below market, and the lender will get one-third of the appreciation.

Zero rate mortgage (ZRM). A ZRM is a mortgage that makes no express provision for interest. If it is a purchase money mortgage, interest is imputed to the mortgagee-seller (and the principal amount of the debt is reduced for the imputed interest) under either IRC Section 483 or 1274, depending on the sale price and the stated note principal. However, the mortgagor-buyer of a personal residence does not adjust note principal and is not entitled to a deduction for imputed interest if the debt instrument is given in consideration for the sale of the property.[5]

Flexible loan insurance program (FLIP). The FLIP is known as the *pledged-account mortgage* because it makes use of a pledged savings account. It operates to provide graduated payments for the borrower and level payments for the lender.

The amount that the purchaser would ordinarily use as a down payment is placed in an interest-bearing savings account with the lending bank. The borrower pledges the account as additional security for the loan. Each month the lender withdraws an amount from the savings account which, when added to the reduced payment afforded the borrower, will equal the normal payment on a conventional mortgage. The borrower's payments increase periodically. As they increase, the payments from the savings account decrease. The computation is such that the savings account is normally completely used up at the end of five years.

Growing-equity mortgage (GEM). Although all self-amortizing mortgages increase the mortgagor's equity, GEMs do so at a faster pace through gradually increasing principal payments. The interest rate remains constant. Because of the accelerated principal payments, the mortgagee is able to offer a lower interest rate than with a conventional mortgage. This factor, plus the shorter period before the principal is paid, along with the fixed interest rate, may make the GEM attractive to a borrower. However, the

[5] IRC Section 1275(b)(1); Regulation Section 1.1275-2(f)(1).

GEM runs counter to the conventional wisdom that from a borrower's standpoint, the longer the term of the mortgage the better because with continuing inflation, future payments may be discharged with ever cheaper dollars. The basic factor to be weighed is whether the after-tax benefit of the lower interest rates saves as much as (or more than) the savings under a conventional mortgage with higher interest rates but a longer term.

Fixed rate with refinancing option. A so-called *reduction-option loan* gives the homeowner/mortgagor a built-in option to refinance without the usual closing costs of refinancing if rates drop at least 2 percentage points. Typically, the refinancing option may only be exercised between the 13th and 59th month of the mortgage. The cost of exercising the option will vary from lender to lender. Some lenders charge $100 plus 0.25% of the principal ($350 on a $100,000 loan). The cost of the option is an initial interest rate that is about a quarter of a percent higher than a comparable 30-year fixed rate mortgage without such an option.

Biweekly mortgages. The homeowner/mortgagor makes a mortgage payment biweekly (every 2 weeks) in an amount equal to half of what the payment would be on a conventional monthly payment mortgage. Interest is charged at the same rate as a conventional monthly payment mortgage. As a result, the borrower annually pays the equivalent of 13 conventional monthly payments. The mortgage is paid off sooner, running anywhere from 17–20 years, depending on terms, rather than 30 years. This reduction in the term of the loan results in far lower aggregate interest payments. On the other hand, the opportunity to benefit from inflation by paying with cheaper dollars is reduced.

Fixed-payment ARM. The lender adjusts the interest rate annually, but the amount of monthly payments remains fixed by lengthening or shortening the term of the loan.

40-year mortgage. Some lenders offer 40-year loans. The differential in the monthly payments is not great, but the difference in aggregate payments over the term of the loan is substantial.

Reverse mortgages. In a *reverse mortgage* (also called a *home equity conversion*) a homeowner borrows against the equity in his or her home by receiving the loan in monthly installments. Thus, the loan balance grows each month. However, the borrower does not have to make a payment as long as he or she lives. A reverse mortgage is a financial planning tool that clients over age 62 can use to convert the equity in their home to cash without having to move or risk losing their home. When the clients die, the loan must be repaid by the clients' heirs, either directly or by the sale of the home. Reverse mortgage loans made after May 2013 require variable interest rates, not fixed rates.

The equity of many home owners may be substantial. At the same time, low interest rates and meager dividend yields have failed to provide a sufficient revenue flow to enable many seniors to maintain the lifestyle they otherwise desire. Many people find themselves to be equity rich, but cash poor. What choices do they have? They can invest more heavily in the stock market to seek higher returns, but that obviously comes with more risk. They can borrow money with a standard mortgage or home equity loan, but that requires monthly repayments at higher rates of interest than they are able to earn on their own investments. They can sell the house, but where do they go? Perhaps they can move to a less expensive place, enabling them to enjoy some of the equity they have cashed out of their home.

The practical problem with the last suggestion is that many seniors do not want to leave their principal residences. How many planners have been told "They'll carry me out of here before I sell!"? The reverse mortgage may offer a solution to these concerns by allowing a person to remain in his or her home and enjoy a regular stream of tax-free income.

In broad outline, a reverse mortgage is a transaction whereby an individual secures his or her home to a lender who provides payments (the payments may be either a steady stream of monthly payments, or a line of credit to be drawn as needed, or a combination of these forms of payment) subject to a capped maximum amount to the individual. The payments do not constitute taxable income to the recipient. Upon the death of the individual, the amounts advanced by the lender, plus an interest factor, are recovered generally by the sale of the home, with the remaining balance, if any, paid to the deceased owner's heirs. If the owner wished to sell the home during the owner's lifetime, the balance due on the reverse mortgage would constitute a lien that would have to be repaid from the proceeds of sale. After the death of the homeowner, the owner's family would also have the option of repaying the loan from another source of funds and retaining the home, if they desired.

In order to be eligible to receive a reverse mortgage, the individual must be at least 62 years old. The amount available depends on a number of factors, including the value of the home, the age of the owner and the market interest rates at the time the loan is taken. There are also "caps," which are adjusted from time to time, imposed on how much equity can be borrowed in a reverse mortgage as a percentage of the owner's equity. The mortgage amount is based on the lesser of either the appraised value of the home, the home equity conversion mortgage (HECM) FHA mortgage limit of $765,600 for 2020 reverse mortgages, or the sales price. The individual must own the home and live in the home to be eligible. The home must be either a single-family home or a two- to four-unit home with one unit occupied by the borrower. There are condominiums and other residential properties that may also be eligible for reverse mortgages.

The monthly amount and available credit line that can be received from a reverse mortgage depends on a variety of factors, including the age of the borrower. Older borrowers may receive larger reverse mortgage loans. AARP provides a great deal of information about reverse mortgages, including a calculator on their website at www.aarp.org/revmort. The same website offers a brochure called "Home Made Money," which can also be obtained by calling 888.687.2277. Fannie Mae also provides an explanatory brochure that can be obtained by calling 1.800.232.6643.

Be mindful of fees when considering a reverse mortgage. They can become substantial. All new reverse mortgages are required to have a variable interest rate. In a rising interest rate environment, this requirement can make the arrangement more costly in the long run. If a reverse mortgage is being considered, the borrower should certainly shop for the best fee arrangement.

Most reverse mortgage fees can be financed as part of the loan. The two main fees are the *origination fee* and the *mortgage insurance premium*.

- **Origination fee:** This is the upfront fee charged by the reverse mortgage lender to initiate the loan. For the HECM, the origination fee is 2% of the maximum loan amount up to $200,000, and 1% on the remainder of the loan amount. However, the origination fee cannot be less than $2,500 or more than $6,000, no matter the loan amount.

- **Mortgage insurance premium (MIP):** This is insurance that protects the borrower. HUD guidelines require that all HECM reverse mortgage borrowers receive reverse mortgage insurance, which guarantees two things. First, it guarantees the borrower will continue to receive benefits no matter what happens to the investor. If the lender suddenly goes out of business or leaves for any other reason, the government would step in and pay the loan payments. Second, the MIP ensures that the borrower will never owe more than the value of the home, even if the value of the home declines or the borrower occupies the home longer than expected. The MIP is .50 of the amount of 60% or less of the principal limit, or 2.5% of the amount greater than 60%

of the principal limit, with a home value limit of $ 765,600, and an annual premium of 1.25% of the loan balance.

In addition to these two fees, all of the other fees that are normally associated with any mortgage may apply.

- **Application fee:** Banks usually charge this fee to determine the ability of the borrower to take on new credit, check the credit score, and process the mortgage application.

- **Appraisal fees:** This is paid to have an expert estimate the market value of the home. This fee is usually unavoidable because it is required every time a house is sold.

- **Third-party closing costs:** This covers services that are required before the reverse mortgage can be finalized and includes such things as appraisals, title searches, surveys, inspections, mortgage, taxes, credit checks, and more.

- **Servicing set-aside fee:** This is used to cover the future costs of services, such as account statements, paying out loan income, and checking that loan requirements are being maintained. Typically these fees are between $20 and $35, and are capped by the federal government at $30 if the interest rate is annually adjusted and at $35 if the interest rate is adjusted monthly. The servicing set-aside fee is not added to the principal of the loan initially, but is applied to the loan balance on a monthly basis throughout the loan.

If the borrower is planning to move relatively soon, the upfront fees make the reverse mortgage less desirable. If the borrower has no intention of moving, and has a reasonable expectation of a long life expectancy, even with the fees, the reverse mortgage can make sense. Some view the reverse mortgage as an option of last resort, because of the potentially high fees.

The federally insured reverse mortgage process now requires a discussion with a HUD reverse mortgage counselor. Before applying for a federally insured reverse mortgage, the borrower must meet with a counselor from an independent government-approved housing counseling agency. Some lenders offering proprietary reverse mortgages also require counseling. The counselor is required to explain the loan's costs and financial implications, and possible alternatives to a HECM, like government and non-profit programs or a single-purpose (offered by some state and local governments or non-profit organizations) or proprietary reverse mortgage (private loans backed by the companies that issue them). The counselor also should be able to help the borrower compare the costs of different types of reverse mortgages and tell the borrower how different payment options, fees, and other costs affect the total cost of the loan over time. To find a counselor, visit www.hud.gov or call 800.569.4287 to find local counselors. Most counseling agencies charge around $125 for their services. The fee can be paid from the loan proceeds, but the borrower cannot be turned away if the borrower cannot afford the fee.

A strategy that may be used in the reverse mortgage context is taking a monthly payment and a line of credit. Use the line of credit either to pay off an existing mortgage or home equity loan or, if no such debts are present, use the line of credit to help pay the premiums for long-term care insurance. Holding off on drawing down the line of credit, if possible, will result in less accumulated interest.

Lenders now must analyze the borrower's ability to meet property tax and homeowners insurance payments before approving a reverse mortgage. Reverse mortgage borrowers are required to undergo a financial assessment. The purpose of the assessment is to determine whether the borrower is reasonably capable of maintaining the requisite tax and insurance payments given their other income, assets and

liabilities, and credit report. If it is determined that the borrower will not reasonably be able to support these payments, then it will be required for these payments to be drawn from the reverse mortgage itself and escrowed; notably, given the dollar amounts and time horizons involved (possibly for the borrower's entire life expectancy), this may effectively mean that the entire reverse mortgage borrowing amount is consumed by just the obligation to potentially maintain property taxes and homeowners insurance for life.

Recent regulations eliminated the risk that a non-borrower spouse could be removed from the home on the death of the borrower spouse.

.04 Tax Credit for First-Time Homebuyers

The Housing and Economic Recovery Act of 2008 (P.L. 110-289) created a tax credit for first-time homebuyers. The credit initially applied to home purchases on or after April 9, 2008, and before July 1, 2009. The credit was subsequently expanded and extended by the American Recovery and Reinvestment Act of 2009 for home purchases on or after January 1, 2009, and before December 1, 2009.[6]

For eligible home purchases prior to 2009, the credit was equal to the lesser of (1) $7,500 ($3,750 for a married individual filing separately) or (2) 10% of the purchase price of a principal residence. For homes purchased after December 31, 2008, and before December 1, 2009, the maximum credit amount was $8,000 ($4,000 for married individuals filing separately).

The credit phased out for individual taxpayers with modified AGI between $75,000 and $95,000 ($150,000–$170,000 for joint filers) for the year of purchase.

The taxpayer was considered a “first-time homebuyer” if he or she had no ownership interest in a principal residence in the United States during the three-year period prior to the purchase of the new home.

A taxpayer was not permitted to claim the credit if the taxpayer’s financing came from tax-exempt mortgage revenue bonds, the taxpayer was a nonresident alien, or the taxpayer disposed of the residence (or it ceased to be a principal residence) before the close of a taxable year for which a credit otherwise could be allowable.

Recapture of the credit. In the case of homes purchased prior to 2009, a taxpayer claiming the credit must pay it back through a “recapture” provision. The recapture provision was generally eliminated for homes purchased on or after January 1, 2009, and before December 1, 2009.

Under the recapture provision, the homebuyer credit is recaptured ratably over 15 years, with no interest charge beginning in the second taxable year after the taxable year in which the home was purchased. For example, if the taxpayer purchased a home in 2008, the credit was allowed on the 2008 tax return, and repayments commenced with the 2010 tax return. For each year of the 15-year period, the taxpayer’s tax liability is increased by an amount equal to 6 2/3% of the credit claimed. Recapture rules may still be in play for persons who acquired homes utilizing this credit.

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[6] IRC Section 36 as added by the Housing and Economic Recovery Act of 2008 (P.L. 110-289) and amended by the American Recovery and Reinvestment Act of 2009 (P.L. 111-5).

If the taxpayer sells the home (or the home ceases to be used as the principal residence of the taxpayer or the taxpayer's spouse) prior to complete recapture of the credit, any remaining credit recapture amount is due on the tax return for the year in which the home is sold (or ceases to be used as the principal residence). However, the credit recapture amount may not exceed the amount of gain from the sale of the residence. For this purpose, gain is determined by reducing the basis of the residence by the amount of the credit to the extent not previously recaptured.

No amount is recaptured after the death of a taxpayer. In the case of an involuntary conversion of the home, recapture is not accelerated if a new principal residence is acquired within a two-year period. In the case of a transfer of the residence to a spouse or former spouse incident to divorce, the transferee spouse (and not the transferor spouse) will be responsible for any future recapture.

¶2815 Deductibility of Home Mortgage Interest

The TCJA has made significant changes in this area. A taxpayer may deduct home mortgage interest only if it constitutes qualified residence interest[7] (that is, interest on either acquisition indebtedness, home equity debt, or both).[8] The total debt that can give rise to a deduction for qualified residence interest is $1.1 million — $1 million for acquisition debt and $100,000 for home equity debt for 2017 and prior years, and is $750,000 for new debt incurred after December 15, 2017. Interest paid on qualified residence interest debt incurred before December 15, 2017, can still be deducted based on a $1 million debt cap.[9]

Prior to 2018, besides the dollar limits, the major difference between the two categories (qualified residence and home equity) was that acquisition debt qualified only if the taxpayer used it for purposes specified in the statute, such as the construction, acquisition, or substantial improvement of a qualifying residence.[10] By contrast, interest on qualifying home equity debt generally was deductible without regard to how the borrower used the funds.[11] That will no longer be allowed. Home equity interest may be deducted only if the loan is incurred for the acquisition, refinancing, or substantial improvement of the residence, and the cap of $750,000 applies to the sum of the qualified acquisition debt and the home equity debt. If the taxpayer used the loan proceeds to buy tax-exempt securities,[12] the interest deduction is barred. If a client presents interest expense deductions, the financial planner should inquire about the reason for the interest payments to be certain that they qualify for the deduction.

In *Voss v. Commissioner*, 796 F.3d 1051 (9th Cir. 2015), the U.S. Court of Appeals for the Ninth Circuit reversed the Tax Court's decision and held that in the case of unmarried co-owners of a qualified residence, the debt limit provisions apply on a per-taxpayer basis, rather than on a per-residence basis in determining the amount of the allowable interest deduction under IRC Section 163(h). Therefore, (prior

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[7] IRC Sections 162(a) and 163(h)(2)(D).

[8] IRC Section 163(h)(3)(F).

[9] IRC Section 163(h)(3)(F).

[10] IRC Section 163(h)(3)(B).

[11] IRC Section 163(h)(3)(C).

[12] IRC Section 265(a).

to the TCJA) two million dollars in acquisition debt and two hundred thousand dollars in home equity debt were permitted for interest deduction purposes on a single residence.

.01 Limitation on Itemized Deductions

For 2018 and beyond, the 3% reduction of itemized deductions (the so-called "Pease limitation") has been repealed. All itemized deductions, to the extent still allowed, may now be claimed without reduction.

.02 Acquisition Debt

A loan is treated as acquisition debt and, thus, gives rise to deductible interest only if the following tests are met:[13]

- **Use of proceeds.** The taxpayer must use the loan proceeds to acquire, construct, or substantially improve a qualified residence or to refinance debt used for these purposes.
- **Security for debt.** The loan must be secured by the qualified residence.
- **Use of residence.** IRC Section 163(h)(4)(A)(i) defines a *qualified residence* as the taxpayer's principal residence within the meaning of IRC Section 121 or one other home considered used as a residence under IRC Section 280A(d)(1), or both. Under the latter IRC section, a home qualifies if the taxpayer uses it personally for more than the greater of 14 days or 10% of the days it is rented in any given year.
- **Dollar cap.** The aggregate amount of acquisition debt does not exceed $750,000 for debt incurred after December 15, 2017. This number is not indexed for inflation.

IRS Notice 88-74[14] adds another requirement. Acquisition debt cannot exceed the cost of the residence (including the cost of improvements).

.03 Home Equity Debt

Like acquisition debt, home equity debt must be properly secured by a qualified residence in order to be deductible.[15] Beginning in 2018, interest on home equity debt is deductible only if used to acquire, construct, or substantially improve or refinance a qualified residence.

.04 Limitation

Home equity debt cannot exceed the difference between the home's fair market value when the loan is obtained less the outstanding acquisition debt at that time.[16] Thus, the deduction for mortgage interest

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[13] IRC Section 163(h)(3)(B).

[14] 1988-2 CB 385.

[15] IRC Section 163(h)(3)(C)(i).

[16] IRC Section 163(h)(3)(C)(i).

would be further limited on a 125% home loan to the interest on the portion of the loan secured by the value of the property at the time of the loan.

In addition, interest is not deductible to the extent the average outstanding home equity debt exceeds $100,000 ($50,000 for married persons filing separately).[17] Be mindful here of the overall cap of $750,000 of acquisition debt and the narrowed purpose of the home equity debt if the interest on such debt is to be deductible.

.05 Grandfathered Debt

A *grandfather rule* applies to debt incurred on or before October 13, 1987, and secured by a qualified residence on that date and at all times thereafter before the interest is paid or accrued. Such debt automatically is treated as acquisition debt, regardless (generally) of how the proceeds are used. Grandfathered debt is not subject to the otherwise applicable $1 million ceiling.[18] Any outstanding grandfathered debt reduces the $1 million limit on acquisition debt, but not below zero.

.06 Residence

A *residence* includes a house, co-op, condominium, mobile home, boat, or house trailer that contains sleeping space and toilet and cooking facilities.[19] Time-share units also qualify as residences.[20] A time-sharing plan is an arrangement between parties that limits one's interests in the property or limits the right to use it to a certain portion of the year (for example, two weeks).

.07 Points

A lender may impose a variety of charges in connection with a home mortgage. Typically, one of the largest charges is for points, a one-time payment that increases the lender's yield on the loan. A point is 1% of the loan amount.

Generally, because points represent prepaid interest, a cash-basis taxpayer must deduct the interest expense ratably over the term of the loan. However, IRC Section 461(g)(2) carves out an exception for points paid in connection with debt incurred to buy or improve a principal residence and secured by the residence. Such points are deductible as interest in the year paid (subject to the restrictions of IRC Section 163(h)) as long as the payment of points is an established business practice in the area where the debt is incurred, and the points levied are not in excess of the amount generally charged in the area.

Points paid in connection with refinancing a principal residence or obtaining a home equity credit line secured by the home are currently deductible only to the extent that the loan amount is used to improve

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[17] IRC Section 163(h)(3)(C)(ii).

[18] IRC Section 163(h)(3)(D).

[19] Temporary Regulation Section 1.163-10T(p)(3)(C)(ii).

[20] Temporary Regulation Section 1.163-10T(p)(6).

the residence.[21] A taxpayer may amortize points that are not currently deductible over the life of the loan. The taxpayer may deduct any unamortized points at the time the loan is paid off.

A purchaser may deduct points paid by the seller on a mortgage loan obtained by the purchaser to purchase the taxpayer's principal residence. The purchaser treats the points paid by the seller and deducted as a reduction in the basis of the property.[22]

.08 Alternative Minimum Tax Factors

- For AMT purposes, otherwise eligible acquisition debt does not give rise to a deduction for AMT purposes if the taxpayer uses the proceeds to build, buy, or substantially improve a boat or a mobile home used on a transient basis. [23]

- The AMT deduction is limited to interest paid or accrued on acquisition debt only and the refinancing of such debt.

When the debt was incurred, it must have been secured by either a

- principal residence of the taxpayer or

- home, apartment, condominium, or non-transient-use mobile home used by the taxpayer or his or her brother, sister, spouse, ancestor, or lineal descendant.

.09 Mortgage for Business Loan

IRC Section 163(h) prohibits any deduction for personal interest (that is, interest paid on personal loans, credit card debt, car loans, tax underpayments, etc.). However, IRC Section 163(h) does not limit the deduction for interest incurred for loans used for business purposes.[24] If a taxpayer borrows against his or her home equity and uses the proceeds for business purposes, the taxpayer may deduct the interest on the appropriate form on the tax return (for example, Schedule C for sole proprietors and Schedule F for farmers). The taxpayer may deduct the interest on a business loan even if the amount of the loan exceeds the value of the home. Taxpayers should be aware of the tracing rules to prove the business use of the borrowed funds to ensure a deduction for business interest.[25]

¶2820 Exclusion of Gain on Sale of Residence

An individual may generally exclude up to $250,000 ($500,000 on a joint return) of gain realized on the sale or exchange of a principal residence. To qualify for the $250,000 exclusion, the individual must have owned (the ownership test) and occupied (the use test) the home as a principal residence for an

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[21] Revenue Ruling 87-22, 1987-1 CB 146.

[22] Revenue Procedure 94-27, 1994-1 CB 613.

[23] IRC Section 56(e).

[24] IRC Section 163(h)(2)(A).

[25] Temporary Regulation Section 1.163-8T.

aggregate of at least two of the five years before the sale or exchange. The exclusion applies to only one sale or exchange every two years.

.01 Married Individuals

The amount of excludable gain is increased to $500,000 for married individuals filing jointly if (1) either spouse meets the ownership test, (2) both spouses meet the use test, and (3) neither spouse is ineligible for the exclusion because of having made a sale or exchange of a residence within two years.

.02 Gain Recognized to Extent of Depreciation

The exclusion does not apply, and gain is recognized, to the extent of any depreciation allowable with respect to the rental or business use of a principal residence.[26] Except for the gain due to depreciation recapture, the portion of the home used for business purposes (such as a home office or day care center) is eligible for the $250,000 (or $500,000) exclusion.[27] However, if the taxpayer used a separate structure on the property for business purposes, any gain allocated to the separate structure is not eligible for the exclusion.[28]

.03 Exclusion Prorated

If a taxpayer does not meet the ownership or residence requirements, a pro rata amount of the $250,000 or $500,000 exclusion applies if the sale or exchange is due to a change in place of employment, health, or unforeseen circumstances. In such cases, the amount of the available exclusion is equal to $250,000 (or $500,000) multiplied by the portion that the shorter of (1) the aggregate periods during which the ownership and use requirements were met during the five-year period ending on the date of sale, or (2) the period after the date of the most recent sale or exchange to which the exclusion applied bears to two years. The following example illustrates the proration formula:

> **Example 28.2.** On September 1, 2019, Al and Lisa Jackson purchased a townhouse in Boston for $450,000. Lisa received an offer of employment in Atlanta, and on July 1, 2020, the Jacksons sell their townhouse for $480,000 and purchase a home in a suburb of Atlanta for $350,000. The Jacksons realize a $30,000 capital gain on their townhouse. Their exclusion is limited to $208,333 ($500,000 possible exclusion × 10 months of use ÷ 24). Because their allowable exclusion exceeds their realized gain, they may exclude all of the $30,000 gain from their gross income.

.04 Less Need for Recordkeeping?

One of the stated reasons behind the enactment of the $250,000/$500,000 residential sale exclusion was eliminating the need for many homeowners to keep detailed records with respect to their residential purchases and sales. Nevertheless, the financial planner should advise clients to keep records of capital improvements if there is any possibility that the client might be required to recognize a gain upon the

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[26] Regulation Section 1.121-1(d).

[27] Regulation Section 1.121-1(e).

[28] Regulation Section 1.121-1(e).

sale of a home. Such capital improvements increase the clients' basis in the home and may help eliminate or mitigate the amount of gain should there be a sale. Such a situation may arise under any of the following circumstances:

- The homeowners intend to live in the residence for a long period of time.
- The homeowners make substantial improvements to the home.
- The residence is rapidly appreciating in value.
- The homeowners may someday claim a depreciation deduction for a home office or rental use of the residence.
- There is a possibility that the owners may not use or own the residence long enough to qualify for the exclusion.

.05 Incapacitated Homeowners

If a homeowner becomes physically or mentally incapable of self-care and a sale of the home becomes necessary, the homeowner will be considered eligible to claim the entire exclusion for the sale of a principal residence while residing in a licensed care facility, such as a nursing home. For this rule to apply, the homeowner must have owned and used the residence as a principal residence for at least one year during the five years preceding the sale.

.06 Divorced and Widowed Homeowners

If a residence is transferred to a taxpayer incident to a divorce, the time during which the taxpayer's spouse or former spouse owned the residence is added to the taxpayer's period of ownership. A taxpayer who owns a residence is deemed to use it as a principal residence, if the taxpayer's spouse or former spouse is given use of the home as a principal residence under the terms of a divorce or separation agreement or decree.

A widowed taxpayer's period of ownership of a residence includes the period in which a deceased spouse owned the residence, provided the taxpayer has not remarried at the time the home is sold or exchanged.

A surviving spouse who has not remarried can claim a $500,000 exclusion if (*a*) the sale of a home occurs not later than two years after the date of the deceased spouse's death, and (*b*) all of the requirements (use, ownership, and so on) for claiming a $500,000 exclusion on a joint return were met as of the date of the deceased spouse's death.[29]

The benefits of this rule will clearly depend on the potential for gain on a sale by the surviving spouse. If the home was jointly owned with the surviving spouse or solely owned by the deceased spouse, or if it was community property, so that it received a partial or complete step-up in basis on the deceased spouse's death, there may be no need to accelerate a sale to take full advantage of the exclusion. On the other hand, if the home was solely owned by the surviving spouse, and, thus, did not receive a step-up in

[29] IRC Section 121(b)(4).

basis, there may be significant potential for gain on a sale. In that case, the rule will give the surviving spouse some breathing room to maximize the exclusion without making a forced sale in the year of the deceased spouse's death. The rule will also allow a surviving spouse to claim the maximum exclusion for a sale in the year of a deceased spouse's death even if circumstances dictate that a joint return not be filed for that year.

.07 Remainder Interests

The residential gain exclusion provision applies to gain on the sale or exchange of a remainder interest in a principal residence, provided that the person acquiring the residence is not a member of the taxpayer's family or other related person.[30]

.08 Property Converted to a Principal Residence

Although the home sale exclusion applies to only one sale or exchange every two years, an individual can claim the exclusion for any number of home sales during the individual's lifetime, provided the two-out-of-five year ownership and use requirements are met for each home. However, a rule may limit the exclusion if a property was used as a vacation home or rental property prior to its use as a principal residence.

The rule provides that gain from the sale or exchange of a principal residence that is allocated to periods of nonqualified use is not eligible for the home sale exclusion. A period of nonqualified use means any ownership period (not including any period before January 1, 2009) during which the property is not used by the taxpayer or the taxpayer's spouse or former spouse as a principal residence.[31]

For purposes of determining periods of nonqualified use, the following are *not* taken into account: (1) any period after the last date the property is used as the principal residence of the taxpayer or spouse (regardless of use during that period) and (2) any period (not to exceed two years) that the taxpayer is temporarily absent by reason of a change in place of employment, health, or, to the extent provided in IRS regulations, unforeseen circumstances.

The amount of gain allocated to periods of nonqualified use is the amount of gain multiplied by a fraction. The numerator of the fraction is the aggregate periods of post-2008 nonqualified use during the period the property was owned by the taxpayer, and the denominator is the total period the taxpayer owned the property (including periods before 2009).

If any gain is attributable to post-May 6, 1997 depreciation, that gain is not taken into account in determining the amount of gain allocated to nonqualified use.

> **Example 28.3.** Bob Brown, a single taxpayer, buys a property on January 1, 2014, for $400,000, and uses it as rental property for two years, claiming $20,000 of depreciation deductions. On January 1, 2016, Brown converts the property to his principal residence. On January 1, 2018, Brown moves out and sells the property for $700,000 on January 1, 2019. Under the rule for post-May 6, 1997, depreciation, $20,000 of the gain is included in Brown's income. Of the

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[30] As defined by IRC Section 267(b) or 707(b).

[31] IRC Section 121(b) as amended by the Housing and Economic Recovery Act of 2009 (H.R. 3221).

remaining $300,000 gain, 40% of the gain (2 years divided by 5 years) —that is, $120,000 — is allocated to nonqualified use and is not eligible for the exclusion. Because the remaining gain of $180,000 is less than the maximum gain of $250,000 that may be excluded by a single person, the gain of $180,000 is excluded from Brown's gross income.

Example 28.4. Laura, a single taxpayer, buys a principal residence on January 1, 2009, for $400,000, resides there, moves out on January 1, 2019, but continues to use the home occasionally as a vacation home. On December 1, 2021, Laura sells the property for $600,000. The entire $200,000 gain is excluded from gross income because periods after the last qualified use do not constitute nonqualified use.

.09 Claiming a Home Sale Loss

An individual's personal residence is a capital asset. If the requirements for exclusion of gain if the residence is sold are not met, the taxpayer must recognize a capital gain on its sale or exchange. However, a taxpayer may not recognize a loss on the sale of a personal residence. Such a loss is considered a nondeductible personal loss.[32]

When faced with the possibility of a loss on the sale of a principal residence, one strategy is to convert the residence into rental property before the sale. In such cases, a loss is computed on the difference between the amount realized from the sale and the lesser of (1) the fair market value of the property at the time of the conversion or (2) the property's adjusted basis for loss at the time of the conversion, determined under Regulation Section 1.1011-1. Accordingly, if the fair market value of the property as of the conversion is less than the adjusted basis of the property, the fair market value becomes the adjusted basis for purposes of calculating a loss.

.10 Impact of the Tax on Net Investment Income

To the extent the sale of a principal residence qualifies for the IRC Section 121 exclusion, the gain is not part of AGI and is not subject to the 3.8% tax on net investment income. If the gain on the sale exceeds the amount of the exclusion, such excess is included in AGI and may be subject to the 3.8% net investment income tax, depending upon whether the AGI of the taxpayer exceeds the applicable threshold. See chapter 38, "Planning for the Additional Medicare Tax and the Net Investment Income Tax."

¶2825 Business Use of a Home

IRC Section 280A bars the deduction of expenses attributable to a taxpayer's use of a home for business purposes, except for such expenses that are attributable to the portion of the home used exclusively and on a regular basis as the following:

- The principal place of any business of the taxpayer
- A place of business that is used by patients, clients, or customers in meeting or dealing with the taxpayer in the normal course of trade or business

[32] IRC Section 165(c).

A home office will also qualify as a taxpayer's principal place of business if the taxpayer meets the following conditions:

- The office is used by the taxpayer to conduct administrative or management activities of the taxpayer's trade or business.
- There is no other fixed location where the taxpayer conducts substantial administrative or management activities of the business.

In addition to allowing affected taxpayers with a legitimate home office claim to deduct a portion of residential interest, real estate taxes, utility charges, and so on, many taxpayers may deduct the cost of traveling to and from their home offices to other locations where they conduct business.[33]

Planning Pointer. The definition of a taxpayer's principal place of business does not affect the requirement that home office expenses are deductible only if such office is used by the taxpayer exclusively on a regular basis as a place of business. If the taxpayer is an employee, the home office deduction is a miscellaneous itemized deduction, no longer allowed beginning in 2018 per the TCJA.

There are two specific exceptions to the exclusive use rule that may be helpful. One deals with the allowance of a deduction in which a portion of the home is used for storage of inventory and product samples, and the other allows a deduction for the portion of a home used as a daycare facility under a state license. Another exception to the IRC Section 280A rules of importance to homeowners who take in overnight guests is found in the section's definition of a *dwelling unit*, so as to exclude the portion of a unit which is used exclusively as a hotel, motel, inn, or similar establishment, and thereby, deny the home office deduction.[34] This exception is likely to be of particular importance to persons operating a bed-and-breakfast out of their home.

The amount of a home office deduction (other than expenses that are deductible without regard to business use, such as real estate taxes) is limited to the gross income from the business activity, reduced first by all other deductible expenses attributable to the activity but not allocable to the use of the home itself. The taxpayer may carry forward disallowed home office deductions indefinitely, subject to the gross income limitation, which will continue to apply even if the unit is not used as a residence. The amount of the home office deduction is usually calculated by determining the ratio of the square feet of the home used exclusively for business purposes to the total square feet of the home. That percentage is multiplied by the various home expenses to determine the amount of the home office deduction.

The IRS issued Revenue Procedure 2013-13, which gives taxpayers an optional safe harbor method to calculate the amount of the deduction of expenses for business use of a residence during the tax year under IRC Section 280A.

Individual taxpayers electing this method can deduct an amount determined by multiplying the allowable square footage by $5. The *allowable square footage* is the portion of the house used in a

[33] Revenue Ruling 99-7, IRB 1999-5, 4 (January 15, 1999).

[34] IRC Section 280A(f)(1)(B).

qualified business use, but not to exceed 300 square feet. The maximum amount a taxpayer can deduct annually under the safe harbor is $1,500. The IRS may update the $5 allowance from time to time.

Electing the safe harbor method is done on a timely filed original tax return (instead of on Form 8829, "*Expenses for Business Use of Your Home*," which is used for the actual home office expense method), and taxpayers are allowed to change their treatment from year-to-year. However, the election made for any tax year is irrevocable.

No depreciation of the residence is allowed for the years in which the safe harbor is elected, but it is permitted in the years in which the actual expense method is used. The revenue procedure has detailed examples of how depreciation is calculated in a year subsequent to a year in which the safe harbor method is used.

To use the safe harbor method, taxpayers must continue to satisfy all the other requirements for a home office deduction, including the requirement that the space in the residence used as an office be used exclusively for that purpose.

The deduction under the safe harbor method cannot exceed the amount of gross income derived from the qualified business use of the home minus business deductions, and a taxpayer cannot carry over any excess to another tax year. If a taxpayer uses the actual expense method for calculating the deduction and has the deduction limited by the gross income limitation in that year, the taxpayer can deduct this amount in the next year the actual expense method is used, but cannot use the disallowed amount in a year the taxpayer elects the safe harbor. This limit on carryovers for the safe harbor method means taxpayers must be careful before electing it to be sure they will not lose any of their deduction.

Taxpayers sharing a home (for example, roommates or spouses, regardless of filing status), if otherwise eligible, may each use the safe harbor method provided by the revenue procedure, but not for qualified business use of the same portion of the home. The revenue procedure contains detailed rules for use of the home for part of the year. It allows taxpayers who have a qualified business use of more than one home for a tax year to use the safe harbor for only one home, but it permits them to use the actual expense method for the other homes.

Generally, a principal or second residence is not considered a qualified residence for purposes of the deduction for qualified residence interest (as discussed in ¶2810) to the extent the home is used for trade or business purposes or for rental. Thus, for example, an attorney who uses part of a home to meet or deal with customers or clients in the ordinary course of business cannot treat all of the otherwise qualifying interest expenses as residence interest. The taxpayer must allocate interest expense between the qualified residence portion and the home office portion in the same way he or she allocates other expenses.

Planning Pointer. As a result of the $10,000 limitation on deduction of state and local taxes as imposed by the TCJA, a Schedule C filer should consider claiming a home office deduction, as previously described, that will absorb a portion of the taxpayer's real estate tax, allowing some or all of the balance to be claimed as an additional itemized deduction on Schedule A of Form 1040.

¶2830 Vacation Homes

A vacation home does not pose any special tax problems if the taxpayer uses it solely for personal reasons. The primary issue is whether interest paid on debt secured by the vacation home is qualified residence interest. There also are no income tax implications if the taxpayer rents the home for less than

15 days during a year. Under IRC Section 280A(g), the income from this limited rental period is not taxable, and no deductions are allowed with respect to this rental period.

Many vacation home owners rent the property for more than two weeks during the year. In such cases, the tax rules become more difficult to address.

The main issues are as follows:

- Whether the vacation home is considered to be the taxpayer's residence or an investment property
- Which expenses are deductible in connection with rental use of the home
- How expenses are allocated between personal use and rental use
- How to treat expenses in excess of income

.01 Character of Vacation Home

IRC Section 280A(d)(1) uses a mechanical test to determine the tax character of a vacation home. A dwelling unit is considered the owner's residence for a tax year if personal use exceeds the greater of (*a*) 14 days or (*b*) 10% of the days the unit is rented.[35] If personal use does not exceed this test, then the vacation home is considered held as an investment property, although the taxpayer still must allocate expenses between personal and investment use.

.02 Consequences of Residence Versus Investment Use

The tax character of the home determines how the taxpayer deducts interest expense, the amount of expenses the taxpayer may deduct currently, and how the taxpayer must treat expenses in excess of income. The consequences are summarized in the following table:

Vacation Home Used as Residence	*Vacation Home Held as Investment Property*
1. Interest paid generally is not subject to the interest allocation rules of Reg. Sec. 1.163-8T.	1. Interest paid is subject to the interest allocation rules of Reg. Sec. 1.163-8T.
2. Interest allocable to personal use of residence is deductible as qualified residence interest, assuming all conditions of IRC Section 163(h) are met.	2. Interest allocable to personal use of home is personal interest and not deductible.
3. Currently deductible expenses are limited to gross rental income, if any	3. Currently deductible expenses are not limited to gross income but may be limited by the hobby loss rules or the passive loss rules.
4. Certain expenses in excess of income, if any, may be carried over to future years. When property is sold, unused carryovers are lost.	4. Expenses not currently deductible because of the passive loss rules may be carried over to future years; unused carryovers are deductible when property is sold, but carryover

[35] IRC Section 280A(d)(1).

Vacation Home Used as Residence	*Vacation Home Held as Investment Property*
	may be barred by the IRC Section 183 hobby loss rule.

¶2835 Capital Improvements to the Home and the Medical Expense Deduction

A person can include in deductible medical expenses the amounts paid for special equipment installed in a home or for improvements, if the expenditure's main purpose is medical care for the person or a spouse or dependent. The cost of permanent improvements that increase the value of one's property may be partly deducted as a medical expense. The cost of the improvement is reduced by the increase in the value of the property. Only the difference is a medical expense. If the value of the property is not increased by the improvement, the entire cost is deductible as a medical expense.

Certain improvements made to accommodate a home to a person's disabled condition, or that of a spouse or dependents who live in the home, may not increase the value of the home, and the costs can be deducted in full as medical expenses. These improvements include, but are not limited to, the following items:

- Constructing entrance or exit ramps for the home
- Widening doorways at entrances or exits to the home
- Widening or otherwise modifying hallways and interior doorways
- Installing railings, support bars, or other modifications to bathrooms
- Lowering or modifying kitchen cabinets and equipment
- Moving or modifying electrical outlets and fixtures
- Installing porch lifts and other forms of lifts (but elevators generally add value to the house)
- Modifying fire alarms, smoke detectors, and other warning systems
- Modifying stairways
- Adding handrails or grab bars anywhere (not just in bathrooms)
- Modifying hardware on doors
- Modifying areas in front of entrance and exit doorways
- Grading the ground to provide access to the residence

Only reasonable costs to accommodate a home to a disabled condition are considered qualified medical care. Additional costs for personal motives, such as for architectural or aesthetic reasons, are not medical expenses.

2840 Use of the Property as an Airbnb

Airbnb hosts who offer their property for short-term rental are subject to the income tax rules for residential rental property. Airbnb may issue Form 1099-K (Payment Card and Third Party Network Transactions) or make available an earnings summary, reporting the gross amount of rent earned during the calendar year. Regardless of whether a Form 1099-K is received, the rental income earned from Airbnb is reportable on Form 1040, unless the nontaxable rental exception applies (discussed below).

A rental may not be taxable (no matter how substantial the amount) if (*a*) the property was used by a host personally as a residence during the year, and (*b*) it was not rented at a fair rental price for more than 14 combined days during the year. The only deductions allowed related to the rental in this case will be otherwise deductible property taxes and mortgage interest (Schedule A).

If the host provides "substantial services" to guests, the income will be subject to self-employment tax, and Schedule C must be filed. If the host does not provide substantial services, Schedule E is typically filed to report the income and related ownership and maintenance expenses (which are deductible), and the host does not pay self-employment tax.

As a rental activity, the income received is likely to be considered "passive" income, and if expenses and losses exceed passive income, the passive loss limitations on deductions must apply. After passive income is offset by deductions, any excess deductions may not be used currently but, instead, must be carried forward. However, if the taxpayer "actively participates" in the residential rental activity, a loss of up to $25,000 in a tax year may be deductible against non-passive income if the taxpayer's adjusted gross income does not exceed $150,000. A person actively participates in the rental activity by making important management decisions, such as approving new tenants, deciding on rental terms, and approving capital expenditures. Active participation may also be shown by arranging for others to provide services. It is not required that there be regular, continuous, and substantial involvement with the property.

If the property is subject to a combined personal and business use, expenses may be deducted according to a ratio between days used personally and days rented. If otherwise allowable deductions exceed the year's income, they may not be deducted currently but are carried forward.

Chapter 29

Medical Care by Proxy

¶2901 Overview

Living wills, durable powers of attorney, and health care proxies are tools that enable individuals to have some say about their medical treatment when they are unable to speak for themselves. Each, in its own way, shares the common problem of overcoming the common law rule that the authority of an agent expires when the principal's legal capacity to act expires. Statutory provisions overcome this problem.

These statutory provisions also serve to overcome two other common problems. First, physicians and hospitals are under a legal and ethical duty to preserve life. (The statutes provide some relaxation of their legal duties and liabilities.) Second, except where assisted suicide is permitted by law, suicide and attempted suicide are illegal. Statutes providing for living wills, durable powers of attorney, and health care proxies allow individuals to address their health and medical care without risking the state charging them with attempted suicide or charging their trusted agents with attempted murder. Several states have adopted some form of legally sanctioned assisted suicide: Oregon, Vermont, Washington, Colorado, Hawaii, Maine, Montana, New Jersey, the District of Columbia, and California have statutes allowing physician-assisted suicide, and New Mexico has had cases decided allowing assisted suicide. Other states have pending legislation addressing this practice. Each has various safeguards associated with the law.

When reviewing a client's plans, the financial planner should discuss these end-of-life issues and determine if the client is aware of these options and how or if the client wants to address them.

Planning Pointer.

Coronavirus (COVID-19) Personal Financial Planning Resources

Increased health risks related to the COVID-19 pandemic and the financial aspects of the CARES Act and other financial legislation has spurred the need to review and update estate plans and has, from a practical perspective, changed the way estate planning is conducted. For more information about estate planning amid the COVID-19 pandemic, visit aicpa.org/pfp/COVID19.

¶2905 Planning Devices

The following discussions consider each of the three primary planning devices.

.01 Living Wills

All states now recognize living wills. *Living wills* allow an individual who is permanently unconscious or whose death is imminent to direct physicians and hospitals to refrain from using certain life-sustaining medical treatments, such as respirators and feeding tubes.

In some situations, a living will becomes effective only when two physicians certify, in writing, that the individual is permanently unconscious or terminally ill. Other situations allow the attending physician to determine whether the terms of a living will should be invoked. Physicians and other health care providers are not necessarily under an obligation to follow the directives of a living will. They generally have discretion to assess the overall situation. A living will might be of little benefit if its terms are too vague.

The Patient Self-Determination Act of 1990[1] requires that health care providers furnish adult patients with written information concerning their rights under state law to make decisions about their medical care. These rights include the right to accept or refuse care and the right to formulate an advance directive. An *advance directive* is a written instruction recognized under state law that provides direction regarding the individual's health care desires if the individual becomes incapacitated. An advance directive includes a living will or durable power of attorney.

Planning Pointer. The emphasis on state law reminds financial planners that a client with residences in more than one state should provide appropriate directives for each state of residence. In addition, a directive aimed at universal usage is desirable, especially if the client travels frequently to other states. An individual with a living will may want to carry a card that identifies who has a copy of his or her living will. Individuals with a living will may also want to register it with a free registry service on the Internet.

Example 29.1. Dora is a widow who lives in Mississippi. She has one son, John who lives nearby. John has a copy of her living will. She carries a card in her purse stating that John has a copy of her living will. The card also provides John's address and telephone number.

Example 29.2. Jane is a widow. She lives in New Hampshire during the spring and summer. She also travels throughout New England during the summer and sometimes goes to Colorado to see her son, Michael. She lives in Florida with her daughter, Beth, during the fall and winter months. Jane should prepare advance directives that comply with New Hampshire, Colorado and Florida law if there are substantive differences between the laws of those states or if there are formal requirements regarding execution, witnesses, and so on that one state may insist on before such a directive will be deemed valid. Alternatively, because Jane travels often, she should prepare an advance directive aimed at universal usage that could be accepted and activated anywhere.

.02 Durable Powers of Attorney

The individual who signs a durable power of attorney is the *principal*. The individual who holds the power is the attorney-in-fact or agent. An attorney-in-fact does not have to be an attorney-at-law. Depending upon state law, the principal must sign the durable power of attorney before one or more witnesses, a notary public, or both. Some states also require the attorney-in-fact to sign an acceptance of

[1] P.L. 101-508.

the durable power with the same formal acknowledgment as is required of the principal. A durable power of attorney ends upon the death of the principal. In addition, the principal may revoke the durable power of attorney. If one's spouse is the attorney-in-fact, a divorce automatically terminates the durable power of attorney in some states. The durable power of attorney also terminates if the attorney-in-fact is unable or unwilling to serve.

The durable power of attorney should include several important clauses. If it is intended to address health care issues, it does not have to specify the desired medical treatment, but it should acknowledge that the principal has communicated his or her wishes to the attorney-in-fact. It is often preferable (and generally recommended) to have a medical care directive (such as a living will) as a separate document from the durable power of attorney. Still, the principal may want to describe in the durable power of attorney nonexclusive permitted specific directives as a means of providing comfort. The physician or hospital called upon to implement the specifics will appreciate such authorization. Principals should name successor attorneys-in-fact in case the designated attorney-in-fact predeceases the principal or is unable or unwilling to serve. The durable power of attorney can also include a clause providing that if a health care provider refuses to recognize the durable power of attorney, the principal wants his or her health care transferred to another physician or facility. Another important clause states that the principal wants his or her wishes carried out, even if they conflict with the desires of relatives or the policies of health care providers.

Durable powers of attorney have far broader uses than health care. Durable powers of attorney are appropriate in situations in which the principal is not in imminent danger of death. They are useful in cases when the principal is incapacitated or absent, and the attorney-in-fact is authorized to act generally on behalf of the principal and address issues such as banking transactions, deed execution, bill paying, gifting to family members, signing tax returns, and any other actions that could be taken by the principal but for his or her incapacity or absence.

A variation of the durable power of attorney is the springing power of attorney. A *springing power of attorney* does not become effective until the happening of a specific event, such as the incapacity of the principal for a specific period (for example, 60 days). A springing power of attorney may require that one or more physicians certify that the principal is incapacitated. An individual with a durable power of attorney may want to carry a card identifying who holds his or her durable or springing power of attorney for health care.

> **Example 29.3.** Alfred signs a springing power of attorney. It provides that his son, Andrew, will have a durable power of attorney to make all decisions regarding his health care upon the notarized statements of two licensed physicians. Alfred carries a card in his wallet that states that Andrew holds a springing power of attorney. The card also provides Andrew's address and telephone number.

The springing power has its advantages and disadvantages. The major advantage is that the requirement of certification by physicians of the disability of the principal prohibits the attorney-in-fact from acting in the absence of such certification. The major disadvantages are that obtaining such certifications may result in delay when time is of the essence and that when third parties are asked to accept the durable power of attorney as authority for actions, they may require proof that the physicians' certifications not only have been provided, but still remain in effect, causing further possible delays when prompt action may be required.

.03 Health Care Proxies

Some states specifically provide for health care proxies. A *health care proxy* is essentially a durable power of attorney for medical matters. A number of other states allow them as a part of their living will statutes. Typically, the proxy merely names the individual to act under the statutory authority. Health care proxies may be more adaptable to a wider range of circumstances compared to a living will. However, the financial planner should check the governing state statute because it may contain limitations. In many states, the health care proxy and the living will are combined — the living will states the person's desires and directions for end-of-life care and treatment, and the health care proxy names the person or persons authorized to interact with the health care providers to carry out those directions. In selecting the person to hold this proxy, be sure the person will act to order medical treatment to be withheld, where that is the wish of the person signing the proxy.

.04 Address the HIPAA Issues

The Health Insurance Portability and Accountability Act of 1996 (HIPAA) is a federal statute designed to provide privacy protection for patients and limit the manner in which health care providers can use and release medical information. Concern has arisen about whether an agent acting under a health care proxy may be given access to or be permitted to release the principal's protected health information. In order to avoid any potential problems that might arise by an "overzealous" assertion of the patient's privacy rights under HIPAA, it is recommended that the following (or similar) language be inserted in a health care proxy to address the HIPAA concerns:

> RELEASE OF MEDICAL INFORMATION UNDER 45 CFR 164.502(g): The agent named in this document is hereby designated as my "Personal Representative" as defined by 45 CFR 164.502(g), commonly known as the Health Insurance Portability and Accountability Act of 1996 (HIPAA). This individual is to have the same access to my health care and treatment information as I would have if I were able to act for myself. My Agent and Personal Representative named herein is also authorized to take any and all legal steps necessary to ensure his or her access to information, and such action shall include resorting to legal process, if necessary, to enforce my rights under the law and attempting to recover attorney fees, as authorized by [Name of State] law, in enforcing my rights.

.05 Importance of Periodic Review

A financial planner should review a client's documents related to medical care and durable powers of attorney periodically. The review should ensure that the documents still reflect the client's wishes. In addition, the financial planner should make sure that the documents have not been made obsolete by changes in state law. For example, the state of California created a document called the Advance Health Care Directive, which made durable powers of attorney for health care obsolete if they were executed before 1992.[2] In 2010, New York State changed its durable power of attorney rules prospectively to require a more formal execution of the document and to further require the signing of a separate specific authorization if the principal is willing to permit the attorney-in-fact to make gifts. Florida made similar changes in 2012. As a general rule, the financial planner should suggest that durable powers of attorney, health care directives, and living wills be updated periodically. A person does not want his or her

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[2] California Probate Code Sections 4700-4701.

document signed years earlier to be rejected because it is stale, just at the time its use becomes necessary, and it is too late to sign a new document.

Chapter 30

College and Other Education Planning

¶3001 Overview

College planning is a major area of financial planning. Amassing the financial resources and paying for higher education expenses continues to be one of the major drains on a family's (or individual's) ability to attain other economic goals, such as retirement. Although inflation rates in recent years have been tame, the yearly increases in higher educational expenses have typically far outstripped (and sometimes been double or more) the general inflation rate. These increases are felt not only when a family sends its children to college, but increasingly when family wage earners themselves find going back to school necessary or advantageous. Financial planners should encourage their clients to begin planning for their children's college educations when the children are still young.

Financial planners should discuss the financial aid that might be available to defray some of the higher education costs likely to be incurred by the children of their clients. Federal financial aid programs include the following:

- Federal Direct and FFEL Stafford Loans
- Federal Direct and FFEL Plus Loans (for parents)
- Federal Perkins Loans
- Federal Pell Grants
- Federal Supplemental Educational Opportunity Grants
- Federal Work Study

Information about federal financial aid programs is available online at https://studentaid.ed.gov/sa/. To apply for federal financial aid, a student must complete the Free Application for Federal Student Aid

(FAFSA). This application requires reporting financial and tax information for both the parents and the student. The financial planner can be very helpful in assisting families to complete this application. A student may complete the application online at https://fafsa.ed.gov. The student might also qualify for various scholarships and financial aid programs provided by the states or their colleges. Communities sometimes offer scholarship programs, as do civic organizations and private businesses. The internet can provide a wide range of possible sources of scholarship funds. In addition, many students pay for part of their college education by working part-time while attending classes through college-sponsored work-study programs or through other employment and by attending classes full-time during the summer.

Although the cost increases for higher education are certainly anything but good news, the tax law provides some worthwhile incentives for addressing the costs of higher education. Like almost everything else in the tax law, these incentives carry with them certain conditions and requirements. Many of them will be useful only if the taxpayers are under certain income caps and if the taxpayers — almost assuredly with the help of professional advisers — are willing to sort through the maze of complexity that accompanies these potential tax incentives.

The following are some of the more useful, and more commonly available, tax incentives for education in the IRC, with applicable cross-references to sections in this publication where they are discussed in greater detail:

- **Withdrawals from individual retirement accounts.** Qualified educational expenses of the taxpayer, spouse, children, and grandchildren can be paid for from penalty-free withdrawals from IRAs (¶915). The IRA withdrawals are, of course, still subject to income taxes.

- **Withdrawals from Coverdell Education Saving Accounts.** Education expense withdrawals from nondeductible Coverdell Education Savings Accounts can be tax-free (¶3020).

- **Credits for higher education tuition.** Several tax credits are available for payment of higher education or vocational training tuition (¶3005).

- **Qualified tuition programs.** The federal tax treatment of qualified state tuition programs has been clarified and expanded to benefit more individuals (¶3010). Qualified tuition programs include programs maintained by eligible private institutions that satisfy the IRC Section 529 requirements.

- **Educational assistance loans.** Individuals are able to deduct interest paid on qualified education loans subject to a phase-out based on modified AGI (¶3015).

- **Business deduction.** A taxpayer may deduct as business expenses the cost of education that maintains or improves a skill required in the taxpayer's current line of business or is incurred to meet express employer or legal requirements, provided the taxpayer is in a business. Employees may no longer deduct these expenses as miscellaneous itemized deductions beginning in 2018 as the result of the TCJA.[1]

[1] IRC Sections 67(g); 162.

- **U.S. savings bonds.** Taxpayers can exclude interest earned on Series EE and Series I bonds when the bond proceeds are used to pay higher education expenses. This opportunity is fully phased out for 2020 at AGI levels of $153,550 for joint return filers and $97,350 or all other filers[2] (¶315.03).

- **Scholarships.** Degree candidates can exclude from gross income qualified scholarships used for tuition, fees, and books at any primary, secondary, or postsecondary educational institution. However, scholarship funds used to pay for housing, travel, food, insurance, and other living expenses are treated as taxable income to the student.[3]

- **Gift tax educational exclusion.** An unlimited gift tax exclusion is available for tuition payments made directly to an educational institution (¶405).

- **Student loan cancellations.** When it is contingent upon a student working for a specified period in certain professions, the cancellation of educational debt by a governmental, educational, or tax-exempt charitable organization will be excluded from the student's gross income.[4]

- **Deduction for higher education expenses.** Taxpayers may claim an above-the-line deduction for up to $4,000 of qualified tuition and related expenses (¶3025). This deduction has been extended to cover qualified education expenses paid in 2018, 2019, and 2020.[5]

¶3005 Credits for Higher Education Expenses

Two credits for tuition and related expenses can reduce an individual's tax liability: the Hope Scholarship Credit and the Lifetime Learning Credit. Low- and middle-income individuals can elect these credits for tuition expenses incurred by students pursuing college or graduate degrees or vocational training.[6]

There is an expanded version of the Hope Scholarship Credit called the American Opportunity Credit. The allowable modified credit was allowed up to $2,500 per eligible student per year for qualified tuition and related expenses paid for any of the first four years of the student's postsecondary education in a degree or program.[7] The American Opportunity Credit has been made permanent.

The Lifetime Learning Credit may be claimed for up to $2,000 of qualified tuition and related expenses paid by the taxpayer for any year.

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[2] Revenue Procedure 2018-57 (November 15, 2018); IRC Section 135.

[3] IRC Section 117.

[4] IRC Section 108(f).

[5] IRC Section 222.

[6] IRC Section 25A.

[7] IRC Section 25A(i).

Both credits are available for qualified expenses incurred for the taxpayer, spouse, and dependents. The maximum American Opportunity (or Hope Scholarship) credit is allowed on a per student basis. However, the maximum Lifetime Learning credit is calculated per taxpayer paying educational expenses for students, and does not vary depending on the number of eligible students in the taxpayer's family.

If qualified tuition expenses are paid by the taxpayer during a tax year for an academic period that begins during the first three months following that tax year, the credits are claimed in the tax year in which the expenses are paid.[8]

.01 American Opportunity (Hope Scholarship) Credit

The American Opportunity Credit is equal to 100% of the first $2,000 of qualified tuition and related expenses and 25% of the next $2,000 of qualified tuition and related expenses. The maximum annual credit is $2,500. The American Opportunity Credit is available for an individual student for 4 tax years, provided that the student has not completed the first 4 years of postsecondary education before the beginning of the fourth tax year. Forty percent of a taxpayer's otherwise allowable American Opportunity Credit is refundable. However, no portion of the credit is refundable if the taxpayer claiming the credit is a child to whom the kiddie tax applies for the tax year (generally, any child under age 19 or any child under age 24 who is a full-time student providing less than one-half of his or her own support, who has at least one living parent, and does not file a joint return).

The Hope Scholarship Credit (when applicable) is equal to 100% of up to $2,000 of qualified higher education tuition and related expenses plus 25% of the next $2,000 of qualified expenses. The $2,000 figures are indexed for inflation. Unlike the American Opportunity Credit, the Hope credit is available only for 2 tax years. Moreover, it can be claimed only for a student who has not completed the first 2 years of postsecondary education as of the beginning of the tax year. No portion of the Hope credit is refundable.

Planning Pointer. The American Opportunity Credit can be claimed for any given student for up to four tax years. It has been made permanent. The expansion of the credit to cover four years of postsecondary education will allow the credit to be claimed for students who have completed two years of postsecondary education and would not qualify for the Hope credit.

A taxpayer may claim the American Opportunity or Hope credits only if the student is enrolled in a program leading to a degree, certificate, or other recognized educational credential.

The credit is phased out in 2020 for single filers with AGI between $80,000 and $90,000 and for joint filers with AGI between $160,000 and $180,000.[9] These thresholds are not adjusted for inflation.

Qualified tuition and related expenses are tuition and fees required for the enrollment or attendance of a student at a postsecondary educational institution that is eligible to participate in the federal student loan program. Room and board, insurance, transportation, or other similar expenses do not qualify for the credits. Student activity fees and fees for course-related books, supplies, and equipment generally

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[8] Regulation Section 1.25A-5(e)(2)(i).

[9] IRC Section 25A(i)(4).

qualify only if they must be paid directly to the educational institution for the enrollment or attendance of the student. However, for purposes of the claiming the American Opportunity Credit, the definition of qualified tuition and related expenses has been expanded to include course materials.

The cost of a course taken at an eligible institution in order to acquire or improve job skills qualifies for the Lifetime Learning Credit, even if it involves sports, games, hobbies, or is a noncredit course. However, the cost of such a course does not qualify for the Hope or American Opportunity credits unless it is part of a student's degree program.

Planning Pointer. An educational institution may "bundle" all of its fees into a single bill for an academic period. If a student does not receive an allocation showing how much was paid for qualified expenses, he or she should contact the institution for a breakdown. The institution is required to make this allocation on Form 1098-T, "Tuition Statement." This form must be provided to all eligible students.

.02 Lifetime Learning Credit

The Lifetime Learning Credit is allowed for 20% of qualified tuition and fees paid by the taxpayer with respect to one or more students, up to $10,000. Thus, the maximum annual credit is $2,000.

Although the Lifetime Learning Credit shares many of the same rules that apply to the American Opportunity or Hope credits, the Lifetime Learning Credit is different in the following respects:

- It does not vary with the number of students in a taxpayer's household.
- It is available for an unlimited number of years.
- It is available for undergraduate, postgraduate, and professional degree expenses.
- It may be claimed for any course at an eligible institution that helps an individual acquire or improve his or her job skills. (Thus, continuing professional education credits and noncredit professional seminars may qualify for the credit, if provided by an eligible institution.)

.03 Income Limitations

The higher education credits are phased out for higher income individuals. As indicated previously, for 2020, the American Opportunity Credit is phased out for single taxpayers with modified AGI between $80,000 and $90,000 ($160,000 and $180,000 for married taxpayers filing a joint return).

Less generous phase-out limits apply to the Lifetime Learning Credit. For 2020, that credit is reduced for taxpayers with modified AGI above $59,000 for single filers or above $118,000 for joint filers.[10] The benefits of the credits are completely lost in 2020 once AGI exceeds $69,000 for singles and $138,000 for joint filers.

Neither credit is available for married taxpayers filing separately.

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[10] Rev. Proc. 2018-57.

When determining modified AGI for purposes of the credits, a taxpayer's AGI is increased by income earned outside the United States (amounts otherwise excluded from gross income under IRC Sections 911, 931, and 933). For this purpose, income earned in Puerto Rico and U.S. possessions is considered to be earned abroad.

.04 Double Tax Benefits Not Allowed

Taxpayers cannot "double dip" on higher education credits for the same student. Expenses for a student for whom a Hope or American Opportunity credit is allowed for the tax year do not qualify for the Lifetime Learning Credit. However, a taxpayer may claim both credits in a single year with respect to different students. For example, for 2020, a parent may claim the American Opportunity Credit for expenses paid for a child's college expenses and also claim the Lifetime Learning Credit for the expenses of the parent's own education.

In addition, when computing the amount of qualified educational expenses for which a taxpayer may claim a higher education credit, the following items reduce the amount of qualified educational expenses:

- Employer-paid educational expenses excluded from an employee's gross income under IRC Section 127
- Scholarships and fellowships received tax-free under IRC Section 117
- Amounts the student deducts as a business expense under IRC Section 162
- Amount of educational assistance excludable from the gross income of either the student or the taxpayer claiming the credit
- Payments for the student's educational expenses excludable from gross income under any U.S. law

For purposes of these rules, the credit is not reduced by educational expenses paid by reason of gift or inheritance.

Planning Pointer. When the credits will be claimed by the parent of a student, the credits are allowed only to a parent who both pays qualified education expenses and is allowed to claim the student as a dependent. With the repeal of the deduction for personal exemptions by the TCJA, persons involved in divorces will have to address dependency in a manner apart from the ability to claim a tax deduction.

.05 Credit and Exclusion

A taxpayer may claim a higher education expense credit for a tax year and also exclude from gross income amounts distributed from a Coverdell Education Savings Account or a Section 529 qualified tuition plan on behalf of the same student. However, the distribution must be used for different educational expenses from those for which the higher education expense credit is claimed.

¶3010 Qualified Tuition Programs

A Section 529 plan (also known as a *qualified tuition program* or a *college savings program*; the plan requirements are set forth in IRC Section 529) allows an individual to prepay a designated beneficiary's

education expenses or contribute to an account for paying such expenses. Section 529 plans are maintained either by states or eligible educational institutions. In many cases, employees can contribute to state-sponsored plans on a payroll deduction basis.

Contributions to a Section 529 plan are not deductible. However, earnings on the funds in the plan are not taxable while they remain in the account. In addition, amounts withdrawn from the account (including earnings) are not taxable to the extent they are used to pay qualifying education expenses of the designated beneficiary.

These Section 529 plans have become a popular tool for planning for the costs of children's college education.

As the result of the TCJA, the opportunity to use funds in a Section 529 plan has been significantly expanded. The funds may now be used (up to $10,000 per year per student) for persons in grades K through 12, in public, private, and parochial schools, as well as for the payment of college expenses. In addition, if a person is disabled prior to age 26, funds in a Section 529 plan can be converted into an ABLE account plan under IRC Section 529A.

The SECURE Act added some new rules for Section 529 plans. Now, up to $10,000 from a 529 account can be used to repay the beneficiary's student loans. Plus, up to another $10,000 can be used to repay student loans held by each of the beneficiary's siblings. (For example, if a student had two siblings with student loans, another $20,000 total could be withdrawn, without penalty, to pay their debt.)

The new law also allows 529 funds to be used to pay for apprenticeships, which typically combine on-the-job training with classroom instruction, often at a community college. To qualify, the apprenticeship must be registered with the U.S. Department of Labor.

Exercise some care when using a Section 529 plan in combination with student financial aid. The Free Application for Federal Student Aid (FAFSA) generally ignores Section 529 plans owned by grandparents until money from the plan is actually paid to a college. When that happens, FAFSA treats the distributions as income to the student and will reduce the aid award by half of the amount of the distribution. Alternatively, if the parents of the student or the student own the Section 529 plan, it must be reported as an asset on FAFSA, and the aid award is reduced by a small percentage of the plan assets, but the distribution from the Section 529 plan is not counted as income available to the student. One must determine from the school to which the student is applying which financial aid application it entertains. Other aid applications favored by some schools (such as the CSS/Financial Aid Profile) treat all plans that benefit a student as assets, and do not count distributions as income available to the student.

.01 Eligible Beneficiary

The designated beneficiary of a Section 529 plan is generally the student (or future student) for whom the plan will provide benefits. The designated beneficiary of a Section 529 plan can be changed without adverse income tax consequences, as long as the new beneficiary is a member of the old beneficiary's family (see ¶3010.06 that follows).

Planning Pointer. Significantly, there are no age restrictions on who may be the designated beneficiary of a Section 529 plan. Consequently, a prospective parent can set up a Section 529 plan naming himself or herself as beneficiary and then change the beneficiary when the child is born. However, a change in the beneficiary of a Section 529 plan could have gift tax consequences if substantial contributions were made to the account (see ¶3010.07 that follows). Generally, people wait until the beneficiaries are born to create and fund the Section 529 plan. Visit aicpa.org/pfpguides to find The Adviser's Guide to Education Planning.

.02 Contributions

Contributions to a Section 529 plan are not tax deductible. However, there are no income limits and no phase-outs for contributors.

In addition, there are no set dollar limits on contributions. Contributions may not, however, exceed the amount necessary to provide for the qualified education expenses of the designated beneficiary. Moreover, a Section 529 plan will not be qualified unless it provides adequate safeguards to prevent contributions on behalf of a designated beneficiary in excess of those amounts necessary to provide for qualified education expenses.[11]

A contribution to a Section 529 plan is treated as a completed gift to the designated beneficiary. Therefore, there is potential gift tax exposure for large contributions. However, contributions up to the annual per-donee exclusion (for 2020, $15,000 for an individual gift or $30,000 if a spouse joins in the gift, and these numbers are indexed for inflation in future years, but an adjustment of $1,000 is required to reach a higher exclusion amount) will be sheltered from gift tax. In addition, if an individual's contributions to a Section 529 plan for a calendar year exceed the annual gift tax present interest exclusion available for that year, the contributor can elect to take the contributions into account ratably over five years. Therefore, a generous family member can significantly pre-fund a child's Section 529 plan without paying gift tax or using the lifetime gift tax exclusion. In 2020, for example, an individual can contribute $75,000 to a Section 529 plan for the benefit of a single beneficiary (5 years × $15,000 = $75,000). If the individual's spouse joins in the gift, the contribution can be $150,000 for a single beneficiary. ($75,000 × 2 = $150,000). If this is done, the annual exclusion for that donee has been used for 2020, and $15,000 is allocated toward the available annual exclusion for such donee in each of 2021, 2022, 2023, and 2024. If the annual exclusion is increased in any of the years from 2021–2024, the amount of the increased annual exclusion may be given to the donee and still be treated as part of the annual exclusion amount for that year.

.03 Distributions

In the case of a cash distribution from a Section 529 plan, the portion representing the amount contributed to the plan is not included in the designated beneficiary's income. That amount represents a return of the investment in the plan. In addition, the designated beneficiary generally does not have to include in income any earnings distributed from a Section 529 plan if the total distribution is less than or equal to qualified education expenses for the year of the distribution. If the distribution exceeds qualified

[11] IRC Section 529(b)(6).

education expenses, a proportionate part of the earnings will be subject to tax.[12] If a distribution is made from a Section 529 plan for reasons other than qualifying education expenses, the earnings attributed to the distribution are taxable distributions and considered taxable income to the recipient.

In the case of an in-kind distribution (for example, a tuition waiver under a prepayment plan), no amount is included in the beneficiary's gross income if the distributions consist of providing a benefit that would be a qualified education expense if paid for by the beneficiary.[13]

Taxable distributions are also generally subject to an additional 10% penalty tax. However, there are a number of exceptions to the 10% penalty. The penalty does not apply to

- a distribution made on account of the death or disability of the account beneficiary;
- a distribution that does not exceed tax-free educational assistance received by the beneficiary;
- a distribution that is included in income only because qualified education expenses were taken into account for purposes of a Hope (or American Opportunity) or Lifetime Learning Credit; or
- a distribution made on account of the attendance of the designated beneficiary at a U.S. military academy.[14]

When determining whether a Section 529 plan distribution qualifies for tax-free treatment, qualified education expenses must be reduced by tax-free scholarships and fellowships, veterans' education assistance, Pell grants, employer-provided education assistance, and other tax-free educational assistance (but not gifts or inheritances).

A distribution from a Section 529 plan is not treated as a taxable gift, unless it involves a change of beneficiary or an account rollover in favor of a beneficiary who is in a younger generation than the previous beneficiary. (See ¶3010.06–.07 that follows).[15]

As a general rule, no amount is includable in the gross estate of any individual for federal estate tax purposes by reason of such individual having an interest in a Section 529 plan. However, there is the possibility of an estate inclusion in the estate of the designated plan beneficiary if there is a distribution from the plan made on account of the death of such a beneficiary. An estate inclusion will also apply if a person has made a permitted multi-year gift to a Section 529 plan but dies before the expiration of the number of years covered by the gift.[16]

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[12] IRC Section 529(c)(3)(B)(ii).

[13] IRC Section 529(c)(3)(B)(i).

[14] IRC Sections 529(c)(6) and 530(d).

[15] IRC Section 529(c)(5)(A).

[16] IRC Section 529(c)(4)(A-C).

.04 Losses

As the result of the TCJA, if a Section 529 plan produces a loss such that the total distributions are less than the unrecovered basis of the account (that is, the amount of total contributions), the loss is treated as a miscellaneous itemized deduction, no longer deductible for 2018 and beyond.

.05 Qualified Education Expenses

Qualified education expenses in the context of a Section 529 plan include tuition, fees, books, supplies, equipment, and certain room and board expenses for undergraduate or graduate education at an eligible educational institution.

The beneficiary can be enrolled full-time, half-time, or less than half-time. However, room and board expenses are considered qualified expenses only if the beneficiary is enrolled on at least a half-time basis. A student is enrolled at least half-time if enrolled for at least half of the full-time academic workload for the course of study the student is pursuing, as determined under the standards of the school where the student is enrolled.

Moreover, room and board qualifies only to the extent the costs are not more than the greater of the following two amounts:

1. The allowance for room and board, as determined by the eligible educational institution, that was included in the cost of attendance (for federal financial aid purposes) for the academic period.

2. The actual amount charged if the student is residing in housing owned or operated by the eligible educational institution.[17]

Accordingly, the costs of off-campus housing count only to the extent they do not exceed the room and board allowance set by the school.

An *eligible educational institution* is any college, university, vocational school, or other postsecondary educational institution that is eligible to participate in a student aid program administered by the United States Department of Education. This includes virtually all accredited public, non-profit, and proprietary (privately owned profit-making) postsecondary institutions in the United States. In addition, certain educational institutions located outside the United States also participate in the U.S. Department of Education's student aid programs. The TCJA added grades K–12 to the list of eligible education providers, but only to the extent of $10,000 distributions per year per student.

In addition to all the foregoing uses of Section 529 plan funds, the SECURE Act added payments for apprenticeships to the list of qualified payments. To qualify, the apprenticeship must be registered with the U.S. Department of Labor.

[17] IRC Section 529(e)(3).

.06 Rollovers

An amount distributed from a Section 529 plan is not treated as a distribution if it is rolled over within 60 days to another Section 529 plan for the same beneficiary or for a member of the beneficiary's family. Only one rollover is allowed in any 12-month period.

Planning Pointer. Although rollovers from one beneficiary's Section 529 plan to a Section 529 plan for another beneficiary are permitted, they are not as imperative as they are for Coverdell education savings accounts, which must be distributed within 30 days after the beneficiary attains age 30, or within 30 days after the death of the beneficiary. Section 529 does not contain an age cut-off for account beneficiaries. Therefore, a Section 529 plan can remain in existence indefinitely without triggering a deemed distribution to the designated beneficiary. Nonetheless, if the beneficiary of a Section 529 plan has completed his or her education, a rollover to a plan for another family member with ongoing education expenses will be beneficial.

For rollover purposes, a beneficiary's family includes the beneficiary's spouse and the following other relatives of the beneficiary:

- Child or descendant of a child
- Brother, sister, stepbrother, or stepsister
- Father or mother or ancestor of either
- Stepfather or stepmother
- Son or daughter of a brother or sister
- Brother or sister of father or mother
- Son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law, or sister-in-law
- The spouse of any individual listed previously
- First cousin[18]

A typical rollover from one child to another is not subject to gift tax. However, the gift tax (and possibly the generation-skipping transfer tax) rules do apply to a rollover unless the new beneficiary is (*a*) in the same generation as, or a higher generation than, the old beneficiary and (*b*) is a member of the family of the old beneficiary.[19]

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[18] IRC Section 529(e)(2).

[19] IRC Section 529(c)(5)(B).

.07 Change of Beneficiaries

An alternative to a rollover is simply to change the designated beneficiary of a Section 529 plan. A change in the beneficiary will not be treated as a distribution if the new beneficiary is a member of the family (see previous paragraph .06) of the old beneficiary.[20]

However, a change in beneficiary from a parent to a child (a lower generation) would be treated as a gift. The annual gift tax and GST present interest exclusion or the lifetime gift tax and lifetime GST exclusion could shelter the gift from tax. The TCJA also authorized the change in beneficiary to a disabled person eligible for an ABLE account under IRC Section 529A.

.08 Interplay with Other Education Incentives

Contributions can be made to both a Coverdell education savings account and a Section 529 plan for the same beneficiary in a given year.

In addition, a Hope (or American Opportunity) or Lifetime Learning Credit (but not both) can be claimed in the same year a beneficiary receives a tax-free distribution from a Section 529 plan, as long as the same education expenses are not taken into account for purposes of both benefits.

A beneficiary can also receive tax-free distributions from both a Coverdell education savings account and a Section 529 plan in the same year. However, if the combined amount of distributions exceeds qualified education expenses, the qualified expenses must be allocated between the two distributions, and any excess distribution may be considered income to the distributee.

¶3015 Interest on Education Loans

Individuals may claim interest paid on qualified education loans as an above-the-line deduction when computing AGI under IRC Section 221. Thus, the deduction is available regardless of whether the taxpayer itemizes deductions. Claiming an interest deduction for the use of a home equity loan to pay an educational expense is no longer permitted after 2017 per the TCJA.

.01 Deduction Limits

The maximum deduction allowed under IRC Section 221 for interest paid on an education loan is $2,500. To be deductible, the interest must be paid with respect to qualified higher education expenses incurred when attending college or certain vocational schools. These costs include tuition, fees, room and board, books, and supplies, reduced by the following amounts paid for these costs that are excluded from gross income:

- Employer-provided educational assistance[21]

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[20] IRC Section 529(c)(3)(C)(ii).

[21] IRC Section 127.

- U.S. savings bond interest used to pay higher education costs[22]
- Coverdell Education Savings Account distributions[23]
- Section 529 plan distributions[24]
- Excludable educational expenses (such as scholarships under IRC Section 117) that are not gifts or inheritances

.02 Phase-Out of Deduction

For tax year 2020, the education interest deduction of $2,500 is phased out beginning with modified AGI of $70,000 for single taxpayers and $140,000 on a joint return. The deduction is completely phased out at $85,000 for single taxpayers and heads of households and at $170,000 for a married couple filing a joint return.[25] These income phase-out ranges are adjusted annually for inflation. Married taxpayers filing separate returns may not claim this deduction. Form 1098E should be received from the interest payer. Interest due on federal student loans has been temporarily suspended in 2020 due to the pandemic.

Planning Pointer. The phase-out of the deduction for educational interest expenses begins at levels that will make the deduction unavailable to many middle income (and all high income) taxpayers. However, when it is available, a taxpayer can use its benefits in addition to the higher education credits.

¶3020 Coverdell Education Savings Accounts

.01 Contributions

Taxpayers may contribute each year to a Coverdell Education Savings Account for any child under age 18. A taxpayer may contribute to a Coverdell Education Savings Account for a child with special needs who is age 18 or older. The contributor does not have to be the parent of the child. Anyone, including the child, may contribute to the child's Coverdell Education Savings Account. The law does not allow contributions of securities or other property to a Coverdell Education Savings Account. Taxpayers must make all contributions to the Coverdell Education Savings Account in cash. The maximum annual contribution for a child is $2,000, regardless of the number of contributors. Taxpayers may not circumvent this limit by using multiple Coverdell Education Savings Accounts for the same child.

Phase-out rules reduce the annual amount that can be contributed if the taxpayer's modified AGI exceeds certain threshold amounts.[26] The $2,000 maximum annual contribution is phased out for married

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[22] IRC Section 130.

[23] IRC Section 530.

[24] IRC Section 529.

[25] Revenue Procedure 2018-57.

[26] IRC Section 530(c).

couples filing a joint return who have modified AGI between $190,000 and $220,000. The phase-out rules apply to other filers with modified AGI between $95,000 and $110,000. Taxpayers with modified AGI greater than or equal to the phase-out limits may not make any contributions to a Coverdell Education Savings Account on behalf of anyone. The annual contribution limit applies to each child, but the phase-out rules apply to each contributor. Thus, if a parent's maximum allowable contribution to a Coverdell Education Savings Account is less than the annual contribution limit, another eligible family member or friend could make up the difference.

When the modified AGI reaches the threshold, the taxpayer must reduce the maximum annual contribution by an amount that bears the same ratio to the maximum annual contribution (that is, $2,000) as the amount by which the contributor's modified AGI for the tax year exceeds the amount at which the threshold begins.[27]

> **Example 30.1.** Sara, a divorced single parent, has modified AGI for tax year 2020 of $104,000. Under the contribution phase-out provision, her annual contribution to the Coverdell Education Savings Account established for her son, Joseph, is limited to $800. To arrive at this amount, she must do the following:
>
> 1. Compute the excess of her modified AGI of $104,000 over $95,000 ($104,000 − $95,000 = $9,000).
> 2. Compute the ratio that the excess amount of $9,000 bears to $15,000 (the phase-out limit range) ($9,000/$15,000 = .6).
> 3. Compute the reduction amount by multiplying the maximum amount of $2,000 by .6 ($2,000 × .6 = $1,200).
> 4. Subtract the reduction amount of $1,200 from the maximum amount of $2,000 to arrive at her annual contribution limit of $800 ($2,000 − $1,200 = $800).
>
> The contribution reduction applies only to Sara. Another contributor (including her ex-husband) may contribute up to $2,000 to her son's Coverdell Education Savings Account for tax year 2020, assuming the contributor's AGI does not exceed the applicable thresholds. If she remarries and files a joint return, any contribution by Sara and her new spouse will begin phasing out at modified AGI of $190,000.

Modified AGI is the taxpayer's AGI for the tax year increased by any amount excluded from gross income under IRC Sections 911 (relating to foreign earned income), 931 (relating to income from sources within Guam, American Samoa, or the Northern Mariana Islands), and 933 (relating to income from sources within Puerto Rico).[28]

Although a taxpayer may not deduct contributions to a Coverdell Education Savings Account from gross income, the amounts in the account grow on a tax-deferred basis.

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[27] IRC Section 520(c)(1).

[28] IRC Section 530(c)(2).

.02 Excess Contributions

IRC Section 4973 imposes a 6% excise tax on excess contributions to a Coverdell Education Savings Account. The first item treated as an excess contribution is any excess over the maximum annual contribution amount per beneficiary. If the contributor's allowable contribution for the year is reduced based on the modified AGI phase-out,[29] then the excess contribution is the sum of the contributions minus the allowable reduced contributions.[30]

The excise tax is applicable in each year in which an excess contribution remains in a Coverdell Education Savings Account, not just the year in which the excess contribution is originally made.[31]

.03 Distributions

A taxpayer may exclude withdrawals from Coverdell Education Savings Accounts from gross income to the extent used to pay for qualified education expenses of the designated beneficiary in the year of withdrawal.[32] Qualified education expenses include tuition, fees, books, supplies, and equipment required for the enrollment or attendance of a designated beneficiary at an eligible institution.[33] Room and board expenses also qualify if the designated beneficiary is enrolled for at least one-half of the normal full-time course load in a program leading to a degree or certificate. Amounts paid for a beneficiary for credits or certificates under qualified tuition programs are qualified education expenses.[34] However, a taxpayer must reduce the qualified expenses by any tax-free scholarship and other tax-free payments received for education expenses, except payments received by gift or inheritance.[35]

A taxpayer may waive the exclusion from gross income for withdrawals from a Coverdell Education Savings Account.[36] A taxpayer might do so to claim the Hope credit or Lifetime Learning credit based on the qualified education expenses. A taxpayer who excludes from income amounts received from a Coverdell Education Savings Account may not claim one of these credits based on the same expenses.[37]

An eligible educational institution includes accredited, postsecondary educational institutions offering credit toward a degree or other recognized postsecondary credential.[38] Proprietary and postsecondary

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[29] IRC Section 530(c)(1).

[30] IRC Section 4973(e)(1)(A).

[31] IRC Section 4973(a).

[32] IRC Section 530(d)(2)(A).

[33] IRC Sections 529(e)(3)(A) and 530(b)(2)(A).

[34] IRC Section 530(b)(2)(B).

[35] IRC Sections 25A(g)(2) and 530(b)(2)(A).

[36] IRC Section 530(d)(2)(C).

[37] IRC Section 25A(e)(2).

[38] IRC Sections 530(b)(3) and 520(e)(5).

vocational institutions, as defined under *Education, U.S. Code* (USC) 20, Section 1088, also qualify as eligible educational institutions. The educational institution must also be eligible to participate in the United States Department of Education student aid program. Qualified education expenses also include elementary and secondary education expenses (Kindergarten through grade 12). The school may be a public, private, or religious school. Qualified elementary and secondary school expenses include expenses for tuition; fees; books; supplies; equipment; academic tutoring; the purchase of computer technology or equipment; internet access or related services; and expenses for room and board, uniforms, transportation, and supplementary items and services, such as extended day programs, as required or provided by the school.

If distributions exceed the qualified education expenses for the year, the taxpayer computes the taxable portion of the distributions under the IRC Section 72 annuity rules.[39] Thus, distributions would consist of a tax-free return of capital (recall that contributions are not deductible) and taxable earnings.[40] A taxpayer computes the tax-free portion of a distribution by multiplying the distribution by the ratio of the total contributions to the account balance at the time of the distribution.[41]

> **Example 30.2.** Lisa receives a $2,000 distribution from her Coverdell Education Savings Account in a year in which she did not incur any qualified education expenses. On the date of the distribution, her account balance is $10,000, and contributions made to the account total $4,000. The amount of the tax-free distribution from contributions is $800 ($2,000 × [$4,000/$10,000]). Lisa will include $1,200 ($2,000 − $800) in her gross income.

A beneficiary could incur qualified education expenses during the year but receive distributions from a Coverdell Education Savings Account exceeding the qualified expenses. In that case, the law treats the qualified education expenses as paid from a pro rata share of both contributions and earnings on the account.[42] Thus, the taxpayer computes the portion of earnings excludable from gross income based on the ratio that the qualified education expenses bears to the total distributions. The beneficiary includes the remainder of the earnings in gross income.

> **Example 30.3.** Bruce receives a $1,000 distribution from his Coverdell Education Savings Account. The distribution consists of $200 of contributions and $800 of earnings. Bruce pays $750 in qualified education expenses for the year. Bruce excludes $600 ($800 × [$750/$1,000]) from his gross income. Bruce includes the remaining $200 from earnings in his gross income.

The distribution from a Coverdell Education Savings Account included in gross income is generally subject to an additional 10% excise tax.[43] The additional 10% tax does not apply to distributions made on account of the beneficiary's death or disability, waiver of the exclusion of distributions from gross

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[39] IRC Section 530(d)(1).

[40] IRC Sections 72(e)(2)(B) and 72(e)(9).

[41] IRC Sections 72(e)(8) and 72(e)(9).

[42] IRC Section 530(d)(2)(B).

[43] IRC Section 530(b)(4).

income for attendance at a U.S. military academy,[44] to the extent of a scholarship, or the return of excess contributions and earnings.[45]

The balance remaining in a Coverdell Education Savings Account must be distributed within 30 days after a beneficiary reaches age 30 unless the beneficiary is a special needs beneficiary.[46]

In addition, the account balance must be distributed within 30 days after the death of a beneficiary under age 30.[47] In the event of a required distribution, the account balance is deemed to be distributed at the end of the 30-day period,[48] and the beneficiary must include the earnings portion of the distribution in his or her gross income.[49]

.04 Loans and Other Prohibited Transactions

A person may not use a Coverdell Education Savings Account as collateral for a loan. Other prohibited transactions include the use of the assets in the Coverdell Education Savings Account by the beneficiary or a fiduciary for anything except the intended educational purposes of the account.[50]

.05 Community Property Laws

For tax purposes, community property laws do not apply to Coverdell Education Savings Accounts.[51]

.06 Rollovers

Before a beneficiary attains age 30, the balance of a Coverdell Education Savings Account may be transferred or rolled over to a Coverdell Education Savings Account for a family member to defer or possibly avoid any tax liability on the earnings in the account. A beneficiary of a Coverdell Education Savings Account may receive distributions from that account and roll them over into a Coverdell Education Savings Account for a member of the beneficiary's family.[52] Family members include ancestors, descendants, brothers, sisters, nephews, nieces, certain in-laws, and the spouses of these relatives. Stepparents, stepsiblings, and stepchildren are also considered members of the family.[53] The

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[44] IRC Section 530(d)(4)(B)(iv).

[45] IRC Section 530(d)(4)(B).

[46] IRS Restructuring and Reform Act of 1998, Conference Committee Report on P.L. 105-206.

[47] IRC Section 530(b)(1)(E).

[48] IRC Section 530(b)(8).

[49] IRC Section 530(d)(1).

[50] IRC Section 4975(c).

[51] IRC Section 530(f).

[52] IRC Section 530(d)(5).

[53] IRC Sections 529(e)(2) and 152(a).

beneficiary does not include these distributions in gross income, provided that the beneficiary rolls the funds over within 60 days of the distribution. Similarly, any change in the beneficiary of a Coverdell Education Savings Account does not constitute a distribution for tax purposes if the new beneficiary is a member of the family of the original beneficiary as defined in IRC Section 529(e)(2). The new beneficiaries in these circumstances must be under age 30 as of the date of the distribution or change in beneficiary.[54] Rollover contributions do not count against the annual limit on contributions.

The rollover provisions allow families to roll funds not needed by one child into a Coverdell Education Savings Account for the benefit of another child.

> **Example 30.4.** Paco and Elena Martinez set up a Coverdell Education Savings Account for their son, Juan. Paco and Elena determine that their daughter, Belita, will need more financial assistance with her education than will Juan. They roll $3,000 from the Coverdell Education Savings Account set up for Juan into a Coverdell Education Savings Account for Belita. The rollover is tax-free.

Taxpayers may also roll over amounts in a Coverdell Education Savings Account into another Coverdell Education Savings Account for the benefit of the same beneficiary. A taxpayer might affect such a rollover to obtain greater investment diversification.

.07 Estate and Gift Tax Considerations

For gift tax purposes, a contribution to a Coverdell Education Savings Account is a completed gift of a present interest at the time of the contribution.[55] Therefore, the contribution is eligible for the annual gift tax exclusion ($15,000 for 2020 and indexed annually for inflation).[56] The contribution is also eligible for the annual exclusion from the generation-skipping transfer tax.[57]

The IRC generally does not treat distributions from a Coverdell Education Savings Account as taxable gifts. Also, if a taxpayer rolls over a beneficiary's interest in a Coverdell Education Savings Account to another beneficiary or changes the beneficiary, no gift or generation-skipping transfer tax consequences result, provided the two beneficiaries are of the same generation. An interest in a Coverdell Education Savings Account is not includible in the gross estate of any individual except with respect to amounts distributed on account of the death of the designated beneficiary.

The divorce of the designated beneficiary does not have to cause a taxable distribution to the spouse or ex-spouse. The transfer of a beneficiary's interest in a Coverdell Education Savings Account to a spouse or ex-spouse under a divorce or separation agreement is not a taxable transfer. After the transfer, the tax law treats the interest in the account as belonging to the recipient.[58]

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[54] IRC Section 530(d)(5) and (6).

[55] IRC Sections 530(d)(3) and 529(c)(2)(A).

[56] IRC Section 2503(b).

[57] IRC Sections 530(d)(3) and 529(c).

[58] IRC Sections 530(d)(7) and 220(f).

If a spouse or family member acquires a beneficiary's interest in a Coverdell Education Savings Account at the death of the beneficiary, the tax law views the spouse or family member as the account beneficiary of the Coverdell Education Savings Account. However, if a person other than a spouse or family member is the designated beneficiary, the Coverdell Education Savings Account terminates at death. In these circumstances, the account balance is includible in the beneficiary's gross income as of the date of death (or, if the beneficiary is the decedent's estate, on the decedent's final income tax return).

¶3025 Deduction for Higher Education Expenses

A deduction was available to be claimed for qualified tuition and related expenses. This deduction was extended for 2018–2020.

A taxpayer can claim the deduction when computing AGI. A taxpayer does not have to itemize deductions on Schedule A to claim the deduction. The maximum deduction is $4,000 for taxpayers with AGI not more than $160,000 on a joint return and $80,000 on other returns. A taxpayer whose AGI exceeds the limits but does not exceed $180,000 on a joint return or $90,000 on other returns can deduct up to $2,000 in qualified expenses.[59] However, a married individual who files a separate return cannot claim the deduction.[60] A taxpayer who was a nonresident alien for any part of the tax year can claim the deduction only if the taxpayer elects to be treated as a resident alien under IRC Sections 6013(g) or 6013(h).

The AGI limit is determined without regard to the foreign earned income exclusion and the exclusion for foreign housing costs and income of residents of Guam, American Samoa, the Northern Mariana Islands, and Puerto Rico. However, the following items are taken into account when computing AGI solely for determining eligibility for the deduction for qualified higher education expenses:

- Taxable Social Security benefits
- Exclusion for certain U.S. savings bond interest used to pay higher education expenses
- Exclusion for employer-provided adoption assistance
- The deduction for retirement savings (traditional IRAs)
- Student loan interest payments
- The disallowance of passive activity losses

[59] IRC Section 222(b).

[60] IRC Section 222(d)(4).

Taxpayers cannot double dip by deducting their qualified higher education expenses and claiming another tax benefit for the same expenses.[61] In addition, an individual who can be claimed as a dependent on another taxpayer's return cannot deduct qualified higher education expenses.[62]

The taxpayer must identify on his or her tax return the name and Social Security number of the student for whom qualified tuition and related expenses were paid.[63]

Qualified tuition and related expenses include tuition and fees required for the enrollment or attendance of the taxpayer, the taxpayer's spouse, or any dependent at an eligible educational institution for courses of instruction. Eligible educational institutions include accredited public, non-profit, or proprietary postsecondary institutions.

The deduction is allowed for expenses paid during an eligible tax year, in connection with enrollment during the year or in connection with an academic term beginning during the year or the first three months of the following year.[64]

Planning Pointer. Education planning requires CPAs to be knowledgeable about tax planning, financial aid planning, and cash flow planning, and more importantly, to be aware of how each of these planning areas interact with one another so families can receive holistic guidance. Visit aicpa.org/pfpguides to access more in-depth content in The Adviser's Guide to Education Planning.

[61] IRC Section 222(c)(1).

[62] IRC Section 222(c)(3).

[63] IRC Section 222(d)(2).

[64] IRC Section 222(d)(3).

Chapter 31

Investment and Financial Planning Strategies and Vehicles

¶3101 Overview

Investors are concerned about how tax factors and economic risks affect their investments and prospective investments. These considerations are discussed in ¶3101.01 and ¶3101.03, respectively.

Both the investor and the financial planner should have a basic familiarity with securities laws as they affect investments. Having a knowledge of securities laws is especially important because recent scandals have increased government scrutiny of corporations and securities transactions (¶3101.04).

In addition, the Sarbanes-Oxley Act of 2002 added to the legal complexity. This act created the Public Company Accounting Oversight Board to regulate accountants. This act also increased financial reporting requirements for publicly held companies. In addition, the CEO and CFO must prepare a statement to accompany the audit report to certify the appropriateness and accuracy of the financial statements and disclosures.

Specific investments, other investment considerations, and other financial planning matters are discussed in the balance of this chapter.

Planning Pointer. Free Guide on Investment Advisory Business Models and Legal/Regulatory Issues.

CPAs who are providing personal financial services (including tax, estate, retirement, investment, or risk management planning) to their clients are in an optimal position to add investment advisory services to their businesses. Surveys show that CPAs are ranked among the most trusted advisers. They put their clients' interests first when providing advice, which is an especially critical element for the American public when choosing investment advisers.

There is significant untapped revenue in the investment advisory market, but many CPAs do not enter into this line of business because they believe the regulatory issues are too complex to navigate. The business model you select for your firm for providing investment services will determine the legal and regulatory issues you will face.

The AICPA PFP Section offers a free guide outlining investment advisory business models and guidance on when you have crossed the line into providing investment advice and are required to register as an investment adviser. Access The CPA's Guide to Investment Advisory Business Models, free on the PFP Section website.

.01 Investments and Taxation

Investments and investors are, in one way or another, affected by three federal taxes — income, estate, and gift — but principally by the income tax. State and local taxes also affect investments, but the focus of this chapter is the taxation of investments at the federal level.

Most investors are aware of the tax factors affecting their investments, at least in a general sense. Nevertheless, they and some of their financial advisers might profit by the following summary primer on very basic tax principles.

The catchall. All income and gain from whatever source derived is includible in gross income (subject to tax) unless specifically exempted.[1]

Tax-free income. Generally, the interest earned on obligations of a state or subdivision thereof, or of any U.S. territory or possession, or any subdivision thereof, or of the District of Columbia, is exempt from federal income tax,[2] but not necessarily from income taxes by other states, and may nevertheless be includible in the gross income base for determining tax on an individual's Social Security benefits.[3] Income derived from tax-exempt private activity bonds is subject to the AMT but not to the regular income tax.

Return of capital. Amounts received as a return of capital or investment are not taxable as income.

The IRC provides for the tax-free return of capital through depreciation[4] and depletion[5] deductions and deduction of a portion of annuity payments.[6]

When property is sold or exchanged, the IRC permits recovery of the investment and treats only the excess as realized gain.[7]

Open transactions. When property is sold and the fair market value of property received by the seller is not reasonably ascertainable, the transaction may be deemed open. In such cases, the seller will not be taxed on the unascertainable amount until it becomes ascertainable. However, the IRS will recognize transactions as open only in rare and extraordinary circumstances.

Capital gains and losses. Although the tax rates have changed over time, the rate of tax on net long-term capital gains is less than the rate of tax on ordinary income. Qualified dividends and long-term capital gains are subject to a maximum tax rate of 15% for most taxpayers, with the rate for persons filing as single taxpayers with taxable income in excess of $441,450 and for married persons filing jointly with taxable income in excess of $496,600 at 20% for 2020. The taxable income thresholds are indexed annually for inflation. The 20% threshold for trusts and estates is $13,150 for 2020. Individuals in the 10% or 12% marginal tax rate bracket for ordinary income are subject to a 0% tax rate on qualified dividends and most long-term capital gains. In addition, the 3.8% net investment income tax applies to net investment income of single persons having AGI over $200,000, married persons filing jointly with AGI over $250,000, married persons filing separately with AGI over $125,000, and trusts

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[1] IRC Section 61(a).

[2] IRC Section 103.

[3] IRC Section 86(b)(2)(B).

[4] IRC Section 167.

[5] IRC Section 611.

[6] IRC Section 72(b).

[7] IRC Section 1001(a).

and estates with income over $12,950. The AGI thresholds for this tax for individuals are not indexed for inflation.

High-income individuals benefit substantially if a particular transaction gives rise to a long-term capital gain as opposed to ordinary income. An even better tax result can be achieved if the individual can use short-term or long-term losses to offset capital gains. In addition, if the capital losses exceed capital gains, the first $3,000 of excess losses ($1,500 for married persons filing separately) may be used to offset ordinary income.[8] The disallowed losses are carried forward indefinitely for the individual's lifetime.[9]

An exclusion for 50%, 75%, or 100% of the gain on the sale or exchange of qualified small business stock held for more than 5 years depending on the date the stock was acquired[10] (¶3125) and a deferral mechanism for investment in specialized small business investment companies[11] (¶3125) also aid small businesses.

Deferring tax on gain. An individual can be viewed as becoming wealthier as his or her property appreciates in value. The gain on appreciation of property is not taxed until the gain has been realized through a sale or exchange.[12]

Involuntary conversions. A taxpayer's voluntary action is usually a prerequisite to the realization of gain or loss. The IRC prescribes non-recognition rules for gains on involuntary conversions of property (that is, destruction in whole or in part, theft, seizure, or condemnation or sale under threat of condemnation) under certain conditions.[13] Generally, qualified replacement property must be acquired within two years after the end of the tax year of the conversion.[14] However, the period for the replacement of property involuntarily converted due to a federally declared disaster ends four years (instead of the regular two years) after the close of the first tax year in which any part of the gain upon conversion is realized.[15] For condemned real estate, a taxpayer has three years from the end of the tax year in which the conversion occurred to obtain qualified replacement property.[16] Losses incurred (after taking into account insurance recoveries, if any) on the involuntary conversion of business or investment property are recognized.

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[8] IRC Section 1211.

[9] IRC Section 1212.

[10] IRC Section 1202.

[11] IRC Section 1045.

[12] IRC Section 1001(a).

[13] IRC Section 1033.

[14] IRC Section 1003(a)(2)(B).

[15] IRC Section 1033(h)(1)(B).

[16] IRC Section 1033(g)(4).

Like-kind exchanges. No gain or loss is recognized on an exchange of real property (no longer personal property after 2017 as the result of the TCJA) held for productive use in a trade or business or for investment solely for other property of a like kind to be held for business or investment.[17] (See ¶3115.) If the taxpayer also receives money, relief from debt, or nonqualified property in the exchange, the gain is taxable to the extent of such money, debt relief, and the fair market value of the disqualified property.[18] Such money and disqualified property is called "boot." The property received in exchange must be first identified and then received within certain time limits prescribed by law to qualify for non-recognition.[19] Most of these exchanges are not simultaneous exchanges involving two parties. Rather, the vast majority of like-kind exchanges are deferred exchanges involving three parties and are made through a qualified intermediary.

Installment sales. The installment method of reporting, when available, generally permits delaying the reporting of gains until payments are received.[20] The installment method is not available for sales of stocks and bonds traded on an established securities market or for the sale of inventory.[21] On a sale of depreciable property, any recapture of depreciation must be reported in the year of sale.[22] Receipt of a purchaser's obligation that is payable on demand or that is readily marketable (that is, traded on an exchange) is treated as cash.[23] Special rules govern installment sales of nonfarm real estate having a sales price in excess of $150,000 if the seller's deferred payments for all such real property sales exceed $5 million.[24] Installment sales to related parties must be handled carefully. If the related purchaser sells the acquired property within two years of the acquisition, the gain on the sale will be taxed to the original seller.

Investment expenses. As the result of the TCJA, the previously allowed individual deductions that were connected with the production or collection of income, for the management or maintenance of property held for the production of income, or for the determination, collection, or refund of any tax, are part of the pool of miscellaneous itemized deductions subject to a floor of 2% of AGI that are no longer deductible.[25] IRC Section 212 deductions attributable to rents and royalties are deductible from gross income when computing AGI (above the line), were not subject to the 2% floor of AGI, and remain deductible. Also, the following itemized deductions are not subject to the 2% floor: interest, state and local taxes (now limited to $10,000 per year), certain losses, expenses in connection with personal property used in a short sale, deductions relating to annuity payments that cease before the annuitant

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[17] IRC Section 1031(a).

[18] IRC Section 1031(b).

[19] IRC Section 1031(a)(3).

[20] IRC Section 453(a)(1).

[21] IRC Section 453(k)(2).

[22] IRC Section 453(i).

[23] IRC Section 453(f)(4).

[24] IRC Section 453A.

[25] IRC Section 67(g).

recovers his or her investment, amortizable bond premium, and deductions by cooperative housing corporation tenant-shareholders.[26] Allowable itemized deductions are no longer subject to the overall limitation on itemized deductions (the "Pease limitation") which was repealed by the TCJA.

Deduction of investment interest. The deduction for investment interest paid is limited to the amount of investment income received.[27] Interest paid to acquire or carry tax-exempt bonds is not deductible.[28] Amortizable bond premium is treated as an offset to interest income on the bond, rather than as a separate interest deduction subject to the investment interest limitation.[29] Most dividends are no longer included in investment income for the purpose of calculating the limit on the deduction for investment interest because qualified dividends are taxed at a preferred rate of 15% or 20%. A taxpayer may elect to include dividends in investment income for purposes of calculating the limit on the investment interest deduction. However, any dividends the taxpayer elects to include in investment income are taxed as ordinary income and subject to a maximum ordinary income tax rate of 37% for 2020 and beyond. A taxpayer makes the election on Form 4952, "Investment Interest Expense Deduction."

Net long-term capital gain from investment property and qualified dividends generally are not counted as investment income for purposes of figuring the investment interest limit.[30] However, taxpayers may elect to treat net capital gain from investment property and qualified dividends as investment income by giving up the reduced tax rate advantage on these categories of assets. If the taxpayer makes the election on Form 4952 to relinquish this advantage, the net capital gain and qualified dividend is taxed as ordinary income.[31]

Passive losses. In general, salary, active business income, and portfolio income (interest, dividends, annuities, and gains from the disposition of property held for investment) may not be offset by losses from passive activities.[32] Losses generated by a passive activity, may, as a general rule, only be used against income from a passive activity.[33] Unused passive losses are carried forward indefinitely for the life of the taxpayer and can be used to offset passive income. In addition, the unused passive losses are allowed to be utilized on a fully taxable disposition of the property that was the subject of the passive losses.[34]

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[26] IRC Section 67(b).

[27] IRC Section 163(d)(1).

[28] IRC Section 265(a)(2).

[29] IRC Section 171(e).

[30] IRC Section 163(d)(4)(B)(iii).

[31] IRC Section 1(h)(3).

[32] IRC Section 469(a).

[33] IRC Sections 469(a) and 469(d)(1).

[34] IRC Section 469(g)(1).

An activity is passive if it involves the conduct of a trade or business in which the taxpayer does not materially participate.[35] A passive activity generally includes most rental activities except the rental of property to one's own business (self-rental income) or the activities of a real estate professional.[36] Interests in a limited partnership will generally be treated as not involving material participation.[37] Material participation requires regular, continuous, and substantial participation in the activities of the business.[38]

Some relief from the passive loss rules is provided for the activities of real estate professionals,[39] as discussed in ¶3180. In addition, individuals who actively participate in rental real estate activities may deduct up to $25,000 of losses from such activities against active income and portfolio income.[40] Active participation requires a lower level of participation than does material participation. The $25,000 maximum amount is phased out by 50% of the amount by which the taxpayer's AGI exceeds $100,000.[41] Accordingly, at $150,000 of AGI, the opportunity to claim the deduction is lost. The taxpayer's AGI for this purpose is computed before the rental real estate loss and without regard to certain other items.[42]

Taxes. Most state, local, U.S. possessions income, real estate, personal property, and sales taxes are deductible under IRC Section 164, but as the result of the TCJA, the deduction of these taxes is capped at $10,000 per year. Sales taxes paid on depreciable property are added to the basis of the property and depreciated. Sales taxes may be deducted in lieu of income taxes, but all state and local taxes are subject to the $10,000 cap. Sales taxes paid on items deductible as business expenses, such as office supplies, are treated as an additional cost of such items.

Losses. Losses on the sale or exchange of investment property are deductible above the line (to the extent of the gains from such property, plus an additional $3,000 of losses against other forms of income) in computing AGI.[43] Such losses are not an itemized deduction. Personal theft and casualty losses for individuals are no longer deductible as itemized deductions as a result of the TCJA, unless the casualty is a presidentially declared disaster.[44]

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[35] IRC Section 469(c)(1).

[36] IRC Section 469(c)(2).

[37] IRC Section 469(h)(2).

[38] IRC Section 469(h)(1).

[39] IRC Section 469(c)(7).

[40] IRC Sections 469(i)(1) and 469(i)(2).

[41] IRC Section 469(i)(3).

[42] IRC Section 469(i)(3)(e).

[43] IRC Section 62(a)(3).

[44] Regulation Section 1.165-7(c).

Individual alternative minimum tax. After calculation of an individual's regular tax, it might be necessary to compute the tentative AMT. If the latter is higher, the taxpayer must pay the excess in addition to the regular tax.[45] Exemptions apply that vary with the taxpayer's filing status. The law now provides for annual inflation indexing of the AMT exemptions. The exemption amounts for tax years beginning in 2020 are $113,400 for joint filers and surviving spouses, $72,900 for other unmarried individuals, $56,700 for married individuals filing separate returns, and $25,400 for estates and trusts.[46]

The AMT exemptions are subject to a phase-out rule based on the individual's alternative minimum taxable income (AMTI). These exemptions are phased out when there is AMTI in excess of $1,036,800 in the case of a joint return or a return of a surviving spouse, and $518,400 in the case of individuals. A taxpayer must use special rules when computing AMTI, adding back to the AMT tax base items such as the amount of deductible state and local taxes, private activity bond interest, and a variety of other specific adjustments,[47] but no longer the repealed personal exemptions or miscellaneous itemized deductions as the result of the TCJA.

A two-tiered set of tax rates applies to the excess of the AMTI over the exemption amount. For 2020, a 26% rate applies to the first $197,900 of this excess unless the taxpayer files as married filing separately, in which case, the 26% rate applies to the first $98,950 of this excess, and a 28% rate applies to the remainder.[48]

The limitation on certain itemized deductions that applied prior to 2018 (the "Pease limitation") has been suspended effective for tax returns from 2018–2025.

.02 Capital Gain Tax Breaks

Net capital gains are generally taxed at lower rates than ordinary income.[49] A net capital gain is the excess of a net long-term capital gain over any net short-term capital loss.[50] A *net long-term capital gain* is the excess of long-term capital gains over long-term capital losses.[51] A *net short-term capital loss* is the excess of short-term capital losses over short-term capital gains.[52] Long-term capital gains and losses result from the sale or exchange of capital assets held for more than one year.[53] Short-term capital gains

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[45] IRC Section 55(a)(1).

[46] IRC Section 55(d)

[47] IRC Sections 55(b)(2), 56, 57, and 58.

[48] IRC Section 55(b)(1)(A).

[49] IRC Section 1(h)(1).

[50] IRC Section 1222(11).

[51] IRC Section 1222(7).

[52] IRC Section 1222(6).

[53] IRC Sections 1222(3) and 1222(4).

and losses result from the sale or exchange of capital assets held one year or less.[54] In some cases, the IRC deems a sale or exchange to occur. For example, a worthless security is deemed sold for zero on the last day of the tax year in which it becomes worthless.[55]

Financial assets, such as stocks and mutual funds that emphasize long-term capital appreciation, are conveniently usually capital assets[56] with the potential for favorable capital gains treatment. Although land used in a business and depreciable assets used in a trade or business are not treated as capital assets,[57] gains on the sale or exchange of such assets have the potential for long-term capital gain treatment under IRC Section 1231(a)(1). Although the tax rates on net long-term capital gains remain favorable in 2019, an individual or a married couple filing a joint return may not deduct more than $3,000 a year of a net capital loss against ordinary income.[58] The taxpayer may carry forward indefinitely the remaining net capital loss for the duration of the taxpayer's lifetime.[59]

The favorable tax rates for net capital gains and qualified dividends discourage investments in assets that pay out their benefits in the form of interest. Interest is taxed as ordinary income and subject to a tax rate as high as 37% for 2020 and beyond, with the possible addition of the 3.8% net investment income tax.[60]

The prime examples of investments that pay interest include bank deposits, money market funds, certificates of deposit, bonds, and bond mutual funds. Rental properties held primarily for their rental income, rather than for their appreciation potential, might also be less attractive than stocks because the rental income is taxed as ordinary income and may also be subject to the 3.8% net investment income tax.

Investments that derive advantage from tax deferral (such as qualified retirement plans and tax-deferred annuities) are less attractive (once payments from them that are taxed as ordinary income are made) than long-term investments in securities and other property because of the lower tax rates that are imposed on net long-term capital gains and qualified dividends. However, tax-deferred investments that also provide tax-deductible opportunities (such as traditional IRAs) remain popular.

Gains realized on sales and exchanges of collectibles[61] are generally subject to a capital gains tax rate of 28%.[62]

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[54] IRC Sections 1222(1) and 1222(2).

[55] IRC Section 165(g)(1).

[56] IRC Section 1221(a).

[57] IRC Section 1221(a)(2).

[58] IRC Sections 165(f) and 1211(b).

[59] IRC Section 1212(b)(1).

[60] IRC Sections 1 and 1411.

[61] IRC Section 408(m).

[62] IRC Section 1(h)(4).

The financial planning strategy of making charitable contributions of appreciated property through the use of split-interest trusts (for example, charitable remainder annuity trusts and charitable remainder unitrusts) to avoid realization by individual taxpayers of capital gains has become more beneficial for 2020 and beyond as a result of the capital gain rate of 20% for wealthy taxpayers and the imposition of the 3.8% tax on net investment income.

> **Note:** When determining how long an asset was held, the taxpayer should begin counting on the date after the day the property was acquired. The same date in each following month is the beginning of a new holding period month, regardless of the number of days in the preceding month. For example, if property was acquired on June 1, 2020, the taxpayer's holding period began on June 2, 2020. The date the asset is disposed of counts as part of the holding period.

Tax rates on net capital gains. Generally, net long-term capital gains are subject to a tax rate of 15%, with (for 2020) a 20% rate imposed on single taxpayers with taxable income in excess of $441,457 and married taxpayers filing jointly with taxable income in excess of $496,600.[63] This rate is reduced to 0% for individuals in the 10% or 12% ordinary income tax brackets.[64]

The 15% tax rate for net long-term capital gains (and for qualified dividends) applies not only to individuals but also to estates and trusts, with the 20% rate for estates and trusts beginning at undistributed taxable income in excess of $13,150 for 2020. This number is indexed annually for inflation.[65] In addition, the same rates apply when the taxpayer is determining his or her liability for the AMT.[66]

Depreciable real estate. The IRC Section 1231 gain from the sale or exchange of depreciable real property that is treated as a capital gain is classified as IRC Section 1250 property and is taxed at a maximum rate of 25%.[67] The balance of the remaining IRC Section 1231 gain is treated as a long-term capital gain and taxed at a rate of 15% or 20%, or 0%, depending on the taxpayer's taxable income.[68] Such gain may also be subject to the 3.8% net investment income tax.

> **Example 31.1.** In 2020, Joe Green sold a building for $125,000. Green had originally paid $50,000 for the building a number of years ago. Over the years that he owned the building, Green had deducted $50,000 depreciation. Thus, his adjusted basis in the building was zero at the time of sale. Of his $125,000 recognized gain, he would pay a maximum rate of 25% on $50,000 of gain (the amount that had been allowable as IRC Section 1250 depreciation) and a maximum income tax rate of 15% or 20% (depending on his taxable income) on the remaining $75,000 of

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[63] IRC Section 1(h)(1)(C).

[64] IRC Section 1(h)(1)(B).

[65] IRC Section 641(b).

[66] IRC Section 55(b)(3).

[67] IRC Section 1(h)(7)(A).

[68] IRC Section 1(h)(1)(C).

gain. The entire gain may also be subject to the 3.8% tax on net investment income depending on his AGI and filing status.

Collectibles. As a general rule, collectibles do not qualify for the 15% rate (or 20% rate) on net capital gains. For example, gain from the sale of stamps, antiques, gems, artwork, and most coins are taxed at the maximum rate of 28%.[69] However, certain newly minted gold and silver coins issued by the federal government and coins issued under state law qualify for the lower capital gains rates, even though such coins generally would fall within the definition of collectibles.[70]

Small business stock. When a taxpayer sells or exchanges certain small business stock (that is, IRC Section 1202 stock) that the taxpayer has held for more than 5 years, a percentage of the gain may be excluded from the taxpayer's gross income.[71] The excludable percentage is 50% for qualified stock acquired between 1993 and February 17, 2009. The 50% exclusion was increased to a 75% exclusion of gain if the stock was acquired after February 17, 2009, and before September 27, 2010. If the small business stock was acquired on or after September 27, 2010, the exclusion from gain was increased to 100%. If taxable, the tax rate on the sale of Section 1202 stock is 28%. None of the excluded gain from the sale of Section 1202 stock acquired after September 27, 2010, will be considered an AMT preference. Refer to IRC Section 3125 for further explanation of qualified small business stock.

Pass-through entities. An individual's capital gains include his or her share of capital gains from a pass-through entity (such as a mutual fund, S corporation, partnership, LLC, estate, or trust).

.03 How Economic Risk Affects Investment

The one certainty about the stock market is that prices will fluctuate; its direction is never completely certain.

Risk of loss can be minimized through diversification and asset allocation. The goal of asset allocation is to tailor a portfolio of stocks, bonds, money market investments, foreign securities, precious metals, and other investments in a mix that recognizes the client's risk and return preferences and also hedges against big drops in the stock market. Asset allocation involves choosing the right categories of assets for the investor and a willingness to sacrifice a maximum gain in good times in order to avoid the worst in bad times.

Asset allocation comes highly recommended but is not without its potential drawbacks. It might promote a passive attitude toward true value investing when the emphasis is to buy good investments and hold them for a long time, maximizing values while minimizing trading and transaction costs. Asset allocation also relies on an investor profile, which can change if the investor's preference for risk and return also changes over time. Any reallocation of assets is likely to involve transaction costs. Asset allocation also involves the periodic readjustment of assets. This periodic readjustment might be integral to the asset allocation strategy, if percentage holdings in one category rise above a certain level. Formal application of the strategy calls for a sale of the surplus asset and the purchase of an asset that is

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[69] IRC Section 1(h)(5).

[70] IRC Sections 1(h)(6)(A) and 408(m)(3).

[71] IRC Section 1202(a).

underrepresented in the portfolio. This process can, again, trigger annual or more frequent activity in a portfolio, raising transaction costs. All of these factors should lead the investor to some skepticism and the avoidance of false hopes. Asset allocation has the hopeful air of science about it. However, its successful performance will not always be replicated in the real world.

.04 Investments and Securities Laws

Federal and state securities laws affect investments. Such laws are highly complex. The securities law contains many statutes and case law, along with administrative regulations and rulings. This law contains a body of knowledge that is much more than an investor or the issuer of investment securities would need to know. However, the average buyer or seller of securities and the financial planner should be familiar with some aspects of the federal and state securities laws.

Common law fraud. Long before the enactment of our current federal securities laws (the Securities Exchange Act of 1934 [the 1934 Act] and the Securities Act of 1933 [the 1933 Act]) and state counterparts of the 1934 Act, common law principles of fraud and contract were applicable to transactions involving the sale, purchase, or issuance of securities.

Statutory fraud. The 1933 Act deals with the issuance and registration of securities and concerns issuers. Portions of the 1934 Act, as they affect buyers and sellers of securities, are the primary concern here.

The 1934 Act built on common law fraud concepts and expanded them. Section 10(b) of the 1934 Act and Securities and Exchange Commission (SEC) Rule 10b-5 made the following acts unlawful in the sale or purchase of a security through the mail or other means of interstate commerce:

- Use of any device or scheme to defraud
- Making a material misstatement or omission of fact
- Commission of any act that operates as an attempt to defraud or deceive an individual

The omissions provision makes unlawful the fraudulent omissions of material facts that make the representations misleading.

The misstatement and omission provision has given rise to more litigation and rulings than the other parts of the rule. It applies to securities transactions generally, whether conducted face to face or through brokers. It applies to unregistered securities and those exempt from registration under the 1933 Act, including the stock of closely held corporations. Many, if not most, state “blue sky” securities laws contain provisions similar to Rule 10b-5. The phrase *blue sky laws* refers to state regulations established as safeguards for investors against securities fraud.

Materiality. To come within Rule 10b-5, the misstatement or omission must be of a material fact (opinion will not suffice). What is material in this context? Basically, it is something a reasonable investor would take into consideration when making an investment decision. However, ascertaining what a reasonable investor would do will usually not be an easy task.

Nonpublic information about a firm’s financial condition, a proposed cut or increase in dividends, a stock split, or a new product or discovery will ordinarily qualify as material. Preliminary merger talks might qualify, depending on the particular circumstances, even though they have not reached the point

of an agreement in principle. The proximity or remoteness of the occurrence of a particular fact can affect its materiality.

Rule 10b-5 is often invoked in insider trading cases. The rule can apply to individuals having no direct relationship with the corporation. For example, an employee of a law firm that has been retained in connection with a planned tender offer tells a friend or relative about a planned tender offer being processed by the law firm. This scenario illustrates a relationship between a tipper and a tippee. The tippee buys the target company's stock. When the tender offer becomes public, the tippee sells the stock at a profit.

In this example, the tipper is not a buyer or seller of the target company's stock. Nevertheless, he or she may be held liable as having engaged in an unlawful transaction under Rule 10b-5 under a theory developed by some courts and upheld on appeal by an equally divided U.S. Supreme Court in *U.S. v. Carpenter*.[72] The tipper is held liable on the grounds of having misappropriated confidential information belonging to the employer and the employer's client. The tipper and tippees of the primary tippee who buy and sell securities on the basis of the tip can also be held liable.[73] If the tippee did not know of the confidential nature of the tipped information, liability might be avoided.[74]

Rule 10b-5 is used most frequently against true corporate insiders, such as officers, directors, and 10%-or-more shareholders and their tippees who trade on good or bad nonpublic information about the tippers' companies. Such insiders can be held personally liable, even though they derive no direct profit. The profits of the tippee will be considered profits of the insider-tipper.

To invoke the rule, a purchase or sale of securities must occur. The rule may not be invoked if an individual might have bought or sold securities but for the fraud charged. If a purchase and sale does occur, the connection between the fraud and the purchase or sale might be quite tenuous. The rule's application is not limited to transactions in publicly traded securities. One of the first cases that applied the rule involved closely held stock.

Short swing profits. Insiders in a narrower sense than discussed previously, namely officers, directors, and 10%-or-more shareholders of a corporation whose stock is publicly traded, are subject to Section 16(b) of the 1934 Act. It provides that if such individuals buy and then sell or sell and then buy their company's stock within a six-month period, they must expel any profits made and pay over the profits to their corporation.

This provision is operative even though the insider is not shown to have traded on inside information. Thus, an irrefutable presumption of law is that the purchase and sale or sale and purchase were made on the basis of inside information.

Certain exemptions apply for stock acquired under employee benefit plans, subject to certain conditions. Company counsel should be called upon to provide details.

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[72] 108 SCt 316 (1987).

[73] *SEC v. Musella*, AICPA Federal Securities Law Reports ¶93,589.

[74] *Chestman*, CA-2, 903 F.2d 75 (2d Cir. 1990) and *Willis*, 737 F. Supp. 269 (D.C. N.Y. 1990).

¶3105 Saving More as a Means of Coping with Low Yields

In times of low interest rates, many individuals have sought alternative investments to boost returns.

A financial planner can suggest investments and planning to help the client increase returns and wealth. A financial planner can work with the client and create a financial plan that will help the client to achieve better money management, which, in turn, will increase savings and wealth. The process of developing the plan might reveal that the client is spending too much on certain discretionary personal items.

Other benefits of a financial plan include helping the client to avoid late charges on mortgage payments, estimated taxes, and fees for bouncing checks. The plan might help the client reduce total interest and finance charges on credit card debt.

A financial planner should not overlook traveling as a means of savings. Clients who routinely book flights near their actual travel dates can realize big discounts by booking well in advance, when feasible.

The following are some other steps the financial planner can recommend that can help increase wealth:

- Moving funds from money market accounts into mutual funds invested in intermediate or short-term Treasuries. This change might result in marginally higher yields without substantially increasing risk. Further, the income from Treasury securities will not be subject to state and local income taxes. Note, however, that as interest rates increase, the value of bonds decreases. This is especially true for longer-term bonds.

- Taking full advantage of any opportunity to participate in a company 401(k) plan, especially if the plan provides matching employer contributions. The client's contribution will save income taxes, and the tax on earnings on the funds in the account will be deferred.

- Paying credit card balances or transferring credit card debt to lenders who charge lower interest.

- Buying mutual fund shares in equal amounts at regular intervals to dollar cost average, rather than making sporadic purchases.

Participating in a company automatic savings plan. Some companies offer these plans. Deductions from paychecks are automatically transferred to brokerage accounts or IRAs at regular intervals.

¶3110 Tax-Exempt Government Obligations

Under IRC Section 103(a), gross income does not include interest on any state (the District of Columbia and possessions of the United States included) or local (any political subdivision of a state) bonds, subject to the exceptions in Subsection 103(b). The latter exempts from the income exclusion (1) any private activity bond that is not a qualified bond, (2) any arbitrage bond, and (3) any bond that is not registered.

Private activity bonds may be generally taxable. A bond is a private activity bond if (1) a trade or business use test and a security or payment test is satisfied, or (2) a private loan restriction is satisfied.[75] However, a number of private activity bonds qualify for tax exemption, including exempt facility bonds and qualified enterprise zone facility bonds to help finance property located in an empowerment zone or in an enterprise community.[76] In general, the regular tax-exempt bond rules apply. Proceeds from these bonds may be used for acquiring both new and used property. Also, more than 25% of the net bond proceeds may be used to finance the acquisition of land. Empowerment zone bonds are similar to enterprise zone bonds, except that empowerment zone bonds (1) are not private activity bonds under IRC Section 146 and are not subject to the value cap on such bonds and (2) are not subject to the $3 million per empowerment zone limit.[77]

The foregoing is simply an overview of very complex special rules directly affecting tax-exempt bonds. Financial planners and investors must be aware of the possible AMT consequences of investments in private activity bonds, making the bond interest taxable for AMT purposes, even if not taxable for regular tax purposes.[78] In addition, both must be sure that any private activity bonds acquired on the basis that they are tax exempt do, in fact, qualify for the exemption or that their qualification is guaranteed by a responsible issuer or independent guarantor, or both. Finally, both should be aware that the characterization of a particular issue as exempt from "all" taxation refers to income taxation and does not provide an exemption from estate tax, and further, that one state may tax the interest on bonds issued by another state.[79]

A prospective investor in tax-exempt bonds must be concerned with factors that are truly beyond his or her control. The future trend of interest rates and the interrelated factor of inflation can have a great bearing on the ultimate success of a tax-exempt investment. The investor who is fairly convinced that interest rates and inflation will increase significantly will not want to hold long-term bonds. Their value will decrease if interest rates rise, and significant inflation takes place.

.01 The Minimum Tax and Tax-Exempt Bonds

Interest on private activity tax-exempt bonds is a preference item subject to the AMT.[80]

AMT-subject bonds may yield a higher rate of interest than comparable issues of fully exempt bonds (that is, typically one-quarter to one-half percent more). Many clients will not face the AMT. Careful investors can obtain higher yields with AMT-subject bonds than with fully exempt bonds.

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[75] IRC Section 141.

[76] IRC Section 1394.

[77] IRC Section 1394(f).

[78] IRC Section 57(a)(5)(A).

[79] *Wells Fargo Bank*, 485 U.S. 351 (1988).

[80] IRC Section 57(a)(5)(A).

.02 Investment Vehicles

The investor has three basic ways to invest in tax-exempt obligations: individual purchases, purchases of shares in a unit trust, and purchases of shares in a mutual bond fund.

Individual bonds. Factors bearing on the purchase of individual bonds are as follows:

- Bonds issued by the investor's own state, or a subdivision thereof, will usually be exempt from state and local taxes, as well as from federal income taxes.
- Bonds with good ratings are readily saleable.
- The cost of buying and selling bonds is usually less than the cost of stock transactions. Nevertheless, dealers prefer to deal in round lots, and several points can be lost in odd lots. Placing an order for a few thousand dollars of tax-exempt bonds is difficult. Bonds issued after June 1983 must be registered to be eligible for federal tax exemption.[81]
- Many bonds are callable. A call forces the bondholder to return the bond and be paid its face value. Calls typically arise when interest rates decline and the particular bond yield is above market rates. The issuer of registered bonds will directly contact the holder.

Unit trusts. Most municipal bond funds are unit trusts consisting of a fixed portfolio of long-term bonds to be held until maturity or until called by the issuers. The unit trust is not a managed fund and is appropriate for the investor who is willing to buy and hold a trust portfolio.

Unit trusts offer the investor a means of profiting from declining interest rates and rising bond prices. They can also involve a loss of value before maturity with a rise in interest rates.

Most trusts charge no redemption fee but do carry a sales charge to be paid upon making the initial investment in the trust.

Mutual funds. *Mutual funds* are managed funds (unlike unit trusts) in which fund managers adjust the fund portfolio to meet changing market conditions. For their services, mutual funds charge an annual management fee that may range generally from 1.0% to 2% (or less, depending on the fund) of the amount invested. In addition to the management fee, if the fund is an open-end type of fund, with shares being continually sold, the fund might charge a sales charge, ranging from 1% to as much as 8.5% of the amount invested. Many no-load mutual funds are available that charge no sales fee but may have exit fees. Some funds (such as Vanguard, for example) charge substantially lower fees than those fees noted previously.

Closed-end funds do not continually offer new shares. Once they have made their initial offering of shares, sales by the fund are closed. Investors must then buy and sell their shares in the market. Closed-end funds can trade at, below, or above net asset value.

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[81] IRC Section 149(a)(1).

.03 Tax-Exempt Zero-Coupon Bonds

A tax-exempt zero-coupon bond is sold at a deep discount from its face value. Unlike a coupon bond, it pays no current interest. As with other forms of zero-coupon securities, tax-exempt zeros provide the investor with a chance to lock in favorable rates of interest over the long term without having to suffer reinvestment risks each time an interest payment would be made. Of course, the long-term benefits of tax-exempt zeros can be undercut by call provisions in the bonds or payment at maturity in dollars whose value has been eroded by inflation. IRC Section 1286(d) provides special rules for stripped tax-exempt securities.

Tax-exempt zeros can be a particularly good way for parents to avoid the kiddie tax, which subjects unearned income of a child in excess of $2,200 for 2020 to income tax at the rates applicable to the parents of the child as a result of changes made by the SECURE Act.[82] The kiddie tax applies to all children under age 19 and to full-time students under age 24.[83] (See ¶3205.)

¶3115 Like-Kind Property Exchanges

For the person holding appreciated real estate property who wants to dispose of it and replace it with other property, a like-kind exchange (IRC Section 1031 exchange) can be an effective way of doing so without incurring a current tax liability. Recognition of the gain on the appreciation is deferred until the property received in the exchange is disposed of in a taxable transaction during the recipient's life. Recognition may be indefinitely postponed as long as the property is held by the recipient or is exchanged in one or more subsequent like-kind exchanges during the recipient's lifetime. If the recipient holds the replacement property until his or her death, the untaxed pre-death appreciation will permanently escape income tax because of the step-up in basis.[84]

Before a client enters into a like-kind exchange, the financial planner should help the client explore the following:

- The extent of the gain on a sale. With the low capital gains rates available (0% or 15% or 20% maximum rate for capital assets held for more than 1 year, with the percentage rate dependent on the taxable income of the taxpayer, plus the 3.8% net investment income tax), the question of whether a capital asset or an IRC Section 1231 asset should be sold outright deserves consideration.

- Whether the property owners have realized losses that may offset any gains that would be realized on a sale of the property.

- Whether a sale can be made using the installment method of reporting provided by IRC Section 453. If an installment sale is possible, the financial planner should remember the rule that any

[82] IRC Section 1(h).

[83] IRC Section 1(g)(2).

[84] IRC Section 1014(a).

depreciation recapture income must be recognized in the year of an installment sale, even if no payments are received in that year.[85]

- How a sale of the property and reinvestment of the proceeds in other property, with possibly higher depreciation deductions and lower taxes on a resale of the replacement property, compares with a like-kind exchange.

- The current tax bracket of the owner and any possible changes therein within the foreseeable future, whether resulting from changes in the law or the owner's circumstances, or both.

- Whether the property owner will retain the replacement property indefinitely and whether it will be included in the owner's estate and receive a stepped-up basis.[86]

The basic requirement for a tax-deferred like-kind exchange is that the exchange be of like-kind properties and otherwise satisfy the requirements of IRC Section 1031, as described next.

.01 Requirements of a Like-Kind Exchange

The requirements of a like-kind exchange as set out in IRC Section 1031 are as follows:

- Both the property exchanged and that received in exchange be held for productive use in a trade or business or for investment.[87]

- The properties exchanged must be of like kind.[88]

- The property to be received in the exchange (the replacement property) must be identified as such within 45 days after the property relinquished in the exchange is transferred.[89]

- The replacement property must be received no later than the earlier of:

  — 180 days after the property relinquished in the exchange is transferred[90] or

  — the due date of the taxpayer's return, determined with regard to extensions.[91]

The IRC expressly excludes from eligibility for like-kind exchange treatment stock in trade or other property held primarily for sale; stocks, bonds, notes, or other securities or evidences of indebtedness;

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[85] IRC Section 453(i).

[86] IRC Section 1014(a).

[87] IRC Section 1031(a)(1).

[88] IRC Section 1031(a)(1).

[89] IRC Section 1031(a)(3)(A).

[90] IRC Section 1031(a)(3)(B)(i).

[91] IRC Section 1031(a)(3)(B)(ii).

certificates of trust or beneficial interest; and rights that can be enforced by legal action (for example, debts or tort actions).[92] IRC Section 1031 no longer applies to personal property as the result of the TCJA. Only real estate exchanges will qualify for like-kind exchange treatment after 2017.

.02 Partnerships

Generally, partnership interests are not eligible for like-kind exchange treatment.[93] Interests in partnerships electing to be excluded from subchapter K are treated as interests in the assets of the partnership. Such interests would, therefore, in the case of real estate, be eligible for like-kind exchange treatment.

.03 Like-Kind Property

For purposes of IRC Section 1031, like-kind property is property of the same character, nature, or class.[94] However, as a general rule, an exchange of any parcel of real estate for another will qualify as a like-kind exchange without regard to its location or use. This rule permits raw land to be exchanged on a tax-deferred basis for an office building, and a farm for urban rental property or for timberland. However, foreign real property is never considered of a like kind to U.S. real property.[95]

.04 Receipt of Cash and Other Forms of Boot

Often, in an exchange, one party will be called upon to make cash payments, assume a mortgage or take the property subject to a mortgage, or deliver property of a different kind in order to equalize values. The cash payments, debt relief, and property of a different kind are called "boot." If a transferor assumes a mortgage on the property received or receives property subject to a mortgage, such mortgage will reduce the boot received from debt relief on the transferred property. However, the debt incurred may not offset other forms of boot, such as cash.[96] The receipt of boot will have no effect on whether the exchange of properties is entitled to non-recognition of gain. However, the party who receives the boot must recognize any gain realized to the extent of the boot received.[97] The gain not recognized is the gain deferred. The basis in the new like-kind property is equal to its fair market value minus the gain deferred. The basis of any property of a different kind received is its fair market value at the time of receipt.[98] Losses are never recognized on like-kind exchanges, even if boot is received or paid.[99] If a loss

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[92] IRC Section 1031(a)(2).

[93] IRC Section 1031(a)(2)(D).

[94] Regulation Sections 1.1031(a)-1(b) and 1.1031(a)-2.

[95] IRC Section 1031(h)(1).

[96] Regulation Sections 1.1031(b)-1(c) and 1.1031(d)-2

[97] IRC Section 1031(b).

[98] IRC Section 1031(d).

[99] IRC Section 1031(a)(1).

is realized on a like-kind exchange, the basis of the new like-kind property is the basis of the property exchanged decreased by the amount of loss suffered by the taxpayer on the exchange.[100]

.05 Related Party Exchanges

If a taxpayer completes an exchange of like-kind property with a related person, and the taxpayer or the related person disposes of the like-kind property received in the exchange within two years after the date of the last transfer made to complete the exchange, the nonrecognition of gain on the exchange is disallowed. A *related person* includes one's spouse, lineal heirs, descendants, and siblings. Exceptions to the denial of like-kind treatment are provided in the event of death, compulsory or involuntary conversion, or a showing that the transaction did not have as one of its principal purposes avoidance of federal income tax. IRC Section 1031(f).

¶3120 Investments in Securities

Investment in securities has always involved a strong element of risk in assessing a company's prospects. Economic considerations, diversification, and asset allocation are discussed in ¶3101.03. Here, the primary concern is the tax factors involved in such investments.

.01 In General

Before-tax and after-tax earnings on an investment in securities are important elements to consider. Also, consider the after-tax costs of realizing any capital appreciation. See ¶3101.01 for discussion of the tax treatment of capital gains and losses. Year-end planning for securities transactions is discussed in ¶3310.

.02 Short Selling

Most individuals buy stocks with the hope that the stocks will go up in value, and they will make money on the appreciation. In addition, the investor might receive dividends. An owner of stock is said to be "long" in the stock. Individuals who feel that particular stocks are overpriced and will go down in value sometimes attempt to make money by short selling. With short selling, an individual actually sells the stock before he or she owns it. An individual must use a margin account to sell stock short.

> **Example 31.2.** Stock of Widget, Inc. is currently selling at $60 per share. Frank Smith thinks the Widget stock is overvalued and will go down in price. He tells his broker that he wants to sell 200 shares of Widget short.
>
> What actually happens is that Smith's broker lends him 200 shares of Widget. Smith then immediately sells them for $60 per share, leaving the $12,000 (less selling expenses) on deposit with the broker. Smith then waits for the price of the stock to go down.
>
> The stock goes down to $30 per share. Smith thinks the price has hit bottom. So, he buys 200 shares at $30 per share at a total cost of $6,000 (plus any applicable commission). He uses these shares to pay back the shares he borrowed from his broker. The broker then gives Smith the

[100] IRC Section 1031(d).

$12,000 (less any applicable selling expenses) from the broker. Thus, Smith has made $6,000 (less transaction costs) by correctly predicting that the stock would decrease in value.

Risks and costs. In times when stocks appear to be grossly overvalued, individuals might be very tempted to try to make money by selling short. However, a financial planner should warn his or her clients of the risks of short selling.

With a long position, the most that the client can lose is the amount paid for the stock. With a short sale, the client theoretically has unlimited risk in that the client could be wrong, and the price of the stock could soar. The client eventually has to buy the shares and return them to the broker. If the client covers the short position at a time when the stock has appreciated in value from the time the client sold the stock borrowed from the broker, the client will lose money.

Sometimes, a flurry of short covering, in and of itself, will contribute greatly to the quick rises in value of particular stocks. Going back to the previous example, assume that a few days after Smith shorted the stock, its price jumped to $80 per share. If he immediately covered (that is, bought 200 shares at $80 per share), he would be out $4,000 (plus transaction costs). Also, if the price increases before the short seller covers, he has to deposit additional funds with the broker to address the required margin limitations. Furthermore, the short seller must pay any dividends on the borrowed stock until the seller covers.

Shorting against the box. With this technique, the individual sells short shares already owned. Frequently, this is done at the end of a year when an investor wants to lock in a gain currently but not be required to recognize the gain until the following tax year. A short sale against the box is a hedged position. If the stock appreciates, the investor gains on the stock owned, but loses the same amount on the short sale. If the stock declines in price, the reverse is true: the investor sustains a loss on the stock owned, but realizes a gain on the stock sold short.

Short-against-the-box transactions are generally treated as constructive sales of the appreciated stock as of the date of the transaction. A safe harbor exists, however, for certain short-against-the-box transactions that are closed within 30 days after the end of the year that the transaction was opened.[101] The gain or loss is considered a long-term capital gain or loss if the property used to close the sale is a capital asset held for the required one year and a day holding period in the hands of the selling taxpayer.

For transactions that meet certain safe harbor rules, no gain or loss is recognized until the short sale is closed by the delivery of the replacement stock to the lender. The gain or loss is the difference between the proceeds received from the short sale and the cost of the property used to close it.

¶3125 Capital Gains Exclusion for Qualified Small Business Stock

The IRC provides a significant tax break that is designed to help qualifying small businesses raise capital by allowing a long-term non-corporate investor in original issue stock issued by a qualifying corporation after August 10, 1993, to exclude at least 50% (and very possibly 100%) of the gain from his or her gross income. The taxpayer must have held the stock for more than 5 years.[102] The taxable

[101] IRC Section 1259.

[102] IRC Section 1202(a).

portion (if any) is a long-term capital gain, taxed at the maximum rate of 28%[103] (the 15% or 20% long-term rate[104] is not available when the seller qualifies for the 50% exclusion from gain[105]). Seven percent of the gain excluded from gross income is a tax preference item for AMT purposes.[106]

> **Example 31.3.** Gene Gray invests $100,000 in qualifying small business stock acquired in 2008. His investment is very profitable, and he sells the stock 12 years later in 2020 for $1.1 million. He has substantial gross income from other sources during the year of sale.
>
> If Gray is not subject to the AMT in the year of sale, his tax on the gain will be $140,000 [28% × ($1,000,000 – $500,000)]. If all of his gain were subject to tax, his tax rate would be 20%, and his tax would be $200,000 ($1,000,000 × 20%). Thus, the IRC Section 1202 exclusion saved him $60,000 ($200,000 – $140,000). If Gray is subject to the top 28% AMT rate when he sells the stock, he will pay $149,800 of AMT on his gain {[28% × ($500,000 × 7%)] + ($500,000 × 28%)}. Add to this another potential tax of $38,000 as the result of the net investment income tax being applied to the sale ($1,000,000 × 3.8%).

Planning Pointer. The denial of the 15% capital gains rate in tax years when the 50% exclusion applies is designed to keep a taxpayer from reaping a double tax benefit. If a taxpayer, after holding the small business stock for more than one year,[107] but less than five years, sells the stock in 2020, the gain would qualify for the prevailing maximum rate, depending on the taxable income of the taxpayer.[108]

Several important rules have been added to the law with respect to the sale of qualified small business stock. The 50% exclusion was increased to a 75% exclusion of gain if the stock was acquired after February 17, 2009, and before September 27, 2010. If the small business stock was acquired on or after September 27, 2010, the exclusion from gain has been increased permanently to 100%. In addition, none of the 100% excluded gain from the sale of such stock will be considered an AMT preference.

.01 Qualifying for the Break

The 50% (or 75% or 100%) capital gains exclusion applies only to gain on eligible stock (1) originally issued by a qualifying C corporation after August 10, 1993, and (2) held for more than five years.

.02 Eligible Stock

The 50%, 75%, or 100% exclusion generally applies only with respect to

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[103] IRC Section 1(h).

[104] IRC Section 1(h)(1)(C).

[105] IRC Sections 1(h)(5) and 1(h)(8).

[106] IRC Section 57(a)(7).

[107] IRC Section 1222(3).

[108] IRC Section 1(h)(C).

- stock that was acquired by the taxpayer at its original issue ("founder stock") after August 10, 1993. The stock can be acquired directly or through an underwriter. Stock received by gift or inheritance from a founder qualifies for the exclusion.

- stock acquired in exchange for money or other property (other than stock) or as compensation for services provided to the corporation (other than acting as the stock's underwriter).[109]

The tax break applies to preferred stock (including convertible preferred), as well as to common stock, assuming the taxpayer meets all the requirements.

The eligibility rules for the 75% exclusion and the 100% exclusion are the same as those for the 50% exclusion — with the exception of the required acquisition dates (after February 17, 2009, and before September 27, 2010, for the 75% exclusion and after September 27, 2010, for the 100% exclusion).

.03 Ineligible Stock

The exclusion does not apply to a taxpayer's stock if either of two conditions exists:

1. The issuing corporation directly or indirectly buys *any* of its own shares from the taxpayer or persons related to the taxpayer within a four-year period that begins two years before the stock's original issue date. Related persons are determined under the rules of IRC Sections 267(b) (for example, close family members) or 707(b) (for example, a person and his or her more than 50% controlled partnership).

2. The issuing corporation redeems, within a two-year period beginning one year before the stock's issuance, more than 5% by value of its stock as of the beginning of the two-year period. A corporation that redeems stock through a related corporation under IRC Section 304(a) is considered to have bought its own stock in the amount of the deemed redemption distribution under IRC Section 304(a).[110]

.04 Issuer Qualifications

The exclusion does not apply unless the corporation issuing the stock is a qualifying entity that (1) meets an active business test, (2) is engaged in a qualifying business (most service businesses are excluded from benefitting from IRC Section 1202), and (3) passes a gross assets test (that is, the corporation must be a C corporation engaged in an active business and may not have more than $50 million of assets at its inception).[111] If an S corporation converts to a C corporation, Section 1202 is not available because the corporation was not created as a C corporation.

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[109] IRC Section 1202(c).

[110] IRC Section 1202(c)(3).

[111] IRC Section 1202(d).

.05 Tax-Free Transfers

Although the law does not allow the exclusion to a post-issuance purchaser of otherwise qualified stock, the tax break is preserved for those who receive such stock as a gift or due to the death of the original purchaser. The transferor's holding period also carries over to the transferee. Similarly, qualified stock distributed by a partnership to its partners keeps its tax character intact, as long as the partners held their partnership interests when the stock was acquired, but only to the extent their shares of the partnership have not changed since the stock was bought. The partnership holding period for the qualified stock also carries over to the distributee-partners.[112]

.06 Maximum Excludable Amount

For each eligible corporation, a shareholder can exclude gain only to the extent the gain does not exceed the greater of (1) 10 times the taxpayer's adjusted basis in the stock disposed of during the tax year (post-issuance additions to basis are disregarded), or (2) a $10 million gain ($5 million for married taxpayers filing separately) reduced by gain excluded in earlier years from sales of stock in the corporation.[113]

.07 Special Basis Rules

If property (other than money or stock) is transferred to a corporation in exchange for its stock, the basis of the stock received is treated as not less than the fair market value of the property exchanged. If the qualified stock's basis is later increased by the holder's additional capital contributions, the contributed property's basis at that time is at least equal to its fair market value at that time. These rules assure that only gains that accrue after the transfer are eligible for the exclusion.[114]

Planning Pointer. The combination of the IRC Section 1202 rules allowing 100% gain exclusion on the sale of qualifying stock and the 21% tax rate on C corporations offers a significant planning opportunity. If a taxpayer can create the C corporation, take minimal or no distributions for salary, and reinvest the profits so that reasonable compensation, dividends, and accumulation of earnings are not issues, the combination of a 21% annual tax rate and no tax upon sale of the business stock if held for at least five years offers a powerful planning combination.

.08 Rollover of Gain on Sales of Qualified Small Business Stock (IRC Section 1045)

For sales of qualified small business stock, a selling taxpayer other than a corporation may elect to roll over capital gain from sales of such stock held for more than 6 months if the taxpayer purchases other small business stock within 60 days of the stock sale. Accordingly, gain is recognized only to the extent that the amount realized on the sale exceeds the cost of the replacement stock, as reduced by the portion of such cost, if any, that was previously taken into account.[115] To the extent that capital gain is not

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[112] IRC Section 1202(h).

[113] IRC Section 1202(b).

[114] IRC Section 1202(i).

[115] IRC Section 1045(a).

recognized, that amount will reduce the basis of the replacement stock.[116] The rollover break is available only to taxpayers other than a corporation.[117] Partnerships and S corporations are eligible to make the election if, at all times during the tax year, all the interests in the partnership or S corporation were held by individuals, estates, and trusts with no corporate beneficiaries.[118] Regulation 1.1045-1 explains how IRC Section 1045 applies to partnerships, including tiered partnerships. C corporations are not eligible to make the election.

Planning Pointer. For investors who choose to have a certain portion of their portfolio always invested in qualified small business stock, this rollover provision will allow indefinite postponement of tax on small business stock gains.

¶3130 Deferral for Investment in Specialized Small Business Investment Companies

The election to defer recognition of capital gain realized on the sale of publicly traded securities if the taxpayer used the sale proceeds to purchase common stock or a partnership interest in a specialized small business company (SSBIC) is repealed for sales after 2017 by the TCJA.

Prior to 2018, this election was available. It permitted investors who sold publicly traded securities to elect to defer the recognition of any capital gain realized by purchasing an interest in a SSBIC. The interest may be common stock or a partnership interest, as long as the company qualified as an SSBIC. The profit on such sales was not currently taxed to the extent that the stock sale proceeds were reinvested within 60 days in an SSBIC.[119] An SSBIC is a company licensed under section 301(d) of the Small Business Investment Company Act of 1958 as in effect on May 13, 1993. Generally, an SSBIC is an investment company that finances small business concerns owned by disadvantaged persons.

.01 Basis Reduction

As with other rollovers, tax on the gain was deferred, not eliminated. The mechanism for deferral was a downward basis adjustment in the SSBIC stock or partnership interest, equal to the gain that was not currently taxed.[120]

Gain on the SSBIC stock may have qualified for the 50% exclusion (¶3125).[121] However, if the SSBIC purchase qualified as small business stock eligible for the 50% capital gain exclusion, basis in the SSBIC stock was not reduced for purposes of calculating the gain eligible for the exclusion.[122] This

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[116] IRC Section 1045(b)(3).

[117] IRC Section 1045(a).

[118] Committee Reports on P.L. 105-206 (IRS Restructuring and Reform Act of 1998).

[119] IRC Section 1044(a).

[120] IRC Section 1044(d).

[121] IRC Section 1202(a).

[122] IRC Section 1044(d).

treatment prevented the deferred gain from qualifying for the exclusion but made it available for appreciation occurring after the SSBIC stock was acquired.

.02 Rollover Limits

The amount of gain eligible for the rollover for a tax year was generally limited to the lesser of (1) $50,000, or (2) $500,000 reduced by previously excluded gain ($25,000 and $250,000 for married individuals filing separately). For C corporations, the limits were $250,000 and $1 million.[123]

¶3135 U.S. Government Securities

The Treasury Department currently offers Treasury bills, notes, and inflation-protected securities. U.S. savings bonds, which are also issued by the Treasury Department, are discussed separately in the text that follows.

Taken as a group, Treasury securities offer these advantages:

- Treasury (or "T") bills are issued with maturities of 4, 13, and 26 weeks. The minimum purchase is $1,000, but an investor may purchase a larger amount in multiples of $1,000 above the minimum. The maximum purchase on a noncompetitive basis is $5 million. The maximum purchase on a competitive basis is 35% of the offering amount. The Treasury sells them at a discount to their face value. They are issued in book-entry form, rather than as an engraved certificate. Book-entry securities protect the owner against loss, theft, and counterfeiting.

- Treasury notes are issued in terms of 2, 3, 5, and 10 years and are offered in multiples of $1,000. The price and interest rate of a note are determined at auction. The price may be greater than, less than, or equal to the note par value.

- Treasury inflation-protected securities (TIPS) are issued in terms of 5, 10, and 20 years and offered in multiples of $1,000. The principal is adjusted according to the Consumer Price Index (CPI). With a rise in the index, or inflation, the principal increases; with a fall in the index, or deflation, the principal decreases. TIPS pay interest every 6 months. The interest rate is a fixed rate determined at auction. Though the rate is fixed, interest payments vary because the rate is applied to the adjusted principal. The amount of each interest payment is determined by multiplying the adjusted principal by one-half the interest rate.

Original issue Treasury securities may be purchased online at www.treasurydirect.gov through noncompetitive bidding. This website also has more complete information on Treasury bills and other Treasury securities. Previously-issued securities must be purchased through commercial banks or securities dealers.

.01 Tax Treatment of T-Bills, Notes, and Bonds

In general, periodic inclusion of original issue discount (OID) is required of the holders of debt obligations. However, for T-bills, discount is not considered to accrue until the obligation is paid at

[123] IRC Section 1044(b).

maturity or otherwise disposed of.[124] Accordingly, a taxpayer can defer income by purchasing T-bills that mature in the next year. This practice was eliminated for banks, securities dealers, accrual-basis taxpayers, and certain others by requiring current accrual of income.

Although cash-basis investors were exempt from the accrual rule, the ability of a cash-basis investor to make leveraged purchases of T-bills as a device to defer tax on ordinary income is limited by IRC Section 1282, which operates to defer interest deductions for such leveraged investments. However, this rule does not apply if the taxpayer elects to accrue the discount currently.

Gain on the sale of a T-bill (on which the discount has not been currently accrued) is treated as ordinary income to the extent of the "ratable share of acquisition discount," and any gain in excess of this amount is treated as short-term capital gain. Acquisition discount is the difference between the stated redemption price at maturity and the taxpayer's basis. The ratable share is the portion equal to the ratio of the number of days the T-bill is held to the number of days between the date of acquisition and the date of maturity. Loss on a sale is treated as a short-term capital loss.

Notes return a fixed rate of interest and have maturities of not less than 2 years or more than 10 years. Usually, the issues with longer maturities carry greater interest. Notes may be purchased online at www.treasurydirect.gov or through brokers or commercial banks for a fee. They are issued in a minimum amount of $1,000. Larger amounts are available in increments of $1,000. The maximum purchase is $5 million on a noncompetitive basis or 35% of the offering on a competitive basis.

Bonds have fixed rates of interest and have maturities of at least 5 years, but usually 30 years. Bonds may be purchased on margin, sometimes for as little as 10% down, which encourages speculation. Large gains and losses are possible, depending on the fluctuation of interest rates.

TIPS were introduced in January 1997 by the U.S. Treasury Department. The Treasury issues TIPS in terms of 5, 10, and 20 years, with the principal adjusted daily for inflation. The adjustment is payable at maturity but has a current effect because semiannual interest payments are determined as a fixed percentage of the inflation-adjusted principal at the time the interest is paid. An investor may purchase TIPS online at www.treasurydirect.gov or through banks or brokers. The minimum purchase of TIPS is $1,000. Additional amounts are available in multiples of $1,000. The maximum purchase is $5 million on a noncompetitive basis or 35% of the offering amount on a competitive basis.

.02 Savings Bonds

Series EE bonds issued by the Treasury between May 1997 and before May 2005 earn a variable rate of interest based on the market. Series EE bonds issued on May 1, 2005, and thereafter earn a fixed rate of interest. Series EE savings bonds issued May 2020 through October 2020, will earn an annual fixed rate of 0.10%, and Series I savings bonds issued from May 1, 2020, through October 31, 2020, will earn a composite rate of 1.06%, a portion of which is indexed to inflation every 6 months.

Available in denominations as low as $50 and as high as $10,000, Series EE bonds lend themselves to systematic accumulation programs, either through payroll deduction arrangements or individual plans. When an investor purchases an EE bond online at www.treasurydirect.gov, the minimum purchase is

[124] IRC Section 454(b).

$25 for an EE bond with a face value of $25. The maximum annual purchase of Series EE bonds is $30,000.

No interest is paid until maturity, and the holder is not taxed until the bond is redeemed unless the holder makes an election to be taxed annually. Interest on the bonds is exempt from state and local taxes.

An investor may exchange Series EE bonds for Series HH bonds. Series HH bonds pay interest semiannually. Owners who deferred reporting interest on the EE bonds given up in exchange for the HH bonds can continue to defer reporting such interest until the HH bonds are redeemed, disposed of, or reach final maturity. However, the interest earned on the HH bonds is currently reportable.

Series I bonds are savings bonds that offer protection against inflation. The Treasury issues them at face value. The minimum purchase is $25 for a Series I bond purchased online at www.treasurydirect.gov. The interest is indexed to inflation. The interest is added to the Series I bond each month and paid when the bondholder redeems the bond. Federal income taxes on the interest income can be deferred for up to 30 years (that is, when the bonds mature). The interest rate on a Series I bond purchased between May 1, 2020, and October 31, 2020, is 1.06%.

Planning Pointer. Series EE (or Series I bonds) might be useful when dealing with the kiddie tax, which subjects unearned income of certain children to tax at the rates applicable to trusts and estates. The buildup of interest through Series EE bonds will not subject the minor to current tax. The Series EE bonds may be redeemed after the minor is no longer subject to the kiddie tax, at which time the proceeds can be used for other investments. For 2020, the unearned income in excess of $2,200 of a child subject to the kiddie tax is taxed at the rates of the children's parents. [125] The kiddie tax applies to all children age 18 or younger and full-time students over age 18 but under age 24.[126] (See ¶3205.)

¶3140 Mutual Funds

Mutual funds offer the investor the following advantages:

- Diversification of investment
- Professional research and management of investments
- Liquidity
- Pass-through of income and gains without tax at the fund level
- Governmental regulation of the industry

Mutual funds also allow for greater financial flexibility than is available with purchases of individual stocks or bonds. For example, the amount paid for stocks is controlled by the price at which the stocks are trading. With a mutual fund, an individual merely needs to invest the minimum amount required by

[125] IRC Section 1(j).

[126] IRC Section 1(g)(2).

the fund, which, in many cases, is $1,000 or $2,500. Additional shares can be purchased in smaller increments.

Mutual funds include open-end funds and closed-end funds, but open-end funds are, by far, the most common. Open-end funds stand ready on any business day to have additional shares sold and to have shares tendered by existing fund shareholders redeemed.

Closed-end funds have a fixed capitalization. After the initial offering, the shares trade in the open market or on an exchange. Unlike open-end fund shares, shares in closed-end funds are not redeemable by the fund. Occasionally, additional shares may be distributed to existing shareholders as stock dividends and sometimes may be offered to existing shareholders of record.

Closed-end funds often trade at substantial discounts from their net asset value. One reason for their trading at a discount is that the funds will not redeem the shares. As a result, a shareholder who wishes to dispose of his or her shares must act through a broker, who, in turn, must find a buyer.

The size of the discount, if attributable to a marketability factor only, would vary with the lack of marketability. If the market is very thin, for example, the discount would be greater than if the shares had a ready market.

The brokerage rates charged in such transactions are also a factor. The usual rate will be the rate charged for equity trades of similar value for a similar type of customer. When making any comparison with open-end funds, the financial planner should remember that open-end funds might charge a redemption fee.

Some funds sell at a premium (that is, at a price above net asset value).

.01 The Rise of No-Loads; Comparison of Load and No-Load Funds

No-load funds (those without sales charges) now have greater acceptance than ever before compared to load funds (those with sales charges).

A financial planner can easily understand why an individual with $10,000 to invest would feel more comfortable with the full $10,000 invested. The investor in a load fund, by way of contrast, might have as much as $850 deducted from the $10,000 investment for sales charges. At first glance, that $850 might be thought of as 8.5% of the amount invested. However, if the sales charge is applied to the $9,150 left for investment, the percentage jumps to 9.3%.

The investor in a load fund might have to wait a year or more before reaching the break-even point. If the investor earns less than 9.3% after taxes, the break-even point might take much longer.

The other factor working in favor of no-load funds is primarily a psychological one. Seldom can an investor easily walk away from a poor investment. However, walking away from a fund in which the investor has the full $10,000 invested when it is down $500 is easier than when the load fund is down to $8,650, and the investor stands to lose $1,350.

Despite sales charges, load funds do sell. A large portion of the sales is made on a person-to-person basis. Sales of no-loads primarily rely on advertisements in the financial and investment press.

The personal selling is most often done by emphasizing past performance and the potential of continued future performance. The registered representative might tell the investor that the investment should be

looked upon as a long-term investment. Thus, if performance is good over the long term, the initial sales charge is of small consequence. Moreover, if the fund being sold is a member of a family of funds, the investment may be transferred without additional sales charges to a fund that holds higher promise or that better suits the needs of the investor at the time. No-load mutual funds also offer similar switching opportunities within their family of funds.

Planning Pointer. The investor should be mindful that commission-free switches between families of funds will not alter the usual tax consequences that attend a sale of a capital asset and the purchase of another. The seller will recognize gain or loss even though investing in another fund in the same family.[127] To the extent that the investor wishes to reduce the gain occasioned by sales of fund shares, the best approach may be to make a commission-free sale of shares at a loss in another fund within the same family. For further details on the tax treatment of mutual funds, see the discussion in the section "Tax Treatment and Strategies" that follows.

Both types of funds charge management fees, which are not likely to vary greatly between them. The investor should check whether the fund has a 12b-1 fee to cover marketing and promotional expenses. The investor should also check whether the fund has a deferred sales load, deducted either upon redemption or in installments over time, subject to specified conditions.

.02 SEC Fee Disclosure and Advertising Standards

Mutual funds must use specified standards in prospectuses and advertising. The standards apply to fee disclosure, as well as periods for reporting past performance. Investors should benefit from the ability to compare the fees of funds and understand projected returns but should not limit their inquiry to fee comparisons.

.03 Types of Funds and Fund Objectives

Many different types of mutual funds with different investment objectives are available as follows:

- *Aggressive growth funds* emphasize rapid growth, which generally means speculative investment in new companies with high growth potentials.
- *Straight growth funds* hold well-known blue-chip company stock with good capital growth records in order to obtain a safe, steady, and long-term increase in capital.
- *Growth funds* normally invest in companies with long-term earnings that are expected to grow significantly faster than the averages of stocks in the major unmanaged stock averages.
- *Growth and income funds* combine a growth of earnings objective with an income requirement for level or rising dividends.
- *Fixed income funds* typically have more than 75% of their assets in fixed-income issues, such as money market instruments, bonds, and preferred stock.

[127] IRC Section 1001(c).

- *Bond funds* typically hold portfolios that consist primarily of corporate or municipal bonds, accent income rather than growth, and tend to be more conservative than income funds. Enhanced bond funds that invest primarily in U.S. government bonds might achieve still higher current returns through sales of options on bonds. However, the exercise of call options by purchasers will undermine the fund's ability to participate in increases in the bond market. Thus, over the long term, predicting whether these enhanced bond funds (which typically involve payment of a sales charge) will out-perform no-load funds is difficult.

- *Income funds* normally invest less than 75% in fixed income issues and less than 50% in equities in order to obtain their principal aim of generating income.

- *Balanced funds* maintain a portfolio of stocks and bonds in a ratio of about 60/40 in order to achieve net asset stability.

- An exchange traded fund (ETF) is a marketable security that tracks an index, a commodity, bonds, or a basket of assets like an index fund. Unlike mutual funds, an ETF trades like a common stock on a stock exchange. ETFs experience price changes throughout the day as they are bought and sold.

- *SPDR Funds* "S&P Depository Receipts." These are funds that track Standard & Poor's 500 Stock Index —— or a specific sector of the market (energy companies, health care, and so on).

Other types of mutual funds are discussed in the following text.

.04 Zero-Coupon Mutual Funds

These funds have been created to capitalize on the advantages of the zero-coupon concept, which is to reduce reinvestment risk for the holder (¶3160). By using the fund's superior buying power, the investor might be able to obtain zero-coupon bonds (particularly in small denominations) at better rates than through a direct purchase. Dealer markups on direct purchases might be considerable. Zero-coupon mutual funds permit easy redemptions and enable the investor to increase investments through much smaller reinvestments than would ordinarily be allowed through direct purchase. Recordkeeping services are provided. These funds appear to be more liquid than zero-coupon bonds owned directly by the investor. The funds can be designed to provide target maturity dates every five years.

Although zero-coupon mutual funds may be offered on a no-load basis, the share price for the fund will reflect the management fee and expenses paid to the fund's operator. The financial planner will have to check such prices to ascertain the real cost of investing through a zero-coupon mutual fund. Also, because liquidity must exist to fund early redemptions and sales, a zero-coupon mutual bond fund cannot be fully invested in such securities. The fund must contain some element of cash equivalents. Purchase of zero-coupon bonds through a mutual fund cannot alter the risks inherent in the zero-coupon concept: A rise in interest rates before the anticipated maturity date of the underlying bonds necessarily will cause the value of the underlying bonds to fall, which, in turn, will cause the value of the investor's mutual fund shares to drop. Accordingly, fund managers indicate that investors should hold their shares until maturity, if possible.

.05 Tax Treatment and Strategies

Mutual funds pass through their income, less expenses, to shareholders in the form in which it is received by the fund, that is, as ordinary income, capital gains, or tax-exempt income.

.06 Determination of Basis

Keeping track of basis can be difficult when fund shares are purchased over a long period, or when dividends or capital gain distributions are reinvested and used to purchase shares, or both. However, under Regulation Section 1.1012-1(e)(1), a taxpayer may elect to have basis determined by the use of one of two averaging methods, if the shares (1) are left in the custody of a custodian or agent in an account maintained for the acquisition or redemption of shares of the fund and (2) were acquired at different prices or bases.

The two averaging methods are the double-category and single-category methods. Under the former, at the time of each sale, shares are divided into two categories: (1) those held more than one year and (2) those held one year or less. The basis of a share in either category is the total basis of all shares in the category divided by the total number of shares in that category. The seller may specify to the custodian or agent from which category the shares are to be sold.

Under the single-category method, all shares are considered as a single category, regardless of when acquired. The average basis of each share is the total basis of all shares in the account divided by the number of shares in the account. The shares sold are considered to be those shares first acquired.

Once chosen, a method may not be changed without IRS consent. When neither of the averaging methods is used, basis is determined under the rules applicable for determining the basis of stock, such as first-in, first-out; last-in, first-out; or average total cost.

¶3145 Money Market Investments and Strategies

A large percentage of America's savings is in money market instruments. These instruments include money market funds, unit investment trusts, money market annuities, and bank money market accounts. Bank certificates of deposit (CDs), broker CDs, and equity CDs can also be viewed as money market instruments, along with Treasury bills (T-bills). The latter were discussed in ¶3135.

Money market instruments are suitable for investors seeking a high degree of liquidity, safety, better yields compared to traditional passbook savings accounts, and no loss of principal (or gain) as a result of changes in interest rates. Specific features of the different instruments are considered in connection with the separate discussions of the various instruments.

Money market funds are mutual funds that invest in money market instruments of the kind indicated, along with commercial paper and repurchase agreements.

Unit investment trusts invest primarily in CDs and can be viewed as six-month money market funds. However, unit investment trusts do not have the checking privileges and other conveniences offered by money market funds. The rate of return is fixed. They usually are more aggressive than money market funds in their investments. Their CDs might include Eurodollar CDs, deposits of foreign banks in New York, and deposits in foreign banks. A slightly higher risk is involved when dealing with overseas funds, but most professionals discount it. Yields are likely to be higher than for bank CDs. The minimum investment is usually $1,000. Also, the amount invested can be withdrawn during the first four months, and some trusts may permit withdrawal during the last two months.

Interest rates vary almost daily, and money market instruments reflect these changes sooner or later.

.01 Strategies

When moving in and out of the money market funds and from one money market investment vehicle to another, the investor must be concerned about safety, liquidity, and yield.

Safety can be found in three ways, with some qualifications:

1. FDIC or similar government insurance, currently $250,000 per account. Within the same bank, all of a customer's different deposits are added together and insured in the aggregate for $250,000, although separate categories of accounts (for example, single accounts, joint accounts, and self-directed retirement accounts) may be eligible for separate insurance coverage limits. Self-directed retirement accounts are currently insured for up to $250,000.

2. A diversified, professionally managed portfolio in a highly regulated industry. The investor can achieve further diversification by dividing investments among different vehicles of the same class and different classes of vehicles.

3. The guarantee of a bank or other major financial institution.

Money funds and unit investment trusts provide liquidity. Bank-offered, long-term deposits of six months or more are generally lacking in liquidity. Some banks have permitted loans to be made against the deposit, with loss of interest on the amount withdrawn, plus an added point or more of interest. Broker-offered bank CDs offer a secondary market that will provide liquidity before maturity of the underlying CD.

.02 Tax Factors

If T-bills are held by a money market fund, unit investment trust, or bank, the exemption from state and local income tax might not be passed through to the holders of interests in the fund, trust, or CD. The investor should check with the fund or trust on this account. If the fund is organized as a limited partnership, then the exemption from state and local taxes is passed through to the investor as a limited partner. In such situations, the investor will receive a Schedule K-1, "Partner's Share of Income, Credit, Deductions, Etc.," from the fund, which will show the exempt nature of the income on the schedule.

Some CDs do not pay accumulated interest until the certificate matures. In this respect, they are different from money market funds. Thus, in some situations, a certificate can provide a means of deferring tax. For example, if a calendar year taxpayer buys such a 26-week certificate in July, the interest earned will be includible in gross income for the following year.

Another factor to consider in connection with bank CDs is that the investor might incur penalties for early withdrawal of funds. The penalty for premature withdrawal is an allowable deduction from gross income in arriving at the depositor's AGI (that is, it is deductible from gross income to AGI without requiring the taxpayer to itemize deductions).[128]

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[128] IRC Section 62(a)(9).

¶3150 Ginnie Maes, Fannie Maes, and Freddie Macs

The Government National Mortgage Association (GNMA or "Ginnie Mae"), Federal National Mortgage Association (FNMA or "Fannie Mae") and the Federal Home Loan Mortgage Corporation (FHLMC or "Freddie Mac") are three entities that pass through mortgage interest and principal on a pool of home mortgages to investors on a monthly basis. Interest on Ginnie Maes, Fannie Maes, and Freddie Macs is subject to federal, state, and local income tax.

The securities offered by each of these entities have slightly different features. Ginnie Mae insures payment of principal and income from FHA and VA mortgages of the same coupon and maturity that are assembled by a mortgage banker who deposits them with a bank custodian. Ginnie Mae does not formally act as issuer of these securities. However, Ginnie Mae is an agency of the U.S. government, and its guarantee is backed by the full faith and credit clause, as are U.S. Treasury bonds. Interest and principal are paid monthly to certificate holders on a modified pass-through basis. Thus, the interest and principal are passed through, regardless of whether they have been collected on time. The modified pass-through is to be distinguished from a straight pass-through, under which payments are passed through only as collected.

Although the original life of the mortgages in the pool might be 25 or 30 years, the average life of the pool of mortgages will be closer to 10-12 years. This reduction in the average life of the pool is due to prepayments as a result of sales, refinancing, and other factors inducing prepayment.

The minimum purchase requirement on these securities is $25,000 (see mutual funds and unit trusts permitting much smaller investments in the text that follows), with $1 increments above this amount.

The characteristics of Fannie Mae and Freddie Mac securities are quite similar to those of Ginnie Mae, with certain important differences. Unlike Ginnie Mae, these two entities actually issue mortgage-backed securities. Fannie Mae and Freddie Mac securities are not backed by a full faith and credit guarantee of the U.S. government. Rather, they are semi-private corporations for which such an airtight guarantee is unavailable. These entities also have differing policies on pass-through. Fannie Mae, like Ginnie Mae, guarantees a modified pass-through. However, Freddie Mac will guarantee timely payment of interest only. It guarantees that principal will be repaid, but the repayment of principal can be up to a year late.

¶3155 Commodities Futures Funds

Commodities futures funds offer investors the potential to realize substantial profits through leverage but without the unlimited risk that direct trading in commodities futures involves. The investor's risk is limited to the initial investment with the funds, which also offer diversity. However, these funds incur substantial indirect costs that are passed on to investors:

- **Registration.** Public funds can incur legal, accounting, and printing costs of $500,000 or more in registering with the SEC and the Commodity Futures Trading Commission. Because these costs are charged against the fund's equity, the value of an investor's unit in the fund can decline even before the first trade is executed.

- **Trading adviser fees.** Trading advisers typically are paid an annual fee of 4% of the fund's equity, plus a percentage of profits. By way of comparison, fees paid to managers of mutual funds typically (but subject to numerous exceptions) range from 0.5% to 1.0% of the fund's equity.

- **Commissions.** The high volume trading triggered by the limited life of futures contracts and the volatile nature of the market generates substantial commissions that can cost from 10% to 35% of the average annual equity in the fund.

These indirect costs will, no doubt, bear on a decision of whether to invest in a commodities futures fund. A particular fund's track record will be an even more important consideration.

¶3160 Original Issue Discount and Zero-Coupon Bonds

Bonds issued at a price lower than the redemption price are OID bonds. The investor's return consists of periodic interest paid on the bond, plus the spread between the issue price and the redemption price.

Some OID bonds do not provide for the payment of periodic interest. In effect, the issuer borrows both the principal and the interest for the term of the bond. These bonds are known as *zero-coupon bonds*.

IRC Section 1272 provides a method of amortizing original discount in a way that parallels the manner in which interest accrues through borrowing with interest-bearing, non-discount bonds. The computation begins with a determination of the yield to maturity of the discount obligation using annual compounding. The yield so determined is then applied to the value of the obligation at the date of issuance and at the end of each one-year period ending with the anniversary of the date of issue. The computed value of the obligation will increase each year by the portion of the yield due to original discount but not by any portion attributable to a coupon payment.

Any excess of a subsequent purchaser's cost over the adjusted issue price is amortized over the remaining maturity period of the bond on a straight-line basis and reduces OID income.

The rules apply not only to corporate bonds but also to bonds issued by any government or political subdivision, except short-term government bonds or U.S. savings bonds. Bonds issued by individuals and tax-exempt bonds are not subject to the rules.[129]

.01 Investment Feature of Zero-Coupon Bonds

A key investment feature of zero-coupon bonds is that they provide the investor with the assurance of a set yield throughout the term. The lock-in feature is desirable if interest rates decline, is of no special value if interest remains the same, and has negative value if rates increase. However, another form of investment risk with zero-coupon bonds is the risk of default at maturity.

.02 Risk of Default at Maturity

All bonds, coupon bonds issued at par, coupon bonds issued at a discount, and zero-coupon bonds involve some risk of default at maturity. With coupon bonds issued at a discount, the risk is somewhat greater than with coupon bonds issued at par. With coupon bonds issued at par, the holder, prior to maturity, will be receiving the stipulated coupon interest, which the holder will also receive with OID bonds, although most likely, at a lesser rate. The holder might also have imputed interest included in gross income, unless the holder is tax-exempt or not taxable. Any resulting tax on the interest will further reduce yield. With zero-coupon bonds, the holder's loss on default at maturity will necessarily be

[129] IRC Section 1272(a)(2).

even greater because he or she will not have received any interest before maturity. Zero-coupon insured CDs, discussed in the following section, are designed to provide FDIC insurance against default. Also, the mock zero-coupon bonds developed with stripped long-term Treasury bonds are calculated to provide a U.S. Treasury guarantee against default.

.03 Zero-Coupon Insured CDs

Bank CDs have the same advantages and disadvantages as other zero-coupon debt obligations. If the bank is a member of the FDIC, depositors have government insurance up to the regular $250,000 ceiling ($250,000 as well for self-directed retirement accounts) per account to assure payment of principal at maturity. Banks are not permitted to repurchase their own CDs under a Federal Reserve Board regulation.

Some CDs that have been issued are nonnegotiable. Such certificates would lock the investor in until maturity, which might not prove to be too great a burden if maturity is relatively soon. Other CDs are negotiable. However, without a secondary market, they might be difficult to dispose of before maturity, except at sacrifice prices. A brokerage house offering these CDs might make a secondary market and agree to buy them back at the market price at the time of repurchase. This factor should be considered by the prospective investor.

Planning Pointer. Zero-coupon bonds are useful as a means of locking in good interest rates (if available) at the time of purchase and avoiding the reinvestment risk involved with coupon bonds.

The usefulness of zero-coupon bonds is limited to three principal categories:

1. **Tax-sheltered accounts.** Zero-coupon bonds can produce high yields (if available) in qualified retirement plans in which the participant may direct investments or in participant-directed investments in Keogh plans, IRAs, tax-sheltered annuities, and other tax-deferred retirement plans.

2. **Minors and low-bracket taxpayers.** Zero-coupon bonds can also be useful in providing funds for a minor or other person likely to be taxed at a low rate on the imputed interest, if taxed at all. For 2020, the kiddie tax causes unearned income in excess of $2,200 to be taxed at the tax rates applicable to the parents of the child. [130] The kiddie tax applies to all children age 18 or younger and full-time students over age 18 but under age 24.[131] (See ¶3205.)

3. **Tax-exempt zero-coupon bonds.** Such bonds can be useful for avoiding tax by persons in top tax brackets and for possibly avoiding the kiddie tax rules (see ¶3205).

When taxable zero-coupon bonds are owned by persons who are subject to tax, such persons should consider the fact that even higher amounts of interest will be imputed as the security nears maturity. If the security is negotiable, a transfer at a point when the imputed interest becomes burdensome to a trust for a number of low-income family members might be considered as a means of splitting the imputed income among separate taxpayers. The value for gift tax purposes necessarily would take into account

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[130] IRC Section 1(j).

[131] IRC Section 1(g)(2).

the tax burden that the security carries as it reaches maturity. The tax burden would also be considered when fixing a sale price if the security were to be sold.

The fundamental problem with corporate zero-coupon bonds, especially those of the long-term variety, remains the possibility of default in payment at maturity. Also, STRIPS (separate trading at registered interest and principal securities) might prove attractive because they are direct obligations of the U.S. government and are backed by its full faith and credit. The Treasury does not issue STRIPS. The Treasury allows holders of Treasury notes and bonds to separate them into their interest and principal components. STRIPS can be held and traded in the commercial book-entry system. Holders may also reconstitute the separate interest and principal components into whole notes or bonds.

The demand for long-term Treasury zero-coupon bonds has stemmed from their ability to lock in interest yields by avoiding reinvestment risk if interest rates fall. This feature is a plus when yields are high but not when interest rates are low and expected to increase.

As sales commissions charged on zero-coupon bonds appear to be considerably higher than those charged on conventional Treasury obligations, the prospective investor might wish to weigh commission costs when determining whether to buy zero-coupon bonds. The STRIPS zero-coupon bond program (¶3165) could provide a low-cost means for buying zero-coupon bonds.

One may wish to reverse conventional wisdom about zero-coupon bonds and buy zero-coupon bonds with relatively short maturities (when yields exceed conventional Treasury bonds) and to invest in conventional Treasury bonds for the long term. The latter securities also have a better-established secondary market than zero-coupon bonds and appear to suffer less if interest rates rise.

¶3165 Stripping Coupon Interest from Bonds

The seller who strips coupons and then disposes of either the bond or the coupons must allocate basis to each in proportion to their relative fair market values at the time of sale. This basis allocation eliminates any artificial tax loss.

Further, any unreported interest accrued on the coupons before the disposition of either the bond or the coupons must be included in the seller's gross income and added to the basis allocated between the bond and the coupons.

The items not disposed of (the coupons, for instance) are to be treated as OID bonds and are subject to the OID rules discussed in ¶3160.

The purchaser of either the bond or the coupons must treat them as bonds issued at a discount and subject to the OID rules discussed in ¶3160. The result is that the purchaser must include the amount of OID in gross income over the remaining term of the bond, instead of being able to defer recognition of income until maturity or earlier disposition.

In the face of these rules, one might be disposed to pronounce coupon stripping dead. Such a pronouncement might be premature. Despite the rules, some leading brokerage houses have bought large amounts of long-term Treasury bonds, placed them in the hands of a custodian, and developed mock zero-coupon bond issues and separate issues of the stripped coupons. The use of a custodian is designed to avoid the difficulty that would exist if a brokerage house guaranteed that they would pay all the funds. The use of Treasury bonds, instead of corporate bonds, is designed to guarantee payoff at maturity unless the government defaults.

Purchasers of these issues have been primarily tax-exempt trusts. They have purchased them with the idea of locking in higher returns. This strategy is ordinarily useful only when returns are higher at the time of purchase than at projected future rates.

Despite the fact that individual purchasers must pay taxes on the imputed interest that they do not receive, some individuals have invested in these bonds as a convenient way of receiving a lump-sum amount to make future balloon payments on mortgages. Another reason would be to build an educational fund for children.

These issues are sold with varying maturities with a view to meeting the particular needs of the investor. The principal problems in connection with these issues are likely to be overpricing and the absence of a secondary market.

.01 Tax-Exempt Bonds

The OID inclusion rules do not apply to tax-exempt stripped bonds. Nevertheless, a seller of a tax-exempt stripped bond or coupons detached from the bond must allocate the basis of the bond with coupons attached between the items retained and the items disposed of.[132] Thus, as in the case of taxable obligations, the seller of a stripped tax-exempt obligation may not create an artificial loss because the seller must allocate basis to the retained coupons. In addition, if the taxpayer sells tax-exempt coupons separately, the seller might realize taxable gain on the sale or redemption of the retained stripped bond attributable to allocation of a portion of the seller's basis to the detached coupons.

For purchases or sales of stripped tax-exempt obligations or stripped coupons (subject to exceptions discussed in the text that follows), a portion of the OID must be treated as if it comes from a tax-exempt obligation, whereas OID in excess of tax-exempt OID is treated as if it comes from an obligation that is not exempt from taxation.[133] The tax-exempt portion of the OID is the excess of a tax-exempt obligation's stated redemption price at maturity (or the amount payable on a coupon's due date) over an issue price that would produce a yield to maturity on the purchase date of a stripped bond or stripped coupon, equal to the lower of (1) the coupon rate of interest on the tax-exempt obligation from which the coupons were stripped or (2) the actual yield to maturity (on the basis of the purchase price) of the stripped coupon or bond.[134] Instead of using the coupon rate in item (1), a purchaser may elect to use the original yield to maturity of the tax-exempt obligations.

.02 Gain on Disposition of Market Discount Bonds

Because of interest rate increases occurring after their issuance, bonds often sell below par value, but Congress considers market discounts on bond prices to be indistinguishable from OID.

IRC Section 1276 generally requires that gain on disposition be taxed as ordinary income to the extent of its accrued market discount, as defined in IRC Section 1278(a)(2). Instead of recognizing income on disposition, the investor may elect to treat income as accruing annually during the life of the bond.

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[132] IRC Section 1286(d)(1)(C).

[133] IRC Section 1286(d)(1).

[134] IRC Section 1286(d)(2).

Under IRC Section 1278(b)(4), the taxpayer's basis in the bond is increased by the amount includible in gross income by virtue of the election.

IRC Section 1277 contains complicated provisions limiting an investor's ability to take current income tax deductions for interest on debt incurred to purchase or carry a market discount bond. Any excess deductions are carried forward until the year of disposition of the bond.

The term *market discount bond* does not apply to short-term obligations (with maturities of less than one year), tax-exempt bonds purchased before May 1, 1993, U.S. savings bonds, installment obligations, or taxable bonds issued on or before July 8, 1984, and purchased before May 1, 1993.

¶3170 Options as a Gains Hedge

An investor can use options to protect gains in stock already owned by using buy put options (the right to sell at a given price) and sell call options (the right to buy at a given price). The examples that follow assume that the investor owns a corresponding amount of appreciated stock covered by the respective put or call and that the investor is not simply trading in the options themselves (referred to in options parlance as *naked trading*). The examples also assume that the stock held by the investor is publicly traded. In addition, for purposes of the examples that follow, the transaction costs of purchasing puts and selling calls are not taken into account (although investors should keep in mind that such costs are generally considerably greater than regular investment brokerage commissions).

.01 Buying Puts and Selling Calls

Buying puts and selling calls offer different kinds of protection against a decline in value of the appreciated security held by the investor. The two methods are also subject to different income tax rules.

Example 31.4. Carla Nelson is an investor who owns 100 shares of stock with a basis of $30 and a current market price of $70. She fears a decline in price but does not want to sell. She buys a put option on the stock at $70, which is to last for 6 months. The price (or premium) for the put is $7 per share. By using a put option, Nelson gains the right to sell the stock at any time during the next 6 months at a price of $70. What Nelson has purchased is a kind of insurance policy for her gain, illustrated as follows:

Stock Basis	$3,000
Plus: Unrealized Appreciation	4,000
Value of Investment	$7,000
Minus: Cost of Put	$700
	$6,300
Minus: Stock Basis	3,000
PROTECTED GAIN	$3,300

If the price of the underlying stock declines during the 6-month period, the decline will be protected, or hedged, by the put option, which gives Nelson the right to sell at $70 during this period. On the other hand, if the price for the underlying stock increases, Nelson will benefit fully from such increase, and her only cost is the premium paid for the put. However, if the price of the stock does not fluctuate significantly during the 6-month period, the option will expire,

and she will lose the entire investment in the put. Nevertheless, Nelson will have purchased almost complete protection against market decline during the finite period of the option.

The investor can obtain cash on the sale (or "writing," in options jargon) of a call option. Unlike the put buyer, the seller of call options receives a premium because he or she is taking the risk of having to deliver stock to the buyer at a price above the market price sometime in the future. Selling a call option offers significantly less protection than that available to the put holder.

Example 31.5. To illustrate the effect of selling a call, the same stock basis and unrealized capital gain will be used as in the previous example, but a premium of $7 to Nelson, the call seller, will be assumed. The effects of both slight and significant market declines will then be illustrated.

I. Decline of $3 in stock value during option period, with option held until expiration date:

Stock Basis	$3,000
Plus: Unrealized Appreciation	4,000
Value of Investment	$7,000
Plus: Call Premium	$700
	$7,700
Decrease of Stock	300
Net Value of Investment	$7,400

Accordingly, the sale of a call option under these circumstances does more than protect the unrealized capital gain on the stock. It actually results in a profit on the options transaction of $400.

II. Decline of $20 in stock value during option period, with option held until expiration date:

Stock Basis	$3,000
Plus: Unrealized Appreciation	4,000
Value of Investment	$7,000
Plus: Call Premium	$700
	$7,700
Decrease of Stock	2,000
Net Value of Investment	$5,400

When a stock significantly declines in value, the sale of a call option only protects the unrealized gain to the extent of the premium received by the investor ($700). Beyond that, the call seller, unlike the put buyer, is exposed to market risk. Here, $1,300 of price decline remains unprotected. Further, if the price of the stock rises, the call seller will not benefit because the buyer will demand the underlying stock at the exercise price. This case can be contrasted with the situation of the put buyer, who receives no premium upfront but who does stand to gain if the price of the stock increases beyond the price of the put.

The decision about whether to buy puts or sell calls depends on such factors as the size of the premium to be received from the sale of a call, the relative risk involved, the level of pessimism of the investor, and the degree to which the investor wants to protect an unrealized capital gain.

.02 Stock Index Options and Index Futures

The investor in publicly traded stock faces two key risks: company risk and market risk. The first category relates to the fortunes or misfortunes of the particular company. This risk is known as *alpha risk* or *nonsystematic risk*. The second recognizes that no matter how well the particular company may perform, if the stock market as a whole shows a downtrend, it may carry the particular stock with it. This risk is known as *beta risk* or *systematic risk*.

A put option on a particular stock will protect the investor against both types of risk. If the investor holds a diversified portfolio of securities, the purchase of individual put options on each security might be too costly or cumbersome. The investor might feel that the principal risk is market risk rather than the risk attending the particular securities. In that case, the investor should consider an index option as a means of protecting against market risk.

Index options give the holder the option to buy or sell a specified value of an index by a specified time. Index futures contracts are also available. These futures contracts *obligate* the holder to buy or sell. An index future is subject to margin calls and theoretically has an unlimited risk, although as a practical matter, the downside risk and upward movement of the index is limited.

The risk of a purchaser of an index option or an option on index futures is limited to the price of the option. Because of the high-risk factors associated with futures, the primary focus of the discussion that follows is on index options.

Index options. Index options are traded in much the same manner as regular stock options, except that the settlement is in cash, rather than stock. In addition, the settlement is based on the difference between the exercise or strike price of the option and the index value at the close on the day of exercise, multiplied by a specified multiplier. Different indexes are calculated in different ways.

> **Example 31.6.** John holds a put option on a particular index exercisable at $80. If he exercises the option when the index drops to $75, and the particular index uses a multiplier of 100, he would be entitled to receive $500 [($80 − $75) × 100] in cash.

The amount received on settlement is not all profit. The cost of the option must be taken into account. The cost basically depends on the strike price and the period for which the option is good. The strike price might be above the current index value (in the money), at current value (at the money), or below current value (out of the money). With a put option, the higher the strike price in relation to current value, the higher the price of the option. With a call option, the higher the strike price in relation to current value, the lower the price of the option.

Options on index futures. Options on index futures are similar to index options in that they offer limited risk. However, unlike index options, options on index futures are not settled in cash. Rather, settlement involves transfer of the underlying futures contracts themselves. After settlement, the investor has the option of retaining the position acquired, with the risks and profit opportunities associated with it, or liquidating the position by making an offsetting transaction.

As with exercises of index options, exercises of options on index futures involve loss of whatever remaining time value the option might have. Thus, a sale is usually preferable. A sale also offers the opportunity to cash out immediately.

¶3175 Junk Bonds

Junk bonds are high-yield corporate bonds with lower than investment grade ratings from Moody's or Standard & Poor's. The low ratings of junk bonds are often the product of unfavorable conditions at the issuing company or municipal authority, high debt/equity ratios, and other factors that tend to downgrade conventional estimates of their safety. In the case of new junk bonds, the issuing corporation or entity is forced to offer a higher rate of interest than would be necessary if the bonds enjoyed a higher rating. A company might use junk bonds to finance a leveraged buy-out.

If the rating services are correct, the purchase of junk bonds involves added risk for the investor over standard, high-grade corporate bonds. Proponents of these bonds, however, argue that the higher interest rate is ample recompense for the added risk.

Double-digit returns advertised for junk bond funds might attract much attention in an otherwise single-digit market. However, the advertised yields can be misleading in that junk bond funds typically carry higher load charges or redemption fees, or both, than other funds.

The funds comprise bonds rated below triple B or unrated bonds. The low rating reflects the risk of default. Because the funds diversify, the risk might be reduced.

Not all junk bonds are the same, and the composition of the fund should be scrutinized. Corporate junk bonds issued by relatively new companies whose track records are untested could be reasonable risks. On the other hand, municipal junk bonds might be backed by a declining public sovereignty and could be a poor risk. However, unrated municipal bonds might be issued by small but sound governments and could be a good risk.

¶3180 Real Estate Investing

Historically, real estate investments have had four key components of special potential benefit: leverage, cash flow, tax savings, and appreciation. The combination made real estate investments more attractive than most other investments. An investor could buy real estate with a down payment ranging from 10% to 25% of its price and have tax losses stemming from depreciation in amounts equal to 40% of the purchase price over the first 5 years. The real estate investment would produce high after-tax benefits for those in high income tax brackets.

Moreover, investors were often bailed out of poor investments by inflation that pushed up rents which, in turn, pushed up prices. Investors and promoters made money quite handsomely. However, in a "bubble" economy, prices rose to artificial heights. In the rush to invest in real estate, investors often lost sight of economic reality. Buildings were constructed for tax reasons with little regard for demand. Willing lenders, eager developers, and tax-burdened investor-buyers combined to create a vast oversupply in many real estate markets. Banks contributed to the oversupply. Construction loans carry higher interest rates than permanent financing; deregulation and other factors boosted deposits; and competition boosted rates on deposits, leading to an increased reliance on construction loans to support deposits.

.01 The Current Tax Picture

Depreciation. The 19-year accelerated depreciation in place before the Tax Reform Act of 1986 was replaced by 31.5-year (commercial property) and 27.5-year (residential) straight-line depreciation. The Revenue Reconciliation Act of 1993 increased the recovery period for nonresidential real property to 39 years, effective generally for property placed in service on or after May 13, 1993.

Dividends and capital gains. Qualified dividends and net long-term capital gains are subject to a maximum tax rate of 20% in 2020, plus the possibility of an additional 3.8% net investment income tax.[135] The top ordinary income tax rate is 37% in 2019, plus the possibility of the additional 3.8% net investment income tax.

Leverage — at risk rules. The at-risk rules apply to real estate,[136] with an exception for qualified nonrecourse financing (that is, when the borrower does not have personal liability for the loan) by nonaffiliated lending institutions.[137]

Passive activity rules generally. Deductions arising from passive activities, to the extent that they exceed income from all such activities (exclusive of portfolio income, that is, generally interest, dividends, capital gains, and royalties), usually may not be deducted against other income of the taxpayer.[138] *Passive activities* are defined to include trade or business activities in which the taxpayer does not materially participate[139] (for example, a limited partnership interest in an activity) and most rental activities.[140] In the case of rental real estate in which an individual actively participates, up to $25,000 of losses from all such activities may be taken each year against non-passive income of the taxpayer.[141] This amount is, however, phased out ratably between $100,000 and $150,000 of AGI (determined without regard to passive losses).[142] Suspended losses may be carried forward indefinitely during the lifetime of the taxpayer.[143]

The $25,000 allowance is applied by first netting income and loss from all the taxpayer's rental real estate activities in which he or she actively participates. If the taxpayer has a net loss for the year from

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[135] IRC Sections 1(h)(1)(C) and 1411.

[136] IRC Section 465.

[137] IRC Section 465(b)(6).

[138] IRC Section 469(a)(1).

[139] IRC Section 469(c)(1).

[140] IRC Section 469(c)(2).

[141] IRC Section 469(i).

[142] IRC Section 469(i)(3).

[143] IRC Section 469(b).

such activities, net passive income (if any) from other activities is then applied against it in determining the amount eligible for the $25,000 allowance.[144]

For example, assume that a taxpayer has $25,000 of losses from a rental real estate activity in which he or she actively participates. If the taxpayer also actively participates in another rental real estate activity, from which there is $25,000 of gain, resulting in no net loss from rental real estate activities in which the taxpayer actively participates, then no amount is allowed under the $25,000 allowance for the year. This result follows whether the taxpayer has net losses from other passive activities for the year.

Income from passive activities may also be subjected to the 3.8% net investment income because passive income is considered to be net investment income for purposes of this tax.

Credits from passive activities. Credits from passive activities are generally limited to the tax liability allocable to the passive activities.[145] Suspended credits may be carried forward.[146]

Rehabilitation[147] and low-income housing credits[148] (but not losses from such activities except to the extent indicated previously) may be used to offset tax on up to $25,000 of non-passive income, regardless of whether the taxpayer actively participates, subject to a phase-out between $200,000 and $250,000 of AGI.

Real estate professionals get relief from PAL rules. Taxpayers who are real estate professionals may treat losses from real estate activities in which they materially participate as non-passive losses.[149]

A taxpayer is a *real estate professional* only if the taxpayer performs more than half of his or her trade-or-business personal services and spends more than 750 hours a year in real property trades or businesses in which the taxpayer materially participates.[150] *Real property trades or businesses* are broadly defined to include "any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business."[151] Each real estate business is tested separately to determine if the material participation test is met.

Suspended PALs from a rental real property activity treated as non-passive losses because of the relief provision are treated as losses from a former passive activity.[152] Suspended losses (from prior periods

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[144] IRC Section 469(i)(1).

[145] IRC Section 469(d)(2).

[146] IRC Section 469(b).

[147] IRC Section 469(i)(3)(B).

[148] IRC Section 469(i)(3)(C).

[149] IRC Section 469(c)(7)(A).

[150] IRC Section 469(c)(7)(B).

[151] IRC Section 469(c)(7)(C).

[152] Regulation Section 1.469-9(e)(2) and IRC Section 469(f).

when the activity was treated as passive) can only offset income from the activity (no longer treated as passive due to the taxpayer's material participation). Such suspended losses cannot offset other income. When the taxpayer disposes of his or her interest in the activity in a fully taxable transaction with an unrelated party, any remaining suspended PALs allocable to the activity from the time it was considered passive would be allowed in full.[153]

Limitation on investment interest. Investment interest is deductible only to the extent of net investment income.[154]

Rehabilitation credits. The 10% rehabilitation credit for qualified rehabilitation expenditures with respect to qualified rehabilitated buildings placed in service before 1936 that are not certified historical structures has been eliminated by the TCJA. The rehabilitation credit is limited to 20% of qualified rehabilitation expenses for qualified buildings claimed ratably over a five-year period beginning in the tax year when the building is placed in service. The building must be a certified historical structure and the expenditures must be certified rehabilitation expenses.[155] A taxpayer may use this credit to offset tax on any type of income, subject to a phase-out, as discussed previously (in ¶3180.01, under "Credits from passive activities").

Low-income housing credit. The low-income housing credit[156] offers taxpayers one of the few true tax shelter investment opportunities available today. The credit is claimed over 10 years.

The amount of the credit for any tax year in the credit period is the applicable percentage of the qualified low-income building's qualified basis. For any new building that is not federally subsidized and that was placed in service after July 30, 2008, the applicable percentage will not be less than 9% for so-called "competitive" properties and 4% for "noncompetitive" properties. This provision has been permanently extended by the PATH Act of 2015.

The credit is especially generous for high-income investors. Although tax credits and losses from low-income rental real estate are subject to the passive activity restrictions, the credit can offset tax each year on up to $25,000 of non-passive income, such as wages, self-employment income, interest, or dividends. High-income investors generally do not qualify for this break for losses from most other rental real estate activities, for two reasons:

1. The $25,000 maximum allowance for deducting passive real estate losses phases out between AGI of $100,000 and $150,000.[157] However, it is fully available for credits from qualified low-income housing investments, with no phase-out.[158]

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[153] IRC Section 469(g)(1).

[154] IRC Section 163(d)(1).

[155] IRC Sections 47(a) and (c).

[156] IRC Section 42.

[157] IRC Section 469(i)(3)(A).

[158] IRC Section 469(i)(3)(C).

2. The $25,000 exception to the passive loss rules for most rental real estate losses and credits is available only to investors who actively participate in the management of the property.[159] Investors in low-income housing qualify for the exception, even if they are totally uninvolved passive investors, such as limited partners.

Although the tax benefits of the low-income housing credit can be excellent, investors should consider that these investments are generally unsuitable for low net worth individuals who need current income from their investments. The return is generally provided by a combination of leverage and current tax advantages. Depending upon the kind of development, how well it is managed, and the long-term health of the real estate market, low-income housing investments might or might not also return an IRC Section 1231 gain or long-term capital gain when later sold.

The IRC Section 199A Qualified Business Income deduction. Persons owning interests in real estate taxed as partnerships, sole proprietorships, or S corporations may be eligible for the 20% qualified business income pass-through deduction of IRC Section 199A, as provided by the TCJA. This IRC Section will be discussed further in volume 4.

Opportunity zones. These new creations of the TCJA allowing deferral of capital gains will be discussed in volume 4.

.02 Real Estate: Demand Will Remain

Real estate remains a prime beneficiary of the law of supply and demand. Even moderate population and industry growth will, in the longer term, support higher real estate values, which means higher rents and prices. The appreciation potential remains. Real estate will remain a beneficiary of whatever inflation-induced price increases take place. However, financial planners should exercise caution when advising clients about real estate investments in areas that have rapidly appreciated and could experience a downturn. The real estate market in the period from 2008–2013 experienced serious price declines, foreclosures, and short sales. Many locations have subsequently improved, some more than others. It remains to be seen when (or if) this market will regain the full momentum it enjoyed for many years. There are reports in areas of decreasing population leading to decreasing demand for housing. Other areas see high demand from citizens of foreign nations seeking a safe haven for their money or senior citizens looking to downsize their place of residence. The financial planner should be mindful of the local real estate market and be careful counseling clients looking to purchase a home. There should not be an assumption made that real estate values will always increase. Clients should look at a home purchase as a place they wish to live and raise a family, rather than any type of a guaranteed appreciating investment.

.03 Escape from Depreciation Limitations

An investor might consider using a ground lease to obtain rent deductions for land. In effect, the investor receives depreciation deductions for land by the use of such a lease.

Buyers of buildings on an installment basis might seek to reduce the purchase price of the property by offering higher interest payments. The higher interest payments would be deductible currently, whereas the buyers' depreciation deductions would be stretched out for years. The seller with a low basis might

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[159] IRC Section 469(i)(1).

prefer, however, for the payments to take the form of an IRC Section 1231 gain or capital gain, rather than interest, in order to have the benefit of the maximum capital gains rate (generally 15% or 20% for long-term capital gains for 2020, although a maximum rate of 25% applies to a portion of gain that is attributable to allowable IRC Section 1250 depreciation)[160] as against a top rate of 37% on interest in 2020, plus the possible application of the 3.8% net investment income tax.

.04 Favored Investments

Real estate has an advantage over traditional fixed income investments in that it stands to afford some long-term inflation protection by staying abreast of the CPI, if not ahead of it.

The emphasis on income orientation generally means reduced leverage. Higher leverage makes for higher mortgage service and interest charges and reduces income. The unavailability of seller nonrecourse financing also makes for reduced leverage. Larger down payments are warranted. Still, with a 40% down payment, a 50% rise in the value of the property gives the investor a 125% profit (50/40) (before taxes). Whether such a rise in property value will occur in the foreseeable future certainly cannot be anticipated with any confidence.

Some promoters offer all-cash deals (no mortgages). They offer higher rates of return (not necessarily counting the investor's loss of use of the cash invested) than leveraged deals but require 100% appreciation for the investment to double (before taxes).

Health care facilities. Health care facilities operated as a trade or business can benefit from the ever-increasing demand for such facilities by the graying population. The primary source of income for investors may be the services and care provided, rather than the housing.

Real estate investment trusts. Real estate investment trusts (REITs) are not subject to the limitations reducing the tax benefits of limited partnerships. Neither are they subject to the corporate tax provisions or the AMT. Moreover, REITs are not likely to be hurt by the longer depreciation schedules because they have generally always used the longer schedules. Also, they have never been able to pass through losses. An advantage of REITs is their requirement to distribute most of their income; hence, the high dividend yields for REIT investors. Still, caution with REITs is advised, especially with respect to REITs heavily invested in shopping centers in light of the reported decline of shopping driven by foot traffic in favor of increased online shopping. REITs do have a valuable advantage because REIT income is subject to the 20% qualified business income deduction under IRC Section 199A at all levels of income.

¶3185 Brokerage Accounts

Investments in securities are generally made through a securities broker. The three basic elements in investing are selection, timing, and execution. The broker might give advice in connection with selection and timing. Full-service brokers offer such services, but discount brokers generally do not. All participate in execution.

The focus of this section is on execution techniques. An understanding of such techniques can help minimize trading costs. The use of discount brokers lowers commission charges. In 2019, most discount

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[160] IRC Section 1(h).

brokers reduced their commissions on sales and purchases to zero. An understanding of the spread between bid and ask prices can also reduce costs. Trading on margin and the broker's holding of securities in street names will also be considered, along with Securities Investor Protection Corporation (SIPC) protection and claims against brokers.

.01 Discount Brokers Versus Full-Service Brokers

Many discount brokers offer savings in commissions over those charged by full-service brokers. The ranks of discount brokers include banks and savings and loans and some very large firms.

The most important difference between discount brokers and full-service brokers, apart from the commissions charged, is that the discount brokers generally do not offer regular advice or recommendations about investments. Also, they might not offer new issues.

However, discount brokers might offer some of the same non-advisory services that full-service brokers offer. Most, for example, offer every kind of order, free safekeeping of securities, toll-free phone numbers, individual trade confirmations, and monthly statements. Many discount brokers also offer current news on securities, dividend reinvestment, and cash management accounts.

Commissions. The commission savings with discount brokers can be substantial. Commissions vary greatly from broker to broker and depend on the kind of trade. A typical full commission on a sale of 200 shares of a $40 stock could be as much as $144. (This will vary widely among different brokerage companies, sometimes depending on the volume of assets or transactions, or both, maintained by the client with such companies.) The commission of a discount broker for the same trade might be less than $10, and very likely, zero.

How are the discount brokers able to offer such savings? Most of the savings are achieved by eliminating the commissions paid to registered representatives; utilizing the internet; reduction of overhead costs (that is, eliminating a research department and services most customers do not use); and by high volume, to some extent. They earn money on the funds investors leave with them and pay the investors a very low rate of interest.

Full-service brokers might be willing to reduce commissions on request, based on the size of the account and the volume of trading an individual routinely maintains.

Almost all discount brokers have their own commission structures. Some will increase or reduce commissions depending on an individual's total trading volume, whether an order is placed before a certain time, whether a specified form of order is used, whether a purchase and sale are made on the same day, and whether other variations occur.

The fee schedules of a number of discount brokers should be obtained and examined from the standpoint of what appears to be best for the particular investor, taking into account his or her trading patterns and volume of trading. Again, the industry is moving to a zero cost-based trading model.

Some brokers set their commissions on the basis of the value of the trade, the basis of the number of shares, without regard to value, and some use both methods. The share method is better for the investor buying high-priced stocks; the value method favors the individual generally trading in low-priced stocks.

With certain over-the-counter (OTC) NASDAQ stocks, the charge may be a markup instead of a commission. The markup might not always be disclosed on statements. The investor must inquire and

compare the markup with the commission of discount brokers, if any. Some full-service brokers might be able to buy OTC stocks from a broker that makes a market in the particular stock and sells it from inventory. In such a case, the investor might be able to buy the stock at a better price with a full-service broker than with a discount broker.

On odd lots or transactions with a value of $2,000 or less, discount brokers, like full-service brokers, might have minimum charges. In such cases, the investor might not realize any savings with a discount broker, unless all commissions are waived.

Price is not the only consideration. An investor may prefer to deal with a large firm, one that is nearby or convenient, with a person responsible for the investor's account, with a bank that combines brokerage with banking, or with a discount broker that offers services that the investor wants or needs.

When not to use discount brokers. The investor who wants or needs regular advice on investments and respects the advice of a full-service broker should most likely stay with that firm. Other reasons for staying with a full commission broker with whom the investor is satisfied include the following:

- Low frequency of trading and low value of trades so that savings with a discount broker would not warrant change.
- Trading initiated by a brokerage firm that has done well. (Trades initiated by an investor could be handled through a discount broker if savings would be significant.)
- The convenience of handling all transactions through a regular broker. Convenience is worth more than the savings with a discount broker for some transactions.

.02 Trading on Margin

Borrowing through a margin account to purchase securities obviously permits the purchase of a larger block of stock than would otherwise be possible. Thus, buying on margin magnifies potential gains and losses.

Margin accounts require an initial margin and a maintenance margin. The initial margin is regulated by the Federal Reserve. Currently, for common stocks, convertible securities, and short sales, the investor must put up a minimum account deposit, along with 50% of the value of the stock acquired, and can only borrow on margin the remaining 50%.

Stock exchanges and brokerage houses set maintenance margins. The New York Stock Exchange maintenance margin is 25%. Most brokerage houses require at least 30%. If the value falls below the maintenance level, the investor receives a call for more margin. If the investor fails to respond, the stock is sold, and the broker credits the proceeds against the margin debt. The investor receives any remaining proceeds.

If the value of the stock rises above the initial margin requirement, the investor may be able to withdraw the excess if the margin account is not restricted. A restricted account is one in which the sum of all securities and margin debt produces an overall margin that is between the initial margin and the maintenance margin.

The investor incurs an interest charge on the amount borrowed. The rate is geared to the call money rate, the charge on loans to brokers on stock exchange collateral, and is usually one and one-half to two

points over that rate. This call rate varies from time to time. The larger brokerage houses might offer a lower rate than smaller houses. The investor should ask the brokerage house about its interest rate on margin debt.

Short sales. Short sales are also subject to margin requirements. In short selling, the investor borrows the securities that the investor sells. The broker retains the proceeds of the sale. Generally, no interest is paid. The broker will ordinarily invest the money in money market funds and keep the earnings.

In addition to the proceeds, the short seller must deposit cash or securities as initial margin. Initially, the short seller puts up margin equal to 50% of the value of the securities borrowed. If the securities borrowed go up in value, he or she must deposit more cash to maintain the percentage level ("short covering").

Example 31.7. Sam Cole sells short 100 shares of borrowed stock at $50 per share. The proceeds of the sale, $5,000, are kept by the broker. In addition, Cole must deposit 50% of the value of the stock, or $2,500, to maintain the initial margin.

> Assuming that the maintenance margin is 30%, Sam will get a margin call when the price of the stock rises by a percentage equal to one plus the initial margin times the purchase price ($50) divided by one plus the maintenance margin times the purchase price ($50), (that is, {[(1 + .50) × $50] ÷ [(1 + .30) × $50]} = $75 ÷ $65 = 115.38%; 115.38% × $50 = $57.69). In this case, the price will be just below $58.

In a short sale, any cash dividends from the shorted stock must be paid to the broker. Stock can be shorted only on an uptick (that is, when the price is higher than on the previous trade).

.03 Use of Street Name or Customer's Name

Securities may be left by the owner in the broker's custody and name, referred to as a *street name*. The use of street names facilitates transactions in the securities owned, obviating the need for the owner to execute a transfer. Traders often leave all their securities in street names as a matter of convenience. Investors who intend to hold securities on a long-term basis also sometimes leave their holdings in street names. However, to leave the securities in a street name for any considerable length of time involves a dual risk for the owner. This risk extends to the trader as well when there is a fair time period between trades. The risks are as follows:

- The risk of bankruptcy or financial failure on the part of the broker.
- If a customer enters into a short sale, the risk that the broker might lend the securities to the short seller, with the adverse result discussed separately in the following text.

In the event of the broker's bankruptcy, the trustee must reduce to money all securities that are part of the bankrupt's estate, except customer securities. In other words, securities held in street names are sold, consistent with good market practice, and the proceeds become part of the bankruptcy estate. Regarding

customer name securities, the trustee must deliver such securities to the customer, unless the customer has a negative net equity.[161]

The customer whose securities are left in a street name is protected by the SIPC (Securities Investor Protection Corporation). Still, the customer could reduce this risk by having securities registered in his or her own name.

.04 Securities Investor Protection

The SIPC grew out of the voluntary liquidations, mergers, receiverships, and bankruptcies of many brokerage houses in the early 1970s.

The SIPC extends protection to securities customers of SIPC member firms in the following manner:

- First, customers of a failed firm will receive securities registered in their names or in the process of such registration. No dollar limit applies to the value of the securities.
- Second, the customers will receive, on a pro rata basis, all remaining cash and customers' securities held by the firm. Again, no dollar limit applies to the value of the property returned.
- Third, SIPC funds will be available to satisfy the remaining claims of each customer up to $500,000, except that claims for cash, instead of securities, are limited to a maximum of $250,000.
- Finally, any remaining assets after payment of liquidation expenses may be available to satisfy any remaining customer claims on a pro rata basis.

The dollar limits of protection apply to accounts with each SIPC member. A customer may have accounts with the same SIPC member in different capacities and still be protected to the dollar limit on each separate account.

Investors should be aware of the dollar limitations regarding both cash and securities. At the same time, the investor should remember that in the event of broad-scale failures in the brokerage industry, the SIPC might not be able to provide full indemnification up to the $500,000/$250,000 limits for each customer.

Protection against failure. The best protection against broad-scale failures would seem to be to have securities in the customer's name only and limit cash on deposit with the brokerage house at any time. The investor should transfer the proceeds of sales to an insured bank account or insured savings and loan account as soon as feasible.

To minimize the risk of failure to the customer of an individual firm or firms, registration of securities in the customer's name would seem best, along with withdrawal of excess cash. Separate accounts in different capacities with the same firm or the use of different firms should also be considered.

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[161] See Bankruptcy Act Sections 748 and 751.

Claims against brokers. The typical brokerage account agreement with a customer calls for the settlement of all claims against the broker by arbitration. The U.S. Supreme Court has upheld the validity and enforceability of such arbitration clauses even as applied to fraud claims under Rule 10b-5 and Racketeer Influenced and Corrupt Organizations Act (RICO) claims.[162] The U.S. Supreme Court has held that investors' claims arising under the 1933 Act are subject to arbitration pursuant to a pre-dispute agreement.[163]

.05 Asset Management Accounts

Asset management accounts set up by brokerage firms, banks, and insurance companies under various names permit customers to coordinate and conduct their financial activities in one place. Minimum deposit requirements and services available vary from company to company. A financial planner should consider whether a client's financial needs would be served better by using these accounts or by using different companies for different services.

Services provided. Individual accounts, such as a checking account, money market fund, and a brokerage account, are linked together. Money can be transferred freely from account to account. A customer can transfer excess checking account cash into money market funds to assure the highest yield on the money. Conversely, a margin loan can be automatically transferred into a checking account to prevent a check from bouncing. If the account is with a brokerage firm, dividends on securities can be credited immediately to a money market or other designated mutual fund. Financial services firms might also provide credit cards, debit cards, and a personal line of credit with these accounts.

Financial activities of the account are reported each month in a consolidated statement. Most brokerage firms do not return canceled checks without request and the payment of a fee.

Assessing desirability of asset management funds. Whether such accounts make sense must be answered on a client-by-client basis. For a client who regularly buys or sells securities with a brokerage firm in excess of required account minimums anyway, the additional annual fee may be inconsequential compared with the services it engenders. The client might have other reasons for opening an asset management account.

.06 American Depositary Receipts

Increased interest in foreign securities has led sophisticated investors to search for a convenient way to own them. Although a U.S. investor can buy foreign stocks through foreign exchanges or U.S. brokers who have overseas affiliates, the U.S. investor might find that direct ownership is inconvenient. The investor could encounter legal, transfer tax, and probate difficulties inherent in ownership of foreign property. Dividends are often paid in foreign currency, and information about the company itself is often difficult to obtain.

American depositary receipts, popularly known as ADRs, are a convenient alternative to direct ownership of foreign securities. An ADR is a negotiable certificate issued by a U.S. bank evidencing that shares of the foreign company's stock (or the company's bonds) are on deposit in the bank. The

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[162] *Shearson/American Express, Inc. v. McMahon*, 482 U.S. 220 (1987).

[163] *Rodriguez de Quijas v. Shearson/American Express, Inc.*, 490 U.S. 477 (1989).

bank, and not the ADR holder, is the owner of record of the underlying security and is charged with relieving the ADR holder of the burdensome task of ownership of the security.

The principal advantages of ADR investments over direct ownership are as follows:

- **Ease of transfer.** The transfer of these certificates is relatively uncomplicated, especially when probate and foreign inheritance tax proceedings are considered.

- **Bearer form.** Many foreign securities, including stocks, are issued in bearer form. Announcement of dividends is made by publication in a foreign newspaper, and the physical presentation of share certificates is necessary to obtain the dividend. This procedure is greatly simplified through the ADR system because the bank has an organized way to collect dividends.

- **U.S. dollars.** ADR holders are paid in U.S. dollars and not in foreign currency, which saves the holder the costs of currency conversion.

- **Current information.** Although direct investors in foreign securities might have difficulty obtaining current information about the foreign company, banks routinely obtain such information. In the case of sponsored ADRs, when the foreign issuer pays some or all the costs of the bank's management of the ADR account, the ADR holder can receive information directly from the issuer or through the bank.

- **Liquidity.** ADRs are registered securities on U.S. markets and traded on U.S. exchanges (most often, over the counter). As such, they provide the holder with more liquidity than direct ownership of foreign securities.

Under a sponsored ADR, the holder is relieved of some or all the costs of maintaining the account (aside from brokerage). Non-sponsored ADRs involve transaction costs to the investor upon creation of the account (for example, the investor makes a direct purchase of a foreign security but then arranges for an ADR account at a bank). The costs of creating an account may vary. Some run from $3–$5 per hundred shares, depending on the price per share. Non-sponsored ADR accounts also charge the holder a fee upon dividend or interest payments (in the case of foreign stocks, only a few cents per share).

Planning Pointer. Although ADRs make ownership of foreign securities easier than direct ownership, investment in any foreign company can pose problems for a U.S. investor. Foreign companies are not subject to U.S. corporation or securities laws. Also, as with any individual investment, the stock exchange index in which the foreign security is traded may soar, but the security represented by the ADR might not rise.

Choosing a reputable international mutual fund whose managers presumably have current information and insights about fund investments might be safer for the investor.

¶3190 Commissions and Investment Charges

The financial planner and client will want to know the costs of buying and selling an investment, including approaches that offer the prospect of reducing the costs of investment.

The costs of investment might include commissions, fees, and other compensation for persons who advise the client or sell the investment to the client. However, the client would appear to have no reason to pay for services that he or she does not need or use. If the client, without the aid of the organization or

its sales personnel, can analyze the facts connected with the investment and make the investment decision alone, the client has less need to compensate outsiders for a service. Instead, the client is free to buy or sell the investment through the least costly medium.

The client might have less freedom to make a low-cost sale in some classes of investments than in others. Discount brokerage opportunities exist for stocks, bonds, and commodities transactions. For other assets, the nature of the investment (for example, tax shelters) or contractual provisions (as in the case of "back-end load" mutual funds) might limit the client's options when buying or selling the asset at the best price.

In many cases, buying or selling an investment at the best price can more than compensate for added costs paid to the broker, agent, or other person. This potential savings holds particularly true when a large dollar amount is involved.

In addition to purchase and sales charges, the financial planner should also be alert to management fees, which may be charged to the client's account for as long as the client owns the investment or maintains the account.

As the result of the TCJA, which suspended the allowance for miscellaneous itemized deductions through 2025, the deduction for various management fees, advisory fees, commissions, and so on are no longer deductible beginning in 2018. Some advisers may try to add costs to trades to increase basis and attempt to reduce gains on sales. In general, however, clients will not get any income tax deduction for the payment of fees, something that could cause tensions between clients and their advisers.

.01 Commission or Load Arrangements

In most cases, the person buying or selling an investment will have to pay upfront charges for the investment activity. These charges can take the form of a commission, the payment of which reduces the client's account or causes direct out-of-pocket expense. The charges can also take the form of loads, by which the client is not directly charged. Instead, less than the full amount paid will be invested. The difference is the load.

Limited partnership interests. Purchase of a limited partnership interest will generally involve the payment of a load or commission to the agent who brought about the purchase, as well as to other persons connected with the sponsorship and offering of the investment. Such loads are not out-of-pocket charges. Instead, the prospectus will show that a percentage of the purchase price for a unit will not go to the actual acquisition of the asset. Rather, the difference will constitute sales and distribution expenses to compensate the agent, sponsor, and others for selling the investment to the client. The prospectus will reveal the amount of such commissions.

Sale of limited partnership investments presents a difficult problem for the financial planner. A nonpublic interest is likely to be hard to sell. Public limited partnership interests are more readily salable, but the client usually will have little opportunity to know the amount of brokerage costs in advance.

Stocks. Brokerage commissions are charged on stock purchases and sales when the firm is acting as an agent for the purchaser or seller. Transactions in over-the-counter stocks, when the broker makes a market in the security, might be made on a mark-up basis, with some markups being very high and undisclosed to the account holder.

Although the commissions on many stock transactions are competitive or negotiated, as opposed to the fixed commission system that previously prevailed, full-service brokerage houses claim to provide more services in the form of investment research and advice than discount brokers. Under the system of negotiated rates, a major client might be able to negotiate for lower rates. The client's success will have much to do with his or her market power.

The client who wishes to reduce commissions can have two accounts: a full-service account, in which the client seeks investment advice, and a discount account to handle situations in which the client performs the investment analysis.

For a further discussion of fee arrangements comparing full-service and discount brokers, see ¶3185.

Bonds. Bond investments are generally sold at fairly low commissions, at least when compared to stocks. The broker obtains compensation because of a spread or markup on the bond. This markup will cause the investor to pay more for bonds yielding a specified amount on purchase and may cause the investor to receive less than expected upon sale of the bond. Zero-coupon bonds may be sold on a mark-up basis to the investor, based on a percentage of their ultimate face value and not of their initial discounted price. The unaided investor might have difficulty when determining the amount of the markup. However, the investor might be able to obtain more attractive prices on larger transactions.

A person may invest in U.S. government securities directly through a Federal Reserve Bank at no cost.

Commodities. Like stocks and bonds, commodities brokers include full-service firms charging higher commissions for a range of services and discount brokers that charge only for execution of trades.

Mutual funds. Mutual funds are often sold on a load basis with higher loads of 8% or more for smaller lots. The load varies with the number of shares purchased. The prospectus will reveal the amount of the sales commission, both as a percentage of the asked price and as a percentage of the bid price or net asset value. For example, 8.5% of the asked price is 9.3% of the bid price. As with stock and bond investments, the client who has a firm grip on investment information, is willing to perform investment analysis, and is confident in making decisions might choose a no-load mutual fund. The client would see no reason to buy a load fund, which compensates salespersons who were not instrumental in bringing about the purchase.

Both load and no-load funds charge annual management fees, which are often comparable.

For a further comparison between load and no-load funds, see ¶3140.

.02 No-Load Arrangements

Investors have shown increased interest in arrangements that will eliminate upfront sales commissions in order to maximize the amount of money actually invested. No-load arrangements are not, in any sense, free. No-load arrangements might be sponsored by organizations that can market their products without an expensive outside sales force. However, the sponsors of no-load funds will receive income from annual or more frequent maintenance charges and other fees.

The client who is interested in acquiring a no-load investment should ascertain the extent to which the investment in question is no-load or whether the equivalent of a load will be charged later, rather than simply relying on the no-load label. Outstanding investment performance by a fund with a back-end load can counterbalance the apparent handicap of redemption and distribution charges.

¶3195 Debt Consolidation

Clients with several different debts might be able to reduce interest costs by consolidating their debts. As the result of the TCJA, interest expenses incurred in using a home equity loan to pay for debts not related to the acquisition, financing, or improvement of a home are no longer deductible beginning in 2018.[164] Having only one bill to pay monthly also eases paperwork burdens.

The client could have other financial planning reasons for consolidating debts. For example, such a move might be advisable if a client needs more time to pay debts.

.01 Types of Consolidation Loans

Banks generally allow individuals to borrow against the equity in their residence. Interest on $100,000 of home equity loans was deductible for income tax purposes prior to the TCJA, but is now only allowed to acquire, finance, or improve a home.[165]

Home equity loans differ somewhat from home equity lines of credit. Home equity loans charge a fixed rate of interest and extend for a term selected by the borrower. Home equity lines of credit have a variable rate and a revolving line of credit.

Home equity loans. Many lenders offer two types of home equity loans. One type has the following features: maximum loan amount of $50,000, no application fee or prepayment penalties, but a mortgage recording fee and, in some cases, a mortgage tax. In many cases, paying a slightly higher interest rate avoids such closing costs.

The second type of home equity loan allows far greater amounts to be borrowed. However, as a general rule, often depending upon state and local practice, the borrower will have to pay an application fee, attorney fees, title insurance, recording fees, mortgage tax, and points. As a result of the 2017 TCJA, interest on home equity loans may only be deducted if the loan proceeds are used for home improvement, refinancing, and related expenses, not for expenses unrelated to the home itself.

Home equity lines of credit. With a home equity line of credit, the homeowner receives a revolving line of credit using the home as collateral. The interest rate is variable and typically is based on an index, such as the prime rate plus two or three percentage points. One can usually obtain such credit lines without paying application fees or closing costs unless it is a very large credit line. In some cases, an individual can effectively use a home equity line of credit to refinance a first mortgage loan. This technique is useful if the balance on the first mortgage is relatively low, and the interest rate on it is relatively high.

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[164] IRC Section 163.

[165] IRC Section 163(h)(3)(C).

Unsecured loans. A client also can use an unsecured loan (that is, not a home equity loan) to consolidate debts, but such loans often carry very high interest rates. In addition, the interest will not be deductible if the proceeds are used for personal purposes.[166]

.02 Other Factors

Clients should not consolidate debts carrying no interest in the absence of other factors favoring immediate payment. For example, bills owed to professionals might not carry interest and generally should be paid under their regular payment schedule. Of course, if the physician, dentist, accountant, financial planner, or lawyer will not complete services until the bill is paid, then such debts should be consolidated.

Also, clients must be made to realize that they will lack flexibility when they consolidate their debts. Clients will have no opportunity to choose which debt or debts to pay in times of extreme cash flow problems, which would be the case if they did not consolidate their debts.

Moreover, a financial planner should impress upon clients that they should not view consolidation as meaning that their financial condition has improved so greatly that they can now go on a spending spree. Clients might wish the payment on their consolidated debt to be smaller than the total payments on their unconsolidated debts. A financial planner should advise these clients that a smaller principal payment will result in an increase in interest costs.

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[166] IRC Section 163(h).

Chapter 32

Family Income-Splitting Techniques

¶3201 Overview

The individual who buys a ticket in a $500,000 lottery and writes in the names of his four children on the ticket, along with his own, may not be fully aware of some of the fine points of family income splitting. However, he or she has captured the basic idea that each dollar of added income a person receives is taxed at that person's marginal tax rate. Thus, by diverting income to children or other members of the family with little or no income of their own, one can increase the family's overall after-tax income. The income tax on $500,000 for one taxpayer is significantly more than the income tax on $100,000 multiplied by five.

For 2020, a 27% spread exists between the 37% top rate and the 10% bottom rate. In addition, a 23-point spread exists between the 35% bracket and the 12% bracket. These spreads provide a strong incentive for income shifting as a means of reducing overall family income tax rates. However, wealthy taxpayers are subject to a maximum tax rate of 20% on most net long-term capital gains and qualified dividends, whereas most persons' long-term capital gains and qualified dividends are taxed at a 15% rate. The capital gains rate on collectibles is 28%, and the tax rate on unrecaptured IRC Section 1250 gains (dealing with depreciation recapture on realty) is 25%.[1] In 2020, there is also the additional Medicare tax of 0.9% on wages and earnings and the 3.8% tax on net investment income. The additional Medicare tax and the net investment income tax apply in 2020 to single taxpayers with AGI in excess of $200,000, married taxpayers filing jointly with AGI in excess of $250,000, married persons filing separately with

[1] IRC Section 1(h).

AGI in excess of $125,000, and trusts and estates are subject to the net investment income tax with undistributed income in excess of $12,950.

If income splitting is to succeed, it is usually not quite as simple as the preceding lottery example might have suggested. The parent must have made a completed gift of a share in the ticket before the drawing. In all cases, one must do more than simply split income. No one can avoid paying tax on dividends, interest, or other income merely by instructing the payer of the income to pay or credit all or part of it to children or other family members. That would be separating the "fruit from the tree" to avoid being taxed on the fruit, which the courts and the IRS state is something that taxpayers cannot do because of the assignment of income doctrine.[2] Unless the taxpayer transfers the "tree" (the underlying source of the income) along with the "fruit" (the income), there is no effective income shifting or splitting.

Consider this limitation. It is not a serious limitation when all that is being given away is an interest in a $2 lottery ticket before the drawing. It is a different story, however, if stock or other property of far greater present value and present income-producing capacity is the vehicle for income splitting. When considering any gifting, the financial planner should always determine the comfort level of the prospective donor. Especially in times of low interest rates and low dividend yields, clients are concerned that they will not have enough income to address a comfortable retirement, as well as any unexpected expenses. There is a concern about outliving one's savings. The rest of this chapter will explore a variety of family income-splitting techniques that might be of practical use when building family resources. Many of these techniques have been described in other portions of this publication, and the treatment here will be concise.

¶3205 Unearned Income of Children

Despite popular conceptions to the contrary, parents can still achieve intrafamily savings by shifting income-producing assets to their children, even if they are subject to the kiddie tax.[3]

.01 Kiddie Tax Basics

The kiddie tax separates a child's unearned income into three slices. For 2020, assuming the child has no earned income and no itemized deductions, the breakdown looks like this:

100% tax-free income: Unearned income up to $1100, sheltered by child's special $1100 standard deduction	$1100
Income subject to tax at the child's rate	$1100
Net unearned income subject to tax at the parents' tax rate	Unearned income over $2,200

Unearned income generally means anything other than wages, salaries, professional fees, or any other amounts received, whether as an employee or a self-employed person, as compensation for services actually rendered.

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[2] IRC Section 73 and *Lucas v. Earl*, 281 U.S. 111 (1930).

[3] IRC Section 1(h).

Assuming a child has no other income, the transfer of assets that produces $2,200 in income saves federal income taxes.

If the child's unearned income already is substantially above the net unearned income limit, it is still possible to cut overall family income taxes by making gifts of property designed to produce income or profit in the future, when the child is no longer subject to the kiddie tax. Such gifts include the following:

- Growth stock or growth mutual funds that have no or low current dividends but that one hopes will increase in value (and dividend yield) over the long term.
- Stock in the family business, which the corporation can redeem after the child is no longer subject to the kiddie tax.
- Assets that produce no income currently but may pay off handsomely years down the road (for example, prime undeveloped land).
- Series EE or Series I bonds, on which the child can defer the tax on the accrued interest until the child redeems the bonds, presumably when no longer subject to the kiddie tax.

.02 Age Limitation

The kiddie tax applies if a child (1) has not reached the age of 19 by the close of the tax year or (2) has not reached age 24 by the close of the year and is a full-time student.[4] The tax applies only to children whose earned income does not exceed one-half the amount of their support.

If a child is below the age limit, the kiddie tax applies if (1) either of the child's parents is alive at the end of the tax year; (2) the child's unearned income exceeds a threshold amount; and (3) the child does not file a joint return for the tax year. The unearned income threshold is $2,200 for 2020.

The investment income of a child who is under age 19 (or under age 24 and a full-time student) and married is not subject to the kiddie tax if the child files a joint return with his or her spouse for the tax year. However, the child's eligibility to file a joint return is not enough to avoid application of the kiddie tax. The child must actually file a joint return for the tax year.

.03 New Kiddie Tax Rules Effective in 2019; Changed Again for 2020 and Beyond

As the result of the TCJA, the income of a child subject to the kiddie tax was no longer included in the income of the child's parent or taxed at the parents' rate as it had been under prior law. Instead, for tax years beginning in 2018, a child's income subject to the kiddie tax was taxed at the rates applicable to trusts and estates.

This law was changed again by the SECURE Act for tax years beginning in 2020. Some families of relatively low levels of income, including gold star families whose children were receiving government benefits, found themselves paying more income tax at the trust and estate rates than they had paid using

[4] IRC Section 1(g)(2)(A).

the parents' tax rates. Their pleas to Congress were heard, and the law returned to using the parents' rates as the basis for income taxation.

¶3210 Transfers That Avoid the Kiddie Tax

A parent can give investment property to children in a variety of ways, with the advantage that the property and the income are kept within the family. For 2020, the kiddie tax can only be avoided with no or minimal earned income if

- the child is either
  - age 19 or older if not a full-time student or
  - age 24 or older if a full-time student, or
- the expected income does not exceed the dollar threshold for the kiddie tax.

Because the parents' effective income tax rate could be as much as 37% for 2020 (plus the possible imposition of the 3.8% tax on net investment income) and could rise even higher, taking Social Security and Medicare taxes into account along with state and local taxes, shifting income to children who are not subject to the kiddie tax can result in substantial income tax savings for the family.

Although the emphasis is on regular income tax savings, parents should also consider the effects on possible AMT, estate and gift tax consequences, and legal considerations. If the donor is within range of the AMT, a transfer to a child of property that generates tax preference items has added advantages for the family, provided the minor is not within range of the AMT. The AMT exemption for 2020 for a child subject to the kiddie tax will be the lesser of (1) $7,900 (up from $7,750 for 2019) plus the child's earned income, or (2) $72,900 (up from $71,700 for 2019). The discussion that follows lists several methods of making gifts to children when the child is age 19 or older if not a full-time student (or 24 or older if a full-time student) or when the child's income will not exceed the kiddie tax dollar threshold. Not all of these tactics result in shifting income, but those that do not are included to illustrate "how not to shift income." In all instances, the various pros and cons are discussed.

.01 Outright Gift

Income is shifted. The property is taken out of the parent's estate. The annual gift tax exclusion is available, which is $15,000, or $30,000 if the other parent consents to split gifts under IRC Sections 2503(b) and 2513 (for 2020 and adjusted annually for inflation). There is generally no legal problem in transferring the property to the child, but the child may have legal problems when dealing with the property and the income. As a general rule, the child cannot make an effective will if younger than the age of legal majority (generally age 18). If the child dies, the property normally reverts to the parent under the intestacy law of the state of the decedent's domicile. The financial planner may suggest making outright gifts to trusts created for minor beneficiaries instead of gifts directly in the name of the minors to avoid the issues of legal title, along with providing for asset protection for the minor and, if necessary, an orderly plan of succession for the transferred property. Such a trust could provide for transfer outright to the minor once a designated age is reached. Alternatively, the trust could be structured to last for the entire lifetime of the minor, with the trustees given discretion to pay income and principal at any time, even to the point of distributing the entire trust property, if appropriate.

If a child is not subject to the kiddie tax and has modest personal income, the child is in the 0% bracket for long-term capital gains and qualified dividends if filing for 2020 as a single taxpayer with taxable income under $40,125 or filing as married filing jointly with taxable income under $80,250.

.02 Joint Ownership

Income tax consequences vary, as do gift tax consequences, with the property involved. Usually, there is no gift on the creation of a joint bank account. The gift occurs when the child withdraws and uses the money in the account.[5]With securities, there is an immediate gift when the securities are registered in joint names.[6]The income tax consequences follow the gift tax rules. When the child receives a gift, the child becomes taxable on the income attributable to the child's interest in the property, and the parent is relieved of income tax on that part. Even though the transfer into joint names is a completed gift, the property is, nevertheless, includible in the parent's gross estate if the parent predeceases the child, unless the child can prove contribution to the value of the joint property.[7] There is no legal problem on the initial transfer. Although the property remains in joint ownership, each party may have a veto over a sale, or possibly have the right to petition a court to order a partition of the property to divide it between or among the owners.

.03 Revocable Trust

The parent transfers property to a trust for the benefit of the child, but retains the right to revoke the trust. There are no income, estate, or gift tax consequences as a result of the transfer of property by a grantor to a revocable trust. The grantor remains taxable on all of the trust income. If the parent dies without revoking the trust, then it becomes irrevocable and results in inclusion of the trust property in the parent's estate. While the parent is alive, the trust provides management and protection, with the parent retaining ultimate control. If transfers are made from the revocable trust to a child, such transfers will be treated as gifts from the trust grantor to the child.

.04 Totten Trust

This trust is merely a sort of revocable trust in a type of joint bank account that exists in some states. When the parent dies, the balance passes to the named child. In some states, it is akin to a payable-on-death designation.

.05 U.S. Savings Bonds

The parent buys Series EE or Series I bonds in the child's name. Interest will be taxable to the child. However, the child can defer the income tax until the bonds mature or are redeemed, unless the child elects to report the interest income each year. Consider doing so after the kiddie tax vulnerability ends, but before the child earns enough money to enter a higher tax bracket. The annual gift tax exclusion and gift splitting are available to the parents of the child. The bond is excluded from the parent's gross estate and includible in the child's gross estate. The child may redeem the bond at any time if old enough to act.

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[5] Regulation Section 25/2511-1(h).

[6] Regulation Section 25.2511-1(h)(5).

[7] IRC Section 2040(a).

.06 Custodial Account

These special accounts are authorized by the various states' Gifts to Minors Acts. Many states have adopted a Uniform Transfers to Minors Act (UTMA), which replaces the Uniform Gifts to Minors Act (UGMA). UTMA lifts some property limitations and makes other favorable changes to the UGMA rules, as discussed in ¶425. Even though a child must be at least age 19 (and possibly as old as 24, if a full-time student) to avoid the kiddie tax, a custodial account may still make tax sense in some situations. For example, in most states, the "turnover" age for custodial accounts is age 21. Also, the kiddie tax will not be a factor even when the child is under kiddie-tax age if the annual income expected from the account does not exceed the kiddie tax dollar threshold. Income from the account that is used to satisfy the parent's obligation of support becomes taxable to the parent. The annual gift tax exclusion and gift splitting are available to the parents. On the child's death, the account is includible in the child's gross estate. If the parent is the donor and also the custodian and dies during the child's minority, the account is included in the deceased parent's gross estate. The financial planner should advise the parents to separate the transferor of property from the custodian of the account to avoid this possible estate tax issue if liability for the estate tax is a concern.

.07 Special Trust for Minors

IRC Section 2503(c) recognizes a special type of trust for minor beneficiaries designed with gift tax considerations in mind. This trust qualifies for the annual gift tax exclusion and gift splitting, provided its conditions are met (that is, the property and income must be expendable on behalf of the child before the child reaches age 21 and must pass to the child when reaching age 21). Special forms of trusts may hold S corporation stock (¶1945). Income from a trust that names a child or children as beneficiaries irrevocably will be taxed to the parent only to the extent used for the child's support. The trust property is removed from the parent's gross estate as long as the trust is not used to support the child and is includible in the child's gross estate if the child dies while the trust is still in place. Income will be taxable under the usual trust rules. Income distributed to, or on behalf of, the child will be taxable to the child, and income accumulated in the trust will be taxable to the trust. Because of the sharp compression of the trust tax brackets, trusts with substantial assets are very unattractive vehicles for accumulating income for minors. For example, for tax years beginning in 2020, the 10% rate applies to taxable income up to $2,600; the 24% rate applies to taxable income between $2,600 and $9,450 ; the 35% rate applies to taxable income between $9,450 and $12,950 ; and the 37% rate applies to taxable income over $12,950.

.08 Irrevocable Trust

In an irrevocable trust for the benefit of a minor, the trustee is generally given discretion to use principal and income for the benefit of the minor. Income is not taxable to the parent, except as used for support, but when retained in the trust is taxable under the usual trust rules (see preceding paragraph .07). Those rules can make accumulating income in trusts quite costly. As a general rule, no annual gift tax exclusion is available because the gift to the trust is not of a present interest in property.[8] However, if the trust is drafted to include a *Crummey* power right of withdrawal of contributions to the trust, such a right of withdrawal will create a present interest in the trust, allowing the use of the annual gift tax exclusion. Property transferred to an irrevocable trust is removed from the parent's gross estate, as long as the

[8] IRC Section 2503(b)(1).

parent does not retain the use or enjoyment of the property or the right to have it used to support the minor child.

.09 Charitable Remainder Annuity Trust or Unitrust

The financial planner should be aware of the charitable remainder trust technique as a way to make certain there is an annual flow of income to children and still achieve the charitable goals of the transferors of property. The parent transfers property to a trust to pay a certain sum as an annuity to the child (no less than 5% of the initial value of the property transferred) or a fixed percentage (no less than 5%) of the value of the property determined at least annually for a specific number of years (no more than 20) or for life. At the end of the term of years or at the child's death, the remaining trust principal passes to charity. The income from the property is not taxable to the parent. The parent also receives an income tax charitable contribution deduction for the present value of the charity's remainder interest, assuming it is worth at least 10% of the value of the property transferred to the trust.[9] The annual gift tax exclusion is available to offset a portion of the value of the child's life interest, and the property is removed from the parent's gross estate.

A note of caution: If the beneficiaries of a charitable remainder trust are young, even if the distribution to them is modest (it may not be less than an annual 5% payment), it is unlikely that the trust grantor will receive an income tax deduction. Given the currently low IRS interest rates (AFR), the annuity interest of a young person would be valued quite high, with the trust unlikely to provide an actuarially calculated (and required by law) 10% interest for charity. In such a case, the financial planner should consider a trust for 20 years (or less) for young beneficiaries, so that they will receive a reasonable benefit, possibly during college education years, and allow the trust grantor to claim an income tax deduction.

In light of the SECURE Act and its requirement that many plan beneficiaries receive their distributions over a 10-year period, consider the charitable remainder trust as an alternative retirement plan beneficiary. The terms of the charitable remainder trust can provide for a life benefit (or a benefit for up to 20 years) for a chosen beneficiary, which may be preferable to the 10-year requirement of the SECURE Act.

Planning Pointer. With the increased standard deduction and the limitation of itemized deductions, clients may be better off "bunching" their charitable deductions to gain an income tax deduction benefit. Using a charitable remainder trust is one suggestion to accomplish this.

¶3215 Transfers to Other Family Members

Income may also be shifted to parents and other relatives, as well as to children.

When an individual transfers income-producing property, the transfer might have gift tax consequences. The gift tax annual exclusion ($15,000 in 2020 or $30,000 with gift splitting under IRC Sections 2503(b) and 2513 as adjusted annually for inflation) and the applicable lifetime exclusion amount of

[9] IRC Section 170.

$11,580,000 or $23,160,000 with gift splitting for 2020, also adjusted annually for inflation (unified credit),[10] can shelter the transfer from gift tax.

¶3220 "Defective" Grantor Trusts

Historically, the grantor trust rules (¶605) were viewed as a stumbling block to saving income taxes. However, in some cases, a family can realize tax savings by purposely causing the grantor trust rules to apply, resulting in a "defective" grantor trust. With this technique, the trust grantor retains a power that requires that the income will be taxed to the grantor at the grantor's tax bracket, despite having the income received by others. The income tax cost may be lower than if the income were taxed at the trust's rates. This allows the grantor to "burn off" assets in his or her estate by paying the required income tax, while the trust beneficiaries receive the benefit of the income earned by the trust without being charged any income tax liability. Also, payment of the income tax by the grantor will not be regarded as a taxable gift by the grantor to the beneficiary who directly benefits by the payment because the grantor is seen as paying the grantor's own obligation.[11]

Planning Pointer. As noted previously, sometimes setting up a trust in which income will be taxed to the grantor will be beneficial under the grantor trust rules. But doing so poses the danger that the trust property will be included in the grantor's gross estate. However, differences between the grantor trust rules and the estate tax inclusion rules allow the income to be taxed to the grantor without the property transferred to the trust being included in the grantor's gross estate. Carefully limiting a grantor's administrative control over a trust and giving the grantor the power in a non-fiduciary capacity to substitute property of an equivalent value are techniques for achieving the desired result.[12] The defective grantor trust technique is often utilized by having the grantor create the defective trust and then sell property to the trust that has the potential for long-term appreciation in exchange for an installment note. The sale by the grantor to the trust is not a taxable event because it is viewed as a sale by the grantor to him- or herself.[13] The grantor and the grantor trust are viewed as "alter egos" of each other. The value of the property is thereby frozen in the future estate of the grantor at the amount of the note balance due to the grantor. Future appreciation on the property sold to the trust then inures to the trust beneficiaries and is not considered part of the grantor's estate. Planning suggests, in appropriate cases (a minority interest in property or in a business, for example), using a discount to reduce the value of the property sold to the trust by the grantor.

¶3225 Gift-Leaseback of Business Property

In a gift-leaseback of business property, a business owner transfers property (as a gift) used in business to a trust, usually created for the benefit of the owner's children. The trust then leases the property back to the settlor at a rental based on the property's fair rental value. The goal is for the settlor to get a deduction for the rent paid to the trust, which makes income available to members of the settlor's family

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[10] IRC Section 2505.

[11] Revenue Ruling 2004-64.

[12] Revenue Ruling 2008-22; Revenue Ruling 2011-28.

[13] Revenue Ruling 85-13.

who are presumably in a lower tax bracket. The gift or sale and leaseback technique will generally not be available for an individual who needs or wants to get ownership of the property back. But the technique is viable for one willing to part with the property permanently, subject to the caveat that the technique will not avoid the kiddie tax when the beneficiaries are subject to it (¶3205).

Other uses of this technique may also be considered. For example, an individual who is assisting parents may want to give them an income interest in a trust for life, with the remainder over to children.

If a grandchild is named as a remainder person, the generation-skipping transfer tax (GST) could come into play. Appropriate generation-skipping exemption should be allocated to the transfer. No gift tax will result if the unified credit is available to offset the tentative gift tax. Also, GST annual exclusions will be available for gifts of present interests if the trust is created for a single beneficiary, and certain other requirements are observed (that is, if the trust is one requiring the mandatory distribution of income at least annually, one for a minor conforming to the requirements of IRC Section 2503(c), or one containing a Crummey power of withdrawal).

Assuming there is no reversionary interest to the trust settlor, the property will not be brought back into the settlor's gross estate, assuming the settlor retains no prohibited controls over the property transferred to a trust or uses the trust income to support a trust beneficiary.

The most frequently transferred property in a gift-leaseback transaction is a rental property. Often, the transaction takes place when the settlor has begun to run out of depreciation deductions on the building and anticipates that the rental income will be substantially higher than any depreciation deductions available to offset it.

Normally, the IRS will respect a gift-leaseback if the following conditions are met:

- The donor does not maintain substantially the same control over the property as before the transfer.
- The leaseback is in writing and requires a reasonable rental.
- The leaseback by the donor (as distinguished from the gift) has a bona fide business purpose; and
- The donor does not maintain an equitable interest in the trust.

¶3230 Splitting Business Income with Family Members

To split business income with a family member, the business owner gives the member an interest in the business. If the business is in corporate form and has elected S corporation treatment, the owner is limited to gifts of the single class of stock allowed such corporations.[14] However, an S corporation may have voting and nonvoting common stock without violating the one-class-of-stock rule, as discussed in ¶1945. If it is a regular C corporation, the owner may give donees not only common stock, but also preferred stock and debt securities if the capital structure of the corporation permits.

[14] IRC Section 1361(b)(1).

If the business is a partnership or a LLC that is taxed as a partnership, and an interest is gifted, the donee family member receives a partnership interest (or an LLC interest) and is recognized as a partner (or as a member of the LLC) for tax purposes. This treatment applies even though the new partner (or member) performs no services, as long as he or she owns an interest in the capital of the entity and capital is important in producing the entity's income (in other words, it is a material income-producing factor). See ¶2005 for a discussion of family partnerships.

If the business is a sole proprietorship, the owner could restructure the business as a family partnership, a corporation, or an LLC.

Putting children to work in the family business and paying them is another way of splitting business income. Placing the child on the business payroll enables the child to make deductible IRA contributions, even if the child is a participant in the retirement plan of the business, provided the child's income is below a certain level. With the child in a low-income tax bracket, consider a Roth IRA for the child here. Further, earned income will be taxed to the child at the child's low-bracket rate (10% on taxable income up to $9,875 for 2020). Another benefit is that if the child is under age 18 and employed by a parent in a sole proprietorship or a partnership consisting only of the parents, the child's wages are exempt from Social Security and Medicare tax.[15] In such cases, the deduction of the child's wages expense would also reduce the parent's income tax and self-employment tax.[16] Wages paid to one's children must be reasonable for work actually performed.

Putting children to work in the family business may also help avoid the kiddie tax. The kiddie tax applies only to children whose earned income does not exceed one-half the amount of their support. Putting children on the family payroll may increase their earned income to an amount in excess of one-half their total support, thus, exempting their unearned income from the kiddie tax.

¶3235 Gifts of Property in Anticipation of Sale

If a family member in a high tax bracket holds property that is expected to sell at a profit, a better overall family tax result might be achieved by giving the property to a member of the family in a lower tax bracket, who then makes the actual sale. A transfer to a child subject to the kiddie tax may not achieve the desired result because the child's unearned income over the kiddie tax dollar threshold ($2,200 in 2020) is taxed at the income tax rates of the child's parents (¶3205).

A district court case sanctioned this approach. In so doing, it relied on charitable bail out cases that allow the owner of a closely held corporation to contribute stock to a charity with the specific intent of having the corporation redeem the stock from the charity. In these situations, the redemption is not treated as a redemption to the shareholder, as long as the donor parts with all dominion and control over the stock, and there is no written promise by the corporation that it will redeem the stock.[17]

In holding that the gain on sale was taxable to the donee and not to the donor, the court said, "Though the facts in this case show a tax avoidance, they also show legal transactions not fictitious or so lacking

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[15] IRC Section 3121(b)(3)(A).

[16] IRC Section 162(a).

[17] *D. Palmer*, 62 T.C. 684 (1974) (Acq.), *aff'd* 523 F.2d 1308 (8th Cir. 1975); Revenue Ruling 78-197, 1978-1 CB 83.

in substance as to be anything different from what they purported to be..."[18] However, the parent would be wise not to negotiate the sale of the property to a third party before making the gift to a family member to avoid any chance of the IRS invoking the step-transaction and assignment of income doctrines. This is very much a facts and circumstances situation.

If a taxpayer uses this approach, the taxpayer should file a timely gift tax return (if the requisite gift tax filing amount is involved) and show clearly that the donor has surrendered all dominion and control over the property transferred. If the donor merely wishes to make a gift of the gain on the sale of the property, the IRS may "collapse" the transaction and treat it as a sale of the property by the donor, taxable to the donor, followed by a gift to the donee of the amount of the gain realized on the sale.

[18] *J. Haley*, 400 F. Supp. 111 (D.C. Ga. 1975).

Chapter 33

Year-End and New Year Tax Planning

¶3301 Overview

Year-end tax planning presents important tax-saving opportunities for financial planners and their individual and business clients. The planning should begin no later than early in the last quarter of the tax year. This time is usually late enough to have a good picture of the year. In addition, the planner will have a fair basis for predicting the client's income and deductions for the next year.

The 2017 TCJA presented the largest tax law changes in 30 years. It has profound planning implications for the near term, as well as the future. Since 2017, the SECURE Act and the CARES Act have introduced other planning opportunities and complexities to the tax system.

Planning Pointer.

Proactive Planning Toolkit

Legislation like the TCJA and the SECURE and CARES Acts have added more complexity to financial planning. Technical content, tools, and other resources are available to PFP Section members at aicpa.org/PFP/ProactivePlanning to help you get up to speed on all the intricacies, so that you can educate your clients and proactively help them meet their life goals and give them peace of mind while navigating the complex financial landscape.

A common objective of year-end planning is to shift a part of this year's tax burden to the next year. A taxpayer shifts income to the next year by deferring receipt (or accrual) of some income until next year or by accelerating deductions from next year to this year, or both. The real advantage of the tax deferral

is that it gives the taxpayer continued use of funds that would otherwise have gone to pay taxes. The use of the funds for a longer time can be a decided benefit.

There are now multiple levels of tax concerns to address in year-end tax planning. Financial planners need to advise clients about multiple different systems for tax planning. Among the difficult planning issues to navigate (discussed in more detail in the text that follows) are the following:

- For the wealthiest taxpayers, the highest marginal tax rate has been reduced to 37%.
- For those same wealthy taxpayers, the tax rate on long-term gains and qualified dividends remains at 20%.
- Many taxpayers will be subject to the additional Medicare tax on their earned income and self-employment income of 0.9%. There is also a 3.8% tax on a taxpayer's net investment income, which includes interest, dividends, rents, capital gains, and passive income.
- Many itemized deductions have been repealed, and others significantly reduced. The loss of these deductions will increase some persons' tax liability. State income taxes tied to the federal system may increase where the lost deductions result in more taxable income.
- The higher standard deduction will see many taxpayers claiming it, with fewer taxpayers itemizing deductions.
- The AMT will continue to affect individual taxpayers, but most likely fewer than before the TCJA.

Many of the preceding concerns involve a variety of thresholds (that is, amounts of either AGI or taxable income) above which these adverse tax rules become operational. It may be helpful to explain these thresholds to clients as "buckets." The idea in planning is to fill the bucket with income to the highest level, without allowing it to overflow, causing the taxpayer to become liable for a higher level of income taxation.

The specific thresholds are discussed in the following section. The challenge for the financial planner is to look at each client's situation and do everything possible to keep the client from exceeding a threshold, which will result in either higher taxes or lost deductions, or both. This planning may involve attempting to move income-producing assets to family members in lower brackets (that is, persons whose income falls below one or more applicable thresholds). It may involve paying close attention to harvesting gains and losses to "fine tune" the application of the thresholds. In some cases, it may involve multiyear tax planning to defer and, in other cases, accelerate, income and deductions to achieve the best overall tax result possible.

To summarize here, year-end planning has become a case-by-case, client-by-client challenge, with many moving parts for each client. Traditional notions of accelerating deductions and deferring income, although still viable, may not be enough to address the multiple levels of complex considerations that may arise with respect to many clients.

If a client must postpone the receipt of cash or spend cash to get a tax deduction, the loss of the use of this money must be measured against the use of the tax money deferred. If the client can get a deduction without spending cash, the benefit is obvious. Examples include a bad-debt deduction or a loss on a securities transaction.

Two other important points about tax deferral are as follows:

- The client cannot assume that he or she is going to have the use of the tax dollars saved for the full year. The client should consider the impact of estimated taxes. Depending on various factors, the client might have to pay the tax dollars saved this year in quarterly installments next year.

- If the effect of deferral is to push the client into a higher bracket next year, the client might pay more in total taxes for the two years than if matters had been left alone.

Another key objective in year-end tax planning is to level out taxable income from one year to the next. In a progressive income tax system such as ours, the tax bite is minimized by maintaining income level from one year to the next. If the client expects that next year's income will be higher, the client should accelerate some of next year's income into this year and postpone some of this year's tax deductions until next year. If the client expects a drop in next year's income, then the client should reverse the process by postponing income while accelerating deductions.

As with the tax deferral approach, the financial planner should work with the client to perform a cost/benefit analysis. When the client is increasing cash income and postponing cash layouts, the client is getting the use of more money. How much is that worth to the client, and how much must be paid in added taxes to get it? How much will the leveling off save overall? Complicating this analysis is the potential impact of the AMT, which can cause deductions allowed against regular income to be added back to calculate AMTI and result in AMT liability. The impact of the TCJA is likely to reduce regular tax deductions (with the elimination of personal exemptions and miscellaneous itemized deductions and the reduction in the deductions for state and local taxes and mortgage interest) and dramatically decrease the amounts added back for AMT purposes for many taxpayers.

Another important objective of year-end planning is to reduce or avoid the penalty for underpayment of estimated taxes.

.01 Impact of Tax Legislation

One factor that can dramatically affect a decision to accelerate or postpone income or deductions is the passage of tax legislation. Planning in 2020 and 2021 will require thoughtful strategies and opportune actions due to the 2017 TCJA and the SECURE Act and amplified by the economic impact of the COVID-19 pandemic and the CARES Act.

The TCJA has provisions that will, in some way, significantly affect how taxpayers treat particular items of income and deduction. Most of the TCJA provisions became effective on January 1, 2018.

A recent trend in tax legislation has been to enact temporary tax breaks to provide tax relief for a limited period of time or to encourage certain investments. The PATH Act of 2015 made many provisions of tax law permanent and extended others. The TCJA has many provisions that will sunset after 2025. In addition, many of the provisions have thresholds that are indexed to inflation, so that they will have a possibly different impact on certain taxpayers in 2020 than they did in 2019.

For example, IRC Section 179 expensing is now set at the $1 million level indexed for inflation. The 2020 amount is $1,040,000. Businesses with over $2,590,000 in purchases in 2020 will have the expense deduction phase out dollar for dollar for costs in excess of $2.59 million. Qualified real property is included. The law continues to allow expensing for computer software and revocation of elections

without IRS consent.[1] The exclusion of cancellation of indebtedness income for qualified mortgages was extended through 2020.[2] First-year bonus depreciation is increased to 100% for property placed in service after September 27, 2017, and before January 1, 2023. After that, a 20% annual phase down schedule begins. The purchase of used property now qualifies for bonus depreciation. Qualified improvement property (now including qualified leasehold improvements and improvements to restaurant property) is eligible for 15-year MACRS depreciation.[3] Taxpayers should factor these and other permanent extensions and "limited time offers" into their year-end tax plans. Also, 2020 continues the additional Medicare tax of 0.9% on earned income and the tax on net investment income for persons over certain prescribed AGI thresholds ($200,000 single filers, $250,000 for married persons filing jointly, and $125,000 for married persons filing separately, $12,950 for trusts and estates). All of this will certainly have an effect on 2020 year-end planning.

It is within this annual context and atmosphere that the financial planner must advise clients about year-end planning for 2020 and what to do for 2021. Complicating planning decisions is the effect of the 2020 COVID-19 pandemic on a particular taxpayer. If 2020 income is especially low, and recovery in 2021 is anticipated, electing to take income not otherwise required in 2020 (such as a distribution from a retirement plan) may be a good idea. Conversely, if 2020 has been a "normal" income year, avoiding taking an RMD from a retirement plan may be a good idea.

Some specific strategies that financial planners should consider as the end of 2019 approaches include the following:

- Accelerate deductions into 2020 and defer income until 2021, unless the taxpayer is trying to fill up tax brackets (the buckets described in the previous section) for multiyear planning purposes.

- Consider the five-year carryback for losses earned in 2018, 2019, or 2020 and other NOL relief provisions under the CARES Act.

- Consider "bunching" of charitable deductions into a single taxable year to gain a benefit from charitable contributions that may be lost with the limitations on other itemized deductions. Consider using a donor-advised fund.

- Harvest capital losses to offset any capital gains. Be wary of the "wash sale" rule that prohibits recognition of a loss if stock sold at a loss is purchased or repurchased before the expiration of 30 days from the date of the sale. If the client has net long-term capital gains for 2020, the effective tax rate on the gain may be 23.8%, 20%, 18.8%, or 15% (the 23.8% and 18.8% rates combine the 20% or 15% long-term capital gains tax and the 3.8% tax on net investment income, assuming the taxpayer has sufficient AGI for the net investment income tax to become applicable).

- As an alternative to harvesting losses, consider the planning technique of *filling buckets* as described in the previous section, (that is, looking at each tax bracket a client may reach and

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[1] IRC Section 179.

[2] IRC Section 163.

[3] IRC Section 168, as extended by the American Taxpayer Relief Act of 2012.

filling up that bracket without exceeding it). That may suggest maximizing gains and holding off realizing losses in some circumstances, but be wary of the net investment income tax threshold, if applicable.

- Consider using charitable remainder trusts to bunch charitable giving and to manage and avoid realization of capital gains and smooth out income within a multiyear/multi-scenario, customized individual plan.

- Consider converting a traditional IRA to a Roth IRA. The 2020 tax rate on the conversion could be as high as 37%, depending on the size of the conversion and the person's other income. However, under present law, there will not be required distributions by the participant from the Roth IRA in future years. Traditional IRA withdrawals, required once the client reaches age 72 and possibly needed sooner, although not considered net investment income, will still increase the client's AGI and may help push the client over the 3.8% net investment income tax AGI threshold. **Caution:** Once a Roth conversion is done, the opportunity to recharacterize is repealed by the TCJA for conversions done in 2018 or later. If 2020 is a low-income year, consider doing a Roth conversion as a positive planning opportunity.

- Review the client's portfolio to ensure assets are located properly for tax efficiency purposes. Income that is tax exempt (municipal bonds) will both avoid the higher tax rates and not be considered net investment income.

- Consider using S corporations to pay the business owner a modest salary (to minimize exposure to self-employment and Medicare taxes on compensation) and a more generous dividend because distributions from active businesses to active owners are not net investment income for purposes of the net investment income tax. Coordinate this suggestion with the W-2 income issues arising under the new IRC Section 199A. Determine where the taxpayer falls with respect to the IRC Section 199A qualified business income (QBI) deduction and do what is necessary to either fall below the taxable income threshold (if possible) or look at things that can be done for taxpayers with income above the threshold to still qualify for a QBI deduction. IRC Section 199A is discussed at length in volume 4.

- Consider investments such as depreciable real estate, when the depreciation deduction may offset a portion of the rental income, or investments focused more on growth than on current income.

- Consider installment sales — either elect out of the installment method for a 2020 sale and pay all the tax on the gain at the 2020 rates, if still in the 15% bracket or with a loss carryforward, or use installment sale treatment to stretch out reporting of a gain.

- Consider the use of a like-kind exchange (IRC Section 1031) to defer reporting of a gain on the sale of real estate investment property. Be aware that the like kind exchange opportunity was eliminated for personal property by the TCJA.

- Consider voluntary withdrawals from IRAs and qualified retirement plans, as long as they will not be subject to the 10% excise tax. The CARES Act expanded the opportunity to take penalty-free IRA withdrawals in 2020 if a taxpayer has been adversely affected by the COVID-19 pandemic (for health or economic reasons).

- Consider whether skipping 2020 RMDs is appropriate, under the CARES Act, if taxpayers do not need the additional source of funds for cash flow purposes.

- Pay attention to clients with trusts. Income in trusts will be taxed at the 37% bracket when $12,950 (for 2020) of undistributed trust income is reached. When possible, encourage distributions to individual beneficiaries with higher AGI and taxable income thresholds.

- Address estimated tax situations. If gains were accelerated in 2019, estimates may be overpaid if a safe harbor was used for 2020. Estimates may be underpaid if the 0.9% additional Medicare tax, the net investment income tax, and the 2020 tax rates have not been addressed, and a fail-safe safe harbor was not used.

- Be aware of income tax basis issues. Gifting low-basis assets with their carryover basis to younger donees might not be the correct decision, especially if the donor will not have an estate in excess of the applicable exclusion. Consider gifting low-basis assets "upstream" to elderly family members who will hopefully live at least one year and thereafter leave them to the donor, thereby gaining a basis increase to the donor as an heir.

Planning Pointer.

Proactive Planning Toolkit

Legislation like the TCJA and the SECURE and CARES Acts have added more complexity to financial planning. Technical content, tools, and other resources are available to PFP Section members at aicpa.org/PFP/ProactivePlanning to help you get up to speed on all the intricacies, so that you can educate your clients and proactively help them meet their life goals and give them peace of mind while navigating the complex financial landscape.

.02 Manipulating AGI

A taxpayer might need to accelerate or defer income in order to meet AGI limitations that accompany certain tax benefits. For example, a taxpayer may wish to lower his or her AGI to take advantage of several tax benefits tied to AGI, including the following, based on limitations for the year 2020. Inflation-adjusted amounts can be found in Revenue Procedure 2019-44.[4]

- **Roth IRA contributions.** Phased out beginning in 2020 at AGI of $196,000 for married couples filing jointly ($0 for married persons filing separately) or $124,000 for single taxpayers.[5]

- **Contributions to Coverdell Education Savings Accounts.** Phased out beginning in 2020 at AGI of $190,000 for married couples ($95,000 for single taxpayers).[6]

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[4] Rev. Proc. 2019-44 (November 6, 2019).

[5] IRC Section 408A(c)(3).

[6] IRC Section 530(c)(1)(A)(i).

- **American Opportunity Credit.** Phased out beginning in 2020 at AGI of $160,000 for married couples ($80,000 for single taxpayers).[7]

- **Lifetime Learning Credit.** Phased out beginning in 2020 at AGI of $118,000 for married couples ($59,000 for single taxpayers).[8] These amounts are indexed for inflation.[9]

- **Child tax credit.** Phased out beginning in 2020 at AGI of $400,000 for married couples ($200,000 for single taxpayers).[10] These amounts are not adjusted for inflation.

- **Education loan interest deduction.** Phased out beginning in 2020 at AGI of $140,000 for married couples ($70,000 for single taxpayers).[11] These amounts are adjusted for inflation.[12]

- **Personal and dependency exemptions.** These are repealed beginning in 2018 by the TCJA.

- **Certain itemized deductions.** The 3% phase out of certain itemized deductions (the "Pease limitation") is repealed for tax years beginning in 2018 by the TCJA.

- **IRA contributions for active qualified plan participants.** Phased out beginning in 2020 at AGI of $ $104,000 for married couples filing jointly or qualifying widow(er)s. The phase-out threshold begins at $65,000 for a single taxpayer. The phase-out threshold for a taxpayer who is not an active participant but whose spouse is an active participant begins at $196,000.[13]

- **Social Security income.** Up to 85% includible in gross income if AGI exceeds certain amounts (based on formulas).[14]

- **Credit for household and dependent care services necessary for gainful employment.** Commonly called the "child care credit," it decreases in 2020 for AGI of more than $15,000 and levels out at AGI in excess of $43,000, for both married couples filing jointly and single taxpayers.[15]

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[7] IRC Section 25A.

[8] IRC Section 25A(d)(2)(A).

[9] IRC Section 25A(h)(2)(A).

[10] IRC Section 24(b).

[11] IRC Section 221(b)(2)(B).

[12] IRC Section 221(g).

[13] IRC Section 219(g)(3)(B).

[14] IRC Section 86.

[15] IRC Section 21(a).

- **Interest exemption for savings bonds used for qualified higher education expenses.** Phased out in 2020 completely at AGI of $153,550 for married couples filing jointly ($97,350 for other returns).[16]

- **Exception to the passive loss deduction limitation for active participants in real estate.** Phased out starting at AGI of $100,000 for both married couples filing jointly and single taxpayers (a higher limit applies if rehabilitation tax credits were utilized).[17]

Planning Pointer. As the result of the TCJA, the deduction for miscellaneous itemized deductions has been suspended effective for 2018–2025.[18] The 7.5% floor on medical expense deductions is effective through 2020.[19] The deduction for casualty and theft losses was repealed effective in 2018, except for presidentially declared disasters.[20] Lowering AGI allows more medical expenses to be deductible. On the other hand, lowering AGI may reduce the charitable deduction because the deduction is generally limited to 60% of AGI for cash contributions (30% for capital gain property and 20% for property given to private foundations).[21]

.03 AMT Considerations

For those within range of the AMT,[22] the need for year-end tax planning becomes particularly acute. Such individuals may find themselves in a situation in which further deductions against their regular income only serve to expose them to additional AMT liability. Thus, any additional deductions would be wasted. To avoid loss of these deductions, the client could shift the deductions, or part of them, to a year in which they would provide a tax benefit. Alternatively, the strategy might be to limit the deduction in the first place. For example, the client could use alternative depreciation, rather than regular depreciation, in appropriate situations.[23] The major AMT "add backs" for most taxpayers (the personal exemption, all state and local taxes, and miscellaneous itemized deductions) have either been eliminated or reduced beginning in 2018, making it less likely that many taxpayers will be liable for the AMT.

If the client cannot avoid the AMT, a different strategy can save taxes: Accelerate income into the year when the AMT is due. The rate of tax on extra income subject to AMT is either 26% or 28%,[24]

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[16] IRC Section 135.

[17] IRC Section 469(i).

[18] IRC Section 67(g).

[19] IRC Section 213(a).

[20] IRC Section 165(h).

[21] IRC Section 170.

[22] IRC Section 55.

[23] IRC Section 168.

[24] IRC Section 55(b)(1)(A)(i).

compared to a regular tax top rate of 37% for 2018 and beyond.[25] Another planning strategy is to attempt to alternate years when deductions are high — then low — to try to address the AMT issues.

¶3305 Planning Methods

After deciding whether to postpone or accelerate income or deductions, the individual then looks for ways and means to accomplish the chosen objectives.

.01 Postponing Income

The traditional opportunities for an individual to postpone income are limited. Some key methods include the following:

- Postponing the sale of investments at a profit
- Making installment sales of property that qualify for installment reporting, thereby deferring all or a portion of the gain to subsequent years
- Deferring compensation under a plan
- Postponing the receipt of lump-sum distributions from a pension or profit-sharing plan until next year or taking only the required IRA or other retirement plan payments
- Giving income-producing property to family members age 19 or over (unless they are full-time students under age 24) in lower tax brackets before the right to income ripens
- Delaying billing customers or clients until the beginning of the new year
- Delaying the completion of sales and contracts, finishing construction jobs, etc.
- Purchasing Treasury bills, certificates of deposit, and other investments that will mature in the next year (provided that the taxpayer is a cash-basis taxpayer)
- Making additional contributions to qualified plans or IRAs, if available
- Making additional contributions to an Archer Medical Savings Account[26] or a health savings account[27]
- Investing a realized capital gain in a qualified opportunity fund
- If at least age 70 ½, transferring up to $100,000 of an IRA to a qualified charity

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[25] IRC Section 1.

[26] IRC Section 220.

[27] IRC Section 223.

If the employer defers payment of a year-end bonus until January, the employee recognizes the income in the new year. But the employer must generally not give the employee a choice about when payment is to be made because the employee would then be deemed to be in constructive receipt when the choice is presented, unless the payment is subject to a substantial risk of forfeiture, in which case, deferral is proper until the risk of forfeiture ends. If the employee is given a choice of timing, the employee must report the income in the prior year when the employee constructively received it.[28]

.02 Accelerating Income

One of the practical ways an individual has to accelerate income is to make profitable sales of assets this year instead of next year. Harvesting capital gains in 2020 may prove to be an excellent planning strategy to lock in the 15% capital gains rate, when the taxpayer's taxable income threshold falls short of being subject to the 20% rate and also avoids the 3.8% net investment income tax threshold.

A redemption of U.S. savings bonds can accelerate interest income. Distributions from traditional IRAs or qualified plans can be accelerated. Dividends can be taken out of a closely held corporation. Sending bills to clients early enough so collection during the current year is expected might be an effective way to accelerate income. Similarly, completing sales, contracts, and construction jobs may help — assuming that accelerating income is desired.

.03 Postponing Deductions

The major ways of postponing deductions are as follows:

- Delay the sale of a loss investment.
- Delay payment of deductible items (if doing so does not impair credit standing or incur late charges).
- Postpone charitable contributions.

.04 Accelerating Deductions

An individual may accelerate into this year certain deductions he or she would otherwise take next year. These strategies would not be recommended if the tax rates increase for the subsequent year over what they are in the current year. Given that the TCJA raised the standard deduction now $12,400 in 2020 for single taxpayers and $24,800 in 2020 for married taxpayers filing jointly, and eliminated or capped many itemized deductions, fewer taxpayers will be able to benefit from accelerating deductions. If possible, an individual may accelerate deductions by doing the following:

- Increase charitable contributions, making next year's and this year's currently; a pledge will not do.
- Take losses on investments.

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[28] IRC Sections 409A, 451 and Regulation Section 1.451-2.

- Prepay state or city income taxes. When the taxing authority has the estimated tax system, this will generate a deduction. If the taxing authority does not have such a system, prepayment will be deductible if the authority accepts it as payment, not merely as a deposit against future tax.

- Prepay already assessed property taxes. The IRS will allow a deduction for prepayment of property taxes if the taxing authority accepts amounts tendered as payment, not as a deposit against future taxes. The TCJA limits the deduction of all state and local taxes to $10,000 per year for single persons and married persons filing jointly, and $5,000 for married persons filing separately.

- Incur above-the-line expenses early, such as self-employed health insurance premiums, student loan interest repayments, or retirement plan contributions.

In general, a deduction for prepaid interest is allowable only in the tax year in which the interest is earned or accrued.[29]

¶3310 Year-End Planning for Securities Transactions

The tax rate for most net long-term capital gains realized by most taxpayers through the end of 2020 is 15%. For taxpayers in the 10% or 12% marginal rate brackets for ordinary income, the tax rate for most net long-term capital gains realized in 2020 is 0%. For some wealthy taxpayers (those with taxable income over $441,450 for single filers and over $496,600 for married persons filing jointly), the tax rate of 20% on net long-term capital gains will apply. The 2020 20% threshold for long-term capital gains and qualified dividends for trusts and estates is $13,150. In addition, the 3.8% tax on net investment income applies in 2020. This tax applies to single taxpayers with AGI over $200,000, married taxpayers filing joint returns with AGI over $250,000, and married persons filing separately with AGI over $125,000. It applies to trusts and estates with undistributed investment income in excess of $12,950.

A net capital gain is the excess of a net long-term capital gain over any net short-term capital loss A rate of 28% applies to long-term capital gains from sales or exchanges of collectibles, and a rate of 25% applies to unrecaptured IRC Section 1250 gain (depreciation recapture on real estate). Losses for each long-term tax-rate group will be used to offset gains within the group. If a long-term tax-rate group has a net loss, the loss will be used first to offset net gain for the highest long-term tax-rate group, then to offset the next highest tax-rate group, and so on, eventually allowing long-term losses to offset short-term gains.

> **Example 33.1.** Bob Smith has a net loss for the 15% tax-rate group. That net loss will be used first to offset any net gain in the 28% group, and then net gain in the 25% group (gains on depreciation recapture under IRC Section 1250), and so on.

A carryover of a net long-term capital loss from a prior year can be used first to offset net gain for the long-term highest tax-rate group and so on.

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[29] IRC Section 461(g).

A net short-term capital loss (that is, a net loss from capital transactions involving holding periods of one year or less) can be used to first offset net gain for the highest long-term tax-rate group and so on.

> **Note:** IRC Section 1(h) provides tax rates on the various categories of capital gains. The IRS announced their interpretation of these rules in Notice 97-59.[30] Taxpayers could not get a much better interpretation of the rules on treatment of capital losses. From a year-end tax planning perspective, taxpayers who accelerate the recognition of a net loss in the 15% group can use it to offset net capital gains otherwise taxable at the 28% rate, rather than having to wait to use them to offset 15% rate gains in the next year.

¶3315 Year-End Planning Ideas

Consider the following year-end financial planning ideas before the close of December.

.01 Gifts

The client could make as many annual exclusion gifts ($15,000 for 2020 and indexed annually for inflation) to donees (double the amount of annual exclusion gifts if the client is married, and the spouse consents to split the gifts) as desired. The annual gift tax exclusion per donee is lost if not used before the end of the year.[31] The opportunity is also available in 2020 to use the lifetime gifting exclusion of $11,580,000 per donor ($23.16 million for married couples splitting their gifts and indexed annually for inflation). With the reduced stock market values of 2020, reduced business valuations and the political risk of the 2020 election looming, clients should consider using the available exclusions while the law remains favorable.

.02 Charities

Compute the maximum charitable income tax deduction that the client may be allowed for the year and consider if the client will get a tax benefit by itemizing deductions. If not, consider suggesting bunching deductions in a single taxable year, possibly through the use of a donor-advised fund, to maximize the tax benefit from a gift to charity.[32]

.03 Losses

If a client wants to recognize a year-end loss, the client should not sell securities to a family member. Such a loss will not be allowed on the client's income tax return because losses on sales to related parties are generally not recognized. For this purpose, a *family member* means a spouse, brother, sister, ancestor, or lineal descendant. However, a loss realized on a sale to an in-law, aunt, uncle, nephew, niece, cousin, or unrelated person will be recognized.[33] Consider whether the client has any bad debts or worthless investments that can be deemed worthless and deducted.

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[30] 1997-2 CB 309.

[31] IRC Section 2503(b) and IRC Section 2513.

[32] IRC Section 170.

[33] IRC Section 267.

.04 Spouse's Gains and Losses

If a client is married and files jointly, the financial planner should double-check each spouse's capital gains and losses. Capital gains realized by one spouse may be offset by capital losses incurred by the other. This rule applies even though each spouse owns securities in his or her own name.

.05 Basis

A client should not make a gift of stock or other property that has declined substantially in value since purchased. If the client does so, the donee's basis for determining a loss is the lower of the donor's basis or the fair market value of the transferred property at the time of gift.[34] Thus, the client will probably do better selling the property, realizing a capital loss for tax purposes, and then making a gift of the proceeds of sale.

Making gifts of low-basis stock or other property is not generally recommended, absent expectations of significant future appreciation. Such gifts result in a carryover basis to the donee of the donor's income tax basis in the property. Holding the asset until the donor's death will give the heirs of the donor a basis equal to the fair market value of the property on the donor/decedent's date of death or alternate valuation date, if applicable.

.06 Dividend Income

To shift some dividend income to a lower bracket member of the family, a client could make a gift of the dividend-paying security before the year-end dividend is declared. It will then show up on the donee's income tax return, not the donor's. However, the client should keep in mind the income tax rules for minors and full-time students subject to the kiddie tax. Qualified dividends received through December 31, 2020, are generally taxed at 15% but may be taxed at the 20% rate for single filers with taxable income over $441,450 and married persons filing jointly with taxable income over $496,600. For 2020, qualified dividends are taxed at 0% to taxpayers with income in the 10% or 12% rate brackets.

.07 Keogh and Simplified Employee Pension Plans

For self-employed individuals, a Keogh plan must be set up before the end of the year. However, a self-employed individual may establish a simplified employee pension (SEP) plan up to the extended due date of his or her income tax return. A self-employed individual may make contributions to either plan up to the filing date of a timely filed income tax return.

¶3320 Year-End Planning for Estimated Taxes

Generally, a taxpayer may avoid the penalty for underpayment of estimated taxes by making timely payments of estimated taxes that exceed 90% of the current year's tax liability or 100% of the prior year's tax liability.[35] To use the 100% of the prior year's tax liability exception, the taxpayer must have filed a tax return for the prior taxable year. In addition, the prior taxable year must have been a 12-month taxable year. However, if the taxpayer's AGI was greater than $150,000 in the preceding year,

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[34] IRC Section 1015(a).

[35] IRC Section 6654(d)(1)(B).

the taxpayer must pay 110% of the prior year's tax liability in timely estimated payments to avoid the underpayment penalty.[36]

The underestimation of tax penalty does not apply if the gross tax liability minus withholding is less than $1,000.[37] In addition, the penalty will not apply if the taxpayer did not have any tax liability in the preceding tax year if the preceding tax year was a 12-month year, and the taxpayer was a U.S. citizen or resident for the preceding tax year.[38] For this purpose, *tax liability* refers to gross tax liability, rather than net tax due. The IRC treats tax withheld as though paid in equal amounts on the due dates for estimated payments.[39]

Thus, a taxpayer may be able to reduce or avoid the penalty for underpayment of estimated tax by having tax withheld late in the year. Amounts withheld then are treated as paid throughout the year. A taxpayer who owns a corporation can accept a bonus and withhold income tax to avoid or reduce the penalty. The bonus must qualify as reasonable compensation.[40]

To increase withholding late in the year, consider taking an IRA distribution at the end of the year and having the custodian withhold income taxes from the distribution. Then, repay the amount withdrawn from the IRA within 60 days (at the beginning of the next tax year). There will not be any income tax charged on the withdrawal, the repayment will put the IRA back where it was before anything was withdrawn, and the taxpayer's withholding will be allocated over the entire tax year, not just the quarter in which the withholding occurred.

Note that the estimated tax rules apply for 2020 income to both the additional 0.9% Medicare tax on earnings and the 3.8% tax on net investment income.

¶3325 New Year Planning

Tax planning is not limited to a particular time of year, but it is something that requires consideration throughout the year. In fact, the earlier the process begins, the easier the taxpayer can achieve maximum tax savings. A client should consider the following planning opportunities because they also represent wealth-building strategies.

.01 Reducing AGI

The reduction of AGI will result in less income being subject to taxation. AGI reduction was suggested in the years prior to 2018 to limit the impact of the phase-outs of the personal exemptions and itemized deductions (the "Pease limitation") and allow deduction of more itemized deductions. But the allowances for personal exemptions and miscellaneous itemized deductions were both repealed by the

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[36] IRC Section 6654(d)(1)(C).

[37] IRC Section 6654(e)(1).

[38] IRC Section 6654(e)(2).

[39] IRC Section 6654(g)(1).

[40] IRC Section 162(a).

TCJA, along with the Pease limitation on itemized deductions, all effective beginning in 2018. These developments will give AGI less of an impact on the allowance of deductions.

Where appropriate, to reduce AGI, consider the following:

- Traditional IRA contributions
- Salary reduction plans (401(k) plans and 403(b) plans)
- Keogh contributions
- SEP plan contributions
- Savings incentive match plan for employees (SIMPLE) plan contributions
- Use of pretax dollars to fund a flexible spending account, an Archer medical savings account, or a health savings account
- Voluntary contributions to a qualified plan (takes income earned on contributions out of an individual's gross income)
- Deferred compensation arrangements
- Tax-exempt income
- Converting taxable earned income into tax-favored fringe benefits, such as accident and health insurance, group-term life insurance, company below-market loans, educational assistance, and company services and products acquired at discounts
- Deferred annuity arrangements
- Student loan repayments

  Note: The earlier in the year the taxpayer takes these steps, the greater the benefits.

.02 Family Gifts

A taxpayer can make gifts of income-producing property to family members to remove the income from the property from the taxpayer's gross income. Once again, pay attention to the basis of any gifted property. Be wary of transfers of low-basis assets by persons unlikely to be subject to the federal estate tax.

.03 Capital Gains

Income from most net long-term capital gains for most taxpayers realized through the end of 2020 is taxed at a maximum rate of 15%. However, for taxpayers in the 10% and 12% regular tax brackets, the capital gain rate is 0% for 2020. As described previously, certain taxpayers with large taxable income amounts will pay taxes at a 20% rate on long-term capital gains above certain taxable income thresholds and will pay the 3.8% net investment income tax above certain AGI thresholds. Consider transferring capital assets held for more than one year to family members who may be eligible for the 0% bracket to eliminate tax on the gains. (Be careful of transfers to children who may be subject to the kiddie tax). An

investment of realized capital gains in a qualified opportunity fund will defer the tax on the gain for several years.

.04 Personal Interest

As the result of the TCJA, it is no longer permitted to convert nondeductible personal interest to deductible qualified residence interest through the use of a home equity loan. Such a loan will only permit interest to be deducted if it is incurred to purchase, refinance, or improve a residential property.

.05 College Savings Plan

The earlier in the year the client contributes to the plan (a Section 529 plan), the better. Interest (or other return) on the contributed funds will not be taxed to the client or beneficiary of the college fund.

.06 Employment of Family Members

Owners of family businesses receive tax deductions on compensation paid to family members. In addition, wages paid to one's child under the age of 18 are exempt from FICA tax.[41] Senior family members younger than their normal retirement age who receive Social Security benefits may have compensation tailored to minimize loss of benefits. Social Security recipients collecting at their normal retirement age do not lose Social Security benefits because of compensation or other income received.

.07 Minimum Distributions from Retirement Plans

Delaying the receipt of the RMDs for persons who have attained age 72 until year-end allows the taxpayer to take full advantage of tax deferral. Consider the pros and cons of waiting until April 1 of the year following the year the client attains age 72 to begin RMDs.

.08 Use of Installment Sale

An installment sale can defer and spread payment of tax and possibly reduce tax for those who will be eligible for the lowest capital gain tax rate when the payments are received.

.09 Dependency

Exemptions for dependents are no longer available beginning in 2018 as the result of the TCJA. The standard deduction and the child tax credit for children under age 17 have been increased.

¶3330 Understanding and Planning for the Tax on Net Investment Income

The net investment income tax (NIIT) was enacted as part of the Affordable Care Act. This tax is referred to in the sections that follow and earlier throughout this chapter, and is discussed in more detail in chapter 38, "Planning for the Additional Medicare Tax and the Net Investment Income Tax."

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[41] IRC Section 3121(b)(3)(A).

.01 How Does This Tax Work?

The net investment income tax of 3.8% is assessed on the lesser of a taxpayer's net investment income or the excess of the taxpayer's modified adjusted gross income (MAGI) over what is referred to as the *threshold amount*.

.02 What Is Considered to Be Net Investment Income?

- Interest
- Dividends
- Capital gains
- Rental income
- Royalty income
- Annuities
- Passive activity income

Net investment income does not include the following items:

- Wages, salaries, and income from self-employment
- Income derived from the conduct of an active trade or business
- Distributions from IRAs or qualified retirement plans
- Tax-exempt income

.03 What Is Meant by "Modified Adjusted Gross Income," and What Is the "Threshold Amount"?

The term *modified adjusted gross income*, as used in the law, refers to AGI as calculated in accordance with the standard rules for determining AGI on Line 8b of Form 1040, modified by adding back the amount of the net foreign income exclusion amount, if any, that the taxpayer is entitled to claim.

The threshold amount is determined based on the filing status of the taxpayer. The threshold amount of AGI for married taxpayers filing joint returns is $250,000. The threshold amount for married taxpayers filing separate returns is $125,000. The threshold amount for single taxpayers is $200,000. The threshold amount for trusts and estates is the annually indexed amount when the top rate of federal income tax for trusts and estates begins, that is, $12,950 in 2020.

Note that the threshold amounts are not indexed for inflation, with the exception of the threshold amount that will be applied in the case of trusts and estates. That suggests that more and more taxpayers will eventually become subject to this tax as compensation or other income increases, and inflation is taken into account.

> **Example 33.2.** Tom and Terry Taxpayer are a married couple filing a joint return. Their net investment income for 2020 will be $45,000. Their other income will be $150,000. Assume no

deductions. Their total MAGI is $195,000. They will not be subject to the net investment income tax.

Example 33.3. Charles and Cara Citizen are a married couple filing a joint return. Their net investment income for 2020 will be $10,000. Their other income will be $280,000. Assume no deductions. Their total MAGI will be $290,000. This exceeds the threshold amount of $250,000. They will owe $380 of net investment income tax, that is, the lesser of 3.8% of their net investment income (10,000 × 3.8% = $380) or 3.8% of the excess of MAGI over the threshold amount (290,000 − 250,000 = 40,000 × 3.8% = $1,520).

.04 Is Planning Possible to Limit or Avoid the Net Investment Income Tax?

There are two broad areas to address in planning. First, see if anything can be done to reduce the amount of the taxpayer's MAGI. This suggests such planning maneuvers as making maximum contributions to qualified retirement plans and deductible IRAs. It suggests consideration of conversion of a traditional IRA to a Roth IRA if the effective income tax rates are below the 37% bracket and the removal of the taxable IRA withdrawals, whenever made, from the taxpayer's MAGI.

A second area of planning is to concentrate investments in those categories of income that will not be considered "net investment income." Here, investment in tax-free municipal bonds may be suggested. Deferred annuities will not produce net investment income until the deferral period is over. Similarly, nonqualified deferred compensation plans will defer income, keeping it out of MAGI, and then when income is realized, it will not be considered net investment income. The cash values of life insurance contracts and loans taken from such contracts are not considered net investment income. Real estate investments may produce rental income, but much or all of such income may be offset by depreciation deductions. Charitable remainder trusts can be used here. Gains realized by such trusts are not net investment income, although the distributions from these trusts to their non-charitable beneficiaries will be net investment income. Other techniques, such as the use of installment sales and like-kind exchanges can be used to manage the timing and amounts of both MAGI and net investment income.

Special concerns may arise for beneficiaries of trusts and estates. There may be added pressure on fiduciaries to make discretionary distributions of income, especially when the beneficiary may not be liable for the net investment income tax, and the entity will be so subject. The financial planner may suggest to trust grantors that they put instructions into their documents addressing how much discretion the fiduciary may exercise if there is distribution "pressure" from beneficiaries arising from concerns about this tax.

Planning Pointer.

With the more generous estate tax exclusions under the TCJA, the financial planner's focus will increasingly turn to multiyear income tax planning. The thresholds for a client to be subject to the 3.8% tax on net investment income and the rates on qualified dividends and long-term capital gains are planning areas that will need to be addressed. Gaining a stepped-up basis in assets whenever possible takes on increased importance. Issues and techniques to accomplish this are discussed throughout the guide. Access the Proactive Planning Toolkit available on the PFP Section website.

Chapter 34

Maximizing Deductions and Reducing Taxes

¶3401 Overview

There are many ways to reduce income taxes, and this chapter covers some of the various methods that can be used. The TCJA has made significant changes that became effective in 2018.

¶3405 Exemptions

The TCJA has repealed the personal exemption for tax years beginning in 2018.

.01 Children

A parent will no longer receive a dependency exemption for children. The child tax credit has been increased.

If the parents are divorced or separated, all of the complications that arose prior to the TCJA addressing which parent could claim a dependency exemption for the child are no longer applicable for dependency

exemptions on federal income tax returns but may still be applicable for state income tax returns, depending on applicable state laws.[1]

> **Note:** Dependency claims are still relevant for purposes of the child tax credit, the child care credit, and so on. The parent who is eligible to claim a child as a dependent is also the person responsible for providing health insurance for the dependent under the Affordable Care Act.

.02 Other Relatives

Dependency exemptions for a parent or any other relative are no longer permitted.

.03 Impact on Standard Deduction

The standard deduction of an individual who may be claimed as a dependent by another taxpayer is limited to the greater of $1,100 or the sum of the individual's earned income and $350 for the year 2019, but not to exceed the standard deduction for the dependent's filing status.[2] This limitation does not apply with respect to the additional standard deduction allowed to elderly or blind individuals.

The TCJA increased the standard deduction through 2025. In 2020, the standard deduction for individual taxpayers is $24,800 for married taxpayers filing jointly, $18,650 for heads of household, and $12,400 for all other individuals. The additional standard deduction for elderly and blind taxpayers for 2020 for persons age 65 or older or blind individuals is $1,650 for single or head-of-household filers and $1,300 for married persons filing joint returns, married blind persons, married persons filing separate returns, or widows or widowers.

.04 Reverse Planning for Higher Income Individuals

Individuals with substantial income who previously had to consider the phase-out of the personal exemptions no longer need to address this issue because the exemption has been suspended through 2025.

.05 Multiple Support Arrangements

Under prior law, it may have been necessary for the individuals sharing the support obligation of a person to enter into a multiple support agreement so that the contributors could take turns claiming the dependency exemption. Those agreements and the tax forms to support them are no longer required for 2020 and later because the dependency exemption was repealed. Dependency is still relevant for purposes of the child tax credit and other claims as noted in Section 3405.01 above.

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[1] IRC Section 152(e)(1)(A).

[2] IRC Section 63(c)(5).

¶3410 Tax Credits

.01 Child Care Credit

A parent may receive a tax credit for amounts paid for the care of a dependent child under age 13[3] to allow the parent to work or attend school full-time.[4] This credit is the credit for expenses for household and dependent care services necessary for gainful employment, but it is commonly called "the child care credit."[5] A parent could shift income within the extended family by paying the child's grandparents for taking care of their grandchildren under age 13 while the parent is at work or attending school full-time, subject to the general rules governing the child care credit. However, payments to individuals who are dependents do not qualify for the credit.[6]

The base for the credit is the lesser of (1) the amount paid for eligible expenses; (2) the taxpayer's earned income if single, or if married, the lesser of the earned income of each spouse; and (3) the maximum amount allowed. A parent who is a full-time student is deemed to have earned income of $250 per month for one eligible child or $500 per month for two or more eligible children for each month that the parent is a full-time student.[7] The maximum base for the credit is $3,000 for one qualifying child or dependent and $6,000 for two or more qualifying children or dependents.[8]

For taxpayers with AGI in excess of $43,000, the credit is 20% of the maximum base.[9] Accordingly, the maximum credit for such taxpayers is $600 or $1,200 if there are two or more children or dependents. The maximum amount of expenses eligible for the credit must be reduced by the amount excludable under an IRC Section 129 employer-provided dependent care assistance plan.[10] Financial planners should inform their clients that as long as the payments include compensation for the care of a qualifying individual, payments for household services, such as cleaning, qualify for the credit.[11]

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[3] IRC Section 21(b)(1)(A).

[4] IRC Section 21(d).

[5] IRC Section 21.

[6] IRC Section 21(d)(6).

[7] IRC Section 21(d)(2).

[8] IRC Section 21(c).

[9] IRC Section 21(a)(2).

[10] IRC Section 21(c).

[11] IRC Section 21(b)(2)(A).

.02 Child Tax Credit

In addition to the child care credit, taxpayers who have qualifying children under age 17 are entitled to a child tax credit.[12] The amount of the credit was increased by the TCJA to $2,000 per child beginning in 2018. The TCJA also significantly increased the amount at which the credit begins to be phased out.

At certain levels of modified AGI, the credit begins to be phased out at a reduction of $50 for every $1,000 above the threshold levels.[13] The threshold levels at which the credit begins to be phased out are as follows:[14]

	Phase-out begins at:
Joint filers	$400,000
Married persons, filing separately	200,000
Singles	200,000

The level of modified AGI at which the child tax credit is completely phased out depends on the number of qualifying children. These threshold amounts are not adjusted for inflation.

Part of the child tax credit is refundable for all taxpayers with qualifying children, regardless of the taxpayer's regular tax liability or AMT liability.[15] The refundable portion of the credit is limited to $1400 per qualifying child. An additional $500 nonrefundable credit is available for each dependent who is not a qualifying child.

Planning Pointer. The parent who is entitled to the dependency exemption for a child is the parent who may claim the child tax credit. Therefore, the child tax credit is a major consideration when negotiating divorce agreements and multiple support agreements. Although the deduction for dependency exemptions was repealed by the TCJA, the definition of a dependent remains applicable for purposes of the child tax credit and other tax benefits and obligations.

.03 Earned Income Credit

The *earned income credit* is a refundable tax credit for low income taxpayers.[16] The amount of the credit varies depending on one's level of income and the number of dependents being supported. A taxpayer with investment income (including interest, dividends, capital gains, and royalties) over $3,650 (for 2020 and indexed for inflation) is not eligible for the credit.[17] The maximum amount of the credit for

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[12] IRC Section 24(a).

[13] IRC Section 24(b)(1).

[14] IRC Section 24(b)(2).

[15] IRC Section 24(d)(4).

[16] IRC Section 32.

[17] IRC Section 32(i).

2020 is $538 , if the taxpayer has no qualifying children. If the taxpayer has one qualifying child, the maximum credit for 2020 is $3,584. . If the taxpayer has two qualifying children, the maximum 2020 credit is $5,920. The maximum credit for 2020 for taxpayers with three or more qualifying children is $6,660.

A *qualifying child* includes natural children, stepchildren, siblings, and descendants of any of these qualifying children. In addition, qualifying children include eligible foster children.[18] The child must be under age 19 at the end of the year or a full-time student under age 24.[19] In addition, a child who is permanently and totally disabled at any time during the tax year is a qualifying child, regardless of age.[20] The qualifying child must live with the taxpayer for more than half the year.[21] A taxpayer who does not have a qualifying child may claim the credit if the taxpayer or the taxpayer's spouse is at least age 25 but less than age 65 at the end of the tax year. The taxpayer must have lived in the United States for more than half the year and not be a dependent of another taxpayer.[22] The amount of the credit is based on the taxpayer's earned income.[23] A taxpayer who is married must file a joint return to claim the credit.[24]

The earned income credit is phased out for taxpayers with incomes above certain thresholds. As a general rule, the phase-out amounts for married couples filing jointly have been permanently increased by $5,000 (as adjusted for inflation) above the phase-out amounts for other filers.

The following table shows the income necessary to receive the maximum credit, the income at which the maximum credit begins to be phased out, and the income at which the credit is eliminated for a filing status other than married filing jointly. These amounts and the maximum credit available are adjusted for inflation each year.[25]

For 2020			
Number of Children	Income to Receive Maximum Credit Available	Income at Which Phase-Out Begins	Income at Which Credit Is Eliminated
0	$8970	$8970	$15,820
1	$19,330	$19,330	$41,756
2	$19,330	$19,330	$47,440
3 or more	$19,330	$19,330	$50,954

[18] IRC Section 32(c)(3).

[19] IRC Section 32(c)(3)(C).

[20] IRC Section 32(c)(3)(C).

[21] IRC Section 32(c)(3)(A).

[22] IRC Section 32(c)(1)(A).

[23] IRC Section 32(a)(2)(B).

[24] IRC Section 32(d).

[25] IRC Section 32(j).

The following table shows the income necessary to receive the maximum credit, the income at which the maximum credit begins to be phased out, and the income at which the credit is eliminated for a filing status of married filing jointly. These amounts and the maximum credit available are adjusted for inflation each year.[26]

For 2020			
Number of Children	Income to Receive Maximum Credit Available	Income at Which Phase-Out Begins	Income at Which Credit Is Eliminated
0	$14,680	$14,680	$21,710
1	$25,220	$25,220	$47,646
2	$25,220	$25,220	$53,330
3 or more	$25,220	$25,220	$56,844

Earned income includes only taxable employee compensation and self-employment income.

.04 Credit for the Elderly and the Permanently and Totally Disabled

The law allows a nonrefundable credit for taxpayers who are age 65 or older by the end of the year or who are retired on disability because of permanent and total disability.[27] The credit is equal to 15% of a base amount less Social Security benefits, railroad retirement benefits, and veteran's benefits excluded from gross income. Thus, if Social Security or similar benefits equal or exceed the base amount, the taxpayer is not eligible for the credit. The base amount is $5,000 for a single taxpayer or on a joint return when only one spouse qualifies, $7,500 on a joint return when both spouses qualify, and $3,750 on a married filing separately return. In addition, if the taxpayer is under age 65 at the end of the year, the base amount may not exceed the disability income received during the year.[28] Further, if the taxpayer's AGI exceeds a threshold amount, the taxpayer must reduce the base for the credit by half the AGI over the threshold amount. The threshold amount is $7,500 for a single filer, $10,000 on a joint return, and $5,000 for married taxpayers filing separately.[29] The base amounts and threshold amounts are not adjusted for inflation. A married couple must file a joint return to claim the credit unless they lived apart for the entire year.[30] A nonresident alien may not claim the credit.[31]

Example 34.1. Anthony and Maria Santucci are both age 65. During the year, they began to receive Social Security benefits. They received $2,000 in Social Security benefits during the

[26] IRC Section 32(j).

[27] IRC Section 22(b).

[28] IRC Section 22(c).

[29] IRC Section 22(d).

[30] IRC Section 22(e)(1).

[31] IRC Section 22(f).

year. In addition, they had $13,000 in interest income. They would compute their credit for the elderly as follows:

Base Amount	$7,500
Less: Excluded Social Security	(2,000)
Less: AGI Adjustment ($13,000 – $10,000) × 50%	(1,500)
Base for the Credit	$4,000
Rate	15%
Tentative Credit (Limited to Tax Liability)	$600

¶3415 Charitable Contributions

Chapter 5, "Charitable Giving," offers a detailed treatment of charitable giving from both the income tax and the estate tax points of view. Giving on a major scale is discussed, including such matters as gifts of appreciated property, bargain sales of appreciated property, gifts of charitable remainders, pooled income funds, charitable remainders in a personal residence or farm, and contributions of future interests in tangible personal property (art, paintings, and the like). Chapter 5 also covers charitable annuities and gifts of life insurance, as well as gifts of income. This chapter discusses charitable giving on a more everyday basis.

Taxpayers who routinely make everyday cash contributions should make sure to substantiate their gifts. Note that for 2020, the CARES Act has increased the allowable amount of an individual's gift of cash to a public charity (not to a donor-advised fund or a private foundation) to 100% of the taxpayer's AGI. No deduction is allowed for any contribution of cash, a check, or other monetary gift — regardless of the amount — unless the taxpayer has a record to back up the contribution, such as a bank record or a written communication from the donee showing the amount and date of the contribution.[32] In the case of contributions by payroll deduction, a pay stub or W-2 form showing the contribution amount, along with the donee organization's pledge card, will meet the substantiation requirement.[33] In addition, no charitable deduction is allowed for any contribution of clothing or a household item unless the clothing or household item is in good used condition or better.[34]

The TCJA increased the income-based percentage limit for charitable contributions of cash to public charities to 60%. This rule is effective from 2018 through 2025, subject to the special 100% of AGI rule applicable to 2020. The TCJA also denies a charitable deduction for payments made for college athletic event seating rights. And, it repealed the statutory provision that provides an exception to the contemporaneous written acknowledgment requirement for certain contributions that are reported on the

[32] IRC Section 170(f)(17) as amended by P.L. 109-280; Notice 2006-96.

[33] Notice 2006-110.

[34] IRC Section 170(f)(16)(A) as amended by P.L. 109-280; Notice 2006-96.

donee organization's return (a prior-law provision that had never been put into effect because regulations were never issued).

.01 Contributions of $250 or More

A taxpayer who makes a charitable contribution of $250 or more may not deduct it unless the gift is substantiated by a contemporaneous written acknowledgment from the charity.[35] A canceled check is not considered proof. *Contemporaneous* means on or before the earlier of the date the taxpayer files his or her return for the year in which the contribution is made or the due date plus extensions for the return.[36] From a practical standpoint, however, donors should get written acknowledgment from the charity as soon as they make each affected contribution. The IRS has successfully litigated cases in which they did not accept a written acknowledgment from the charity created at the time of the audit, despite the taxpayer being able to prove the gift was made as claimed. The IRS requires the acknowledgment from the charity to be *contemporaneous* with the gift (*Gaerttner v. Commissioner*, T.C. Memo 2012-43; *Durden v. Commissioner*, T.C. Memo 2012-140).

The disallowance rule for unsubstantiated gifts of $250 or more applies separately to each gift.[37] Although gifts generally are not aggregated, the IRS warns that it is authorized to issue anti-abuse rules to prevent avoidance "by taxpayers writing separate smaller checks on the same date."

There is no prescribed acknowledgment form. The charity's statement must, however, indicate the donor's name (the Social Security number or taxpayer ID is not necessary) and provide sufficient information to substantiate the amount of the contribution. Separate acknowledgments for each $250 contribution are not necessary; the charity can furnish periodic statements substantiating such contributions.[38] The acknowledgment should provide that no goods or services were received in exchange for the donation.

The information that the donor must obtain from the charity depends on the type of donation:

- For gratuitous contributions of $250 or more in cash, the charity indicates the amount given and that the donor received nothing in return.
- For gratuitous contributions of $250 or more in property (or cash and property), the charity must describe, but need not value, the property and also must state that the donor received nothing in return.[39]
- For contributions of $250 or more in which the donor receives intangible religious benefits in exchange, the acknowledgment requirements generally are the same as for gratuitous contributions. However, the charity must state that the donor received an intangible religious

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[35] IRC Section 170(f)(8)(A).

[36] IRC Section 170(f)(8)(C).

[37] Regulation Section 1.170A-13(f)(1).

[38] IRC Section 170(f)(8)(C).

[39] IRC Section 170(f)(8)(B)(i).

benefit, although it need not value or describe it.[40] An *intangible religious benefit* is one provided by an organization exclusively for religious purposes and of a type that is not generally sold outside the donative context. An example of such an intangible religious benefit is admission to a religious ceremony.[41]

Under Regulation Section 1.170A-13, goods or services that have insubstantial value as determined under annually indexed IRS guidelines need not be taken into account by the charity for purposes of the $250 rule. Also, this regulation addresses contributions by payroll and provides that for purposes of the $250 threshold, each paycheck is treated as a separate contribution. The IRS takes a very strict view of the requirement for a contemporaneous acknowledgment from the charity. In other words, do not wait until the taxpayer is audited, then seek the acknowledgment. Get it when the gift is made or shortly thereafter.

.02 Quid Pro Quo Contributions

Charities that solicit or receive *quid pro quo* contributions in excess of $75 (that is, payments that are partly contributions and partly consideration for goods or services from the charity [for example, football tickets provided by a college, dinner supplied by a religious organization, or a CD supplied by a public television station]) must supply the donor with a written statement that essentially makes a good faith estimate of the deductible portion of the payment. There is a *de minimis* exception and an exception for receipt of an intangible religious benefit. Charities that fail to comply are subject to penalties.[42]

.03 Gifts of Used Clothing and Furniture

The important issue here is fair valuation. Some charities give the donor a written statement of value. Regardless of whether the charity gives such a statement, if a donor gives used items whose total valuation exceeds $500 in a taxable year, the donor must file Form 8283.[43] If the total deduction is over $5,000, the donor must obtain appraisals of the values of the donated property, unless the property is stock in a publicly traded company.[44]

.04 Wheelchairs and Medical Equipment

A patient who has recovered from an illness and who no longer requires a wheelchair, special bed, crutches, braces, or other special equipment may donate them to a hospital and receive a deduction for their fair market value, provided the taxpayer held such items for more than one year. The patient might have deducted these same items when acquired as medical expenses and, thus, can generate double

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[40] Regulation Section 1.170A-13(f)(2)(iv).

[41] S. Rep. No. 36, 103d Cong. 1st Sess. (1993).

[42] IRC Section 6115.

[43] Regulation Section 1.170A-13(b)(3).

[44] Regulation Section 1.170A-13(c).

deductions. If the taxpayer held these items for one year or less, the deduction would be limited to the taxpayer's adjusted basis in the items donated.[45]

.05 Scenic Views and Other Easements

Contributions of open-air or scenic easements by a property owner to the federal, state, or local government may be deducted. The value of the contribution is measured by the difference between the fair market value of the property before and after the granting of the easement.[46] Appraisals are necessary here. An enforceable easement in perpetuity contributed to the state by the owner of a mansion declared to be a state landmark has qualified as a charitable contribution of a scenic easement.[47]

A right-of-way conservation easement may also qualify. An easement along the edge of a person's property for use by the general public for hiking and skiing may also qualify.[48] An estate tax charitable deduction for qualified easements is also available.[49]

A corporation that is a qualified farmer or rancher may deduct qualified conservation contributions up to 100% of its taxable income, with a 15-year carryover of contributions in excess of the applicable percentage of AGI limitation.

.06 Donations of Vehicles

If the taxpayer donates a vehicle worth over $500, the taxpayer must obtain a contemporaneous written acknowledgment from the charity. If the charitable organization sells the vehicle without any significant intervening use or significant improvement of the vehicle, the deduction will be limited to the gross proceeds received by the charity from the sale. The acknowledgment must contain the taxpayer's name and taxpayer identification number and the vehicle identification number or similar number. If the charitable organization sold the vehicle without any significant intervening use or improvements, the charitable organization must also state that it sold the vehicle in an arm's length transaction to an unrelated party, provide the gross proceeds from the sale, and state that the taxpayer's deductible amount may not exceed the amount of such gross proceeds.[50]

.07 Unreimbursed Expenses

If a person works for a charity, including providing service as an unsalaried federal, state, or local official, he or she may deduct as a charitable contribution unreimbursed commuting expenses, cost of

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[45] IRC Section 170(e).

[46] Revenue Ruling 73-339, 1973-2 CB 68, as clarified in Revenue Ruling 76-376, 1976-2 CB 53.

[47] Revenue Ruling 75-358, 1975-2 CB 76.

[48] Revenue Ruling 74-583, 1974-2 CB 80.

[49] IRC Section 2055(f).

[50] IRC Section 170(f)(12).

uniforms, telephone calls, materials, supplies, stationery, stamps, and other items. No deduction is available for the value of the services rendered by the volunteer.

If a taxpayer uses his or her car for charitable work, 14 cents per mile can be deducted.[51] No deduction is allowed for charitable travel expenses, such as the cost of a trip to attend an organization's national convention as a delegate of a local group (unless there is no significant element of personal pleasure or vacation time).[52]

.08 Certain Ordinary Income Business Property — Inventory

A corporation, other than an S corporation, may take a deduction for the charitable donation of ordinary income property, such as inventory, in an amount that exceeds its tax basis, on certain conditions:

- The use of the property by the charity is related to its charitable purpose, and the property is to be used solely for the care of the ill, needy, or infants.
- The property is not transferred by the charitable donee.
- The corporation receives from the charity a written statement representing that its use and disposition of the property will be in accordance with paragraphs ¶3415.01 and ¶3415.02.
- If the property is subject to regulation under the Federal Food, Drug, and Cosmetic Act, it meets the applicable requirements on the date of transfer and for 180 days prior to the transfer.

If *all* these conditions are met, then IRC Section 170(e)(3) allows a deduction equal to the taxpayer's basis plus one-half of the appreciation of the property, in no event to exceed twice the basis of the property. Special rules apply to charitable contributions of food inventory. The general rule for such contributions limits the deduction to the donor's basis. However, the special rule allows an enhanced deduction for charitable contributions of food inventory from any trade or business of a corporate or non-corporate taxpayer. The amount of the enhanced deduction equals the lesser of the donated item's basis plus one-half of the item's appreciation or twice the donated item's basis. This deduction has been made permanent by the PATH Act, which extended the limitation on deductible contributions from 10% to 15% of the taxpayer's net taxable income from all trades and businesses from which such contributions were made.

¶3420 Medical Expenses and Insurance

.01 Medical Expenses

Medical care expenses, as discussed in the following text, are tax deductible, subject to certain limitations.

The threshold for deduction of medical expenses is 7.5% of AGI for 2020.

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[51] IRC Section 170(i).

[52] IRC Section 170(j).

IRC Section 213 defines *medical care expenses* to include amounts paid "for the diagnosis, cure, mitigation, treatment or prevention of disease for the purpose of affecting any structure or function of the body." The IRS interprets this as including the services of physicians, surgeons, psychiatrists, dentists, optometrists, chiropractors, osteopaths, physiotherapists, podiatrists, psychologists, nurses, and Christian Science practitioners.

The IRS has ruled that expenses for certain weight-loss programs are deductible as medical expenses.[53] The taxpayer must have incurred the expenses for treatment of a specific disease, including obesity, diagnosed by a physician.

The IRS has also ruled that amounts paid for medical procedures can qualify as deductible medical expenses, even if the procedures are not prescribed by a doctor. According to the IRS, when determining whether an expense is for medical or personal reasons, the recommendation of a physician is important, but it is not crucial. In cases in which expenses are for items that are wholly medical in nature and serve no other function in everyday life, a deduction can be claimed even if no doctor was involved.

The IRS ruling approved deductions for three types of expenses incurred by taxpayers without a doctor's order:

- The cost of an annual physical
- The cost of a full-body scan to detect diseases or abnormalities
- The cost of an at-home pregnancy test

Significantly, in each case, the expenses were incurred, even though the taxpayer was not suffering from any symptoms of a disease or illness. According to the IRS, deductible medical care includes amounts paid for diagnosis; a diagnosis may include a finding that disease is absent or testing for changes in the function of the body, such as those resulting from pregnancy, that are unrelated to a disease.[54]

The IRC further includes medical travel expenses (for driving expenses, the amount of 17 cents per mile is the 2020 deductible amount) and health insurance as deductible items. The IRC's definitions have been the subject of much interpretation by the IRS and the courts. The definition might be broader than one thinks.

Capital improvements to a home for medical care, such as elevators, inclinators, air conditioning, special ramps, intercom systems, a special motor-driven hospital bed, and other items may qualify to the extent that they do not increase the home's value.[55] Also, if a capital expenditure qualifies as a medical expense, the cost of maintenance will also qualify, as long as the medical reason continues.

IRC Section 213(d)(9) generally denies a medical deduction for cosmetic surgery. Exceptions apply for the removal of congenital defects. Cosmetic surgery to ameliorate a personal injury resulting from an

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[53] Revenue Ruling 2002-19, IRB 2002-16, 778 (April 2, 2002).

[54] Revenue Ruling 2007-72, 2007-50 IRB 1154.

[55] Regulation Section 1.213-1(e)(1)(iii).

accident or trauma or to ameliorate a disfiguring disease is also exempt from the denial of the deduction. *Cosmetic surgery* includes any procedure aimed at improving a patient's appearance and that does not meaningfully promote the proper function of the body or prevent or treat disease or illness.[56]

The most serious limitation on the use of the medical expense deduction is found in the rule that restricts the deduction to amounts over the applicable floor. The applicable floor is 7.5% in 2020. The best way to avoid the applicable floor limitation is to pay for medical expenses through an Archer medical savings account,[57] health savings account,[58] or flexible spending account.[59] The next best way to deal with the applicable floor limitation is to bunch as many medical expenses into a single year as possible without jeopardizing health. The expenses cannot always be accelerated or deferred, but some can be. For example:

- Major home installations for medical reasons — air conditioning and other items already mentioned
- Stocking up on prescription drugs and insulin
- Deferred payment of a medical bill
- Timing elective surgery and other nonessential medical or dental work, advancing or postponing from one year to another
- Accident and health insurance premiums are deductible when paid

Generally, a taxpayer may not currently deduct a prepayment of the expense for medical services to be performed in the next year.

The applicable floor of AGI on otherwise deductible medical expenses makes employer-provided medical benefits[60] very attractive.

If one member of a married couple incurs significant medical expenses, it may be worthwhile to test the possibility of having the couple file their income tax returns as married filing separately. If the incomes of the spouses are relatively equal, it may be possible for more of the medical expenses to be deducted if this filing status is elected, rather than a joint return filing. Of course, all other aspects of the tax return filing must also be taken into account if married filing separately is considered, including higher marginal rates at lower levels of income and the phase-out of other deduction opportunities at lower levels of income when the married filing separately option is chosen. If one spouse itemizes deductions when filing as married filing separately, the other spouse must do so as well.

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[56] IRC Section 213(d)(9)(B).

[57] IRC Section 220.

[58] IRC Section 223.

[59] IRC Section 125.

[60] IRC Sections 104, 105, and 106.

Unreimbursed amounts paid for qualified long-term care services provided to a taxpayer or the taxpayer's spouse or dependents are treated as medical care for purposes of the medical expense deduction.[61]

Similarly, eligible long-term care insurance premiums that do not exceed certain limits (based on the insured's age; see ¶3420.04) are treated as medical expenses for purposes of the medical expense deduction.[62]

.02 Health Savings Accounts

Health savings accounts (HSAs) are tax-exempt trusts or custodial accounts created exclusively to pay for the qualified medical expenses of the account holder and his or her spouse and dependents.[63] Contributions to an HSA can be made by "eligible individuals" or their employers or both. Within limits, contributions to HSAs are deductible above-the-line when determining AGI if made by individuals and are excludable from gross income and taxable wages if made by their employers. Distributions from HSAs for qualified medical expenses are not includible in gross income. The cost incurred for a medicine or drug will be treated as a qualified medical expense for purposes of a distribution from an HSA only if the medicine is a prescription drug or insulin. Distributions from HSAs to pay for over-the-counter medicines are not excluded from the gross income of the employee and will be subject to a penalty.

Distributions from an HSA for purposes other than qualified medical expenses are includible in the account holder's gross income and subject to an additional 20% penalty. However, the 20% penalty does not apply to distributions made after death, disability, or after the account holder attains age 65. Therefore, an HSA can serve as a tax-deferred retirement savings vehicle to the extent amounts in the account are not needed for current medical expenses.

An individual is generally eligible to make HSA contributions for any month if he or she (1) is covered under a high deductible health plan (HDHP) as of the first day of that month and (2) is not covered under any other health plan that is not a high-deductible plan and that provides coverage for any benefit covered under the high deductible plan. However, under a special full-contribution rule, an individual can make the maximum contribution for the year if eligible for an HSA on the first day of the last month of the tax year (December 1 for calendar year taxpayers). This full-contribution rule allows an individual who establishes an HSA part-way through the year to make the maximum contributions for the year.

In Revenue Procedure 2019-25, 2019-22 IRB (May 28, 2019), the IRS announced the annual contribution limitations for 2020. For calendar-year 2020, the limitation on deductions under IRC Section 223(b)(2)(A) for an individual with self-only coverage under an HDHP is $3,550 (up from $3,500 for 2019). For calendar-year 2020, the limitation on deductions under IRC Section 223(b)(2)(B) for an individual with family coverage under an HDHP is $7,100 (up from $7,000 for 2019). The catch-up contribution limit for persons age 55 or older is $1,000. Contributions to an HSA cannot be made after the participant attains age 65. Contributions, including catch-up contributions, cannot be made to an HSA

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[61] IRC Section 213(d)(1)(C).

[62] IRC Section 213(d)(1)(D).

[63] IRC Section 223.

after the participant has enrolled in Medicare. However, withdrawals for qualified medical expenses continue to be excluded from gross income regardless of the taxpayer's age.

HDHP for 2020. For calendar year 2020, an HDHP is defined under IRC Section 223(c)(2)(A) as a health plan with an annual deductible that is not less than $1,400 (up from $1,350 for 2019) for self-only coverage or $2,800 (up from $2,700 for 2019) for family coverage, and with respect to which the annual out-of-pocket expenses (deductibles, co-payments, and other amounts, not including premiums) do not exceed $6,900 (up from $6,750 for 2019) for self-only coverage or $13,800 (up from $13,500 for 2019) for family coverage.

In Revenue Procedure 2020-32 (May 20, 2020), the IRS announced the annual contribution limitations for 2021 and the HDHP definition for 2021.

- *Annual contribution limitation*. For calendar-year 2021, the annual limitation on deductions under Section 223(b)(2)(A) for an individual with self-only coverage under an HDHP is $3,600. For calendar-year 2021, the annual limitation on deductions under Section 223(b)(2)(B) for an individual with family coverage under an HDHP is $7,200.

- *High deductible health plan*. For calendar-year 2021, a *high deductible health plan* is defined under Section 223(c)(2)(A) as a health plan with an annual deductible that is not less than $1,400 for self-only coverage or $2,800 for family coverage, and the annual out-of-pocket expenses (deductibles, co-payments, and other amounts, but not premiums) do not exceed $7,000 for self-only coverage or $14,000 for family coverage.

If an employer provides high deductible health plan coverage coupled with an HSA and makes employer contributions to the HSA, the employer must make available a comparable contribution on behalf of all employees with comparable coverage. However, an exception to the comparability rules enables employers to make larger HSA contributions for non-highly compensated employees (NHCEs) than for highly compensated employees (HCEs) (as defined in IRC Section 414(q)). The rule provides that HCEs are not treated as comparable participating employees for purposes of applying the comparability rules to an employer's contributions for NHCEs.[64]

Contributions are considered comparable if they are either of the same dollar amount or the same percentage of the deductible under the high deductible plan. The comparability rule is applied separately to part-time employees (that is, employees who are customarily employed for fewer than 30 hours per week). No restrictions are placed on the ability of the employer to offer different plans to different groups of employees.

.03 Archer Medical Savings Accounts

Archer medical savings accounts (MSAs) were a precursor to HSAs, designed for employees of small employers and self-employed individuals.[65]

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[64] IRC Section 4980G(d).

[65] IRC Section 220.

Like an HSA, an MSA is a tax-exempt trust or custodial account that is set up to pay medical expenses in connection with a high deductible health plan. Contributions to the account are deductible or excludable from an employee's income if made by an employer, and amounts in the account can be withdrawn tax-free to pay for out-of-pocket medical expenses. Amounts withdrawn for other purposes are taxable and subject to a 20% penalty, unless the withdrawal is made after death, disability, or Medicare eligibility.

Only self-employed individuals and employees of small employers (generally, those with 50 or fewer employees) are eligible to establish MSAs.

MSAs were a pilot project that expired at the end of 2007. No new MSAs are currently permitted; however, pre-existing qualifying MSAs remain eligible for tax benefits.

For 2020, the high deductible health plan supporting an MSA must have an annual deductible of not less than $2,350 and not more than $3,550 in the case of self-only coverage or not less than $4,750 and not more than $7,100 in the case of family coverage. Annual out-of-pocket expenses cannot exceed $4,750 for self-only coverage or $8,650 for family coverage.[66] For individuals with self-only coverage, the maximum annual contribution is 65% of the deductible under the self-only high deductible plan; the maximum is 75% of the deductible for individuals with family coverage.

An employee can make contributions to his or her own MSA, or contributions may be made by the employer sponsoring the high deductible plan, but not by both.

As with HSAs, an employer that makes MSA contributions on behalf of employees must make comparable contributions for all employees with comparable coverage. Unlike an HSA, an MSA does not have a $1000 make-up contribution opportunity for persons over age 55.

.04 Long-Term Care Insurance

Qualified long-term care insurance for chronically ill individuals is treated as an accident and health insurance contract.[67] Amounts received under contracts issued after December 31, 1996, are generally excludable from gross income as amounts received for personal injuries and sickness. The excludable amount is capped at a rate of $380 per day for 2020 on per diem contracts.[68] This amount is indexed for inflation. Employer-provided long-term care insurance premiums are not excludable from an employee's income if provided through a cafeteria or other flexible spending arrangement.[69]

The deduction for 100% of health insurance expenses of self-employed individuals[70] applies to the portion of long-term care insurance premiums that would otherwise be deductible as medical expenses under IRC Section 213(d)(10) based on the taxpayer's age. The portion of long-term care insurance

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[66] Revenue Procedure 2019-25.

[67] IRC Section 7702B(a)(1).

[68] IRC Section 7702B(d)(2).

[69] IRC Section 106(c).

[70] IRC Section 162(1)(2)(c).

premiums that would otherwise be deductible as a medical expense may be paid from an Archer medical savings account or a health savings account.[71]

Premiums paid for a qualified long-term care insurance contract are a medical expense, but the amount of the deductible premium is determined by the age of the insured individual at the end of the tax year. For 2020, the inflation-adjusted annual maximum deductible amounts are as follows:

- Age 40 or younger, $430
- Over age 40, but not older than age 50, $810
- Over age 50, but not older than age 60, $1,630
- Over age 60, but not older than age 70, $4,350
- Over age 70, $5,430

These amounts may be deducted by self-employed individuals as medical insurance that may be claimed as a deduction from gross income to AGI.

¶3425 Interest

Various restrictions and limitations apply to deductions for interest. Personal interest (for example, on car loans and credit cards) is not deductible.[72] Interest due on IRS deficiencies is considered personal interest.

Qualified residence interest[73] is deductible subject to certain limitations on the amount of the loan, as discussed in ¶3440. Qualified residence interest is interest on debt secured by a qualified residence. A qualified residence includes the taxpayer's principal residence and a second residence of the taxpayer.[74] Subject to a grandfather rule, qualified residence interest includes interest on acquisition indebtedness up to a maximum amount of $1 million ($500,000 for married individuals filing separately) for loans incurred prior to December 15, 2017, and $750,000 for loans incurred after that date, as a result of changes made by the TCJA.[75]

The TCJA suspended the home equity loan interest deduction (through 2025). Interest on home equity indebtedness is deductible after 2017, but only if the debt is incurred for the purchase, refinancing, or improvement of a qualified residence, and is included in the $750,000 cap. Acquisition debt is debt incurred when acquiring, constructing, or substantially improving a principal or second residence

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[71] IRC Section 220(d)(2)(B); IRC Section 223(d)(2)(C)(ii).

[72] IRC Section 163(h).

[73] IRC Section 163(h)(3).

[74] IRC Section 163(h)(4)(A).

[75] IRC Section 163(h)(3)(B).

(including a boat with cooking, sleeping, and toilet facilities).[76] Acquisition indebtedness is reduced as the debt principal is paid down and cannot be increased by refinancing. Pre-October 13, 1987, mortgage debt on a first or second residence is treated as acquisition debt not subject to the $1 million limit, but it reduces the $1 million (or $750,000 depending on when the debt was incurred) limit on new acquisition debt. In the case of unmarried co-owners of a qualified residence, the debt limit provisions apply on a per-taxpayer basis rather than on a per-residence basis in determining the amount of the allowable interest deduction under IRC Section 163(h) (*Voss v. Commissioner*, 796 F. 3d 1051 (9th Cir. 2015). For a more detailed discussion of home financing, see ¶2810.

Prepaid interest for periods beyond the taxable year is not currently deductible.[77] There is, however, an exception for "points" paid by a homeowner in connection with a mortgage to finance the purchase or improvement of a principal residence. The points are deductible in the year paid and need not be deducted ratably over the period of the loan.[78] If the seller assumes payment of points, the seller may deduct the amount paid from the sum realized on the sale, but may not take an interest deduction. However, when the seller pays points on a loan for the buyer to acquire a principal residence, the buyer may deduct the points as long as the buyer treats the points paid by the seller as a reduction in the buyer's basis of the residence.[79] The exception allowing the deduction for points paid generally does not apply to points paid when refinancing a mortgage unless the proceeds are used for improvements. Also, the exception does not apply to points paid in connection with loans on a second residence or with respect to rental property. In such cases, the points are usually deducted ratably over the period of the new mortgage (see ¶2815 for a discussion). If the mortgage is paid off before its term, the remainder of the points may then be deducted.

Interest on investment debt is deductible only to the extent of net investment income (investment income net of investment expenses other than interest).[80] A client could consider buying stock on margin and receive a deduction for the margin interest up to the amount of the client's investment income. The components of net investment income include only taxable interest, nonqualified dividends, net short-term capital gains, annuities, and royalties. Note that qualified dividends and long-term capital gains are not included in this "net investment income" definition.

Planning Pointer. Nondeductible personal interest can no longer be converted into deductible interest through a home equity loan.

¶3430 Bad Debts

When lending to a relative or friend, a taxpayer should observe loan formalities. The taxpayer should get a note, charge reasonable interest, and fix a due date. These elements are important for establishing the

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[76] IRC Section 163(h)(3)(B).

[77] IRC Section 461(g)(1).

[78] IRC Section 461(g)(2).

[79] Revenue Procedure 94-27 1994-1 CB 613.

[80] IRC Section 163(d). File Form 4952.

basis for a bad-debt deduction if the loan is not repaid and also avoiding having the transaction treated as a taxable gift.

If it is a nonbusiness loan that is not repaid, it will be treated as a short-term capital loss.[81] The nonbusiness bad debt is deductible in the tax year in which it becomes worthless,[82] only up to the amount of net capital gains plus up to $3,000 of ordinary income.[83] The timing of a worthless debt declaration may be an item of contention with the IRS. Proof of the debtor's inability or refusal to pay should be obtained. This may require a formal demand for payment from the debtor.

¶3435 Financial Planning, Tax Advice, and Tax-Related Expenses

Prior to 2018, expenses incurred in connection with tax matters were generally deductible as a miscellaneous itemized deduction[84] to the extent that the total miscellaneous itemized deductions exceeded 2% of AGI.[85] The TCJA suspended the deduction for miscellaneous itemized deductions through 2025. However, expenses for tax advice and preparation related to a business are deductible as business expenses. The costs of tax advice and preparation fees related to rental and royalty property remain deductible against the rental and royalty income.[86]

Financial planning fees and fees paid for investment advice are miscellaneous itemized deductions, and are no longer deductible after 2017. In some cases, such fees may be added to the cost basis of the investment property. However, clients with a business, farm, or rental property receive the benefit of continuing to deduct tax and financial planning advice related to those activities against the income from such activities, using Schedules C, E, and F of Form 1040, rather than claiming these expenses on Schedule A as the no-longer-allowed miscellaneous itemized deductions.

Expenses that were allowed as miscellaneous itemized deductions after applying the 2% of AGI floor were treated as items of tax preference and subjected to the AMT. With the repeal of the deduction for miscellaneous itemized deductions, there will be fewer preference items to include in the AMT calculation.

¶3440 Repeal of the Limitation on Deductions for Itemized Expenses

The TCJA repealed the overall limitation on itemized deductions through 2025. All miscellaneous itemized deductions subject to the 2% floor under prior law are repealed through 2025 by the act.

Prior to 2018, IRC Section 68 imposed an overall limitation on the amount of allowable itemized deductions (not including the deductions for medical expenses, investment interest, casualty losses, and

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[81] IRC Section 166(d)(1).

[82] IRC Section 166(d)(1).

[83] IRC Section 1211(b).

[84] IRC Sections 212 and 67(b).

[85] IRC Section 67(a).

[86] Revenue Ruling 92-29, 1992-1 CB 20.

wagering losses to the extent of wagering income). This was the so-called "Pease limitation." When applicable, itemized deductions were reduced by 3% of AGI in excess of a threshold amount. The TCJA suspended this limitation effective for 2018–2025.

¶3445 Employment Tax

A maximum wage/earnings base applies to the old age, survivors, and disability insurance (OASDI) portion of the Social Security tax. For 2020, the maximum wage/earnings base subject to the 6.2% OASDI portion of the Social Security tax (which employer and employee each must pay) is $137,700. No ceiling exists on the Medicare hospital insurance (HI) portion of the Social Security tax. Thus, employers and employees each must pay 1.45% HI tax on every dollar of wages, plus employees and self-employed workers may pay an additional 0.9% Medicare tax as described in the text that follows.

Self-employed taxpayers pay 12.4% for the OASDI portion of the self-employment tax. The amount subject to the tax is the lesser of 92.35% of the net business income[87] or the maximum wage base. The base for the HI portion of the tax is 92.35% of the net business income with no ceiling. Self-employed individuals pay 2.90% in HI on this amount. Self-employed taxpayers are allowed an above-the-line income tax deduction for one-half of the self-employment taxes paid.[88] There is an additional 0.9% Medicare tax imposed on the self-employment income of certain taxpayers described in the text that follows. No part of this additional Medicare tax may be deducted by a self-employed person.

> **Example 34.2.** In tax year 2020, Mary McNicoll, a self-employed single person, has $200,000 of Schedule C income. Assume she has no other 2020 income.
>
> Mary pays $21,835.90 in self-employment tax (taking into account that the 2020 OASDI wage/earnings base is $137,700). The net amount subject to tax on Schedule SE is $184,700 ($200,000 × .9235). Of that amount, $137,700 is subject to the OASDI portion ($17,074.80), and the entire $184,700 × .029 is subject to the HI portion ($5,356.30). Mary may deduct $11,215.55 (half of $22,431.10) from her gross income to arrive at AGI.

The additional 0.9% HI tax imposed upon the wages and self-employment income of working persons is imposed on single persons with earned income over $200,000, married persons filing jointly with modified AGI over $250,000, and married persons filing separately with earned income over $125,000. These thresholds are not indexed for inflation. There is no employer portion of this additional tax. It is all imposed on the employee or self-employed worker; hence, no part of it is deductible by self-employed persons.

The HI paid can also affect a high-earning self-employed person's Keogh or SEP contribution. Half of the Schedule SE self-employment tax is subtracted from earned income to arrive at the net earned income base against which the Keogh and SEP contribution rates are applied.

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[87] IRC Section 1402(a)(12).

[88] IRC Section 164(f).

There may be some opportunity to avoid these higher taxes by operating as an S corporation and setting one's salary at the low end of the range of acceptable salaries. However, an S corporation shareholder/employee may not avoid all employment taxes by receiving all payments as dividends.[89]

Another way to reduce the self-employment tax is to purchase equipment and take the maximum deductions allowed under IRC Sections 179 (first year depreciation) and IRC Section 168(h) (bonus depreciation).

¶3450 Adoption Credit and Exclusion

.01 Credit for Adoption Expenses

IRC Section 23 allows taxpayers a nonrefundable tax credit for each eligible child of up to $14,300 in 2020 for qualified adoption expenses, including reasonable and necessary adoption fees, court costs, adoption expenses, and other expenses directly related to the adoption of an eligible child. This amount is indexed for inflation. This same amount ($14,300) is allowed for the adoption of a special needs child, regardless of actual adoption expenses. An eligible child is a child less than 18 years old or an individual who is mentally or physically incapable of self-care.[90]

In 2020, the credit for adoption expenses is phased out for taxpayers with modified AGI between $214,520 and $254,520.[91] The credit is nonrefundable.

The adoption credit is one of the nonrefundable personal credits in 2020 that is fully allowed against the taxpayer's combined regular tax and AMT liability.[92]

.02 Exclusion for Adoption Expenses

An employee's gross income does not include amounts paid by an employer (up to $14,300) for the employee's qualified adoption expenses pursuant to an adoption assistance program.[93] The income phase-out here applies the same rules applicable to the preceding credit for adoption expenses. An employee may not receive a double benefit by excluding adoption expenses paid by an employer and taking a credit based on the same amount.[94]

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[89] Revenue Ruling 74-44, 1974-1 CB 287.

[90] IRC Section 23(d)(2).

[91] IRC Section 23(b)(2).

[92] IRC Section 26(a)(1).

[93] IRC Section 137.

[94] IRC Section 23(b)(3).

Chapter 35

Social Security Benefits, Medicare, and Medicaid

¶3501 Overview

This chapter addresses the benefits and rules of Social Security, Medicare, and Medicaid. As baby boomers retire and the overall population ages, financial planners will find an increasing portion of their practices addressing retirement, eldercare, and government entitlement program issues.

Planning Pointer. For important information on how to help your clients with Social Security strategies unique to the pandemic, access personal financial planning resources at aicpa.org/pfp/COVID19.

¶3505 Tax Planning for Social Security Benefits

In order to be eligible for Social Security benefits, a person must have 40 credits. A maximum of 4 credits may be earned in any 1 year. To qualify for a credit in 2020, a person must earn $1,410. The maximum for the year to earn 4 credits is $5,640 of earnings, either as an employee or as a self-employed person. This is adjusted every year by cost-of-living factors. A person must have 40 credits to be fully insured under Medicare, as well.

Under complex Social Security income inclusion rules, some taxpayers must pay tax on 85% of their Social Security benefits.[1] Many benefit recipients, however, are able to exclude all their Social Security benefits from their gross income or pay tax on only half their benefits. These rules drastically increase the marriage penalty for retired couples who are both receiving Social Security benefits.

The rule including 85% of Social Security benefits applies only to those with "provisional income" in excess of $44,000 for joint filers, $0 for a married individual filing separately who does not live apart from his or her spouse for all of the tax year, or $34,000 for all other filers.[2] For most people, provisional income is AGI plus tax-exempt interest, plus one-half of Social Security benefits.[3] These numbers are not adjusted for inflation.

Mechanically, the inclusion rules for Social Security benefits are built on two tiers. The following discussion explains how the rules work for taxpayers other than married persons filing separately who do not live apart from their spouses for the entire year.

.01 First Tier

The rules requiring 50% inclusion of Social Security benefits in gross income apply to those recipients whose provisional income bases are within the following dollar ranges: above $25,000 but not above $34,000 for unmarried taxpayers and above $32,000 but not above $44,000 for married persons filing jointly.[4] For such taxpayers, the maximum amount of Social Security benefits included in gross income is the lesser of (1) 50% of the benefits or (2) 50% of the excess of the provisional income base over the applicable threshold amount ($25,000 or $32,000).

.02 Second Tier

For those who have provisional income bases above $34,000 or $44,000 (as appropriate), gross income includes the following:

- The smaller of
  - — the amount of benefits included in the first tier, or
  - — $6,000 for married persons filing jointly or $4,500 for other taxpayers, plus
- 85% of the excess of the taxpayer's provisional income base over $44,000 for married persons filing jointly or $34,000 for other taxpayers.

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[1] IRC Section 86.

[2] IRC Sections 86(c)(1)(C) and 86(c)(2).

[3] IRC Section 86(b).

[4] IRC Section 86(c).

However, for recipients who fall in the second tier, the amount subject to tax is capped at 85% of the Social Security benefits. Note that the amounts of the provisional income bases are not indexed for inflation.

.03 Married Persons Filing Separately

Taxpayers receiving Social Security who are married at the close of a tax year, file separate returns, and did not live apart from their spouses for the entire year pay tax on 85% of each and every Social Security benefit dollar (or 85% of provisional income, if that is less). In *T.W. McAdams*,[5] the U.S. Tax Court ruled in a case of first impression that living apart means living in separate residences, not merely in separate bedrooms.

.04 Higher Inclusion Has Variable Effect

Social Security recipients with provisional income in excess of $44,000 or $34,000 (as appropriate) include more than 50% of their Social Security benefits in gross income. Depending on income and benefit levels, some pay tax on more than 50% but less than 85% of their benefits. Others pay tax on a full 85% of their benefits.

> **Example 35.1.** Each year, Mr. and Mrs. David English have $40,000 of income from pensions, dividends, and tax-exempt securities and receive $12,000 of Social Security benefits, producing a provisional income base of $46,000 ($40,000 + $6,000).
>
> As a result, $7,700 of their benefits is taxed (roughly 64%). The couple's income is not high enough for the 85 percent-of-benefits cap to come into play.
>
> **Example 35.2.** Each year, Mr. and Mrs. John Bates have $50,000 of income from pensions, dividends, and tax-exempt bonds and receive $14,000 of Social Security benefits. They have provisional income of $57,000 ($50,000 + $7,000).
>
> As a result, $11,900 of their Social Security income is taxed, which is a full 85% of their benefits.

.05 Marriage Penalty Impact

Some Social Security recipients will pay a very high price if they marry instead of living together.

> **Example 35.3.** Assume the same facts as in example 35.2, except that Mr. John Bates and Ms. Rose Piccoli live together, instead of being married, and each has exactly half their combined income. Thus, each has $25,000 of income from pensions, dividends, and tax-exempt bonds and $7,000 of Social Security income.
>
> As a result, the amount of Social Security income subjected to tax is $1,750 for each person and a total of $3,500 for both. This amount is roughly 70% less than the $11,900 of Social Security benefits that would be subject to tax if they were married.

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[5] 118 T.C. 373 (2002).

.06 Social Security Recipients Who Work Part-Time

For Social Security recipients under normal retirement age (age 62 to age 67 depending on date of birth), part-time, supplemental earnings may reduce benefit levels and cause more of what is left to be exposed to tax. For example, under the Social Security earnings test that applies to retirees under normal retirement age, a person can earn $18,240 ($1,520 per month) in 2020 without having benefits reduced. Beyond that dollar level, however, one dollar is deducted from benefits for every two dollars earned over the exempt amount (see ¶3530 for further details). Taking into consideration reduced benefits, a higher income inclusion on Social Security benefits that are paid, FICA taxes, and income taxes, a part-time earner who takes on more work could wind up losing a significant portion of his or her pay increase.

Example 35.4. Jeff Solomon is a single 63-year-old who has $10,000 of salary from a part-time job, $16,940 of income from pensions and investments, and $7,000 of Social Security benefits. Jeff has been asked to work more hours at his part-time job in exchange for $9,000 more in pay. The year is 2020.

If Jeff declines the offer from his employer, he will have provisional income of $30,440 ($10,000 + $16,940 + 50% of $7,000). He will include $3,500 of his Social Security benefits in income. Assuming Jeff is in the 15% tax bracket, he will pay $525 in tax on his benefits.

If Jeff works more hours at his part-time job and is paid an additional $9,000, about 29.64% (9,000 – 6332.50 = 2667.50/$9,000) of the extra pay will be lost to taxes and benefit reductions.

Gross pay boost	$9,000.00
Reduction in benefits ($19,000 − $17,640) × 50%	(680.00)
FICA on $9,000 extra (7.65%)	(688.50)
Income tax on $9,000 of earnings (at 15%)	(1,350.00)
Income tax saved on reduced benefits ($680 × 50% × 15%)	51.00
Net	$6,332.50

.07 Practice Aid for Calculating the Taxable Portion of Social Security Benefits

The following worksheet shows how taxpayers other than married persons filing separately will compute the taxable portion of their Social Security benefits.[6]

FIRST TIER

1.	50% of Social Security benefits	_____
2.	MAGI (generally AGI plus tax-exempt income)	_____
3.	Total of Lines 1 and 2 — Provisional income	_____
4.	Less $32,000 (joint filers) or $25,000 (all others)	_____

[6] Married persons filing separate returns who did not live apart from their spouses for the entire year pay tax on the lesser of (1) 85% of each and every Social Security benefit dollar or (2) 85% of provisional income.

5.	Income over base	_____
6.	50% of Line 5	_____
7.	50% of Social Security benefits	_____
8.	Enter smaller of Line 6 or 7	_____
	If Line 3 does not exceed $44,000 (joint filers) or $34,000 (other taxpayers), Line 8 amount = portion of Social Security benefit includible in gross income	_____
	If Line 3 exceeds $44,000 (joint filers) or $34,000 (other taxpayers), continue with Line 9	_____
SECOND TIER		
9.	Enter smaller of Line 8 or $6,000 (married persons filing jointly) or $4,500 (other taxpayers)	_____
10.	85% of Line 3 less $44,000 (joint filers) or $34,000 (other taxpayers)	_____
11.	Line 9 plus Line 10	_____
12.	85% of Social Security benefits	_____
13.	Lesser of Line 11 or 12 = portion of Social Security benefit includible in income	_____

.08 Strategies for Dealing with Taxes on Benefits

Retired people who are affected by the tax on Social Security benefits, especially those subject to the 85% inclusion rules, may be able to reduce their exposure by using the following techniques. However, taxes should never be the sole motivating factor behind any investment decision.

- Switching funds into investments that pay monthly checks that include a tax-free return of capital component. Annuities are prime examples of such investments. That part of each annuity payment representing the return of the purchaser's investment is not currently taxed and is not factored into the Social Security income inclusion. By contrast, interest (tax-free or not) and dividends directly affect the amount of Social Security income that is taxed.

- For those who are not spending all their investment income for living expenses, deferral techniques might make sense. For example, Series EE and Series I bonds provide tax deferral. The interest buildup in a Series EE or Series I bond is not taxed until the bondholder redeems or elects to report it. Another alternative that may be appropriate would be moving some cash from income funds into growth funds.

- When retirees have a choice, they should consider withdrawing interest from their municipal bond funds before withdrawing cash from IRAs for living expenses. This strategy is helpful because municipal bond fund interest is taken into account in computing the tax on Social Security benefits, regardless of whether it is withdrawn, but interest accruing in an IRA is not. In addition, usually, withdrawing cash from non-IRA accounts before dipping into the IRAs will provide more tax benefits. Withdrawals of the principal from a money market account or mutual fund are not taxed (only the interest or dividend earnings are included in income). By contrast, each dollar withdrawn from a traditional IRA is included in gross income (unless the taxpayer made nondeductible contributions).

- Retirees should try to avoid selling appreciated assets because a large profit could subject a full 85% of their Social Security benefits to tax, or time the sale of appreciated assets to take place before applying for Social Security benefits.

- Consider converting a traditional IRA to a Roth IRA before applying for Social Security benefits so that withdrawals (if any) from the Roth IRA are not included in AGI.

.09 Lump-Sum Social Security Benefits

Prior to changes made by the Bipartisan Budget Act of 2015, a taxpayer could have incurred a substantial tax liability if the taxpayer received a large lump-sum payment of Social Security benefits in a single year that the taxpayer should have received over several years. In many cases, this delayed application for benefits was intentional; the taxpayer was either trying to time the receipt of benefits in an otherwise low-income year or trying to await an older age to receive benefits to gain a higher payment. This strategy is no longer permitted. A person now receives the benefit he or she is entitled to when the claim for benefits is made. No retroactive lump sum is available. This issue is discussed further in ¶3535 that follows.

.10 Social Security Benefits in Lieu of Workers Compensation Benefits

Workers compensation benefits are generally excluded from gross income.[7] However, to the extent that workers' compensation benefits reduce Social Security benefits, the workers' compensation benefits will be taxable as Social Security benefits.[8]

¶3510 Medicare

Medicare is a federal health insurance program primarily designed for individuals entitled to Social Security who are age 65 or older (although younger individuals can also qualify; for example, those receiving Social Security disability and those with end-stage renal disease). One may obtain more information about Medicare by calling (800) MEDICARE (633-4227) or by visiting the Medicare website at www.medicare.gov. It is important to enroll in a timely manner. Persons turning 65 have a 7-month window (3 months before reaching age 65, 3 months after, and the month in which their birthday falls). Later enrollment may result in the imposition of substantial penalties on Part B and Part D premiums that will last for the remainder of the person's lifetime. If a person is an employee (but not a self-employed person) covered by a "credible" health insurance plan maintained by an employer with at least 20 employees, enrollment can be delayed until retirement without incurring a late enrollment penalty. Self-employment insurance and COBRA coverage do not avoid the penalties for late enrollment.

Planning Pointer. For important information on how Medicare benefits have changed due to COVID-19, access personal financial planning resources at aicpa.org/pfp/COVID19.

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[7] IRC Section 104(a)(1).

[8] IRC Section 86(d)(3).

.01 In General

Basic Medicare consists of two parts. Part A covers inpatient hospital services and services furnished by other institutional health care providers, such as skilled nursing homes, home health agencies, and hospice care. Part B is a voluntary insurance program and covers the services of doctors, suppliers of medical items and services, and various types of outpatient services.

Certain items and services are excluded from coverage under both parts. Also, services that involve custodial care (that is, the type of services normally associated with long-term care patients, such as observation and help with daily living activities, and nursing) are not covered. In addition, services determined by Medicare not to be reasonable are not covered.

The patient must pay a portion of the cost of some covered services because of deductible and coinsurance requirements.

Medicare Part C (Medicare Advantage Plans), managed by private insurance companies, combines Medicare Parts A and B (and sometimes Part D) coverage.

Medicare Part D (Medicare Prescription Drug Coverage) is a voluntary program that helps cover the cost of prescription drugs.

> **Note**: If a person is covered by Medicare, the person is deemed to have adequate health care coverage under the Affordable Care Act. There is no requirement to purchase a health insurance policy on an exchange, and no penalty is due.

.02 Enrollment

Part A coverage is automatically provided without charge for persons entitled to Medicare because they, or a spouse, had 40 or more quarters (credits) of Medicare-covered employment. Eligibility is based on entitlement to Social Security or Railroad Retirement benefits. Part B coverage, however, must be paid for through monthly premiums. For 2020, the standard premium for Part B Medicare subscribers is $144.60 per month. For 2020, higher Part B premiums apply to individuals with AGI above $87,000 on a single return or $174,000 on a joint return. This is referred to as an *IRMAA adjustment* (income-related monthly adjustment amount).

For 2020, the monthly premium for a single individual with income in the $87,001 to $109,000 range is $202.40; a single person with income between $109,001 and $136,000 pays $289.20 per month; a single person with income between $136,001 and $163,000 pays $376.00 per month; a single person with income between $163,000 and $500,000 pays $462.70 per month; and a single person with income over $500,000 pays $491.60 per month.

For joint filers with income in the $174,001 to $218,000 range, the monthly premium is $202.40 for 2020; joint filers with income between $218,001 and $272,000 pay $289.20; joint filers with income between $272,001 and $326,000 pay $376.00, joint filers with income between $326,001 and $750,000 pay $462.70; and joint filers with income over $750,000 pay $491.60 per month.

Note that beginning in 2018, the IRMAA adjustments were recomputed and changed (narrowed) to require more people at various levels of income to pay higher Part B premiums.

The Social Security Administration will generally use income from the second preceding year when determining the current year's premium. For example, the income reported on a 2018 tax return is used to determine the monthly Part B premium for 2020. An individual whose income has decreased since that year can request that the income from a more recent tax year be used to determine the premium, but they must meet certain criteria. Accordingly, to avoid potentially higher Medicare premiums in 2020, income planning must have been addressed for 2018 income.

Persons not automatically entitled to Medicare can voluntarily enroll in the program if they pay a monthly Part A premium and also enroll in Part B. The Part A monthly premium is $458 for 2020 but is reduced to $252 for persons with 30–39 quarters (credits) of Social Security coverage or for persons married or formerly married to such a person for certain lengths of time.

.03 Part A Coverage and Limitations

Here is a brief summary of Part A coverage and limitations.

Covered services. Part A covers most hospital services, including the following items and services furnished to an individual admitted to a hospital as an inpatient:

- Room and board
- Drugs and biologicals
- Supplies, appliances, and equipment
- Diagnostic and therapeutic items and services
- Nursing services
- The services of staff doctors not directly related to the personal treatment of individual patients
- The services of all interns, residents, and teaching physicians

Part A also covers certain home health services and hospice care.

Part A covers generally the same inpatient services provided in a participating skilled nursing facility as it covers in a hospital. However, the services must be skilled nursing services and not merely custodial care.

Limitations — Inpatient hospital stays. Part A is limited in terms of how long the program will pay for services, and it requires beneficiaries to share some of the costs. For example, inpatient hospital coverage expires after 90 days of benefits have been used per benefit period (although the beneficiary has an additional 60 "lifetime reserve days" that can be used only once.) *A benefit period* is a period of consecutive days that begins with a hospitalization and ends when the patient has not been an inpatient for 60 consecutive days. A benefit period is sometimes referred to as a *spell of illness*.

Beneficiaries must pay a separate inpatient hospital deductible for each benefit period. The deductible is $1,408 for 2020. There are also coinsurance requirements. There is a per-day coinsurance charge for inpatient hospital stays of more than 60 days in the same benefit period. The 2020 charge is $352 per day for the 61st day through the 90th day of an inpatient hospital stay (there is no coinsurance for the first

60 days) and $704 per day if lifetime reserve days (days 91–150) are used. There is no coinsurance beyond 150 days (that is, the patient is responsible for all the costs).

If a person is discharged from a hospital, remains out of the hospital for at least 60 days, and then is readmitted to the hospital, a new benefit period begins (that is, the first 60 days of such new period costs the patient $1,408 in 2020, and the "lifetime reserve days" are not counted here). If the patient is discharged and then readmitted to the hospital within 60 days, a new period does not begin (that is, there is not a new spell of illness, and the number of days used continues from the number of days reached where the previous hospital stay left off).

Skilled nursing home stays. For stays in a skilled nursing home to be covered by Medicare, the patient must have spent at least three consecutive days in a hospital, be admitted to the nursing home within 30 days after having been discharged from the hospital, and require skilled nursing care, as distinguished from custodial nursing care. *Skilled nursing care* refers to the daily availability and treatment by skilled medical personnel or physical, speech, or occupational therapists. There must also be a physician certification of need.

Skilled nursing care. A patient is deemed to be receiving *skilled nursing care* if he or she requires nursing or rehabilitation services such as intravenous or intramuscular injections and intravenous feeding; insertion and sterile irrigation and replacement of catheters; therapeutic activities or maintenance therapy, when necessary, based on the needs, capability, and tolerance of the beneficiary. Whether skilled nursing care is required for the patient is often a subject of controversy and litigious appeal.

Medicare will pay in full for this care for the first 20 days of each benefit period. From days 21–100, the patient must pay coinsurance of $176.00 (2020) per day (a total of $14,080). After 100 days, the patient pays the entire cost. The 100 days of skilled nursing home coverage are renewable if there is a break of at least 60 days between the patient's discharge from a skilled nursing facility and his or her readmission to such a facility.

Medicare will pay for skilled nursing care services such as the following

- A bed in a semi-private room
- All meals, including special diets
- Regular nursing services
- Drugs furnished by the skilled nursing facility
- Medical supplies
- Physical, occupational, and speech therapy
- Use of appliances
- Medical social services
- Most blood transfusions

Home health visits. Medicare Part A will cover the cost of the first 100 medically necessary home health visits for patients who are confined to the home and require intermittent skilled nursing care; physical, speech or occupational therapy; medical supplies; and medical social services under the direction of a physician. Such requirement must be prescribed by a physician and evaluated by a Medicare-certified home health agency.

Medicare will cover up to 35 hours per week of such visits. Performance of general household chores, such as shopping or meal preparation, is not covered under these rules. Neither are payments for assistance with the activities of daily living, such as bathing and dressing.

Part-time or *intermittent services* are defined as the combined services of less than 8 hours each day and 28 or fewer hours a week, or less than 8 hours each day and less than 35 hours a week determined on a case-by-case basis. *Intermittent* is defined as skilled nursing care on fewer than 7 days each week or less than 8 hours each day for periods of 21 days or less, with extensions allowed in exceptional circumstances when the need for additional care is finite and predictable.

Hospice care. Medicare Part A will cover hospice care for the *terminally ill*, defined as persons having less than 6 months to live. Medicare covers two 90-day periods of hospice care and an unlimited number of additional periods of 60 days each, but the patient must be certified as terminally ill at the beginning of each period. The beneficiary must elect the hospice care, which limits the availability of Medicare coverage for aggressive health services for conditions related to the terminal illness. If hospice care is chosen, the beneficiary may receive both home and inpatient care.

.04 Part B Service and Limitations

Part B coverage is defined in terms of which specific services are involved. Only those services specifically listed as covered will be paid by Medicare, although some of the listed services are quite broad in scope. Not all the covered services are listed here; however, *covered services* include such items as the following:

- Physicians' services, including wellness checkups
- Drugs that cannot be self-administered, such as the flu vaccine
- Outpatient services
- Therapy services
- Diagnostic tests

Many items are specifically excluded (for example, eyeglasses and hearing aids, most dental work, and personal comfort items).

Medicare Part B also provides numerous preventive services. Medicare covers bone mass measurements once every 24 months for qualified individuals and more often if medically necessary. The individual's physician can determine if the individual is a qualified individual. Medicare also covers several different kinds of colorectal cancer screenings for covered individuals age 50 and older. (Note that most people are not eligible for Medicare coverage until attaining age 65, absent a prior disability). These screenings include a fecal occult blood test once every 12 months and a flexible sigmoidoscopy once every 48 months. Medicare covers a colonoscopy for covered individuals, regardless of age, once every 24

months for individuals at high risk for colon cancer or once every 10 years for other individuals, as long as the colonoscopy is not within 48 months of a screening flexible sigmoidoscopy. A physician may use a barium enema instead of a flexible sigmoidoscopy or a colonoscopy. Medicare also covers glucose monitors, test strips, and lancers for covered individuals with diabetes. Certain individuals with diabetes are also eligible for diabetes self-management training. Medicare covers a glaucoma screening once every 12 months for covered individuals who are at high risk for glaucoma. Medicare covers a mammogram screening once every 12 months for women age 40 and over. In addition, Medicare allows one baseline mammogram between ages 35–39 if the woman is covered by Medicare. All women with Medicare may receive a Pap test and pelvic examination once every 24 months. These preventive exams are allowed once every 12 months for women who are at high risk for cervical or vaginal cancer or if the woman is of childbearing age and has had an abnormal Pap test in the previous 36 months. Medicare covers a prostate cancer screening, including a digital rectal examination and a prostate specific antigen (PSA) test once every 12 months for all covered men age 50 and older. Medicare covers an annual flu shot in the fall or winter for all covered individuals. In addition, Medicare covers one pneumonia shot and allows a Hepatitis B shot for certain covered individuals who are at medium to high risk for Hepatitis B.

Part B has deductible and coinsurance requirements for most covered items. For example, the deductible is $198 per year (for 2020), and the coinsurance is generally 20% of the Medicare-approved charge.

.05 Medicare Part C

Medicare Part C or Medicare Advantage Plans are available to Medicare beneficiaries who are entitled to Part A and enrolled in Part B. Medicare Advantage Plans are plans run by private companies that provide all Medicare Part A and Part B benefits. These plans include health maintenance organizations (HMOs), preferred provider organizations (PPOs), private fee-for-service plans, or Medicare medical savings account plans. Part C plans may include vision, hearing, and dental benefits not otherwise provided by the other parts of Medicare. Fees, covered services, and choice of providers varies from one plan to another.

The enrollment criteria for Medicare Advantage Plans are as follows:

- The individual must be enrolled in Part B and continue to pay the Part B premium.
- The individual must live in the plan’s service area.
- The individual cannot have permanent kidney failure.

An eligible individual may join a Medicare Advantage plan when he or she first becomes eligible for Medicare. An eligible individual can switch to a Medicare Advantage plan during open enrollment from October 15 through December 7 of each year. If an individual enrolls during that period, the coverage becomes effective on January 1 of the next year. An individual can also join or switch Medicare Advantage plans from January 1 to March 31 of any year (but cannot drop existing prescription drug coverage during that period).

.06 Medicare Part D Prescription Drug Coverage

All Medicare beneficiaries are eligible for Medicare Part D prescription drug coverage. In selecting a Part D plan, it is important to review the “formulary”(the drugs that will be covered by the plan). All plans are not identical in the specific drug coverage that they provide.

There are two ways to obtain Medicare prescription drug coverage. A beneficiary can join a Medicare prescription drug plan directly or enroll in a Medicare Advantage plan that offers prescription drug coverage. Beneficiaries must pay a monthly premium, which varies by plan, and a yearly deductible (no more than $435 in 2020). Higher income Part D participants pay a higher monthly premium if they are single persons with AGI over $85,000 or married persons filing jointly with AGI over $170,000. Beneficiaries must also pay a part of the cost of prescriptions, including a copayment or coinsurance. Costs will vary depending on the drug plan selected. Some plans may offer more coverage and additional drugs for a higher monthly premium. Beneficiaries with limited income and resources may qualify for extra help and may not have to pay a premium or deductible. Once a beneficiary reaches the Part D initial coverage limit of having paid 25% of the cost of prescription drugs up to $4,020 for 2020, there is a coverage gap (the so-called "doughnut hole"), when the beneficiary pays a substantial percentage of the cost of prescription drugs until the beneficiary has spent $6,350 (for 2020) on drug charges. Thereafter, the beneficiary is in the "catastrophic coverage" area, when there are modest co-payments for generic and brand name drugs. The beneficiary in the "doughnut hole" should receive a discount on brand name and generic drugs. In 2020, anyone reaching the "doughnut hole" will receive a 75% discount on the cost of brand name drugs. In 2020, the maximum copayment on generic drugs while in the doughnut hole is 63%. There is also a $250 rebate payable to persons who are affected by the "doughnut hole."

.07 Medigap Policies

Generally. Medicare beneficiaries should consider purchasing a Medicare supplement policy to fill gaps in the coverage provided by Medicare. To supplement the coverage offered by Medicare's Part A and Part B offerings, private insurance companies sell "Medigap" coverage. These are supplemental insurance plans regulated by the federal government. One must have Medicare Part A and Part B to buy a Medigap policy. Medicare does not pay for any of the costs of a Medigap policy. Once acquired, the insurance company may not cancel Medigap policies, except for nonpayment of premiums.

The best time to purchase a Medigap policy is during the Medicare open enrollment period. This period lasts for six months and begins on the first day of the month in which a person is both 65 or older and enrolled in Medicare Part B. During this period, an insurance company cannot use medical underwriting. Under some circumstances, it is possible that a Medigap policy may enforce a 6-month waiting period with respect to a pre-existing condition. (Original Medicare will still cover the pre-existing condition even if the Medigap policy will not cover the excess). Coverage for a pre-existing condition can only be denied in a Medigap policy if the condition was treated or diagnosed within 6 months before the date the coverage starts under the Medigap policy. However, if a person has at least 6 months of prior creditable coverage (that is, any other health coverage the person had before applying for a Medigap policy where there was no break in coverage for more than 63 days), the Medigap insurance company *cannot* refuse to cover a pre-existing condition.

Standard Medigap plans. The private insurance companies authorized to sell Medigap insurance must follow federal and state laws addressing these policies. The companies may offer standard Medigap insurance plans, designated Plans A–N. Each plan has a different set of benefits. Medigap Plans E, H, I, and J are no longer sold, but if a person already has such a plan, it may be retained. For years beginning in 2006, Medigap plans can no longer be sold with prescription drug benefits, although persons who already had those policies may retain them. All plans with the same letter cover the same benefits, regardless of which insurance company offers a particular plan. However, the premium costs among the plans may vary.

Medigap Plans A–N. All of the 14 Medigap policies cover basic benefits, but each has additional benefits that vary according to the plan. The most basic plan is Plan A. Plans B–N offer everything that Plan A offers and provide additional coverage. Plans K–N offer similar coverage as Plans A–J, but the sharing of costs between the insurance company and the participant for basic benefits are at different levels.

Newest Plans M and N. Plans M and N became available June 1, 2010. At that time, Plans E, H, I, and J were eliminated as the preventive care benefit and the at-home recovery benefits were transferred to basic Medicare, and these plans become identical to the other remaining plans. A new hospice care benefit coinsurance coverage was added to all new Medicare supplement plans. Plan M offers similar benefits to Plan D, but only covers 50% of the Part A deductible and none of the Part B deductible. Plan M costs 85% of Plan F and 92% of Plan D. Plan N offers similar benefits to Plan D but has a $20 copayment for doctor visits and a $50 copayment for emergency room visits, presumably applied after the Part B deductible is met. The cost of Plan N is about 70% of the cost of Plan F (Plan F offers a high-deductible plan — there is a $2,300 deductible for 2020 and a similar deductible for Plan J before the Medigap plan covers anything) and 77% of the cost of Plan D. Only persons eligible for Medicare prior to 2020 will be able to purchase Plans C, F, and high-deductible Plan F beginning in 2020.

Starting January 1, 2020, Medigap plans sold to new people with Medicare will not be allowed to cover the Part B deductible. Because of this, Plans C and F will no longer be available to new Medicare enrollees starting on January 1, 2020. If a person already has either of these two plans (or the high deductible version of Plan F) or are covered by one of these plans before January 1, 2020, the person will be able to keep the plan. If a person was eligible for Medicare before January 1, 2020, but not yet enrolled, one of these plans may still be available.

Limitations in Medigap coverage. Despite the wide varieties of additional policy options, none of the standard Medigap plans cover private-duty nursing services, hearing aids, vision or dental care, or long-term care to help with bathing, dressing, eating, or using the bathroom (toileting).

Supplementing the Part A hospitalization coverage. Recalling the earlier discussion of the benefits available under Medicare Part A (¶3510.03), once the patient has paid the hospital deductible ($1,408 in 2020), Part A pays all hospital costs for up to 60 days in a benefit period. If the patient stays in the hospital more than 60 days, the patient pays $352 (in 2020) per day for days 61–90. If the patient stays longer than 90 days in a benefit period, the cost for each day is $704 (in 2020) for up to 60 days over the lifetime of the patient.

All the Medigap plans cover the patient's costs for days 61–150. In addition, once the patient has used all 150 days of Medicare hospital benefits, all Medigap plans cover the cost of 365 more hospital days in the patient's lifetime.

Plans F or J are high-deductible options, so that the patient must first pay the annual Medigap deductible before these costs will be covered. Plans K or L will require the patient to pay a portion of the hospital deductible before the patient's costs will be covered, unless the patient has already met the annual out-of-pocket maximum for the year. With Plans K and L, after a person meets the yearly Part B deductible ($198 in 2020) and the out-of-pocket yearly limit (Plan K $5,880 ; Plan L $2,940), the Medigap plan pays 100% of the covered services for the rest of the calendar year.

Supplementing the Part B medical coverage. Recalling the earlier discussion of the benefits available under Medicare Part B (¶3510.04), once the patient pays the yearly Part B deductible ($198 in 2020), Medicare will generally pay 80% of physician and other medical services, and 100% of certain other preventive services.

The Medigap plans cover all or part of the patient's share of the services mentioned earlier (that is, 20% of the Medicare-approved amount for physician services and 50% for mental health services). The *Medicare-approved amount* is the amount that Medicare determines is a reasonable payment for a medical service.

Medigap Plans A–N pay for the first three pints of blood each year, which are not otherwise covered by either Medicare Part A or Part B. Medigap Plans C and F pay the annual Medicare Part B deductible ($198 in 2020).

Starting in 2020, "first dollar" supplemental Medicare insurance premiums, or so-called "Medigap" policies, will no longer cover the Part B Medicare deductible for new Medicare beneficiaries. F or C Medigap plans that currently carry no deductibles and no co-pays will not be available for persons purchasing Medigap policies in 2020 or later. Those who already have this coverage will be permitted to keep it.

Supplementing skilled nursing home coverage. Part A of Medicare pays all of the patient's skilled nursing home costs for the first 20 days of each benefit period. If the patient remains in a nursing home for more than 20 days, the patient pays a portion of each day's bill. Medigap Plans C–N pay a portion of the difference ($176 per day in 2020) for days 21–100. There is presently no Medigap plan that pays for any skilled nursing home stay longer than 100 days in a benefit period.

Supplementing physicians who do not accept assignment. In situations in which a physician does not accept assignment, but treats Medicare patients, the physician is not accepting the approved Medicare amount as payment in full. In such a situation, the physician can charge the patient up to 15% more than the Medicare-approved amount. Medigap Plans F, I, and J pay 100% of these excess charges. Medigap Plan G pays 80% of the excess charges.

Supplementing skilled home care. Medicare covers a limited amount of skilled home care given by a nurse or a physical, occupational, or speech therapist. Medicare does not pay for home health care for the activities of daily living, such as bathing and dressing. The patient pays for this type of care. Medigap Plans D, G, M, and N cover this type of home assistance if the patient is already receiving skilled home health care that is covered by Medicare. These plans cover home assistance for up to eight weeks after the patient no longer requires skilled care. There are, however, financial limitations because these plans will not pay more than $40 per visit, seven visits per week, or a maximum of $1,600 each year.

Supplementing foreign travel care. Medicare does not cover any health care received by a patient outside of the United States or its territories, with the limited exception of certain hospital stays in Canada or Mexico. Medigap Plans C–G and M and N cover some emergency care outside the United States. After the patient meets the annual deductible of $250, this benefit pays 80% of the cost of the patient's emergency care during the first 60 days of the patient's trip. There is, however, a $50,000 lifetime maximum benefit applicable to the patient.

Medicare SELECT. Medicare SELECT is a type of Medigap policy sold in some states that requires the use of hospitals and, in some cases, doctors, within its network to be eligible for full insurance

benefits, except in cases of emergency. Medicare SELECT can be any of the standardized Medigap plans. The SELECT policies generally cost less than the other Medigap policies. A person with a SELECT plan who goes out of network will pay some or all of what the standard Medicare coverage does not pay.

Differences in Medigap policy costs. Note that Medigap Plans K and L offer similar coverage as Plans A–J, but there are different cost-sharing arrangements for the benefits provided, and there are annual limits on how much the patient must pay for services. The out-of-pocket limits are different for Plans K and L and are adjusted each year for inflation. For 2020, the out-of-pocket limits are $5,880 for Plan K and $2,940 for Plan L.

Renewals of Medigap coverage. Once a Medigap plan has been purchased, the insurance company must offer ongoing renewals. The insurance company may not change what is covered by the policy and may not cancel the policy unless the patient does not pay the premium. However, the insurance company can increase the premium and must notify the patient in advance of any such increases.

Premium costs will vary. Premium costs of comparable Medigap programs vary widely — by company, region of the country, and age of the person insured. For persons with low incomes, assistance is available for payment of Medicare premiums. The Qualified Medicare Beneficiary Program typically covers cost-sharing for Medicare beneficiaries with incomes of up to 100% of the federal poverty level and assets of $7,860 for an individual and $11,800 for a married couple in 2020. The federal income limits for assistance in this program for 2020 are $1,084 a month for an individual and $1,467 a month for a married couple. Some states provide higher limits for assistance. These numbers are subject to change each year.

Planning Pointer. Is a Nonworking Spouse Eligible for Medicare at Age 65? A nonworking spouse is eligible for Medicare based on a working spouse's work history when the nonworking spouse turns age 65 in the following circumstances:

1. The nonworking spouse is married, and the working spouse is eligible and has applied for Social Security benefits (either retirement or disability benefits), and the spouses have been married for at least one year when the nonworking spouse applies; or

2. The nonworking spouse and the working spouse are divorced, and the working spouse is eligible for, and has applied for, Social Security benefits (either retirement or disability), and the spouses must have been married for at least 10 years, and the nonworking spouse must now be single; or

3. The nonworking spouse is a widow or a widower and was married to the working spouse (who had at least 40 work credits and therefore was eligible for benefits) for at least nine months before the working spouse died. The nonworking spouse must be single at the time of application.

Consider a situation in which the nonworking spouse turns age 65 before the worker spouse. Can the non-worker get Medicare, or must the non-worker wait until the worker turns age 65?

If the worker is at least age 62 and has worked for at least 10 years in Medicare-covered employment, the nonworking spouse can get Medicare Parts A and B at age 65.

If the worker has worked at least 10 years in Medicare-covered employment but is not yet age 62 when the nonworking spouse turns age 65, he or she will not be eligible for premium-free Medicare Part A until the worker's 62nd birthday. In this case, the nonworking spouse should still apply for Medicare Part B at age 65 to avoid paying a higher Part B premium, unless the worker is still working and the spouse is covered under the worker's group health plan. The non-worker could then delay enrollment in Part B without paying higher premiums.

A problem could arise when the nonworking spouse is younger than the spouse who worked. Even if the spouse who worked is 65 and enrolled in Medicare, the nonworking spouse cannot enroll in Medicare until he or she turns age 65. There is an exception here if the nonworking spouse has been collecting Social Security disability insurance for at least 24 months.

Planning suggests determining whether any employer health coverage or retiree health benefits that the worker spouse may be eligible to receive will cover the medical expenses of the nonworking spouse until he or she reaches age 65 and can qualify for Medicare. In many situations, an older working spouse either purchases a health insurance policy for the nonworking spouse or postpones retirement until the younger nonworking spouse turns age 65 so that there is no gap in the younger nonworking spouse's health insurance coverage.

.08 Checklist of Medicare Mistakes to Avoid

1. Assuming you don't qualify for Medicare if you haven't worked long enough.
2. Failing to enroll in Part B when you should.
3. Believing you don't need Part B if you have retiree or COBRA coverage.
4. Thinking you must reach full retirement age before enrolling.

5. Not signing up for Part D because you don't take prescription drugs.
6. Misunderstanding enrollment periods.
7. Choosing a Part D Plan based on its premium cost.
8. Waiting too long to purchase Medigap with its full protections.
9. Failing to understand the Annual Notice of Change (of premiums).
10. Not realizing help may be available to lower costs (the Qualified Medicare Beneficiary Program).

¶3515 Medicaid

Medicaid is a program of government-financed medical care for specified groups of low-income people. It is a partnership program between the federal and state governments. A detailed discussion of it is beyond the scope of this chapter. Additional information about Medicaid is available online at http://cms.hhs.gov, which is the website for the Centers for Medicare & Medicaid Services (formerly the Health Care Financing Administration) administered by the U.S. Department of Health and Human Services. However, because many middle-class individuals give their assets away in an attempt to qualify for Medicaid so that the costs of medical care will not wipe out their assets, this chapter provides some details on allowable income and resources. The treatment is brief and is not intended to be exhaustive.

The financial eligibility standards that govern Medicaid eligibility allow an individual, a couple, or a family to keep a small amount of income plus the following assets: a home, a car, personal and household items, (within limits) property essential for self-support, $1,500 of cash value life insurance, burial spaces, very limited amounts of cash or cashable assets, and a few other resources. The government counts all additional income and resources when determining eligibility for Medicaid.

Most of the income that a single Medicaid recipient can keep while living at home becomes available to pay for nursing facility care if the individual enters a nursing facility. Medicaid covers long-term nursing facility care that Medicare rejects as custodial.

The Medicaid system has been significantly affected by the Affordable Care Act. The Affordable Care Act gave states the option to cover persons with income at 138% of the federal poverty level in their Medicaid programs in exchange for the federal government accepting all of the extra costs of benefits for several years. Many states accepted this program; many others did not. As a result, Medicaid availability varies widely from one state to another, and several million people have been added to the Medicaid rolls. The Affordable Care Act has generously accepted persons into the Medicaid health care coverage program based solely on their income and without regard to their level of wealth. In the short term, this will lead to higher costs of coverage for the increased number of eligible Medicaid recipients. Perhaps states will attempt to recover their costs from the assets of the estates of these persons when they die. Only time (and further political and court developments) will tell.

The law in many states provides that Medicaid is available for health insurance eligibility based on the income of the applicants, not on their resources. Medicaid rules for acceptance in long-term nursing care facilities are dependent on resources as well as income.

There is an ongoing political debate about whether the federal government should continue to be the primary provider of Medicaid rules and funds, or whether more of this responsibility and discretion should be moved to the states. This debate is at the center of attempts to repeal and replace or extend the Affordable Care Act, or create a universal health plan, such as Medicare for all.

.01 Spousal Impoverishment

A primary concern of a married couple with one spouse in a nursing facility is that they will use a substantial portion of their income and resources to pay the facility. Thus, very little will be left for the spouse who is not in the nursing facility, referred to as the *community spouse*.

Income. The law addresses this issue by allowing the community spouse (the spouse who does not live in the nursing facility) to keep enough of the couple's income to have income equal to at least 150% of the federal poverty line for a couple. The community spouse can keep even more income if the income is in his or her separate name. Community spouses with costly shelter and utility needs within specific limits can keep some additional monthly income. The total monthly income that a community spouse can keep ranges from a minimum of $2,349 (for 2020) to a maximum of $3,216 (for 2019) unless a higher limit is established by a fair hearing or a court order. The allowances at all levels vary widely from one state to another.

Community spouses can keep a monthly income that ranges from $30 to $200 (as determined by each state) as a personal allowance. They can also use some of their income to pay for non-covered or noninsured medical expenses that they incur and to maintain dependents.

Resources. The community spouse can keep a share of the couple's "countable resources" that is the greatest of (1) in 2020, a level between $25,728 and $128,640 established by the state, (2) one-half of the couple's countable resources if that half does not exceed $128,640 in 2020, or (3) a higher limit established by a fair hearing or a court order. This amount is called the protected resource amount. The institutionalized spouse may transfer assets to the community spouse so he or she may obtain the greatest permissible share.

.02 Trusts

Individuals may think that they can use trusts to shelter assets that would otherwise render them ineligible for Medicaid. However, the law deems all of a trust's funds or payments that can be obtained by the individual, the individual's spouse, or anyone acting for the individual or the individual's spouse, to be available to pay for the individual's medical or nursing facility care, even if the funds or payments are not distributed. If a person creates and funds a trust, and names others as beneficiaries, and then applies for Medicaid, the trust's funds are deemed to have been transferred by the Medicaid applicant during a 60-month "lookback period," which may result in a delayed eligibility for Medicaid coverage. Exceptions apply for trusts that contain assets of disabled individuals under age 65, specific retirement income trusts in certain states, and "pooled" trusts managed by non-profit organizations for disabled individuals.

.03 Transfer of Assets

Portions of the Health Insurance Portability and Accountability Act of 1996 (HIPAA)[9] cast a shadow over asset transfers made to qualify for Medicaid. Effective January 1, 1997, it was a criminal misdemeanor or felony to knowingly and willfully dispose of assets in order for an individual to qualify for Medicaid or to assist in such transfers, within (1) 36 months of applying for Medicaid, in the case of an outright transfer, or (2) within 60 months of applying for Medicaid, in the case of a trust. Penalties included up to $25,000 in fines, up to 5 years in prison, and revocation of Medicaid eligibility for up to 1 year. These sanctions were to apply in addition to the delay of eligibility and recovery provisions discussed in the following text. This provision was amended on August 5, 1997. The amended rule applied only to those who, for a fee, advised an individual to make such a transfer. The penalty was to be a maximum of 1 year in prison and a fine of up to $10,000. However, this provision was ruled as an unconstitutional infringement on the right of free speech under the First Amendment and never enforced.[10]

Medicaid eligibility for nursing facility or home and community-based long-term care is delayed for an individual who disposes of assets for less than fair market value on or after a look-back date that is 60 months before the date on which the individual is both (1) a Medicaid applicant and (2) in an institution.

.04 Strategies to Gain Medicaid Eligibility

One of the most effective ways to gain Medicaid eligibility is to make gift transfers well in advance of applying for Medicaid and wait out the look-back periods, now 60 months under the Deficit Reduction Act of 2005 (DRA). Transfers of assets between spouses, when one spouse is institutionalized, are exempt from the transfer penalties. (Refer to 42 USC 1396p(c)(2)(B).) However, the community spouse support requirements and the required pooling of resources between spouses make this strategy less attractive than it first appears. There are a number of other effective techniques for transferring family assets to achieve faster Medicaid eligibility. These strategies include the following:

a. **Pay bills.** The payment of living expenses and the repayment of legitimate debt is not a gift or otherwise ineligible transfer that requires look back. Accordingly, if an individual has more cash than he or she would be allowed to retain, use some of the excess cash to pay off a mortgage on the person's residence. Because asset testing is measured from the time of institutionalization, such a debt should be repaid before the person has been institutionalized. If other debts are outstanding, such as car loans, credit card debt, or bills for professional services, these should be paid as well.

b. **Exempt assets.** Planning suggests moving family assets into exempt asset categories as noted in this ¶3515 to the greatest extent possible.

c. **Fix up the home.** The expenditure of funds for home improvements has the effect of moving assets from countable assets (bank balances, securities) to exempt assets (the home). All of those long-ignored projects can now be addressed appropriately.

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[9] P.L. 104 191.

[10] *New York Bar Association v. Janet Reno et al.*, 999 F. Supp. 710 (N.D. N.Y. 1997).

d. **Purchase a new home.** Sell the old home, and purchase a new, more expensive home. The transactions will move assets from countable to exempt. This may finally be the time for the client who has been a renter to become a homeowner.

i. **Caution regarding homes.** The previous suggestions regarding home improvement and purchase must be conditioned on another provision introduced into the law by the DRA. This law makes a person ineligible for Medicaid if he or she has equity in his or her home in excess of $595,000 , or at the state's option, $893,000 (2020 numbers). This provision is indexed annually for inflation. The home with equity above these levels is a countable resource (to the extent of the excess equity) for Medicaid eligibility purposes unless the home is occupied by the applicant's spouse, a child under the age of 21, or a blind or disabled child.

ii. **Planning regarding homes.** If the community spouse is alive and healthy, consider purchasing an expensive home as a way to shelter family assets. The DRA does not affect a home occupied by the community spouse. If this is not desired or possible, consider using a reverse mortgage or home equity loan to reduce the value of the property owner's equity. However, be careful here. If the healthy spouse needs to apply for Medicaid, loan repayments cannot be made from his or her funds without denying Medicaid eligibility, so the home may be subjected to a forced sale to repay the home equity loan. Similarly, if the homeowner is absent from the home for a prolonged period of time, the terms of a reverse mortgage may require its repayment, and the necessary sale of the home.

iii. **Transfer the home.** An effective strategy may be for the institutionalized spouse to transfer title to the home to his or her spouse, to a child who is under age 21 or who is blind or permanently and totally disabled, to a sibling who was living in the home for at least one year before the individual became institutionalized and who had an equity interest in the home, or to a child who resided in the home for at least two years immediately before the date the individual was institutionalized and who provided care that allowed the individual to reside at home rather than in an institution. If the home must be sold, nursing home residents enjoy a special tax benefit. All other persons must have lived in the residence for two of the preceding five years as a precondition to excluding the first $250,000 of capital gain from income tax liability ($500,000 for a married couple filing a joint return), but a nursing home resident needs to have lived in the residence for only one of the past five years. IRC Section 121(d)(7).

iv. **Transfer the home to a defective grantor trust.** In this plan, the elderly person as grantor transfers (as a gift) a principal residence to a trust for the benefit of children. The grantor retains a power over the trust, such as the power of substitution, which makes the grantor taxable on the trust income, but keeps the trust property out of the grantor's estate. Children are named trustees of the trust. Next, the children, as trustees, sell the residential property. Because the parent is the trust grantor, the trust income is taxable to the parent. Assuming the parent met the two of five-year use and ownership tests of IRC Section 121, the $250,000 or $500,000 exclusion may limit all or at least some of the taxable gain. Now, the children are holding the proceeds of sale of the home as the trust beneficiaries. They use these funds to create a special needs trust for the benefit of the parent(s). Arguably, the children are the grantors and owners of that trust. As such, it will not be considered the property of the parents for Medicaid purposes, and any remaining unused balance will not have to be repaid to Medicaid upon the death(s) of the parent(s).

e. **Purchase household or personal goods.** Although the Medicaid allowance for such items is only $2,000, it is often not enforced, particularly against property such as furniture, clothing, and other personal items the value of which depreciates quickly after they are purchased.

f. **Purchase a car.** If the community spouse purchases a new car when the other spouse is institutionalized, the purchase will constitute a permissible use of funds as part of a Medicaid "spend down." Nothing in the federal regulations mandates how expensive a car may be owned, though some states do impose limits that must be addressed. Therefore, this can be a good opportunity to spend down funds while continuing to enjoy what they are able to purchase.

g. **Prepay funeral expenses.** Prepayment may be done either through the use of an irrevocable trust created for the purpose of paying funeral expenses, or by the irrevocable assignment of a life insurance policy for funeral services. There are no limits on the amount that can be prepaid, so items such as the gravesite, burial, perpetual care, or monument can be addressed.

h. **Purchase an annuity.** Any immediate annuity purchased in which the annuitant's reasonable life expectancy is commensurate with the annuity's duration is deemed actuarially sound and does not constitute a transfer of assets subject to a penalty period. If an annuity is not actuarially sound, the transferor will be treated as having transferred assets without adequate consideration equal to the annuity's payout. (42 USC 1396p(c)(1)(G)(ii)(II)) The purchase of an "actuarially sound" immediate annuity for the benefit of a community spouse not to be paid out longer than the actuarial life of the annuitant will not be considered a countable asset where it is irrevocable and non-assignable, and there is no way for such spouse to convert the annuity to cash to be used for his or her support and maintenance. Such annuities must provide for installment payments in equal amounts during their terms, with no deferral and no balloon payments. However, under the DRA, all annuities must be disclosed, and the state must be named to receive the remainder interest on a term-certain annuity up to the amount of Medicaid benefits paid on behalf of the institutionalized spouse. (In the case of a person with a minor or disabled child, such child may be named the first contingent beneficiary of the annuity, with the state in second position). An annuity is not subject to the Medicaid transfer of assets provisions if it is owned by an IRA or purchased with the proceeds of an IRA, a SEP or a Roth IRA. (42 USC 1396p(e); 42 USC 1396p(c)(1)(F))

i. **Cash in or assign life insurance policies.** Because only $1,500 of cash value in a life insurance policy is an excluded resource, consider cashing in a more valuable policy and using the cash received to pay for an asset in one of the other excluded categories discussed earlier. Alternatively, consider transferring the policy to a younger generation family member or into an irrevocable trust. Such a transfer will be subject to the 60-month look-back rule, but will be measured only by the cash value of the policy, not the death benefit which will remain available to the family if the policy is transferred rather than cashed in.

j. **Purchase a life estate in a child's home.** The DRA provides a "safe harbor" for a parent's purchase of a life estate in another person's home (the child's home) so long as the parent paid full consideration for the life estate (based on the fair market value of the child's home and the parent's actuarial life expectancy) and the parent resides in the home for at least one year after the date of the purchase. If these criteria are satisfied, the payment by the parent will not be treated as a transfer for testing Medicaid eligibility purposes. (42 USC 1396p(c)(1)(J)) The advantages of this technique to the parent include allowing the parent to remain in the community and allowing this transfer to avoid the five-year look-back rule. For the child, there will be a potential capital gain on the sale of the life estate, but at least a portion of the gain

should be offset by a proportionate allocation of the child's cost basis in the home, as well as the use of a proportionate part of the available IRC Section 121 capital gain exclusion ($250,000 for a single filer, $500,000 for a joint filer).

> **Caution:** If the child's home is subject to a mortgage, be careful of triggering the mortgage's "due on sale" clause. Permission of the lender may have to be obtained, as the law protects transfers to spouses and children from invoking the due on sale clause, but not transfers to parents. (See 12 USC 1701j-3.) Also consider if anything needs to be done in connection with the title insurance policy covering the property if there is a change in ownership.

k. **Enter into a care agreement.** A parent may enter into a formal care agreement with a child whereby the child provides care to the parent for compensation, which will be income to the child. Such payments by the parent pursuant to a written agreement, prospective in nature, and providing for reasonable compensation, will not be subjected to Medicaid look-back rules. Consider transferring the parent's residence to a child in exchange for personal care services. (*Reed v. Missouri Dept. of Social Services*, 193 S.W. 3d 839 (Mo. Ct. App. 2006))

l. **Create a trust for a disabled person.** Transfers of otherwise countable assets into a trust for any disabled individual under the age of 65 are protected from the penalty provisions. A disabled person (independently or via a parent, guardian, or court order) may transfer his or her own assets into a special needs trust to pay for things that Medicaid does not provide, and still be granted Medicaid eligibility. Such a trust is subject to the obligation to reimburse the state from any remaining trust property for funds expended when the trust beneficiary dies. (See 42 USC 1396p(d)(4)(A).) This is *not* the same as a special needs trust created by a third party with the funds of the third party for the benefit of a disabled person. Such a trust, properly drafted, is not counted as a resource of the disabled person, and there is no obligation to use the assets of such a trust to reimburse Medicaid when the beneficiary dies.

m. **Consider notes and loan transactions.** For transfer of assets purposes, promissory notes, loans, and mortgages are "suspect" and considered countable transfers unless they include an actuarially sound repayment term as calculated by the Office of the Chief Actuary of the Social Security Administration; payments are made in equal amounts during the term of the loan with no deferral or balloon payments; and the document prohibits the cancellation of the balance upon the death of the lender. The note should contain a provision that it is non-assignable, that the lender cannot demand prepayment, and that the borrower cannot prepay the note. In *Sable v. Velez*,[11] the court found that an intrafamily note designed to create Medicaid eligibility was a disqualifying resource and a "trust like device."

n. **Create a self-settled trust.** An individual is considered to have established a trust if the individual's assets were used to fund all or part of a trust and the trust was established by the individual, or the individual's spouse, or a person, court or administrative body acting on behalf or at the direction of the individual or the individual's spouse. (492 USC 1396p(d)(2))

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[11] 437 Fed. Appx. 73 (3rd Cir. 2011).

i. **Revocable trusts.** The principal of a revocable trust is considered a resource available to the individual, and any payments from the trust to or for the benefit of the individual are considered resources of the individual. Payments from the trust to third parties are considered assets disposed of or transferred by the individual. (See 42 USC 1396p(d)(3)(A).)

ii. **Irrevocable trusts.** If an irrevocable trust is created, and there are any circumstances under which payments from the trust could be made to or for the benefit of the individual, the portion of the trust (principal or income, or both) from which payment to the individual could be made is considered a resource available to the individual. Actual payments made to or for the benefit of the individual are considered income to the individual. Payments made for any other purpose are considered a transfer of assets subject to the transfer penalty rules. (42 USC 1396p(d)(3)(B)) Consider the creation of an income-only trust for the grantor with a duration limited to five years to "cover" the lookback period.

iii. **Trusts with no retained interest.** If the trust income and principal cannot be distributed to the trust grantor, the trust will not be counted as a resource in determining eligibility for Medicaid. However, the creation of the trust and its funding will be considered a transfer of assets for less than fair market value and the 60-month look-back period and possible transfer penalty rules will be applicable.

o. **Use the half-a-loaf strategy.** Transfer half of a person's non-exempt assets and pay for the person's care with the remaining assets during the five-year penalty period.

p. **Use the reverse half-a-loaf strategy.** Transfer all of the person's assets, apply for Medicaid, incur the penalty for transferring assets within the look-back period, and have the recipient return half the assets, thereby reducing the ineligibility penalty.

q. **Divorce the institutionalized spouse.**

i. A far more drastic way to achieve a greater asset balance for the community spouse is to have him or her divorce the institutionalized spouse. This may be an appealing financial option when a family has assets far in excess of the community spouse resource allowance (such as substantial qualified retirement plan assets that could be transferred in divorce by means of a qualified domestic relations order), which would require substantial private pay support of the institutionalized spouse before Medicaid eligibility would be achieved.

ii. Obviously, there are moral and emotional issues to address here beyond the financial issues, but this planning technique should not be ignored, particularly in the cases of families with more substantial wealth. A state could certainly attempt to challenge a divorce as being obtained for improper means, (that is, solely for Medicaid purposes) and refuse to recognize it, but even if such a challenge arises, there may be other factors (such as the prolonged incapacity of one of the spouses) that could be raised in justification.

iii. A community spouse may receive an equitable distribution settlement in a divorce that may exceed the community spouse resource allowance. The community spouse may obtain an alimony award that may exceed the minimum monthly needs allowance. When a divorce is being considered, it must be viewed as an arms'-length transaction, each

party must be represented by separate counsel, there must be full disclosure of the assets of all parties, and the settlement agreement must be approved by a court after testimony and entered into the court record.

¶3520 Types of Social Security Benefits

The benefits that most persons think of when they say "Social Security" are of four basic types: old age or disability benefits for the worker; benefits for the dependents of retired or disabled workers; benefits for the survivors of a worker who has died; and the lump-sum death benefit. The following table describes these benefits in more detail and indicates the insured status that the worker must have before he or she may receive the benefits.

.01 Insured Status and Benefit Table

OLD AGE OR DISABILITY BENEFITS	
Monthly benefits can be paid to	*If the worker*
a retired worker age 62 or over.	is fully insured.
a disabled worker under age 67.	would have been fully insured had he or she attained age 62 in the month the disability began (except in the case of a person disabled because of blindness) and has 20 quarters of coverage out of the 40 calendar quarters ending with the quarter in which the disability began.
a worker disabled before age 31 who does not have sufficient quarters of coverage to meet requirement.	has quarters of coverage in one-half of the quarters elapsing in the period after attaining age 21 and up to and including the quarter of becoming disabled, but no fewer than 6, or, if disabled in a quarter before attaining age 24, he or she has 6 quarters of coverage in the 12 calendar-quarter period immediately before he or she became disabled.
(A worker may be disabled after age 31 if he or she had a period of disability prior to age 31.)	

DEPENDENTS OF RETIRED OR DISABLED WORKERS	
Monthly benefits can be paid to	*If the worker*
the spouse of a person entitled to disability or retirement insurance benefits, if he or she is	is fully insured or insured for disability benefits, whichever is applicable, as shown previously.
• age 62 or over (may be divorced spouse in certain circumstances) or	
• caring for a child who is under age 16 or disabled and entitled to benefits.	
An unmarried child or grandchild (if parents are deceased) of a person entitled to disability or retirement insurance benefits if the child or grandchild is	is insured for retirement or disability benefits, whichever is applicable, as shown previously.

• under age 18,	
• under age 19 if a full-time elementary or secondary school student, or	
• age 18 or over and under a disability that began before the child or grandchild reached age 22.	

SURVIVOR'S BENEFITS	
Monthly benefits can be paid to	*If the worker*
a widow or widower (may be a surviving divorced spouse in certain circumstances) age 60 or over.	is fully insured.
a widow or widower and, under certain conditions, a surviving divorced spouse, if the widow or widower or divorced spouse is caring for a child entitled to benefits if the child is under age 16 or disabled.	is either fully or currently insured.
a disabled widow or widower (may be a surviving divorced spouse in certain circumstances), age 50 or over but under age 60, whose disability began within a certain period.	is fully insured.
An unmarried child or grandchild (if parents are deceased) of a deceased worker if the child or grandchild is	is either fully or currently insured.
• under age 18,	
• under age 19 if a full-time elementary or secondary school student, or	
• age 18 or over and under a disability which began before the child or grandchild reached age 22.	
a dependent parent, age 62 or over, of the deceased worker.	is fully insured.

LUMP-SUM DEATH PAYMENT	
The lump-sum death payment ($255) will be paid in the following order of priority:	*If the worker*
• The widow(er) of the deceased wage earner who was living in the same household as the deceased wage earner at the time of death	is either fully or currently insured.
• The widow(er) (excluding a divorced spouse) who is eligible for, or entitled to, benefits based on the deceased wage earner's record for the month of death	
• Children who are eligible for, or entitled to, benefits based on the deceased wage earner's record for the month of death	
If no surviving widow(er) or child, as defined previously, survives, no lump sum is payable.	

.02 "Fully Insured" and "Currently Insured" Status

Forty quarters (credits) of coverage assure "fully insured" status for life. If a person reached age 62 in 1984, 33 quarters of coverage will suffice, with 34 required if he or she reached age 62 in 1985; 35 if he or she reached age 62 in 1986; 36 if he or she reached age 62 in 1987; 37 if he or she reached age 62 in 1988; 38 if he or she reached age 62 in 1989; 39 if he or she reached age 62 in 1990; and 40 if he or she reached age 62 in 1991 or later. In 2020, a worker receives one credit for each $1,410 of earnings up to a maximum of 4 credits per year. Therefore, earnings of $5,640 in 2020 will constitute qualifying for a full year of coverage. This earnings threshold will continue to increase with inflation.

Fully insured status means that an individual is entitled to full benefits, including retirement benefits.

¶3525 Computation of Social Security Benefits

The computation of benefits is quite complicated. The following steps are required:

1. **Elapsed years.** Count the calendar years after 1950 (or after attaining 21, if later) and before the year in which the worker will attain age 62. In figuring disability benefits, the count ends the year before disability.

2. **Computation years.** From the "elapsed years," deduct five years to get the "computation years." There are special rules for computing disability benefits.

3. **Base years.** List the worker's earnings for each year beginning with 1951 and ending with the year before the year in which the benefits will begin. The following table lists the maximum creditable amounts for each year.

1951-1954	$3,600	1989	48,000
1955–1958	4,200	1990	51,300
1959–1965	4,800	1991	53,400
1966–1967	6,600	1992	55,500
1968–1971	7,800	1993	57,600
1972	9,000	1994	60,600
1973	10,800	1995	61,200
1974	13,200	1996	62,700
1975	14,100	1997	65,400
1976	15,300	1998	68,400
1977	16,500	1999	72,600
1978	17,700	2000	76,200
1979	22,900	2001	80,400
1980	25,900	2002	84,900
1981	29,700	2003	87,000
1982	32,400	2004	87,900
1983	35,700	2005	90,000
1984	37,800	2006	94,200
1985	39,600	2007	97,500
1986	42,000	2008	102,000
1987	43,800	2009	106,800
1988	45,000	2010	106,800
		2011	106,800
		2012	110,100
		2013	113,700
		2014	117,000
		2015	118,500
		2016	118,500
		2017	127,200
		2018	128,400
		2019	132,900
		2020	137,700

4. **Indexing.** The earnings in step 3 must be indexed to national average earnings over the same period in accordance with the following listing of average earnings, **which are always two years "behind" in their calculation**:

1951	$2,799.16	1980	12,513.46
1952	2,973.32	1981	13,733.10
1953	3,139.44	1982	14,531.34
1954	3,155.64	1983	15,239.24
1955	3,301.44	1984	16,135.07
1956	3,532.36	1985	16,822.51
1957	3,641.72	1986	17,321.82
1958	3,673.80	1987	18,426.51
1959	3,855.80	1988	19,334.04
1960	4,007.12	1989	20,099.55
1961	4,086.76	1990	21,027.98
1962	4,291.40	1991	21,811.60
1963	4,396.64	1992	22,935.42
1964	4,576.32	1993	23,132.67
1965	4,658.72	1994	23,753.53
1966	4,938.36	1995	24,705.66
1967	5,213.44	1996	25,913.90
1968	5,571.76	1997	27,426.00
1969	5,893.76	1998	28,861.44
1970	6,186.24	1999	30,469.84
1971	6,497.08	2000	32,154.82
1972	7,133.80	2001	32,921.92
1973	7,580.16	2002	33,252.09
1974	8,030.76	2003	34,064.95
1975	8,630.92	2004	35,648.55
1976	9,226.48	2005	37,197.43
1977	9,779.44	2006	38,695.99
1978	10,556.03	2007	40,375.23
1979	11,479.46	2008	41,334.97
		2009	40,711.61
		2010	41,673.83
		2011	42,979.61
		2012	44,321.67
		2013	44,888.16
		2014	46,481.52
		2015	48,098.63

2016	48,642.15
2017	50,321.89
2018	52,145.80

The formula for indexing uses the worker's actual earnings for a given year, national average earnings in the indexing year (which is the second year before the eligibility year), and national average earnings in the year being indexed, as follows:

$$\text{Worker's Actual Earnings} \times \frac{\text{Average Earnings in Indexing Year}}{\text{Average Earnings in Year Being Indexed}}$$

5. **Primary insurance amount.** The next step involves the use of another formula to find the worker's primary insurance amount (PIA). For the worker whose eligibility year is 2020, convert the average indexed monthly earnings (AIME) to a PIA by adding 90% of the first $960 or less of AIME, 32% of any AIME above $960 to $5,785, and 15% of any AIME above $5,785. The result rounded down to the next-lower multiple of 10¢ (if it is not already a multiple of 10¢) is the PIA.

   The PIA is the amount payable to a retiree applying at normal retirement age (age 65–67 depending on the year of birth) and is the basis for computing almost all benefits. For example, retirement benefits at age 62 are a percentage of the PIA.

   The PIA is increased by cost-of-living adjustments for the 3 preceding years in the case of a worker whose benefits commence at normal retirement age (age 65–67 depending on year of birth). On the other hand, the PIA amount of a worker whose benefits begin at age 62 would not be increased to reflect past cost-of-living adjustments.

   Social Security benefit calculators can be found on the Social Security Administration website at www.ssa.gov.

.01 Increases in Benefits — Cost of Living Adjustment

Social Security benefits are subject to change to reflect increases of 3% or more in the Consumer Price Index (CPI).

If reserves in the old age and disability trust funds fall below 20%, the cost-of-living adjustment will be based on the lower of the increase in the CPI or the average increase in wages. There was a cost-of-living adjustment of 1.6% (COLA) for 2020.

.02 Delayed Retirement Credit

For each month a worker delays retirement past normal retirement age, the benefit he or she will get is increased based on a credit that varies depending on age. Workers born in the period 1917–1924 get one quarter of 1% per month (3% per year). Persons born after 1924 get larger increases, and a worker born after 1943 receives a delayed retirement credit of 8% per year. A surviving spouse's benefits are also increased under this rule, but other dependents' benefits are not affected.

When deciding whether to delay retirement and receive a larger benefit, the individual would have to consider the present state of his or her health and life expectancy to determine if more benefits will actually be received in the future than at full retirement age. Other considerations would include availability of other funds for quality of living purposes. Full retirement age is from age 65–67, depending on the year of birth.

Year of Birth	*Full Retirement Age*
1937 or earlier	65
1938	65 and 2 months
1939	65 and 4 months
1940	65 and 6 months
1941	65 and 8 months
1942	65 and 10 months
1943-1954	66
1955	66 and 2 months
1956	66 and 4 months
1957	66 and 6 months
1958	66 and 8 months
1959	66 and 10 months
1960 and later	67

.03 Checking the Status of an Individual's Account

The Social Security Administration has a toll-free telephone number (1.800.772.1213) that can be used to obtain Form SSA-7004, "Request for Social Security Statement." One may also access and print a request form at the Social Security Administration's website at www.ssa.gov. Alternatively, a request can be submitted online at www.ssa.gov/myaccount/.

Within a few weeks of submitting a request, an individual will receive a detailed packet of information called a "Social Security statement." The Social Security Administration mails a copy of an individual's Social Security statement annually within 3 months of an individual's birthday once the person turns age 60. This mailing has been halted and restarted from time to time. Checking the status of an individual's account each year is important to ensure that the Social Security Administration has credited the correct amount of earnings to the account.

.04 Deciding When to Begin Receiving Social Security Benefits

An individual needs 40 credits of coverage to begin receiving Social Security benefits at age 62. If an individual begins receiving Social Security benefits at age 62, the benefit amount is decreased by 5/9 of 1% for each month before full retirement age. Thus, if an individual's full retirement age is 65, the monthly benefits are 20% less than if the individual waited until age 65. If an individual's full retirement age is 67, the monthly benefits for starting benefits at 62 is about 30% less than they would be at age 67. To decide when to begin receiving Social Security benefits, one must consider the increase in benefits from waiting, possible taxation of benefits, loss of benefits because of earnings before full retirement age, life expectancy, and the rate of return that the recipient could earn on investments. In many cases, if

the recipient is not earning over the amount at which he or she would lose benefits, the recipient will be better to begin receiving benefits at age 62. However, the financial planner should evaluate each case on its own and consider all relevant facts to advise a client properly. Statistics indicate that most persons eligible for Social Security benefits begin receiving such benefits at age 62.

¶3530 Avoiding Loss of Social Security Benefits

.01 Working While Receiving Benefits

In 20209, a person eligible for and seeking benefits under full retirement age can earn up to $18,240 ($1,520 per month) without loss of Social Security benefits. If the individual has reached full retirement age, the individual will not lose any Social Security benefits because of earnings. The loss of benefits for earnings in excess of the threshold amounts is $1 for every $2 in excess monthly earnings for retirees under full retirement age. Once the individual reaches full retirement age (age 65–67), he or she can earn an unlimited amount without loss of Social Security benefits.

In the first year of eligibility, a monthly test also applies to the months in the year before the individual attains full retirement age. A worker who is under full retirement age for any month in 2020 and retires in 2020 after attaining full retirement age is entitled to a full benefit for any month in which he or she neither earns more than $4,050 nor is substantially self-employed, regardless of his or her total earnings for the year. On the other hand, if the worker earns more than $4,050 in any month before reaching full retirement age (annualized at $48,600), the worker will lose $1 of benefits for every $3 of excess earnings.

The earnings limitation for a Social Security recipient under full retirement age may create a substantial disincentive for work that provides significant earnings. The results will vary depending on several factors:

- The amount of benefits the individual would be entitled to if he or she did not continue to work.
- In the case of a married participant, the amount of benefits, if any, that the individual's spouse would be entitled to receive.
- The extent to which benefits would be taxed if they were not lost because of earnings.
- The amount of earnings and Social Security taxes thereon.
- The individual's income tax bracket.
- The value of any delayed retirement credit.

.02 Escape Hatch

Income from self-employment is counted in the year in which it is received, except if it is paid in a year after one becomes entitled to Social Security and was earned before the recipient became entitled to Social Security.

On the other hand, the earnings of an employee are counted in the year in which they are earned, regardless of when they are received.

If an individual eligible for Social Security benefits is legitimately self-employed and is able to work out a deferred compensation arrangement with the person for whom he or she performs services, the individual apparently will be able to have earnings in excess of the Social Security earnings limitations without losing benefits. If the deferred income is not actually or constructively paid until he or she attains full retirement age (65–67), no loss of benefits will result. Even a deferral for a year could prove helpful as enabling the individual to retain benefits for the year of deferral.

¶3535 Social Security Planning Issues — FAQs and Case Studies

1. *The worker retired at full retirement age several months ago and began receiving the full Social Security retirement benefit. The worker is now working part-time, and his employer is deducting FICA and Medicare taxes from his paycheck. Will these additional earnings affect future Social Security payments?*

   Future benefits may increase depending upon how the current paycheck compares to earnings received prior to retirement. Social Security retirement benefits are based upon the 35 highest-earning years of work, with reported earnings for past years indexed to reflect inflation. Each year, the Social Security Administration reviews the records for all recipients who work and automatically increases benefits as appropriate. By the fall of the year following the year in which the work occurs, the Social Security Administration should have determined whether the earnings were sufficient to increase the benefit, and any increase would be retroactive to that January. If the worker is receiving larger paychecks than were received during some of the 35 highest-earning years, his or her larger paychecks would replace the lower ones in the government's calculation, and the monthly benefit would increase accordingly.

2. *The worker was forced to retire at age 60 and does not expect to be employed going forward and will not contribute further to Social Security. The projections the worker has seen for her benefit are based on working until age 66. Will her benefit be reduced if she does not work for the next 6 years?*

   The amount estimated on the annual statement will be high for this worker. Social Security assumes that a person will work until normal retirement age when it calculates the estimated benefit. The government indexes actual earnings to account for changes in average wages since the year the earnings were paid until the worker turns age 60. There is no indexing for the wages earned in the years the worker turns age 61 or later. The Social Security Administration then calculates average monthly indexed earnings during the 35 years the worker was paid the most. Cost-of-living adjustments are added to the worker's benefit beginning with the year the worker turns age 62, even if the worker does not start collecting benefits until full retirement age or later. Finally, a formula is applied to those earnings to calculate the basic benefit, (called the PIA) or the amount the worker would receive at full retirement age. There is an online tool to help the worker pinpoint a more precise estimate. Go to www.socialsecurity.gov/estimator and input the exact information, including earnings on record and the anticipated retirement age.

3. *The worker is planning to travel or live outside the United States. Can the worker continue to collect Social Security retirement benefits?*

   Yes. Although living or traveling outside the United States will make Medicare benefits unavailable, Social Security retirement benefits will continue no matter where the person lives.

4. *The worker retired at age 62 and applied for Social Security benefits. That year, the worker received a severance payment from his former employer. Will this severance payment count as wages that will result in the reduction of the Social Security benefit?*

   If the payment to the worker is, in fact, considered wages, it will count against the worker and reduce Social Security benefits. If, however, the payment can be characterized as a pension payment, it will not be treated as wages and will not reduce Social Security benefits. As a general rule, the receipt of severance payments or a buyout from the employer are reflected on Form W-2, which would suggest they are considered part of earnings that could reduce Social Security benefits. If the payments are reported on Form 1099-R, they would then appear to be retirement-related and arguably not wages or compensation. Timing is important here because if full retirement age has been reached, there is no benefit reduction even if the payments are considered wages or compensation. There is some good news here, even if the payment is found to be compensation. If a worker has Social Security retirement benefits withheld because the worker earns too much money, the benefits for that worker are increased, starting at full retirement age, to take into account the months in which benefits were withheld. There may not be a full restoration of the lost benefits, but there is an adjustment calculated by the SSA in the worker's favor.

5. *Is there an annual minimum cost-of-living adjustment for Social Security benefits, regardless of whether there has been an increase in the cost of living?*

   No. If there is no annual increase in the cost of living, there will be no increase in Social Security benefits. If there is deflation, Social Security benefits will not be reduced.

6. *The worker began receiving Social Security payments at age 62 and has now reached age 70. Can the worker return all the money collected from age 62 until the present and restart collecting Social Security benefits?*

   No. The Social Security Administration had previously allowed the worker to pay back Social Security retirement benefits and file a new application allowing the worker to receive larger monthly checks based on the older age. To do this, the worker would have filed Social Security Form 521, "Request for Withdrawal of Application." When the worker returned the past benefits, he or she did not owe any interest, and there was no adjustment for inflation. However, rules issued effective December 8, 2010 eliminated this repayment opportunity. Workers are now allowed one repayment decision to return the benefits received in a single lump sum with no interest due. However, if the worker changes his or her mind 12 months or more after becoming entitled to benefits, the application for benefits may not be withdrawn. The worker is limited to one withdrawal per lifetime, within 1 year of beginning benefits.

   Another similar strategy, referred to as the *hedge your bet* strategy, had allowed a person to suspend benefits after reaching normal retirement age and then elect to claim a reinstatement of the suspended benefit and receive a lump sum in exchange for relinquishing the delayed retirement credits beyond normal retirement age. This strategy has been completely eliminated by the Bipartisan Budget Act of 2015, effective November 2, 2015 (BBA 2015). Now, when a claim for benefits is made, the benefit to which the person is entitled at the time of the claim will be paid, with no retroactive lump sum available.

7. *If both spouses receive separate Social Security benefits on their own earnings and one dies, does the survivor receive half of the benefit of the deceased partner? Would the survivor get both benefits or one or the other?*

   The key factor to answer this question is the age of the survivor when the spouse dies. If the survivor has already reached full retirement age when the spouse dies, the survivor will generally be eligible to receive the deceased spouse's full benefit, assuming that the deceased spouse's benefit is larger than the survivor's benefit, based on earnings history. If the survivor has not reached full retirement age when the spouse dies and claims a survivor's benefit, the survivor will be eligible for a lesser amount than 100% of the deceased spouse's benefit. If a spouse dies and the survivor receives or is eligible for a Social Security retirement benefit based on the survivor's own earnings record, the survivor can either collect his or her own benefit or the survivor benefit, but not both at the same time. A surviving spouse can begin collecting survivor benefits as early as age 60, but at a reduced rate. There are a number of possible options to consider here. If advantageous, a surviving spouse can choose to take a survivor benefit at age 60, (age 50 if disabled) or his or her own reduced retirement benefit at age 62, and then switch to the larger full retirement or survivor payment, whichever he or she had not opted for earlier, upon reaching full retirement age or by waiting until age 70.

8. *For a married couple, does it make sense for one spouse to take Social Security at normal retirement age, and the other to delay until age 70?*

   If one spouse waits until age 70, that would increase that spouse's Social Security benefit. It does make a difference which spouse takes the benefit at full retirement and which one postpones until age 70, but the difference is not realized until one spouse dies. At that time, the survivor is better off if the higher earning spouse waited until age 70 because the surviving spouse is entitled to the larger of the two spouses' benefits.

   One of the best ways to maximize income at later ages is for the high earner to delay retirement benefits until age 70. Assume, for example, the husband was the higher earner and delayed benefits until age 70, and the wife took her own retirement benefit at age 62 at a reduced level. After the husband dies, the wife may switch to the larger survivor benefit. Whether she had taken an early retirement benefit based on her own earnings record or her husband's record would not affect her survivor benefit. What does affect the survivor benefit is the widow's age when she starts taking that benefit. Depending upon the year of birth, the full retirement age may or may not be the same for Social Security retirement benefits and survivor benefits. If the wife was born in 1956, her full retirement age for taking retirement benefits is 66 and 4 months, but her age for survivor benefits is 66. One's full retirement age and percentage reductions for workers and spouses who start collecting at age 62 for each type of benefit is found online at www.ssa.gov/retire2/agereduction.htm.

   If the widow has already reached her full survivor age when she files for a survivor benefit, she generally is eligible for her deceased husband's full benefit. She could start collecting a survivor benefit as early as age 60, but that would be at a reduced rate. If the husband dies before his full retirement age of 66, having never taken Social Security retirement benefits, the widow's survivor benefit would be based on his full retirement benefit at age 66. If he dies after age 66, the survivor benefit includes any delayed credits the husband may have accrued.

   Another strategy that spouses may employ would be to have one spouse, upon reaching full retirement age, file for only that spouse's spousal benefit and not that spouse's earned benefit.

Assume that the applying spouse will receive one-half of the benefit of an older spouse. The younger spouse may then wait until age 70 to collect on his or her own work record, thereby receiving delayed retirement credits, which will increase that spouse's benefit compared to what could have been collected at full retirement age. Presumably, with the delayed credits, the earned benefit at age 70 will exceed the otherwise available spousal benefit.

Note: Under the BBA of 2015, restricted applications for benefits are limited to people who were age 62 and older in 2015; that is, born on or before January 1, 1954. The opportunity remained available even if it meant waiting as long as four years to actually implement this technique.

If the client was younger than age 62 before January 1, 2015, this strategy is no longer available. For those persons for whom this strategy is not available, the new rules provide that filing for spousal benefits will be deemed by Social Security to also trigger the applicant's own retirement benefit, and the person will receive the greater of the two benefits.

When considering these spousal strategies, note that individuals who are younger than full retirement age do not have the option of filing for a spousal benefit without also being deemed to have filed for an earned benefit. Other than a surviving spouse to whom the restricted application rule does not apply, one cannot start collecting a reduced spousal benefit before full retirement age and then later switch to an unreduced benefit based on one's own earnings. Accordingly, waiting until full retirement age is central to many of the spousal strategies.

9. *How exactly does the spousal benefit for Social Security work?*

A married person collects Social Security based on the other (living) spouse's earnings record when the first spouse's own Social Security benefit would not equal or exceed 50% of the other spouse's benefit. If one spouse has reached full retirement age and the other reaches age 62 and decides to start receiving benefits, the spouse age 62 would receive 35% of the other spouse's benefit amount. If, instead of taking benefits at age 62, the spouse waited until full retirement age, such spouse would be entitled to 50% of the other spouse's benefit amount. One spouse cannot collect Social Security based on the other spouse's record until the other spouse files for benefits. To determine one's individual benefit calculation, go to www.ssa.gov/OACT/quickcalc.

There is no marriage penalty under Social Security. That is, two single persons are not better off remaining single and collecting their own benefits as opposed to marrying. Marrying will not reduce a person's Social Security retirement benefit, but might increase it, because married individuals receive the higher of two benefits (that is, the one they are entitled to based on their own work record or the one based upon the spouse's work record). Also, upon the death of one of the spouses, the survivor may be entitled to a survivor benefit that is larger than his or her own earned retirement benefit.

10. *What are the rules regarding Social Security benefits for divorced couples?*

A divorced spouse can collect a Social Security retirement benefit based on the work record of an ex-spouse, and it will not affect the latter's retirement benefit or the benefit of that person's current spouse, if he or she has remarried. The Social Security Administration will not notify a person if an ex-spouse collects a retirement benefit based on that person's earnings record. As a general rule, a divorced spouse who has never worked is allowed to claim Social Security based on the record of a working ex-spouse. For the divorced spouse to collect on that record, the

worker must be at least age 62 and collecting or eligible for Social Security retirement benefits. The divorced spouse also must be at least age 62 and unmarried.

The benefit available to the divorced spouse of a worker is generally equal to half the worker's retirement benefit at his or her full retirement age. That amount is available only if the divorced spouse waits until his or her own full retirement age to start collecting benefits. If benefits are taken earlier, such as at age 62, the monthly benefit is permanently reduced to 35% of the worker's benefit.

An important requirement in the divorce context is that the couple must have been married for at least 10 years before the divorce became final for the divorced spouse to collect Social Security based on the other spouse's work record. If the divorced spouse remarries prior to age 60, he or she generally no longer qualifies for a retirement benefit based on a former spouse's work record. However, if a divorced spouse waits to remarry until after age 60, he or she can still qualify for a widow or widower's benefit when the former spouse dies, assuming the divorced spouse is not married at the time. To receive the largest monthly check possible, the divorced spouse should wait until his or her own full retirement age to start collecting benefits.

If the divorced spouse was born on or before January 1, 1954, the divorced spouse can claim ex-spousal benefits at full retirement age and delay receiving his or her own benefits until reaching age 70. If an ex-spouse suspends his or her benefits, that cannot block a former spouse from collecting benefits on the record of the ex-spouse.

11. How is Social Security calculated for disabled children?

From birth to age 18, children may receive monthly payments under the Supplemental Security Income program (SSI) if they have impairments that meet the Social Security definition of *disability* for children, and the family income falls below certain limitations. If the children are not eligible for SSI because the family has too much income, they may become eligible for SSI at age 18. At that point, the income of the parents will no longer be counted in the financial limits for the children. In order to qualify, the children must be unable to do "substantial" work, meaning they are unable to earn more than $1,260 (in 2020) per month. The substantial gainful activity threshold for blind persons is earnings of more than $2,110 (in 2020) per month. There is also a "trial work period" threshold of $910 per month in 2020.

Once disabled children turn age 18, they may also qualify for a benefit based upon the work record of their parent. However, they will have to wait until the parent begins to collect Social Security retirement benefits to qualify for those payments. Under the Social Security Disability Insurance program (SSDI), adult children age 18 or older may receive monthly payments if they meet three conditions, namely:

- the impairment or combination of impairments meets the Social Security definition of disability;
- the disability began before age 22; and
- one of the parents worked long enough to be insured under Social Security and is either receiving retirement or disability benefits or has died.

Even though the general rule of thumb is that dependents receive one half of the worker's retirement or disability benefit amount, the actual amount depends on three factors: the worker's earnings record, the timing of the worker's retirement benefit claim, and the number of dependents. If the family includes more than one dependent, the benefit paid to such dependents is combined into a family benefit amount (the "family maximum amount"). That amount could be less than the payments the worker and separate dependents would receive if the benefits were paid separately. The family could receive as much as 180% of the retired worker's benefits, but the exact amount will depend on a complex Social Security formula. The worker's benefit would not be reduced, but the dependents' benefits could be reduced proportionately if the family's total benefit exceeds the family benefit amount limit. The maximum family benefit does not apply to spouses when each spouse is collecting retirement benefits based on his or her own work record.

12. *What is the planning technique called "file and suspend"?*

Note: The file and suspend strategy was eliminated by the BBA of 2015 for persons other than those who were age 66 or older and who filed to suspend their benefits by April 29, 2016. Persons who elected to file and suspend before the April 29, 2016 deadline and submitted their application before such date are not affected by this change in the law. They were allowed to suspend their receipt of benefits beyond full retirement age until age 70 and then receive the enhanced full benefit.

The rules after April 29, 2016 provide that a new filer will no longer have the option to receive benefits on anyone else's work record while their benefits are suspended, and no one else (including dependent children) will be able to receive benefits on a person's work record while that person's benefits are suspended.

An exception to the preceding rule applies to divorced spouses who may collect on their ex-spouse's benefits, even if the ex-spouse has suspended his or her benefits.

Note also that the rules enacted in BBA 2015 do not apply to Social Security survivor benefits. Widows and widowers will still be able to optimize the timing of when to start both Social Security survivor benefits and their own Social Security retirement benefits. They may still claim survivor benefits and still defer their own retirement benefits, if that will result in the optimal benefit amount.

Guidance on these points is available at www.socialsecurity.gov/planners/retire/suspend.html.

When it was available, the file and suspend planning technique involved the higher earning spouse filing for his or her benefit at full retirement age (assume age 66) and then immediately suspending his or her claim. This allowed the lower earning spouse to begin collecting spousal benefits upon attaining full retirement age, which may be higher than the lower earning spouse's own attained benefit at that age. When the higher earning spouse attained age 70, that spouse qualified for the enhanced benefit available for persons who waited until age 70 to claim their benefit. The amount paid to the lower earning spouse at that time was not increased, unless the higher earning spouse died, in which case the lower earning spouse then received the enhanced survivor benefit.

The lower earning spouse can collect on his or her own benefit at age 62 but may not collect the spousal benefit until the spouse actually files for his or her own benefit, hence, the file and suspend technique.

Another variation of this technique was to have the lower earning spouse collect his or her full benefit and not suspend that benefit, have the higher earning spouse collect only his or her spousal benefit from age 66–70, and then apply for his or her own enhanced benefit, which will be 32% greater at age 70 than it would have been at age 66 with no penalty. This "restricted benefit" by one spouse may now only be done if the spouse seeking the restricted benefit was born on or before January 1, 1954.

13. *What is the effect of government pensions on Social Security benefits?*

Many state public employees and those federal workers hired before 1984 who are not covered by Social Security are nonetheless affected by provisions of the Social Security system either because they have a spouse contributing to Social Security or because they worked in a job covered by Social Security at some point in their careers. The Windfall Elimination Provision (WEP) was designed to remove an unintended advantage in the Social Security benefit formula for some people who receive a government pension. The Government Pension Offset (GPO) reduces Social Security benefits for certain spouses who receive a government pension.

.01 The Windfall Elimination Provision

The WEP affects the calculation of Social Security benefits for individuals who receive a pension from work not covered by Social Security. Public sector employees in 15 states are not covered by Social Security. The pension such individuals receive may reduce their Social Security benefits. The Social Security benefit formula gives a higher return on lower-paid workers' pre-retirement earnings than that received by highly paid workers. Before 1983, people who spent most of their careers in jobs not covered by Social Security had their Social Security benefit calculated as though they were long-term, low-wage workers. This gave them the advantage of receiving a Social Security benefit representing a higher percentage of their earnings, and also receiving a pension from a job where they did not pay Social Security taxes. Congress passed the WEP to remove that advantage.

The WEP primarily affects individuals who earned a pension in a job where they did not pay Social Security taxes and who also worked in other jobs long enough to qualify for Social Security retirement or disability benefits. The WEP may apply to individuals who

- reached age 62 or became disabled after 1985, and
- first became eligible for a monthly pension based on work where they did not pay Social Security taxes after 1985.

The WEP *does not apply* to individuals who fall into one of the following categories:

- They first became federal workers after 1983.
- They were employed on December 31, 1983, by a not-for-profit organization that did not initially withhold Social Security taxes from their pay but later began withholding Social Security taxes.
- Their only pension is based on railroad employment.

- The only employment in which they did not pay Social Security taxes was before 1957.

The WEP rules apply a rather complex formula to reduce the worker's otherwise available Social Security benefits based on the worker's number of years and amount of earnings. The reduction in an individual's Social Security benefit cannot be more than half of his or her pension that is based on earnings after 1956. This "guarantee" is designed to help protect workers with low pensions. The SSA has an online calculator that can be used to estimate the retirement or disability benefits for workers affected by the WEP. The calculator is available at www.socialsecurity.gov/retire2/anyPiaWepjs04.htm.

Because dependents' benefits are derived from the worker's benefit, the WEP affects dependents' benefits as well. However, the WEP does not affect benefits paid to survivors. Although the WEP does not affect survivor benefits, these benefits may be reduced because of the Government Pension Offset (GPO), described as follows.

.02 The Government Pension Offset (GPO)

The GPO reduces Social Security benefits for certain spouses and surviving spouses who receive a government pension. The GPO applies to individuals who qualify for both a government pension based on their work that is not covered by Social Security and a Social Security spousal benefit based on a spouse's work in covered employment.

The GPO applies to individuals who qualify for both of the following:

- A government pension based on government employment that is not covered by Social Security
- A Social Security spousal benefit

Social Security benefits as a spouse or surviving spouse are *not* reduced for individuals who fall into one of the following categories:

- They receive a government pension that is not based on earnings.
- They are federal, state, or local government employees whose government pension is based on a job for which they were paying Social Security taxes, and
  - — they filed for and were entitled to spouse's or widow(er)'s benefits before April 1, 2004, or
  - — their last day of employment (for pension purposes) was before July 1, 2004, or
  - — they paid Social Security taxes on their earnings during the last 60 months of government service.
- They are federal employees who elected to switch from the Civil Service Retirement System to the Federal Employees' Retirement System after December 31, 1987, and
  - — they filed for and were entitled to spouse's or widow(er)'s benefits before April 1, 2004, or
  - — their last day of service for pension purposes was before July 1, 2004, or

— they paid Social Security taxes on their earnings for 60 months or more during the period beginning January 1988 and ending with the first month of benefit entitlement.

The GPO reduction in Social Security spousal benefits is two-thirds of the government pension that is not covered by Social Security. The GPO reduction can completely eliminate the Social Security spousal benefit**.** In fact, for 74% of those with spousal benefits reduced by the GPO, the reduction is large enough to fully offset any potential spousal benefit. This occurs either because the government pension is relatively large or the potential Social Security spousal benefit is relatively small. The GPO reduction also applies to a surviving spouse's benefit. It does not apply to one's own benefit.

Planning Pointer. Additional resources from the AICPA PFP Division: for more information on planning for Social Security, retirement health care financing, and elder planning, access The Adviser's Guide to Retirement and Elder Planning series (included with PFP/PFS membership).

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