Accredited Retirement Advisor (ARA)

Preparatory Course

NSA

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The **Accredited Retirement Advisor (ARA)** credential recognizes professionals who have a thorough knowledge of topics relevant to retirement planning and special issues of senior citizens including tax planning and tax preparation for decedents, estates, and trusts; and applying your knowledge and skills in reallife situations when serving aging clients.

Experience Requirements

ACAT seeks to ensure that all accredited individuals possess theoretical knowledge and the practical knowledge necessary to be successful practitioners. Candidates for the ARA must be at least 18 years of age and must have a minimum of three (3) years of professional experience, or two (2) years of college-level accounting and one (1) year professional experience.

Individuals who pass the exam, but have not met the three year experience minimum, may promote themselves as having "passed the ACAT Examination for Accreditation in Retirement" but are not entitled to use the ARA designation.

DISCLAIMER PAGE

Knowledge of suggested preparation materials does not guarantee one will pass the exam; rather, it represents guiding information for preparation in advance of test completion.

The examinee is responsible for reviewing the ARA exam blueprint. The exam blueprint is representative of the most frequently cited references in the development of the ACAT ARA exam. Please note that it does not provide an inclusive listing of all references used to build the exam, but the information provided does represent the core of the exam content. As with any preparation materials, knowledge of suggested preparation materials does not guarantee one will pass the exam; rather, it represents guiding information for preparation in advance of test completion.

These course materials are reflective of laws and practices as of 2021.

Chapter 1

SOCIAL SECURITY

LEARNING OBJECTIVES

After reviewing this chapter, you should be able to:

- Identify general eligibility requirements for Social Security benefits
- Distinguish between retirement, disability, survivor, and spousal benefits
- Understand how benefits are calculated
- Describe the penalty for earned income as it relates to the calculation of retirement benefits
- Explain benefits available to divorced or widowed spouses

GENERAL ELIGIBILITY REQUIREMENTS FOR SOCIAL SECURITY BENEFITS

A worker must satisfy all coverage requirements for Social Security benefits before he or she becomes eligible for retirement, survivors, or disability benefits.

Quarters of Coverage

To be entitled to benefits (and be treated as fully insured), a worker must earn a total of 40 quarters of coverage. A quarter of coverage is the basic unit the Social Security Administration (SSA) uses to determine whether a worker is entitled to benefits. A worker earns a quarter of coverage based on his or her earnings (wages and self-employment income) during each calendar quarter.

The amount of earnings needed to obtain a quarter of coverage (QC) changes each year in accordance with changes to the national average wage index. This index reflects cost of living increases. The formula for determining the QC earnings amount is $250 times the ratio of the national average wage index for the current year to the 1976 average wage index, or if larger, the prior year amount. The resulting number is rounded to the nearest $10 multiple.

For 2021, the amount of earnings a worker must have to obtain a QC is $1,470. For 2022, this amount will increase to $1,510. Regardless of how high a worker's earnings are, no more than four QCs may be earned in one year.

NOTE

This calculation was different prior to 1978 when employers reported wages quarterly instead of annually.

The historical QC earnings amounts can be found on the SSA's website:

Amount of earnings needed to earn one quarter of coverage

Year	Earnings	Year	Earnings	Year	Earnings
1978	$250	1998	$700	2018	$1,320
1979	260	1999	740	2019	1,360
1980	290	2000	780	2020	1,410
1981	310	2001	830	2021	1,470
1982	340	2002	870	2022	1,510
1983	370	2003	890		
1984	390	2004	900		
1985	410	2005	920		
1986	440	2006	970		
1987	460	2007	1,000		
1988	470	2008	1,050		
1989	500	2009	1,090		
1990	520	2010	1,120		
1991	540	2011	1,120		
1992	570	2012	1,130		
1993	590	2013	1,160		
1994	620	2014	1,200		
1995	630	2015	1,220		
1996	640	2016	1,260		
1997	670	2017	1,300		

https://www.ssa.gov/oact/cola/QC.html

The 2021 and 2022 QC earnings amounts were calculated as follows:

2021	
Amounts in Formula	
1978 Earnings for One QC	$250.00
Average Wage Index - 1976	$9,226.48
Average Wage Index - 2019	$54,099.99
Calculation	
$250 x 2019 AWI	$13,524,997.50
Divided by 1976 AWI	$1,465.89
Rounded to Closest $10 Multiple	$1,470.00
Highest of Prior Year and Current Year	
2019 Earnings Amount	$1,360.00
2020 Earnings Amount	$1,470.00
Highest Amount is the Earnings Amount	
2021 Earnings Amount	$1,470.00

2022	
Amounts in Formula	
1978 Earnings for One QC	$250.00
Average Wage Index - 1976	$9,226.48
Average Wage Index - 2020	$55,628.60
Calculation	
$250 x 2020 AWI	$13,907,150.00
Divided by 1976 AWI	$1,507.31
Rounded to Closest $10 Multiple	$1,510.00
Highest of Prior Year and Current Year	
2020 Earnings Amount	$1,470.00
2021 Earnings Amount	$1,510.00
Highest Amount is the Earnings Amount	
2022 Earnings Amount	$1,510.00

Insured Status

A worker generally must be insured to receive benefits. Other requirements may also apply depending on the circumstances under which benefits are claimed. There are two different categories of insured status: fully insured and permanently insured.

Fully insured. A worker will be fully insured if he or she earns at least one QC for each calendar year after attaining the age of 21 through the calendar year in which occurs the earliest of: (1) the year before turning age 62, (2) the year before the date of death, or (3) the year in which he or she becomes disabled. Workers born prior to 1930 only need to have earned one QC for each year after 1950. The minimum number of QCs that the worker must have earned is 6, and the maximum number is 40. Any year (all or part of such year) that was included in a period of disability is not included in determining the number of QCs needed.

Permanently insured. A worker will be permanently insured if the worker is fully insured and will not lose his or her status as fully insured when working under covered employment ceases. Workers who have earned 40 QCs are permanently and fully insured.

EXAMPLE

Mary began working in August 1993 as a research assistant for her college professor, earning $210 per month until her graduation in May 1994. Mary turned 21 in March of 1994. After graduation, Mary continuously worked and exceeded the minimum earnings threshold necessary to earn a QC. The calculation to determine by when she will complete the 40 QCs necessary to be insured is as follows:

The quarters in which she earned more than the earnings amount prior to her 21st birthday are disregarded. Since she turned 21 in March of 1994 and she earned $210 each month, she would not satisfy the earnings requirement for Q1 of 1994. However, she would earn a QC for each quarter

beginning in Q2 of 1994. So, Mary would earn QCs as follows:

Year	QCs
1994	3
1995	4
1996	4
1997	4
1998	4
1999	4
2000	4
2001	4
2002	4
2003	4
2004	1
	40

Therefore, Mary would become permanently fully insured on April 1, 2004.

Disability insured. Workers earn disability-insured status when they earn at least 20 QCs in the 10-year period prior to the disability. At this point they are considered fully insured. Exceptions apply to workers under age 31.

To be eligible for disability benefits, a worker must meet two tests: (1) the recent work test and (2) the duration work test.

The recent work test is satisfied if a worker meets a specified number of QCs that are dependent on age. If a worker is under age 24, he or she must have earned six credits in a three-year period ending on the date the disability begins. If a worker is between the ages of 24 and 31, the worker qualifies for disability benefits if he or she has credit for working half of the time between age 21 and the date the disability begins. If a worker is age 31 or older, he or she must have earned 20 credits in the 10-year period immediately preceding the date the disability begins.

EXAMPLE

Sam became disabled on October 1, 2021, when he was 25. Sam turned 25 on April 1, 2021. Sam will qualify for disability benefits if he has credits for working half of the time between the date he turned 21 and the date his disability began. This is determined as follows:

Disability Eligibility			
Sam's Age	Period of Time	Months	Quarters
21	April 1, 2017 to March 31, 2018	12	4
22	April 1, 2018 to March 31, 2019	12	4
23	April 1, 2019 to March 31, 2020	12	4
24	April 1, 2020 to March 31, 2021	12	4
25	April 1, 2021 to October 1, 2021	6	2
	Total	54	18
	Half the Time Between 21 and Disability	27	9

To satisfy the duration work test, a worker must have accrued a certain number of years of work in order to be eligible for disability benefits. The years required depend upon a worker's age at disability as follows:

Age at Disability	Years of Work Needed
Before 28	1.5
30	2
34	3
38	4
42	5
44	5.5
46	6
48	6.5
50	7
52	7.5
54	8
56	8.5
58	9
60	9.5

https://www.ssa.gov/benefits/retirement/planner/credits.html

For this test, a person's work does not have to fall within a certain period. Statutorily blind individuals are only subject to the duration of work test and are not required to satisfy the recent work test.

RETIREMENT BENEFITS

Coverage Requirements

If a worker retires, he or she is entitled to Social Security retirement benefits if the following requirements are satisfied: he or she (1) worked in covered employment long enough to be insured and (2) is at least 62 years old. Social Security is intended to replace a percentage of a worker's pre-retirement income based on the worker's lifetime earnings. Benefits are calculated based on a person's highest 35 years of earnings. Benefit amounts paid vary depending on the amount of wages earned and when the worker elects to begin receiving payments.

OTHERS WHO CAN CLAIM BENEFITS ON A WORKER'S EARNINGS RECORD

The spouse of a retired worker can also claim retirement benefits on the retired worker's earnings record if the spouse either (1) has a child under the age of 16, or a disabled child in his or her care; or (2) is at least 62 years old. This also applies to divorced spouses if the marriage to the beneficiary spouse lasted at least 10 years, which is explained more fully below.

There are three types of child beneficiaries who are also entitled to retirement benefits on a worker's earnings record. These include children of the retired worker who are under the age of 18, adult children who were disabled before the age of 22, and high school students who are under the age of 19.

The Social Security Administration estimates that on average, retirement beneficiaries receive 40% of their pre-retirement income (as limited by the Social Security Wage Base).

FICATAXES

Taxes under the Federal Insurance Contributions Act (FICA) are composed of the old-age, survivors, and disability insurance taxes, also known as Social Security taxes, and the hospital insurance tax, also known as Medicare taxes. Different rates apply for these taxes.

The Social Security Wage Base is the maximum amount of earned gross income upon which employment taxes may be imposed. The Social Security Wage Base is adjusted annually for inflation. In 2021, the wage base is $142,800. The wage base will be $147,000 in 2022.

Social Security taxes consist of two components: (1) employer-paid tax and (2) employee-paid tax. For self-employed individuals, both components are paid by the self-employed person. In 2021, the rate for both the employer-paid portion and the employee-paid portion was 6.2% each, for a total of 12.4%. The rates remain unchanged for 2022.

Medicare tax consists of two components: (1) employer-paid tax and (2) employee-paid tax. Like Social Security taxes, self-employed individuals pay both components. In 2021, the rate is 1.45% for each component, for a total of 2.9%. The rates remain unchanged for 2022.

Electing to Receive Benefits

A worker may elect to start receiving benefits at any of three different times: (1) normal retirement age, (2) early retirement age (age 62), or (3) delayed retirement age (age 70). If benefits begin at age 62, the normal retirement age benefit amount will be reduced by a percentage for each month prior to normal retirement age when benefits are elected to be received. If benefits are delayed to age 70, the monthly benefit amount is increased by a percentage.

Normal retirement age is determined by reference to a person's year of birth as follows:

Year of Birth	Normal Retirement Age
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–	67

NOTE

In 1983, Congress passed the Social Security Amendments of 1983 (P.L. 98-21), which raised the normal retirement age from 65 to 67 for those born in 1960 and later.

SOCIAL SECURITY DISABILITY

Social Security disability benefits are available for disabled workers, spouses of disabled workers, and children of disabled workers if certain requirements are satisfied.

If a worker becomes disabled, the worker will be entitled to disability benefits if he or she worked in covered employment long enough to be insured and had been working in covered employment prior to the onset of the disability.

Disability benefits can be reduced if other disability-based benefits, such as workers' compensation, are paid. Disability benefits are redetermined every three years. Additionally, some family members may receive benefits, in which case benefits may be limited. This is referred to as a family maximum benefit, which is discussed more fully below.

NOTE

Like retirement benefits, the spouse of a disabled worker will be entitled to benefits if the spouse meets the following requirements: the spouse must either (1) have a child under the age of 16, or a disabled child in his or her care; or (2) be at least 62 years old. This also applies to a divorced spouse if he or she was married to the beneficiary spouse for at least 10 years.

There are three types of child beneficiaries who are entitled to disability benefits. These include children who are under the age of 18, adult children who were disabled before the age of 22, and high school students who are under the age of 19.

These benefits are subject to maximums. This maximum is equal to 85% of the worker's average indexed monthly earnings (AIME), which is discussed more fully below. However, in no event may it be less than the worker's primary insurance amount (PIA) or more than 150% of the worker's PIA (also discussed more fully below).

SURVIVOR BENEFITS

Survivor benefits are available to certain children of deceased workers, aged widows(ers), young widows(ers), disabled widows(ers), and parents of deceased workers.

There are three types of child beneficiaries who are entitled to survivor benefits. These include children who are under the age of 18, adult children who were disabled before the age of 22, and high school students who are under the age of 19.

Widows(ers) who are at least 60 years old are entitled to survivor benefits, as well as young widows(ers) with a child under the age of 16 or a disabled child in his or her care.

A disabled widow(er) is entitled to survivor benefits if he or she is disabled and at least 50 years old. A disabled widow(er) will be converted to the category of an aged widow(er) when he or she attains age 65.

Parents of deceased workers are entitled to survivor benefits if they were dependent on the worker and are at least 62 years old.

The number of credits a worker needs for his or her family to be eligible for survivor benefits depends on the worker's age on the date of death. The younger a person is on the date of death, the fewer credits needed. The most credits anyone needs to be eligible for survivor benefits is 40.

If a worker's credits are not sufficient, a special rule may apply that allows the SSA to provide benefits to a worker's children and the spouse caring for the children. Under this rule, benefits may be provided if the worker has six credits in the three-year period immediately preceding the date of death.

If a worker is already receiving retirement or disability benefits on the date of death, survivor benefits will be paid without having to calculate credits again.

COMPUTATION OF BENEFITS

General

Social Security retirement benefits are based on lifetime earnings. These lifetime earnings are then indexed for inflation. Once wages are indexed, they are averaged to determine monthly earnings over the 35 highest earning years to arrive at the average indexed monthly earnings (AIME). A formula is applied to these earnings to arrive at the PIA (the basic benefit amount). This PIA is the amount that would be received at normal retirement age. Depending on whether a worker elects to start receiving benefits at early retirement age (age 62) or at age 70, this amount is adjusted up or down.

Average Indexed Monthly Earnings (AIME)

Before a benefit is calculated, lifetime earnings must be indexed for inflation over the period the worker has been employed. The highest 35 years of earnings (as indexed for inflation) are used for this purpose. Once these 35 years are identified, the indexed earnings are added together, then divided by the total number of months in those years. The resulting number is rounded down to the next lowest dollar amount. This results in the AIME amount.

If a worker becomes eligible for retirement benefits in 2022, the national wage index for 2020 (which is $55,628.60) would be divided by the national average wage index for each year prior to 2020 in which the worker had earnings. This ratio would then by multiplied by his or her actual earnings. This would give the indexed earnings for each year occurring before 2020. The AIME would be calculated and used in calculating the PIA for 2022. For 2023, these amounts increased.

Primary Insurance Amount

The primary insurance amount (PIA) is the sum of three separate percentages of parts of the AIME. The percentages are set by law; however, the dollar amounts are adjusted for inflation each year. These dollar amounts are referred to as "bend points." The bend points identify the three different portions of the AIME.

For workers who become eligible for benefits in 2022, the bend points are $1,024 and $6,172. See Appendix A for a chart with all the historical bend points.

EXAMPLE

Assume Amariya had maximum-taxable earnings in each year since she began working at 22, and she retired in 2022 at age 62. She would have an AIME that equals $11,430. On this basis, the bend points would be $1,024 and $6,172, resulting in a PIA of $3,357.60. She would receive a reduced benefit based on this PIA. The first cost-of-living adjustment (COLA) she would be eligible to receive would be in December 2022.

Monthly Benefit Amounts

Monthly benefit amounts are made based on the PIA. The monthly amount may be higher or lower than the PIA depending on whether a person retires early, retires at normal retirement age, or delays retirement to age 70. If a person retires early, the PIA is reduced by 25%. If a person delays retirement to age 70, benefits are increased, gradually reaching 8% per year (for those born after 1942).

The maximum Social Security retirement benefits payable in 2021 are:

- $3,895 per month for delayed retirement age (age 70)
- $3,148 per month for normal retirement age (ages 65–67 depending)
- $2,324 per month for early retirement age (age 62)

The maximum Social Security retirement benefits payable in 2022 are:

- $4,194 per month for delayed retirement age (age 70)
- $3,345 per month for normal retirement age (ages 65–67 depending)
- $2,364 per month for early retirement age (age 62)

MAXIMUM FAMILY BENEFIT

There is a maximum family benefit that can be paid on any one worker's earnings record. This formula is based on the worker's PIA. For 2022, the sum of the following is used to determine the maximum: (1) the first $1,308; (2) the amount between $1,308 and $1,889; (3) the amount between $1,889 and $2,463; and (4) the amount over $2,463. These are the "bend points" for calculating the maximum family benefit. (See Appendix A for a table that includes historical bend points for this purpose.)

If a worker becomes age 62 or dies in 2022 before reaching age 62, his or her family would be entitled to benefits that do not exceed:

- 150% of the first $1,308 of the worker's PIA, plus
- 272% of the worker's PIA over $1,308 through $1,889, plus
- 134% of the worker's PIA over $1,889 through $2,463, plus
- 175% of the worker's PIA over $2,463.

The total is then rounded to the next lowest multiple of $0.10 (if it's not a multiple of $0.10).

EXAMPLE

Continuing with Amariya's example, assuming a PIA of $3,357.60, her maximum family benefit amount would be calculated as follows:

Maximum Family Benefit			
Formula		Amounts Based on $3,358 PIA	Formula Amount
150%	of first $1308 of PIA, PLUS	$1,308	$1,962.0
272%	of PIA of $1,309 through $1,889, PLUS	$580	$1,577.60
134%	of worker's PIA of $1,890 through $2,463, PLUS	$573	$767.82
175%	of worker's PIA over $2,463	$895	$1,566.25
		Total	$5,873.7

SPOUSAL BENEFITS

Some spouses may be eligible for benefits when a worker files for retirement benefits. This spousal benefit is based on the worker's earnings. In order to be eligible for spousal benefits, the spouse must be at least 62 years of age or have a qualifying child under his or her care. A qualifying child is one who is under age 16 or who receives Social Security disability benefits.

Spousal benefits may be up to an amount equal to half of the worker's PIA, but this depends on the spouse's retirement age. If the spouse elects to begin receiving benefits before normal retirement age, the spouse will receive a lower benefit. However, if the spouse is caring for a qualifying child, this benefit is not reduced.

If a worker elects to begin receiving retirement benefits early, his or her benefit will be reduced. This can result in a benefit that may be only 32.5% of the worker's PIA. A spousal benefit would then be reduced 25/36 of 1% for each month before normal retirement age, up to 36 months. If the number of months is more than 36, the benefit is reduced further by 5/12 of 1% per month. If a spouse is not eligible for his or her own retirement benefits on the basis of their own earnings, the reduction formula is applied to the base spousal support benefit (i.e., 50% of the worker's PIA).

EXAMPLE

Assume Miranda's primary insurance amount is $2,200, and her spouse, Max, chooses to begin taking spousal benefits 36 months before normal retirement age. The benefit is calculated as follows: 50% of $2,200 is $1,100. This is the base spousal benefit. Then the reduction formula is applied. This is 36 times 25/36 of 1%, or 25%. The $1,100 is reduced by 25%, for a spousal benefit of $825. This means the final spousal benefit is 37.5% of the PIA.

If the spouse is eligible for both his or her own retirement benefits based on his or her own earnings and a spousal benefit, the higher of the two will be paid.

PENALTY FOR EARNED INCOME

If a worker elects to begin receiving Social Security benefits and continues to work, the benefits will be reduced if yearly earning limits are exceeded. Each year, the SSA reviews the records of all Social Security beneficiaries who report wages. If the wages earned result in one of the worker's highest earning years, the benefit is recalculated and any increase in benefits will be paid.

NOTE

If a worker has reached normal retirement age, there is no limit on earnings and no penalty for earned income.

If a worker is younger than his or her normal retirement age (NRA) and earns more than the yearly earnings limit, benefits paid may be reduced. For 2021, if a worker is younger than NRA for the entire year, $1 for each $2 earned above $18,960 is deducted from benefits paid. For 2022, this threshold is $19,560. For 2021, if a worker reaches NRA during the year, $1 of each $3 earned above $50,520 is deducted until the month NRA is attained. For 2022, this dollar threshold is $51,960.

EXAMPLE 1

Assume Marcus filed for Social Security benefits when he reached age 62 in January of 2021. Also assume his payment is $9,600 per year, or $800 per month. If Marcus earns $26,540 for the year, his earnings would exceed the $18,960 threshold by $7,580. $1 of every $2 earned over the threshold would be $7,580 divided by 2, or $3,790. Therefore, his Social Security benefits would be reduced by $3,790, or 4.738 monthly benefit payments ($3,790/$800 = 4.738). The SSA would withhold all benefit payments from January through May. The $800 per month payments would resume in June. In 2022, the SSA would pay Marcus the amount that was over-withheld in May 2021 ($4,000 – $3,790 = $210).

EXAMPLE 2

Assume Marie filed for Social Security benefits when she reached age 62 and is paid a monthly benefit of $1,000. Marie will attain normal retirement age in November 2021. She expects to earn $51,540 between January and October. The SSA would withhold $1 for every $3 she earns above the $50,520 threshold, or $340 ($51,540 – $50,520 = $1,020/3 = $340). To cover this $340, the SSA would not pay Marie her first $1,000 benefit check of 2021. In 2022, she would be paid the $660 she was owed ($1,000 – $340 = $660) for the over-withholding from the January 2021 benefit payment.¬

For those who work for someone else, only wages count toward the earnings limits. For those who are self-employed, net earnings from self-employment are counted toward the earnings limits. The following do not count toward the limits: other governmental benefits, earnings from investments, interest, annuities, pensions, and capital gains. If an employee makes a retirement plan contribution, the contribution amount is included in earnings for purposes of the earnings limit if the contribution amount is included in the employee's gross wages. If an employee earns wages, the income counts when the wages are earned, not when they are paid. For those who are self-employed, the income counts when received, not when earned, unless it's paid in a year after the person becomes entitled to Social Security and earned before becoming entitled to Social Security.

First year of retirement rule. Those who retire mid-year may have earned more than the annual earnings limit. So, for the first year, retirees are permitted to get a full Social Security benefit payment for any whole month in which they were retired, regardless of yearly earnings. A person younger than normal retirement age for an entire year is considered retired if monthly earnings are less than or equal to $1,580.

EXAMPLE

Assume Sydney retires when she is 62 on October 31, 2021. She earns $45,000 through October, at which point she takes a part-time job beginning in November earning $500 per month. Although her earnings for the year substantially exceed the 2021 annual limit of $18,960, she will receive Social Security benefit payments for November and December. This is due to the fact that her earnings in November and December will be less than $1,580. If she earns more

than $1,580 in either November or December, she won't be paid a benefit for that month. The annual limit will apply beginning in 2022.

For self-employed individuals, the SSA looks at how much work is performed in the business to determine whether an individual is retired. The SSA applies the following general rule: if a person works more than 45 hours in a month in self-employment (i.e., performs substantial services in self-employment), he or she will not be considered retired. Working fewer than 15 hours in a month will be considered retired. If between 15 and 45 hours per month are spent working, a person will only be considered retired if the work is in a job that does not require a lot of skill, or is not the management of a sizable business.

DIVORCED OR WIDOWED SPOUSES

Divorced Spouses

If a worker is divorced, his or her ex-spouse may receive benefits on their record, even if the worker is remarried. This is the case only if the following requirements are satisfied: (1) the marriage lasted at least 10 years; (2) the ex-spouse is not married; (3) the ex-spouse is at least 62 years old; (4) the benefit the ex-spouse is entitled to on the basis of his or her own work record is less than the benefit to which they would be entitled based on the worker's earnings record; and (5) the worker is entitled to Social Security retirement or disability benefits.

The ex-spouse may receive benefits on a worker's record if the worker and ex-spouse have been divorced for at least two continuous years, even if the worker has not applied for retirement benefits (but still qualifies for such benefits). If an ex-spouse is entitled to benefits based on his or her own work history, that amount will be paid first. If the benefit on the worker's record is higher, the ex-spouse will be paid an additional amount that is based on the worker's record such that the total of the two amounts together equals the higher amount.

If a worker's ex-spouse is still working while receiving benefits, he or she is subject to the same earnings limits as apply to the worker. The amount of benefits a worker's ex-spouse gets does not impact the amount of benefits the worker or his or her current spouse is entitled to receive.

Divorced Widows and Widowers

A divorced widow or widower may receive benefits in the following scenarios: (1) at age 60 or older if the marriage to the deceased worker lasted at least 10 years; (2) at age 50 or older if disabled (and the marriage lasted at least 10 years); or (3) at any age if they take care of the deceased's child who is younger than 16 or is disabled.

SSA Press Release: Estimated Average Monthly Social Security Benefits Payable in 2022

Estimated Average Monthly Social Security Benefits Payable in January 2022		
Category	**Before 5.9% COLA**	**After 5.9% COLA**
All Retired Workers	$1,565	$1,657.0
Aged Couple, Both Receiving Benefits	$2,599	$2,753.00
Widowed Mother and 2 Children	$3,009	$3,187.00
Aged Widow(er) Alone	$1,467	$1,553.00
Disabled Worker, Spouse and 1 or More Children	$2,250	$2,383.00
All Disabled Workers	$1,282	$1,358.00

Source: https://www.ssa.gov/news/press/factsheets/colafacts2022.pdf

APPENDIX A

Historical Bend Points

Dollar amounts in Primary Insurance Amount and maximum family benefit formulas

Year [a]	Dollar amounts in PIA formula		Dollar amounts in maximum family benefit formula		
	First	Second	First	Second	Third
1979	$180	$1,085	$230	$332	$433
1980	194	1,171	248	358	467
1981	211	1,274	270	390	508
1982	230	1,388	294	425	554
1983	254	1,528	324	468	610
1984	267	1,612	342	493	643
1985	280	1,691	358	517	675
1986	297	1,790	379	548	714
1987	310	1,866	396	571	745
1988	319	1,922	407	588	767
1989	339	2,044	433	626	816
1990	356	2,145	455	656	856
1991	370	2,230	473	682	890
1992	387	2,333	495	714	931
1993	401	2,420	513	740	966
1994	422	2,545	539	779	1,016
1995	426	2,567	544	785	1,024
1996	437	2,635	559	806	1,052
1997	455	2,741	581	839	1,094
1998	477	2,875	609	880	1,147
1999	505	3,043	645	931	1,214
2000	531	3,202	679	980	1,278
2001	561	3,381	717	1,034	1,349
2002	592	3,567	756	1,092	1,424
2003	606	3,653	774	1,118	1,458
2004	612	3,689	782	1,129	1,472
2005	627	3,779	801	1,156	1,508
2006	656	3,955	838	1,210	1,578
2007	680	4,100	869	1,255	1,636
2008	711	4,288	909	1,312	1,711
2009	744	4,483	950	1,372	1,789
2010	761	4,586	972	1,403	1,830
2011	749	4,517	957	1,382	1,803
2012	767	4,624	980	1,415	1,845
2013	791	4,768	1,011	1,459	1,903
2014	816	4,917	1,042	1,505	1,962
2015	826	4,980	1,056	1,524	1,987
2016	856	5,157	1,093	1,578	2,058
2017	885	5,336	1,131	1,633	2,130
2018	895	5,397	1,144	1,651	2,154
2019	926	5,583	1,184	1,708	2,228
2020	960	5,785	1,226	1,770	2,309
2021	996	6,002	1,272	1,837	2,395
2022	1,024	6,172	1,308	1,889	2,463

[a] Year of eligibility; that is, the year in which a worker attains age 62, becomes disabled before age 62, or dies before attaining age 62.

https://www.ssa.gov/OACT/COLA/bendpoints.html

REVIEW QUESTIONS

1. For 2021, the amount of earnings needed to obtain a quarter of coverage is:

a. $250

b. $1,360

c. $1,470

d. $1,889

2. Absent a disability or other exception, how many total quarters of coverage must a worker have obtained to be considered fully insured?

a. 30

b. 40

c. 50

d. 60

3. If a worker wants to maximize the monthly retirement benefit amount, at what age should he or she elect to start receiving benefits?

a. 60

b. 62

c. 67

d. 70

4. Workers aged 31 and older will earn disability-insured status when they have earned at least 20 quarters of coverage in the ___ -year period immediately preceding a disability.

a. 5

b. 8

c. 10

d. 15

5. For purposes of the disability duration work test, workers need two years of work by the time they reach which age to be eligible for disability benefits?

a. 30

b. 34

c. 38

d. 42

6. Social Security is intended to replace a percentage of a worker's pre-retirement income based on lifetime earnings, which is calculated based on a person's highest ___ years of earnings.

a. 25

b. 30

c. 35

d. 40

7. The total employment tax rate a self-employed person must pay for Social Security and Medicare is:

a. 6.2%

b. 12.4%

c. 13.85%

d. 15.3%

8. The maximum monthly Social Security retirement benefits payable in 2021 for those taking benefits at normal retirement age are:

a. $2,324

b. $3,148

c. $3,895

d. $6,172

9. The minimum amount of a worker's retirement benefit that would be paid to a spouse as a spousal benefit is ___% of the worker's retirement benefit.

a. 32.5

b. 37.5

c. 50

d. 52.75

10. In 2021, if a worker is younger than the normal retirement age for the entire year, $1 for every __ earned above $18,960 is deducted from benefits paid.

a. $2

b. $3

c. $4

d. $5

ANSWERS TO REVIEW QUESTIONS

1. a. Incorrect. This was the 1978 earnings amount.

b. Incorrect. $1,360 was the 2019 earnings amount.

c. Correct. $1,470 of earnings is needed to obtain a quarter of coverage credit.

d. Incorrect. This is one of the bend points for determining a maximum family benefit amount.

2. a. Incorrect. A worker needs more than 30 quarters of coverage to be considered fully insured.

b. Correct. A worker must obtain 40 quarters of coverage to be fully insured.

c. Incorrect. 50 quarters of coverage is not the correct answer.

d. Incorrect. A worker needs fewer than 60 quarters of coverage to be fully insured.

3. a. Incorrect. A worker may not elect to begin receiving retirement benefits as early as age 60.

b. Incorrect. A worker may elect to begin receiving benefits at early retirement age, but he or she will receive a lower monthly benefit amount.

c. Incorrect. At normal retirement age, a worker will receive the full monthly benefit amount of retirement benefits, but this amount will not be increased or decreased.

d. Correct. To get the highest possible monthly retirement benefit amount, a worker should delay receiving benefits until age 70 when his or her monthly benefit amount will be increased by 8%.

4. a. Incorrect. The applicable period is longer than 5 years.

b. Incorrect. 8 years is not the correct number of years.

c. Correct. A 10-year period is correct.

d. Incorrect. A worker is not required to earn 20 quarters of coverage in the 15-year period prior to a disability.

5. a. Correct. A 30-year-old needs to complete two years of work prior to disability to be eligible for such benefits.

b. Incorrect. A 34-year-old needs three years of work to be eligible for disability benefits.

c. Incorrect. To be eligible for disability benefits, a worker who becomes disabled at age 38 needs four years of work.

d. Incorrect. A worker who becomes disabled at age 42 needs five years of work to be eligible for disability benefits.

6. a. Incorrect. The number of years is greater than 25.

b. Incorrect. Lifetime earnings are not calculated based on a person's highest 30 years of earnings.

c. Correct. Lifetime earnings are calculated on the basis of a worker's highest 35 years of earnings.

d. Incorrect. The number of years is fewer than 40.

7. a. Incorrect. 6.2% represents only one part of the FICA tax. Self-employed individuals are required to pay both the employee and employer portion of the FICA tax and the Medicare tax.

b. Incorrect. A self-employed person is obligated to pay Medicare tax as well as the FICA tax.

c. Incorrect. A self-employed person must pay both the employee and employer portions of FICA and Medicare taxes.

d. Correct. A self-employed person must pay both the employee and employer portions of FICA and Medicare (12.4% + 2.9% = 15.3%).

8. a. Incorrect. This is the maximum monthly benefit for those who elect to start receiving benefits at age 62.

b. Correct. The maximum monthly retirement benefit is $3,148 for those that began receiving Social Security at the normal retirement age (ages 65-67 depending on their year of birth).

c. Incorrect. This is the maximum monthly benefit for those who elect to start receiving benefits at age 70.

d. Incorrect. This is the second AIME bend point for 2022.

9. a. Correct. The minimum spousal benefit is 32.5% of the worker's retirement benefit.

b. Incorrect. A spouse's applicable percentage may calculate to 37.5%, but this is not the minimum.

c. Incorrect. The maximum percentage is 50%.

d. Incorrect. The minimum percentage is less than 52.75%.

10. a. Correct. If a worker is younger than NRA and earns more than the yearly earnings limit, benefits may be reduced. For 2021, $1 for each $2 earned above $18,960 is deducted from benefits paid. For 2022, the threshold is $19,560.

b. Incorrect. This is the dollar amount applicable to those who have reached normal retirement age.

c. Incorrect. This is double the correct dollar amount.

d. Incorrect. The dollar amount is less than $5.

Chapter 2

MEDICARE AND MEDICAID

LEARNING OBJECTIVES

After reviewing this chapter, you should be able to:

- Explain the basic differences between Medicare and Medicaid
- Name the different parts of Medicare
- Describe Medicare premiums
- Explain eligibility for Medicaid
- Identify ways other than Medicaid to help pay for Medicare for those with financial need

OVERVIEW

Medicare debuted during the "Great Society" as a way to help seniors pay for medical care. First proposed by President Truman in 1945, it was signed into law by President Johnson in 1965. At that time, the age for Medicare mirrored the age for receiving full Social Security benefits. Over the years, there have been changes to Medicare, expanding those eligible to receive it. The basic age for Medicare has been maintained at 65 even though the full retirement age for Social Security benefits has been increased. Today, more than 62.7 million people are on Medicare.

Medicaid came into effect at the same time as Medicare. Although established under federal law, state rules mean that coverage for individuals depends on where they live. Today, more than 75.4 million people are enrolled in Medicaid.

MEDICARE

Medicare is a federal health insurance program designed for people aged 65 and older, as well as certain younger individuals with disabilities and those with end-stage renal disease or amyotrophic lateral sclerosis (ALS), commonly known as Lou Gehrig's disease. Except as noted below, enrollment in Medicare isn't automatic. A person eligible for coverage must enroll during certain enrollment periods. Enrollment is done through the Social Security Administration (SSA.gov). Details on enrollment are discussed later.

Eligibility

Income and assets do not affect eligibility for Medicare (although income may trigger additional premium costs, explained later). Eligibility for Medicare usually depends on having paid Medicare taxes (part of FICA for employees and/or self-employment tax for self-employed individuals) for at least 40 quarters (i.e., 10 years of work) over a lifetime, but there are exceptions.

The net investment income (NII) tax, which is an additional Medicare tax imposed on investment income of individuals with modified adjusted gross income (MAGI) above a threshold amount relevant to filing status, does not impact Medicare eligibility. The NII tax is not treated as a work quarter.

Other ways to obtain Medicare include:

- Spousal coverage. Those who are married at least one year to a person eligible for Medicare can obtain Part A coverage for free and Parts B and D coverage by paying the applicable premiums (discussed later in this chapter). Those who are widowed or divorced may also qualify for Medicare based on their former spouse's eligibility.

- Paying for Part A coverage. Those who do not have the requisite quarters to qualify for Medicare on their own or through a spouse or former spouse may obtain Part A coverage by paying a premium. This then entitles them to obtain other parts of Medicare by paying the applicable premiums.

Impact on health savings accounts. Once a person enrolls in Medicare, he or she is no longer able to make contributions to health savings accounts (HSAs). No tax penalty will apply if an HSA contribution is made the month before commencing Medicare coverage. However, attaining age 65 means that withdrawals from HSAs for non-medical purposes are not penalized. These withdrawals are includible in gross income; withdrawals to pay qualified medical expenses are not. Qualified medical expenses include Medicare co-payments and deductibles, but do not include premiums for Medicare or supplemental Medicare policies.

Enrolling in Medicare

Enrollment in Medicare is not tied to receiving Social Security benefits. As mentioned earlier, coverage generally begins at age 65, regardless of whether the person is collecting benefits. However, those who began to collect benefits before age 65 are automatically enrolled at this age, as are those receiving Social Security disability benefits for 24 months or from day one for those with ALS. The initial enrollment period begins three months before turning 65 and ends three months after, for a total enrollment period of seven months.

Those who turn age 65 should enroll in Medicare unless receiving coverage through another source (e.g., employer coverage for a group plan with 20 or more employees so that the group plan is treated as primary coverage). The failure to enroll in Medicare when eligible may result in penalties.

- For Part A for those who have to pay for it, the penalty is a 10% higher monthly premium for twice the years for which enrollment was delayed.

EXAMPLE

An individual lacking 40 quarters should have enrolled in 2019 and delays until 2020 (two years). The 10% higher premium applies for four years.

- For Part B, the penalty is 10% for each 12-month period a person should have been enrolled but wasn't for the rest of the person's life. The penalty doesn't apply if the person enrolls during the special enrollment period, explained later.

EXAMPLE

An individual who became eligible to enroll in Part B in the open enrollment period ending December 2019 eventually enrolls in February 2022 during the general enrollment period. The penalty is 20% for as long as the individual has Part B coverage.

- For Part D, the penalty is 1% of the "national base beneficiary premium" (e.g., $33.37 in 2022) multiplied by the number of full uncovered months during which an individual was eligible for coverage. The penalty continues to apply for as long as the individual has Part D coverage. As the national base beneficiary premium increases annually, so too does the penalty.

Enrollment periods. The open enrollment period for Medicare typically runs from mid-October through early December (e.g., December 7, 2021, for coverage beginning January 1, 2022). There is also a late-enrollment period for those attaining age 65 after the open enrollment period.

There is a special enrollment period for those covered by a group health plan at the time initially eligible for enrollment. This is:

- Anytime if still enrolled in a group health plan. A group health plan does not include COBRA, VA coverage, retiree coverage from a previous employer, or coverage through a government marketplace, so having such coverage does not trigger the special enrollment period.
- During an eight-month period that begins the month after employment ends or the coverage ends, whichever is earlier.

Those who choose Medicare Advantage may change to a different Medicare Advantage plan or switch to original Medicare during the first quarter of the year of coverage (e.g., January 1, 2022, through March 31, 2022, for coverage beginning January 1, 2022).

There is also a general enrollment period for those who have to pay for Part A but didn't timely sign up or didn't sign up for Part B. This also runs for the first quarter of the year, but coverage obtained during the open enrollment period doesn't begin until July 1 of that year and higher premiums (explained earlier) apply.

Delaying enrollment. As explained earlier, penalties apply for those who do not timely enroll. However, in some situations, enrollment may be delayed without incurring a penalty. Examples include:

- Coverage through an employer (or spouse's employer)
- Coverage through a union
- Coverage due to being on activity military duty (or having a spouse on active duty).

Having Medicaid is no reason to delay enrollment. In fact, Medicaid will help individuals enroll in Medicare when eligible because Medicare becomes the primary payor, as explained earlier.

Changing from government exchange to Medicare. Those who have been covered through a government exchange and reach age 65 should cancel coverage. Any benefits paid through the exchange after age 65 must be repaid to the government.

Medicare Coverage

There are three basic parts of Medicare (called "original Medicare"):

- Part A is for hospital insurance. This pays for stays in a hospital as well as in a skilled nursing facility, hospice care, and some home health care. There are co-payments and limits on coverage. Part A does not pay for the cost of long-term care.
- Part B is for medical insurance. This covers the cost of doctors' fees, outpatient care, durable medical supplies (e.g., wheelchairs, hospital beds), and preventive services (e.g., screenings, shots, vaccines, and annual "wellness" visits). Again, there are co-payments and limitations on coverage.

- Part D is for prescription drug coverage. It covers the cost of prescription drugs and insulin. Once again, there are co-payments and limitations on coverage. For example, Medicare Part D may pay part of the cost of a particular drug or none at all. Part D also covers for no charge the cost of recommended shots and vaccines, such as those for COVID-19 and annual flu shots.

There is also Part C, which is called Medicare Advantage. This a Medicare-approved plan from a private company that combines Parts A, B, and C. The number of enrollees in Medicare Advantage has been growing annually, and according CMS.gov is expected to reach 29.5 million people in 2022 (https://www.cms.gov/newsroom/press-releases/cms-releases-2022-premiums-and-cost-sharing-information-medicare-advantage-and-prescription-drug).

There are a variety of Medicare Advantage plans, including health maintenance organizations (HMOs) and preferred provider organizations (PPOs). What's covered differs with the plan and the insurance company offering it. Plan offerings differ by location throughout the country. Having Medicare Advantage obviates the need to carry a Medigap policy (described later). And it may provide "extra benefits," such as a health club membership ("silver sneakers"), over-the-counter medications, expanded telehealth services, and rides to doctors' offices. But usually individuals must stay "in network" or pay higher co-payments. And there are higher out-of-pocket costs for hospital stays and other services than under original Medicare.

Original Medicare usually does not cover costs outside the United States (although Medicap policies, discussed later, may provide some help). Similarly, Medicare Advantage does not cover costs outside the United States, although some plans offer a benefit for emergency care needed abroad. Those who travel abroad may want to obtain special insurance coverage for their foreign travel.

Coinsurance and deductibles. Medicare does not cover all costs in all situations. There are various co-insurance amounts or deductibles that individuals pay. It is important to understand the terminology related to costs that may not be fully covered:

- Coinsurance: A portion of the cost of services (after a deductible). Usually, coinsurance is expressed as a percentage (e.g., 20%).
- Copayment: An amount required for medical services or supplies. Usually, a copayment is expressed as a dollar amount (e.g., a $25 copayment for a doctor's visit).
- Deductible: The amount an individual must pay before which original Medicare or Medicare Advantage will begin to pay.

Those with Medicap policies, discussed later, may have these amounts partially or fully paid through this separate insurance. Those with Medicaid have these amounts paid by the government. These coinsurance and deductible amounts may be changed annually.

The Part A hospital inpatient deductible and co-insurance amounts for 2022 are:

- $1,484 deductible for each benefit period
- Days 1–60: $0 coinsurance for each benefit period
- Days 61–90: $371 coinsurance per day of each benefit period
- Days 91 and beyond: $742 coinsurance per each "lifetime reserve day" after day 90 for each benefit period (up to 60 days over your lifetime)
- Beyond lifetime reserve days: all costs

The Part B deductible for 2022 is $203. After this deductible is met, for original Medicare an individual pays 20% of the Medicare-approved amount for most doctor services (including most doctor services while a hospital inpatient), outpatient therapy, and durable medical equipment (DME).

The Part D out-of-pocket costs depend on the drug plan in which the individual is enrolled and the drugs being purchased (e.g., generic, brand names). Most drug plans have a "donut hole," which is a gap in coverage during which the plans limit what they'll pay. The coverage gap begins after a certain amount has been spent on prescription drugs and insulin. For example, in 2022, the coverage gap begins at $4,430. Once the hole has been closed, the plans begin regular coverage again. Once payments for drugs exceed a set amount ($7,050 for 2022), catastrophic coverage begins. Usually, this means paying no more than 5% of the cost of covered drugs through the rest of the year.

For Medicare Advantage, different co-insurance, deductibles, and out-of-pocket costs apply. These depend on the plan in which an individual is enrolled.

NOTE

Regardless of the plans, Medicare beneficiaries as a group pay considerable amounts out of pocket each year beyond the cost of premiums. These added costs may result from:

- Long hospital stays
- Need for long-term care not otherwise covered through Medicaid (below) or long-term care insurance
- Prescription drug costs beyond what's covered
- Certain needs that may be only partially covered or not at all (e.g., vision care, hearing care, dental care).

Medicare Premiums

Even though individuals pay Medicare taxes on their wages and net earnings from self-employment throughout their lives, there are still premium requirements for coverage in most cases.

Premiums for Part A. Most individuals eligible for Medicare do not pay any annual premiums for Part A coverage (referred to as "premium-free Part A"). This is so for anyone with at least 40 quarters of work at a job or self-employment during their lifetime or who have a spouse eligible for premium-free Part A (each quarter is three months of the year). In effect, individuals eligible for premium-free Part A include those age 65 or older who are receiving Social Security or railroad retirement benefits, are eligible for them but haven't begun to collect, or had Medicare-covered government employment (or a spouse has such employment). Those under age 65 may also receive premium-free Part A if they have received Social Security or railroad retirement benefits for disability for at least 24 months or have end-stage renal disease or ALS.

However, individuals who are not eligible for free coverage can purchase it by paying annual premiums. For 2022, someone who paid Medicare taxes for less than 30 quarters pays a standard premium of $499 per month. For those with 30 to 39 quarters, the standard premium in 2022 is $274 per month.

Premiums for Part B Medicare. Part B is a voluntary program for which there is a monthly premium. There is a "standard" premium for Part B coverage paid by most beneficiaries, which may be adjusted annually for inflation. In 2022, the premium is $170.10 per month (compared with $148.50 per month on average for 2021).

Those who fall within a "hold harmless" clause pay a lower monthly premium for 2022. This clause prevents Social Security recipients from having their benefits reduced below the previous year due to increases in Medicare premiums. The hold harmless clause does not apply to those:

- Enrolled in Part B for the first time,
- Paying an income-related monthly adjustment amount premium (explained later), or
- Dually eligible for Medicaid and have Medicare premiums paid by a state Medicaid agency.

Premiums for Part D Medicare. There is no standard Part D premium. It depends on the provider chosen by the individual to pay prescription drugs. This amount may be adjusted annually and hasn't changed much in recent years. The national average Part D premium for 2022 is $33 per month.

Premiums for Medicare Advantage. Beneficiaries usually pay the same premiums charged for original Parts B and D coverage. In some cases, there may be additional charges. And high-income individuals covered by Part C also pay the additional monthly amounts listed in the following table.

Additional premiums. High-income taxpayers pay an additional monthly amount for Parts B and D. The additional amounts also apply to Part C Medicare Advantage. Technically, this is the income-related monthly adjustment amount (IRMAA). It is referred to simply as an additional premium amount.

The current additional amount is based on a taxpayer's current filing status using modified adjusted gross income (MAGI) two years prior (e.g., the 2022 amount is based on 2020 MAGI). MAGI for this purpose means adjusted gross income increased by tax-exempt interest. Individuals may be subject to the additional premiums one year but not the next; it all depends on MAGI two years prior to the year of coverage.

The following tables (one for Part B and one for Part D) show the 2022 surcharges and total premiums for higher-income taxpayers.

Part B and Part D Premiums for 2022

2020 MAGI for joint filers	2020 for other filers*	Total monthly Part B premium for 2022	Total monthly Part D premium for 2022
Up to $182,000	Up to $91,000	$170.10 unless held harmless	Your premium
$182,001 but not over $228,000	$91,001 but not over $114,000	$238.10	$12.40 + your premium
$228,001 but not over $284,000	$114,001 but not over $142,000	$340.20	$32.10 + your premium
$284,001 but not over $340,000	$142,001 but not over $170,000	$442.30	$51.70 + your premium
$340,001 but not over $750,000	$170,001 but not over $750,000	$544.30	$71.30 + your premium
$750,000 or greater	$500,000 or greater	$578.30	$77.90 + your premium

* Married persons filing separately for 2020 who did not live apart for the entire year are subject to a monthly premium for 2022 of $544.30 for Part B and $71.30 for Part D if 2020 MAGI was over $91,000 and under $409,000, or $578.30 for Part B and $77.90 for Part D if 2020 MAGI was $409,000 or more.

Planning strategies to minimize or avoid additional premiums. For some individuals, required minimum distributions (RMDs) may play a role in whether or to what extent they must pay additional Medicare premiums. Consider these factors:

- Because RMDs were suspended for 2020, individuals who might otherwise pay additional Medicare premiums may be not be required to do so for 2022, or at least pay a smaller amount.
- Those age 70½ or older may make qualified charitable distributions (QCDs) from their IRAs. These count toward their RMDs but are not includible in gross income. As such, they reduce MAGI for the year.
- RMDs to a limited extent can be postponed by investing in a qualified longevity annuity contract (QLAC), which provides a guaranteed income. Distributions from the annuity do not have to begin until a time specified under the contract, but must begin no later than age 85. The maximum amount that can be invested is limited to 25% of the account balance, but no more than dollar amount (e.g., $135,000 in 2021).

Waivers for additional premiums. An individual may request a waiver of the additional monthly amounts if paying them would cause a severe financial hardship. This may result from a life-changing event causing a reduction in MAGI in the last three months of a calendar year. The individual will need to request a new decision and provide proof of their life-changing event and tax information for the next year. Examples of life-changing events include:

- Getting married or divorced, having a marriage annulled, or becoming widowed.
- Stopping work or having reduced work hours. If married, a life-changing event for one can apply to both spouses.
- Losing income-producing property due to a disaster or other event beyond a person's control.
- Experiencing a scheduled cessation, termination, or reorganization of an employer's pension plan.
- Receiving a settlement from an employer or former employer because of the employer's closure, bankruptcy, or reorganization.

To request a waiver, call the Social Security Administration at 800-772-1213. This must be done no later than March 31 of the year following the year in which notice about the additional amounts is received. So, the request should be made in the first quarter of the year in which the additional amounts are being paid.

Paying Medicare Premiums

Medicare premiums are subtracted from payments to those receiving Social Security benefits. Those who are not receiving Social Security benefits (e.g., those who delay benefits past full retirement age) pay Medicare premiums to the Social Security Administration. This can be done online by credit card, by debit card, or from a savings or checking account. Payments may be set up using a bank's online bill payment services or Medicare Easy Pay, which is a free service authorizing the Social Security Administration to debit your bank account each month to cover premiums. Or payment may be made by personal check or money order made payable to CMS Medicare Insurance and sent to the Medicare Premium Collection Center.

Deducting Medicare-Related Costs

Annual premiums paid for Medicare are reported annually in box 3 of Form SSA-1099, Social Security Benefits Statement. Premiums paid for Medicare coverage listed on the form, as well as co-insurance, deductibles, and out-of-pocket costs, which are all deductible medical expenses.

Generally, only those who itemize may deduct medical costs, the total of which must exceed 7.5% of adjusted gross income to actually be deductible. However, self-employed individuals may treat their Medicare premiums, as well as those of a spouse, as an adjustment to gross income; no itemizing is required. There is no dollar limit on the deduction for self-employed individuals, but it cannot exceed net earnings from self-employment. Thus, if a self-employed individual's business has a loss,

no deduction is allowed for premiums. Self-employed individuals who deduct their premiums as an adjustment to gross income may also deduct their out-of-pocket costs under Medicare as itemized medical expenses if they itemize personal deductions.

MEDICAID

Medicaid is a federal/state program designed to cover medical costs for those with a financial need. Basically, the program is federally controlled but administered by the states. Medicaid is designed to help individuals who lack the income or resources to pay for their medical costs. As a rule of thumb, these are individuals with gross income below the threshold that would require them to file a federal income tax return.

There is no age requirement for Medicaid as there is for Medicare; it may cover young adults as well as seniors. There is no work history requirement; someone who has never worked may still be eligible for Medicaid. There are no premiums for Medicaid coverage.

Medicaid for Long-Term Care

Medicare does not pay for long-term care, which is essentially custodial care for someone with a chronic condition or cognitive impairment (e.g., those with Parkinson's or Alzheimer's disease). If a low-income person who requires long-term care cannot pay out-of-pocket for this care and does not have long-term care insurance, institutional Medicaid is available for eligible individuals. The person must require the level of care for institutional Medicaid, referred to as "functional criteria." This means having a need for nursing home level of care or meeting functional eligibility criteria.

Eligibility

To qualify for Medicaid, an individual's income and assets must be below certain guidelines. These are referred to as financial criteria. These guidelines vary by state and can change from year to year. As a rule of thumb, states with expanded Medicaid (39 states and the District of Columbia as of September 2021) enable individuals under age 65 to qualify for Medicaid if their household income is no more than 138% of the current year's federal poverty level (which can be adjusted annually). In states that do not have expanded Medicaid (12 as of September 2021), eligibility requirements are stricter. State criteria may be found at https://www.medicaidplanningassistance.org/state-specific-medicaid-eligibility/. Essentially, the income thresholds for Medicaid eligibility fall below the point at which an individual could qualify for the premium tax credit for obtaining health insurance through a government marketplace. Special eligibility rules apply for children and for institutional Medicaid designed for those (primarily seniors) requiring long-term care (explained later).

Income limit for children. Children may be eligible for Medicaid or the Children's Health Insurance Program (CHIP) at a lower household income than for adults.

Income test for institutional Medicaid. There is a special income test for an individual seeking institutional Medicaid. Income, for purposes of Medicaid eligibility, has no relation to taxable income. For example, all Social Security benefits are counted as income, regardless of whether or to what extent they are includible in gross income. Other examples of income for Medicaid purposes include alimony payments, pensions, IRA withdrawals, and stock dividends. Income did not include economic impact payments (EIPs), which were paid by the federal government in 2020 and 2021.

The majority of states have an optional special income level standard for institutionalized Medicaid (discussed below). In most states, the income limit for their fiscal year ending in 2022 is $2,383 per month for a single individual (this means an additional limit applies for part of 2022). The rules for married persons are more complicated. Usually, the income limit is applied per spouse, but special rules come into play if one spouse needs to be in a nursing home while the other remains in the couple's residence.

Asset test for institutional Medicaid. There is a special asset limit for an individual seeking institutional Medicaid. The limitation on assets also varies from state to state. In most states, it's $2,000, other than exempt assets. Some states have higher limits (e.g., New York's limit in 2021 was $15,900, with an updated limit for 2022 to be announced later in 2022). California essentially eliminated the asset limit as of July 1, 2022. Exempt assets, which are assets not counted in determining eligibility for Medicaid, include:

- A person's residence if the person resides in it or has an intent to return to it, provided the equity does not exceed a set amount
- Household furnishings
- Personal belongings (clothing and wedding/engagement ring)
- Car
- Irrevocable trusts (explained later)
- Funeral/burial expenses set aside (up to $2,500, or $5,000 for an individual and spouse)
- Life insurance with a cash surrender value of no more than $1,500

There is a lookback period, requiring assets transferred without consideration (i.e., merely gifted) within this period to be taken into account in determining eligibility. This means it will not help for a person to transfer assets within this period in order to fall below eligibility guidelines. If assets are sold within the lookback period, the proceeds become assets for determining Medicaid eligibility.

Generally, the lookback period is 60 months (five years). For example, a person in Texas applies for Medicaid on January 1, 2022. The lookback period runs to December 31, 2016. However, some states have different periods. California has a 30-month (2.5-year) lookback period. New York, as of July 1, 2021, created a separate lookback period for purposes of community-based services (home health care, adult day care, personal care assistance, and assisted living services); it is 30 months (2.5 years).

This period is phased in, starting with 6 months on July 1, 2021, and increasing by one month until it reaches the full 30 months by July 2023.

While the lookback period generally bars most transfers for purposes of Medicaid eligibility, some transfers are permissible. For example, a home may be transferred (gifted) to an adult child providing caregiver services and who's lived in the home for two years prior to the parent entering a nursing home. Also note that while assets may be exempt for purposes of Medicaid eligibility, it does not make them all free from a Medicaid recovery after death.

EXAMPLE

An individual living at home qualifies for institutional Medicaid and receives in-home care. After death, Medicaid has a right of recovery from the home (i.e., recoup amounts spent on the care from the proceeds of a sale of the home).

Applying for Medicaid

Like Medicare, to obtain coverage through Medicaid, an individual must apply for it. This is done through:

- Healthcare marketplace
- State Medicaid agency

OTHER STRATEGIES FOR MEDICARE AND MEDICAID

Medicare and Medicaid rules are very complex. To further complicate matters, there are some important strategies to optimize coverage through these government programs.

Supplementing Original Medicare

Those who use original Medicare and do not choose Medicare Advantage may want to have a Supplemental Medicare ("Medigap") policy to help pay co-payments, deductibles, and certain other out-of-pocket costs. Spouses must buy separate policies.

Medigap policies are A, B, C, D, F, G, and N, with each providing different coverage. But those who enrolled in Medicare on or after January 1, 2020, may not have Medigap policies covering Part B deductibles (so Plans C and F are no longer available to these individuals). Medigap policies have monthly premiums in addition to Medicare premiums. The premiums are based on the type of policy chosen.

Premiums for Medicap policies are eligible medical expenses for purposes of deducting itemized medical expenses. Similarly, self-employed individuals may deduct the premiums as adjustments to gross income (no itemizing is required), up to self-employment income for the year.

Help Paying Medicare Health Costs

Those who have limited income and resources, but not sufficiently low to qualify for Medicaid, may still be eligible for state programs. These are referred to as Medicare Savings Programs. These include:

- Qualified Medicare Beneficiary (GMB) Program to get help with basic premiums as well as deductibles, co-insurance, and co-payments.
- Specified Low-Income Medicare Beneficiary (SLMB) Program to help pay Part B premiums only.
- Qualifying Individual (QI) Program to help pay Part B premiums only. But grants for this from the state are limited to a first-come-first-served basis.
- Qualified Disabled and Working Individual (QDWI) Program to pay Part A premiums only for those required to make payments but were covered under certain conditions and then lost free premiums.

Help Paying for Drug Costs

Medicare Extra Help is a program to help those with limited income and resources pay their drug costs. It helps pay the costs that would otherwise be paid by those covered by Part D.

Eligibility depends on both income and resources; limits change annually. For 2021, the following limits applied:

	Annual income	Resources
Single	Less than $19,320	Less than $14,790
Married person living with a spouse (no dependents)	Less than $26,130	Less than $29,520

Extra Help automatically applies for those covered by Medicaid as well (see below). Those not automatically covered may apply for Extra Help at any time; there is no special enrollment period.

Other options for help in paying drug costs include:

- State pharmacy assistance programs. Not all states offer them.
- Pharmaceutical assistance programs (also referred to as patient assistance programs). Major drug manufacturers offer assistance to eligible individuals.

Obtaining Dual (Medicare–Medicaid) Coverage

Some individuals qualify for both Medicare and Medicaid ("dual coverage"). Medicare pays first; Medicaid is a secondary payor. Those with dual eligibility have prescription drugs covered through Medicare. In addition, they qualify for extra help paying for these drugs. And Medicaid may cover some drugs not covered by Medicare.

When a person has institutional Medicaid, Medicare still covers medical services required beyond the custodial care in a nursing home. Medicaid will pay for medical costs not covered by Medicare (e.g., co-payments) as well as the cost of nursing home care.

For example, if an elderly person with institutional Medicaid needs to go to a doctor or specialist's office, Medicare will pay for most of these medical services, while Medicaid will pay by covering the remaining costs, such as coinsurances, copayments, and deductibles.

Program of All-Inclusive Care for the Elderly (PACE). This Medicare–Medicaid program helps those who would otherwise be in a nursing home remain in the community. It is offered in some, but not all, states.

Law Changes

The Medicare and Medicaid programs are continually undergoing changes. In October 202 I, Congress was considering the following changes to expand both programs:

- Expand Medicare Part B to include comprehensive coverage for vision, dental, and hearing service.
- Lower prescription drug costs through various measures.
- Expand Medicaid eligibility by increasing the percentage of the federal poverty line.
- Improving the quality of and access to Medicaid home- and community-based services (HCBS).
- Allowing coverage for "reentry" to improve care for those leaving incarceration.

Whether or to what extent the changes are enacted and when they become effective remains to be seen.

ADDITIONAL RESOURCES

More information about Medicare may be found at Medicare.gov (the official government website on the subject) and at the Medicare Rights Center (https://www.medicarerights.org/learn-medicare).

More information about Medicaid may be found by contacting the state health department where the individual lives.

The following IRS publications offer helpful tax information related to Medicare and Medicaid:

- IRS Publication 3, Armed Forces' Tax Guide
- IRS Publication 502, Medical and Dental Expenses
- IRS Publication 554, Tax Guide for Seniors

REVIEW QUESTIONS

1. Which of the following is true regarding Medicare?

a. Enrollment is automatic.

b. No one under 65 is eligible to receive Medicare.

c. It is a federal health insurance program.

d. Enrollment is done through the individual's employer.

2. Which of the following applies to Medicare eligibility?

a. An individual's assets may affect eligibility for Medicare.

b. Those who turn age 65 should enroll in Medicare unless receiving coverage through another source.

c. Enrollment in Medicare is tied to receiving Social Security benefits.

d. Individuals can continue to contribute to a health savings account (HSA) after enrolling in Medicare.

3. Medicare Part A is for:

a. Hospital insurance

b. Medical insurance

c. Prescription drug coverage

d. Medicare Advantage

4. The Part A hospital inpatient deductible for each benefit period in 2022 is:

a. $0

b. $371

c. $742

d. $1,484

5. Which of the following is true regarding Medicare premiums?

a. The standard Part B premium may be adjusted annually for inflation.

b. Most individuals pay for Part A coverage.

c. High-income taxpayers pay the same for Part B coverage.

d. The standard Part D premium is expected to be reduced next year.

6. The Part B surcharge in 2022 for married filing joint filers with 2020 modified adjusted gross income (MAGI) of $200,000 is:

a. $148.50

b. $207.90

c. $297.00

d. $386.10

7. Which of the following is true regarding Medicaid?

a. Medicaid is designed for high-income individuals.

b. Individuals must be required to file a federal income tax return to qualify for Medicaid.

c. There is no work requirement to be eligible for Medicaid.

d. Individuals must be 65 or older to qualify for Medicaid.

8. The asset test for institutional Medicaid includes:

a. A limitation of $5,000 on assets in all states

b. An exemption for household furnishings

c. A lookback period of 36 months

d. The ability to transfer most assets during the lookback period that will not be taken into account in determining eligibility

9. When supplementing original Medicare:

a. An individual must have both Medicare Advantage and Supplemental Medicare.

b. Spouses can use the same Medigap policy.

c. Medigap policies offer no additional premiums.

d. Medigap policy premiums are eligible to be deducted for self-employed individuals.

10. Medicare Extra Help:

a. Has no special enrollment period.

b. Is available to all individuals.

c. Helps pays costs that would otherwise be covered by Part B.

d. Automatically applies for those covered by Medicare.

ANSWERS TO REVIEW QUESTIONS

1. a. Incorrect. Enrollment is not automatic. A person eligible for coverage must enroll during certain enrollment periods.

b. Incorrect. Certain younger individuals with disabilities and certain diseases are eligible for Medicare.

c. Correct. Medicare is a federal health insurance program designed for people aged 65 and older, as well as certain younger individuals with disabilities and those with end-stage renal disease or amyotrophic lateral sclerosis (ALS).

d. Incorrect. Enrollment is done though the Social Security Administration (SSA.gov).

2. a. Incorrect. Income and assets do not affect eligibility for Medicare, although income may trigger additional premium costs.

b. Correct. Those who turn age 65 should enroll in Medicare unless receiving coverage through another source (e.g., employer coverage for a group plan with 20 or more employees so that the group plan is treated as primary coverage).

c. Incorrect. Enrollment in Medicare is not tied to receiving Social Security benefits. Coverage generally begins at age 65, regardless of whether the person is collecting Social Security benefits.

d. Incorrect. Once a person enrolls in Medicare, he or she is no longer able to make contributions to a health savings account.

3. a. Correct. Part A is for hospital insurance. This pays for stays in a hospital as well as in a skilled nursing facility.

b. Incorrect. Part B is for medical insurance. This covers the cost of doctors' fees, outpatient care, durable medical supplies, and prescriptive services.

c. Incorrect. Part D is for prescription drug coverage. It covers the cost of prescription drugs and insulin.

d. Incorrect. Part C is called Medicare Advantage. This is a Medicare-approved plan from a private company that combines Parts A, B, and C.

4. a. Incorrect. There is a $0 coinsurance amount for each benefit period in days 1-60.

b. Incorrect. There is a $371 coinsurance amount per day of each benefit period in days 61-90.

c. Incorrect. There is a $742 coinsurance amount per each "lifetime reserve day" after day 90 for each benefit period.

d. Correct. The deductible in 2022 for Part A hospital inpatient is $1,484. The Part B deductible for 2022 is $203.

5. a. Correct. Part B is a voluntary program for which there is a monthly premium. There is a "standard" premium for Part B coverage paid by most beneficiaries, which may be adjusted annually for inflation.

b. Incorrect. Most individuals eligible for Medicare do not pay for annual premiums for Part A coverage. This applies to anyone with at least 40 quarters of work at a job or self-employment during their lifetime or who have a spouse eligible for premium-free Part A.

c. Incorrect. High income taxpayers pay an additional monthly amount for Parts B and D.

d. Incorrect. There is no standard Part D premium. The premium depends on the provider chosen by the individual to pay prescription drugs.

6. a. Incorrect. The total monthly Part B premium for 2022 is $148.50 for married filing joint filers with 2020 MAGI up to $176,000.

b. Correct. The total monthly Part B premium for 2022 is $207.90 for married filing joint filers with 2020 MAGI of at least $176,001 but not over $222,000.

c. Incorrect. The total monthly Part B premium for 2022 is $297.00 for married filing joint filers with 2020 MAGI of at least $222,001 but not over $276,000.

d. Incorrect. The total monthly Part B premium for 2022 is $386.10 for married filing joint filers with 2020 MAGI of at least $276,001 but not over $330,000.

7. a. Incorrect. Medicaid is a federal/state program designed to cover medical costs for those with a financial need.

b. Incorrect. As a rule of thumb, Medicaid is for individuals with gross income below the threshold that would require them to file a federal income tax return.

c. Correct. There is no work history requirement; someone who has never worked may still be eligible for Medicaid. There are no premiums for Medicaid coverage.

d. Incorrect. There is no age requirement for Medicaid as there is for Medicare; it may cover young adults as well as seniors.

8. a. Incorrect. The limitation on assets varies from state to state. In most states it is $2,000.

b. Correct. Exempt assets, which are assets not counted in determining eligibility for Medicaid include a person's residence if the person resides in it or has an intent to return to it, household furnishings, personal belongings, car, irrevocable trusts, funeral or burial expenses up to certain amounts, and life insurance with a cash surrender value of no more than $1,500.

c. Incorrect. Generally, the lookback period is 60 months (five years), although some states have a different lookback period.

d. Incorrect. There is a lookback period which requires assets transferred without consideration (i.e., merely gifted) within this period to be taken into account in determining eligibility.

9. a. Incorrect. Those who use original Medicare and do not choose Medicare Advantage may want to have a Supplemental Medicare ("Medigap") policy.

b. Incorrect. Spouses must buy separate Medigap policies.

c. Incorrect. Medigap policies have monthly premiums in addition to Medicare premiums. The premiums are based on the type of policy chosen.

d. Correct. Premiums for Medigap policies are eligible medical expenses for purposes of deducting itemized medical expenses. Similarly, self-employed individuals may deduct the premiums as adjustments to gross income, up to self-employment income for the year.

10. a. Correct. Those not automatically covered by Medicare Extra Help may apply at any time; there is no special enrollment period.

b. Incorrect. Medicare Extra Help is a program to help those with limited income and resources pay their drug costs.

c. Incorrect. Medicare Extra Help helps pay the costs that would otherwise be paid by those covered by Part D.

d. Incorrect. Medicare Extra Help automatically applies for those covered by Medicaid.

Chapter 3

VETERANS BENEFITS

LEARNING OBJECTIVES

After reviewing this chapter, you should be able to:

- Explain how to report military retirement benefits for tax purposes
- Name tax-free benefits available to veterans
- Identify tax-free benefits for disabled veterans
- Explain taxable and tax-free benefits available to veterans' survivors and dependents
- Describe state tax rules for veterans

OVERVIEW

There are an estimated 18.5 million U.S. veterans (https://www.bls.gov/news.release/pdf/vet.pdf). They are men and women who served in various wars—World War II, Korean War, Vietnam War, Gulf War era I, or Gulf War era II—as well as in peacetime activities, but are no longer on active duty. They fall within all age groups and are ethnically and racially diverse (https://www.pewresearch.org/fact-tank/2021/04/05/the-changing-face-of-americas-veteran-population/). However, they all have something in common: they performed service for their country and now are entitled to various benefits. What these benefits are and how they are treated for tax purposes varies widely.

BENEFITS FOR FORMER SERVICE MEMBERS

Being a veteran may entitle a person to a variety of benefits. Some benefits are restricted to certain disabled veterans or survivors and dependents of veterans (explained later in this chapter).

Benefits in General

It's basic tax law that benefits are included in gross income and subject to federal income tax unless there is a specific rule providing an exclusion from gross income. When it comes to deductions and credits, these are a "matter of legislative grace," which means they may only be claimed if the tax law allows for them. The following discussion covers payments to or for the benefit of veterans as well as special deductions and credits to which veterans may be eligible. The tax treatment of each benefit or write-off is explained.

Pension benefits. Those who've served in the military may be entitled to pension benefits. The military has two retirement systems:

- Blended Retirement System (BRS) for those who began service on or after January 1, 2018, and completed at least 20 years of service. This benefit pays an annuity for life.
- Legacy High-3 System for those who began service by December 31, 2017, and completed at least 20 years of service. This is a defined benefit plan paying a lifetime monthly annuity. The amount of the benefit depends on the length of service and highest 36 months of basic pay.

The applicable one depends on when a person joined the military and whether he or she opted into the BRS. The receipt of Social Security benefits does not prevent the payment of military pension benefits.

Taxation of pensions. Military pension benefits based on age or length of service generally are taxed the same as civilian qualified retirement benefits, meaning they are taxable. The Defense Finance and Accounting Service (part of the Defense Department) issues Form 1099-R, Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc., reporting to the veteran (and the IRS) the amount of taxable pension benefits as well as any federal income tax withholding. Pension payments are reported directly on Form 1040 or 1040-SR.

The amount a retiree pays to participate in the Survivors Benefit Plan (SBP) is excluded from taxable income.

EXAMPLE

A veteran receives $6,800 a year in military pension income (not disability-related). From this amount, $750 is used to pay for SBP. The taxable amount of the pension for the year is $6,050 ($6,800 – $750).

Military pension benefits are not subject to Social Security and Medicare taxes (FICA), the additional 0.9% Medicare tax on earned income, nor the net investment income (NII) tax for certain high-income taxpayers. Note: Special rules apply to pensions and annuities paid to a veteran on account of service-connected disability (explained later in this chapter).

The IRS notes that almost half of unpaid taxes owed by current and retired federal employees is owed by retired military (https://www.irs.gov/pub/irs-pdf/p4782.pdf). This is because these retirees do not have a complete understanding of their tax obligation. Those leaving the military (a service member about to become a veteran) are advised to complete Form W-4P, Withholding Certificate for Pension or Annuity Payments, to tell the Defense Finance and Accounting Service (DFAS) how much federal income tax to withhold from the monthly retirement pay.

Low-income assistance. Veterans who served in a war and active duty for certain required time periods, were discharged from service under other than dishonorable conditions, and have low income and net worth, may qualify for monthly payments from the Veterans Administration. Payments to low-income veterans are tax-free. Eligibility is based on financial need and requires one of the following conditions to be met:

- The veteran is at least age 65.
- The veteran has a permanent and total non-service-connected disability.
- The veteran is a patient in a nursing home for long-term care due to mental or physical incapacity.
- The veteran receives Social Security disability payments or Supplemental Security Income.

Readjustment or severance payments. Lump-sum payments received upon release from active duty are includible in gross income as long as they are not disability-related severance payments. The taxation does not change even if a veteran later is given a retroactive disability rating by the Veterans Administration.

Moving expenses. The cost of moving household goods, personal effects, and traveling expenses (lodging but not meals) from the last post of duty to a home or to a nearer point in the United States may be deductible as an adjustment to gross income (i.e., it may be claimed whether the person claims the standard deduction or itemizes personal deductions). A move from the last post of duty must occur within one year of ending active duty or within the period allowed under the Joint Travel Regulations (https://www.defensetravel.dod.mil/site/travelreg.cfm).

The cost of driving a personal vehicle for the move can be based on actual expenses or relying on an IRS-set standard mileage rate (e.g., 16¢ per mile in 2021). Deductible costs do not include any amounts reimbursed by the federal government. A deduction for moving expenses is figured on Form 3903, Moving Expenses, and then entered on Schedule 1 of Form 1040 or 1040-SR.

Education assistance. The GI Bill program has been helping veterans pay for their continued education since 1944. The Post-9/11 GI Bill helps veterans pay for the cost of school—undergraduate or graduate—or training. Tax-free education benefits include:

- Tuition
- Training fees
- Test fees for licenses and certifications
- Money to pay for a tutor
- Work study
- Books
- Housing allowance

The American opportunity tax credit and the lifetime learning credit may not be based on excludable education assistance. However, a veteran should subtract certain payments that are made to the veteran (not to the school) in order to claim the credit.

EXAMPLE

A veteran receives $1,200 per month in a Veterans Administration basic housing allowance that is deposited into her checking account, as well as a $4,000 tuition payment that is paid directly to the college. The veteran pays $6,000 in qualified education expenses. The amount she can claim is $2,000 ($6,000 qualified education expenses – $4,000 GI Bill benefits received). The basic housing allowance does not need to be subtracted.

Other tax-free benefits. In addition to tax-free benefits limited to disabled veterans, some benefits are tax-free to all veterans. Examples include education assistance (explained earlier) and:

Bonus payments by a state or political subdivision because of service in a combat zone

Interest on life insurance dividends left on deposit with the Veterans Administration

Veterans' insurance dividends paid to veterans (including the proceeds of a veteran's endowment policy paid before death).

Social Security benefits. Because military pay is subject to Social Security and Medicare taxes (FICA), veterans may be eligible to receive monthly Social Security benefits. Note: There had been special extra earnings for periods of active duty from 1957 through 2001, which were credited to the Social Security earnings record (find details from the Social Security Administration at https://www.ssa.gov/pubs/EN-05-10017.pdf).

Veterans may receive both a military pension and Social Security benefits. Veterans under age 62 who are not disabled may not collect benefits; like all other individuals, benefits do not begin before age 62. Full retirement age depends on the year of birth. Benefits before full retirement age are reduced.

Social Security benefits are reported to recipients on Form SSA-1099. Depending on total income for the year, Social Security benefits are tax-free or includible in gross income at 50% or 85%. "Total income" for this purpose includes only items included in gross income, including half of the Social Security received, plus tax-free interest. It does not include tax-free veteran benefits. Social Security benefits received, as well as the taxable amount, if applicable, are reported directly on Form 1040 or 1040-SR.

Earned income tax credit. The earned income tax credit (EITC) is a refundable income tax credit that is paid to eligible individuals. One condition for eligibility is having earned income from working. A service member who had been active for part of the year may have some earned income on which to figure the credit. However, certain payments are not treated as earned income for purposes of the EITC:

- Basic pay or special, bonus, or other incentive pay that is subject to the combat zone exclusion (unless an election is made to treat nontaxable combat zone pay as earned income)
- Basic Allowance for Housing (BAH)
- Basic Allowance for Subsistence (BAS)
- Any other nontaxable employee compensation
- Interest and dividends
- Social Security and railroad retirement benefits
- Certain workfare payments
- Pensions or annuities
- Veterans' benefits (including VA rehabilitation payments)
- Workers' compensation
- Unemployment compensation
- Alimony and child support

Even disabled veterans may be eligible for the EITC if they have earnings from employment or self-employment. In fact, about two million veterans and military households receive the EITC, according to the Center for Budget and Policy Priorities.

IMPORTANT

Veterans eligible for the EITC must file an income tax return in order to claim this credit, even if their income is below the filing threshold.

SBA assistance. The U.S. Small Business Administration (SBA) has a number of programs designed to help veterans become entrepreneurs. These programs include training, funding, and federal contracting opportunities. Learn more about SBA programs for veterans through the Office of Veterans Business Development (OVBD) (https://www.sba.gov/business-guide/grow-your-business/veteran-owned-businesses).

There are no special tax rules with respect to SBA assistance. The free training programs are a nontaxable benefit offered to veterans. Funding opportunities mean that loans—like any other loans—are tax-free. Interest on the loans is fully deductible provided the business is a "small business" (e.g., average annual gross receipts not exceeding $26 million in the three prior years) or is an electing farming or real property business (see IRS rules for the Code Section 163(j) limitation at https://www.irs.gov/newsroom/basic-questions-and-answers-about-the-limitation-on-the-deduction-for-business-interest-expense). No deduction may be claimed for the repayment of principal.

Benefits for Disabled Veterans

Disabled veterans may be eligible for special benefits limited to persons with a disability. They may also be able to use a number of rules in the tax law open to anyone with a disability to effectively reduce the cost of certain expenses they have to incur as a result of their condition.

Tax-free benefits unique to disabled veterans. Having a disability may enable a veteran to receive certain types of income on a tax-free basis. Military Disability Retirement Pay received as a pension, annuity, or similar allowance for personal injury or sickness resulting from active service in the armed forces is not includible in gross income (it is tax-free); no Form 1099-R is issued each year to report this income. Tax-free treatment applies if any of the following conditions apply:

- The veteran was entitled to receive a disability payment before September 25, 1975.
- The veteran was a member of the military (active or reserves) or was under a binding written commitment to become a member on September 24, 1975.
- Disability payments are on account of a combat-related injury. This is a personal injury or sickness that:
- Resulted directly from armed conflict;
- Took place while the veteran was engaged in extra-hazardous service;
- Took place under conditions simulating war, including training exercises such as maneuvers; or
- Was caused by an instrumentality of war.

- The veteran would be entitled to receive disability compensation from the Department of Veterans Affairs (VA) if he or she filed an application for it (the exclusion under this condition equals the amount to which the veteran would be entitled from the VA).

Other tax-free benefits include:

- Benefits under a dependent care assistance program. A spouse receiving employer-provided benefits may be able to use them to cover the cost of care for a spouse who is a disabled veteran.
- Gifts of homes (or improvements to homes) by charitable organizations (e.g., Homes for Our Troops).
- Grants for homes designed to accommodate disabilities (i.e., wheelchair-friendly designs).
- Grants for motor vehicles for veterans who lost the use of their limbs or their vision.
- Payments to hospital patient and resident veterans for services under the VA's therapeutic or rehabilitation programs.
- Severance benefits for release from active duty due to a disability.

Social Security benefits. Disabled veterans may qualify for Social Security disability payments prior to reaching full retirement age. Those who have a VA compensation rating of 100% permanent and total disability may receive expedited processing of their Social Security disability benefits application. Disability benefits are taxed in the same way as Social Security retirement benefits (explained earlier).

In addition, if the application for disability benefits is approved, Medicare coverage automatically begins 24 months after benefits commence.

Medical expenses. Like other taxpayers, veterans may deduct unreimbursed medical expenses as an itemized personal deduction. Only total out-of-pocket costs exceeding 7.5% of adjusted gross income are deductible. Medical deductions are reported on Schedule A of Form 1040 or 1040-SR.

Examples of deductible medical expenses that may be applicable to disabled veterans include:

- Special hand controls and other special equipment installed in a car for the use of a person with a disability
- Inpatient treatment for drug/alcohol addiction
- Service animals
- Wheelchairs

Usually, the cost of home improvements is a capital expenditure that is not immediately deductible; it is added to the basis of the home. However, the cost of special equipment and improvements needed to accommodate a disability condition of the homeowner, spouse, or dependent may be

currently deductible as an itemized medical expense. Costs that do not add to the value of the home are currently deductible. If improvements add value to the home, only the cost in excess of the increased value is deductible. The costs must be reasonable to accommodate a home to a disability.

Examples of improvements that do not add value and are currently deductible include:

- 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 home)
- Modifying fire alarms, smoke detectors, and other warning systems
- Modifying stairways
- Adding handrails or grab bars anywhere (whether or not in bathrooms)
- Modifying hardware on doors
- Modifying areas in front of entrance and exit doorways
- Grading the ground to provide access to the residence.

In addition to the cost of installation of these home improvements, also deductible are the costs of operation and upkeep.

If a veteran rents a home and makes improvements for medical reasons, the cost may be deductible. The IRS gives the following example:

EXAMPLE

John has arthritis and a heart condition. He can't climb stairs or get into a bathtub. On his doctor's advice, he installs a bathroom with a shower stall on the first floor of his two-story rented house. The landlord didn't pay any of the cost of buying and installing the special plumbing and didn't lower the rent. John can include in medical expenses the entire amount he paid.

Impairment-related work expenses. A person, including a veteran, with a disability may deduct certain work-related expenses. These are ordinary and necessary business expenses that are necessary for a person to do work satisfactorily, are not required (other than incidentally) for

personal activities, and are not deductible under other income tax rules (i.e., not claimed as a medical deduction, explained earlier). To be eligible to deduct work-related expenses, a person must have:

- A physical or mental disability (e.g., being blind or hearing-impaired) that functionally limits the ability to work; or
- A physical or mental impairment that substantially limits one or more of major life activities (e.g., performing manual tasks, walking, speaking, breathing, learning, or working).

Examples of impairment-related work expenses include:

- Special transportation needs (e.g., the cost of adapting a car for hand-controlled braking).
- Attendant care at work. This includes paying someone to provide help in doing work activities (not personal activities).
- Equipment and devices to facilitate working (e.g., vision and sensory aides).

Where to deduct impairment-related work expenses depends on whether the veteran is an employee or a self-employed individual:

- Employee. While employees may not deduct unreimbursed employee business expenses as an itemized deduction for 2018 through 2025, there is an exception for impairment-related work expenses. Impairment-related work expenses are entered on Form 2106, Employee Business Expenses. The result is entered on Schedule A of Form 1040 or 1040-SR. This means itemizing is required to get any tax benefit from impairment-related work expenses.
- Self-employed. Impairment-related work expenses are entered on the applicable business form. Sole proprietors use Schedule C, farmers use Schedule F, and other self-employed individuals (e.g., partners, limited liability company members) use Schedule E.

Benefits for Survivors

Spouses and dependents of veterans may be eligible for certain benefits.

Survivor benefit plans. Generally, a veteran's pension ends at death. However, a survivor continues to receive benefits if the veteran has a survivor benefit plan at retirement. Retirement benefits payable to a survivor—typically a surviving spouse—are included in gross income.

Survivors of wartime veterans who have low income and have not remarried are another type of benefit. These monthly benefits are based on financial need; they are tax-free.

Veterans life insurance. If a veteran chose to pay for Veteran's Group Life Insurance (VGLI) for a limited time after discharge or Servicemembers' Group Life Insurance (SGLI) while in the military, the death benefit payable under the policy is tax-free to the beneficiary.

Death benefit gratuity. The military pays a death gratuity of $100,000 to eligible survivors of members of the Armed Forces, who die while on active duty or while serving in certain reserve statuses. The death gratuity is the same regardless of the cause of death. The death benefit is tax-free.

A member of the military may designate an eligible beneficiary. If there is no designation, then there is a hierarchy to whom the benefit is paid:

1. To the surviving spouse of the person, if any.

2. If there is no surviving spouse, to any surviving children of the person and the descendants of any deceased children by representation.

3. If there is none of the above, to the surviving parents of the person or the survivor of them.

4. If there is none of the above, to the duly appointed executor or administrator of the estate of the person.

5. If there is none of the above, to other next of kin of the person entitled under the laws of domicile of the person at the time of the person's death.

Burial assistance. Any veteran who has been discharged (other than dishonorably) may be buried free of charge in a national veterans cemetery. Eligibility for burial in Arlington Cemetery is limited (e.g., military retirees; Purple Heart recipients). A veteran's spouse and minor child may also be interred in a national veterans cemetery.

If buried in a private cemetery, the family of an eligible veteran—someone receiving a VA pension or disability compensation while alive—is entitled to a burial allowance. This helps to pay for the burial, funeral, and transportation costs. It is tax-free.

Wherever buried, a veteran is entitled to certain funeral honors and memorial items at no cost. They are tax-free. These include:

- Headstone, markers, and medallions
- Burial flag
- Presidential Memorial Certificate

Education assistance. Survivors and dependents of veterans may be eligible for education benefits through the Survivors' and Dependents' Educational Assistance (DEA) program. DEA benefits required to be used for education are tax-free.

Both the survivor or dependent and the veteran must meet certain criteria for the survivor or dependent to be eligible for benefits under the DEA program. The veteran must:

- Be permanently and totally disabled due to a service-connected disability,
- Have died on active duty or as a result of a service-connected disability,

- Be missing in action or captured in the line of duty by a hostile force,
- Have been forcibly detained or interred in the time of duty by a foreign entity, or
- Be in the hospital or getting outpatient treatment for a service-connected permanent and total disability and be likely to be discharged for that disability (i.e., become a veteran).

The following criteria apply to the spouse of a veteran:

- Benefits start on the date the VA specifies eligibility or on the date of the veteran's death; this eligibility period lasts for 10 years.
- If the veteran is permanently and totally disabled with an effective date that is three years after discharge, the eligibility period benefits last for 20 years from the effective date.
- If the service member died on active duty, the eligibility period for benefits is 20 years from the date of death.

The child of a veteran must:

- Be between the ages of 18 and 26 (there are some exceptions), whether married or single; and
- Not be getting Dependency and Indemnity Compensation (DIC) from the VA.

If DEA benefits for school or training began before August 1, 2018, benefits may be claimed for up to 45 months. If benefits began on or after August 1, 2018, benefits are payable for up to 36 months.

A child of a veteran may also be eligible for a Fry Scholarship for up to 36 months to cover the full cost of in-state college tuition at a public school or up to $22,805.34 per year for training at a private or out-of-state school, plus money for housing, books, and supplies. This scholarship applies if the parent died in the line of duty or was a certain Reservist who died from a service-connected disability on or after September 11, 2001. Generally, a child of a veteran must choose between the DEA or Fry Scholarship. However, depending on timing, it may be possible to use these benefits consecutively to extend education assistance. The tax treatment of the Fry Scholarship follows usual tax rules for scholarships and fellowships. This means tax-free treatment applies to tuition, books, fees, supplies, and equipment for a degree program; there is no dollar limit. Tax-free treatment does not apply to any housing allowance.

TAX FILING RULES

Like other taxpayers, veterans must file federal income tax returns each year if they meet filing thresholds or have other reasons they must file. The filing deadlines for veterans are the same as for other taxpayers (there are special deadlines only for certain active military members).

Income Taxes

Veterans must file annual income tax returns and, where necessary, pay estimated taxes to avoid underpayment/late payment penalties.

Veterans receiving military pensions should be sure that their withholding from monthly payments is sufficient to cover their annual tax liability (discussed earlier). Those with other income may want

to increase withholding from their military pension to avoid the need to pay quarterly estimated tax payments.

Amended returns. Like other taxpayers, veterans may file amended returns to obtain a tax refund or for certain other purposes.

There may be situations unique to veterans requiring an amended return. If there has been an increase in the percentage of disability from the Veterans Administration, or there's been a grant of Combat-Related Special Compensation after an award for Concurrent Retirement and Disability, an amended return—Form 1040-X, Amended U.S. Individual Income Tax Return—should be filed to claim a tax refund. Include all documents from the Veterans Administration and the Defense Finance and Accounting Services, explaining the changes, awards, proper tax treatment, and calculations. An amended tax form only needs to be filed for the year of the VA reassessment of disability percentage, including any affected retroactive year, or the year that the Combat-Related Special Compensation is initially granted or adjusted, which may also include affected retroactive years.

Amended returns for 2019 and later may be filed electronically. Amended returns for earlier years must be filed on paper.

Forgiveness of tax liability. If a member of the U.S. Armed Forces dies, federal tax liability may be forgiven. This means that if the tax being forgiven has not yet been paid, it does not have to be paid. If it has already been paid, it may be refunded. This forgiveness applies if the member dies:

- While in active service in a combat zone;
- From wounds, disease, or injuries received in a combat zone; or
- From wounds or injury incurred in a terrorist or military action.

If a member is missing in action or is a prisoner of war, the date his or her name is removed from the missing status for military pay purposes is treated as the date of death. This rule applies even if death actually occurred earlier.

The forgiveness applies to taxes for the year of death. It also applies to any earlier tax year ending on or after the first day the member served in the combat zone in active service, and it applies to any remaining unpaid taxes from previous years.

The claim for forgiveness must identify the conflict or action for which forgiveness is being based:

- All returns and claims must be identified by writing "Iraqi Freedom—KIA," "Enduring Freedom—KIA," "Kosovo Operation—KIA," "Desert Storm—KIA," or "Former Yugoslavia—KIA" in bold letters on the top of page 1 of the return or claim.
- On Forms 1040, 1040-SR, and 1040-X, the phrase "Iraqi Freedom—KIA," "Enduring Freedom—KIA," "Kosovo Operation—KIA," "Desert Storm—KIA," or "Former Yugoslavia—KIA" must be written on the line for total tax.
- If the individual was killed in a terrorist action, write "KITA" on the front of the return and on the line for total tax.

Show the computation for the amount of tax that should be forgiven. (Special rules apply when

the deceased service member files a joint return or is subject to community property rules; see IRS Publication 3). Attach a death certificate. Watch the filing deadline for claiming refund, which is generally three years from the time the return was filed or two years from the time the tax was paid, whichever is later. But there is an automatic extension of the deadline if death was combat zone–related. For example, the deadline is extended for 180 days after the last day of any continuous qualified hospitalization for injury from service in a combat zone or contingency operation or while performing qualifying services outside of the combat zone.

STATE TAX RULES

States may provide income and property tax breaks for veterans. The rules vary by location.

Income Tax Exclusion for Military Pensions

Even though military pensions (other than those for disabled veterans) are includible in gross income for federal income tax purposes, states may partially or fully exclude them from state income taxes. For those that partially exclude military pensions, the dollar amount may be based on age (under age 65, or 65 and older). Check with the state revenue/tax/finance department for details in a particular location.

Property Tax Exemptions

States may give veterans a break on the real estate taxes they pay for homes they own. The amount of the exemption and whether it is conditioned on having a service-related disability varies from state to state. The exemption is not automatic; it must be applied for, and in some locations, renewed annually.

IRS RESOURCES

The following IRS publications offer helpful information related to veterans:

- IRS Publication 3, Armed Forces' Tax Guide
- IRS Publication 502, Medical and Dental Expenses
- IRS Publication 575, Pension and Annuity Income
- IRS Publication 596, Earned Income Credit

REVIEW QUESTIONS

1. Military retirement benefits for a veteran who is not disabled are:

a. Tax-free

b. Fully taxable

c. Excludable from gross income depending on age or length of service

d. Tax-free if not collecting Social Security benefits

2. Which benefit paid to a veteran who is not disabled is taxable?

a. Low-income assistance

b. Education assistance under the GI Bill program

c. Interest on life insurance dividends left on deposit with the VA

d. Readjustment or severance payments

3. Which statement about Social Security benefits is correct (assuming the veteran is not disabled)?

a. All veterans accrue extra earnings from active duty for purposes of determining the amount of Social Security benefits.

b. Social Security benefits reduce the amount of military retirement benefits.

c. Military retirement benefits are taken into account in determining whether and to what extent Social Security benefits are includible in gross income.

d. A veteran may begin to collect benefits upon retiring from the military, regardless of age.

4. Which of the following is treated as earned income for purposes of the earned income tax credit?

a. Military pay prior to leaving the service

b. Military pension

c. Social Security benefits

d. Pay subject to the combat zone exclusion

5. Which benefit received by a disabled veteran is taxable?

a. Military Disability Retirement Pay

b. Social Security disability benefits

c. Gifts of homes (or improvements to homes) by charitable organizations

d. Severance benefit for release from active duty due to a disability

6. Which statement about the medical expense deduction is not correct?

a. Medical expenses may be deducted by those claiming the standard deduction amount.

b. Special hand controls installed in a car for the use of a person with a disability are qualified medical expenses for purposes of deductibility.

c. The cost of keeping service animals may be deducted.

d. The cost of installing ramps in a home is deductible.

7. Which expenditure is not treated as a fully deductible medical expense?

a. Lowering kitchen cabinets

b. Adding handrails or grab bars anywhere

c. A swimming pool installed upon medical advice

d. Widening or otherwise modifying hallways and interior doorways

8. Which benefit payable to a spouse or dependent is taxable?

a. A pension under a survivor benefit plan

b. Veterans life insurance proceeds

c. Death benefit gratuity

d. Burial assistance

9. Educational assistance to a survivor or dependent of a veteran under the Survivors' and Dependents' Educational Assistance (DEA) program is tax-free. Which statement about eligibility is correct?

a. There is no age limit for a child of a veteran to obtain benefits.

b. A child who qualifies for a Fry scholarship may simultaneously receive DEA benefits.

c. Both the survivor or dependent and the veteran must meet certain criteria for the survivor or dependent to be eligible for benefits under the DEA program.

d. The benefits apply to a survivor or dependent of all veterans.

10. Which statement about state income taxation of military pensions for non-disabled veterans is correct?

a. All states exclude military pensions from state income tax.

b. All states fully tax military pensions.

c. States that exempt military pensions have no limits on the amount excludable from gross income.

d. The state tax rules for military pensions vary considerably.

ANSWERS TO REVIEW QUESTIONS

1. a. Incorrect. Tax-free treatment applies only to benefits paid to disabled veterans.

b. Correct. There is no special tax rule allowing for the exclusion from gross income for military retirement benefits.

c. Incorrect. Age or length of service are used to set the amount of military retirement benefits. Because benefits are paid on this basis, all are taxable.

d. Incorrect. The receipt of Social Security benefits does not impact the amount of military benefits nor their taxation.

2. a. Incorrect. Low-income assistance for veterans who served in a war and have low income is not includible in gross income.

b. Incorrect. Payments covering tuition, training, and certain other expenses are tax-free.

c. Incorrect. Such interest is not includible in gross income as well as veterans' insurance dividends paid to veterans.

d. Correct. Lump-sum payments received upon release from active duty are includible in gross income as long as they are not disability-related severance payments.

3. a. Incorrect. There had been special extra earnings for periods of active duty from 1957 through 2001, which were credited to the Social Security earnings record, but this doesn't apply for veterans' service after 2001.

b. Incorrect. The receipt of Social Security benefits has no impact on military retirement benefits.

c. Correct. Because military benefits are taxable, they factor into the income formula for determining whether Social Security benefits are tax-free or included in gross income at 50% or 85%.

d. Incorrect. As for other individuals, Social Security benefits do not begin before age 62, regardless of having retired from the military.

4. a. Correct. One condition for eligibility of the earned income tax credit is having earned income from working. A service member who had been active for part of the year may have some earned income on which to figure the credit.

b. Incorrect. Even though related to work, pensions and annuities are not treated as earned income.

c. Incorrect. While these benefits are based on earned income, they are not treated as earned income.

d. Incorrect. Because such pay is not taxed, it is not treated as earned income.

5. a. Incorrect. Payments received under a pension, annuity, or similar allowance for personal injury or sickness resulting from active service in the Armed Forces is not includible in gross income

b. Correct. The same tax rules that apply to Social Security retirement benefits apply to Social Security disability benefits. Thus, if the disabled veteran has sufficient income, benefits may be includible in gross income at 50% or 85%.

c. Incorrect. These are not taxable to the disabled veteran as well as grants for homes designed to accommodate disabilities.

d. Incorrect. This payment is not taxable as well as benefits under a dependent care assistance program.

6. a. Correct. An individual must itemize deductions to receive any tax benefit from out-of-pocket medical expenses.

b. Incorrect. It is true that special hand controls and other special equipment installed in a car for the use of a person with a disability are qualified medical expenses for purposes of deductibility.

c. Incorrect. Upkeep for service animals is a deductible medical expense as well as the cost of wheelchairs.

d. Incorrect. As long as they do not add to the value of the home (which ramps do not), then the full cost of this home improvement is a deductible medical expense.

7. a. Incorrect. The construction costs for lowering or modifying kitchen cabinets and equipment do not add value to the home; they are fully deductible.

b. Incorrect. The cost of handrails and grab bars within the home are fully deductible medical expenses.

c. Correct. Because the pool adds value to the home, only the cost in excess of the added value is deductible.

d. Incorrect. The cost of adapting space to accommodate a disability that does not add value to the home is fully deductible.

8. a. Correct. Just like veterans who must include their military pensions in gross income, so too must spouses and dependents receiving benefits under a survivor benefit plan.

b. Incorrect. These payments to a spouse, dependent, or other named beneficiary are tax-free.

c. Incorrect. The payment of $100,000 to a survivor of a veteran who died on active duty is tax-free.

d. Incorrect. Internment in a military cemetery and other burial assistance is not taxable.

9. a. Incorrect. The child must be between age 18 and 26 (although there are some exceptions) to qualify for benefits.

b. Incorrect. The child must choose between these benefits, although it may be possible to obtain them consecutively.

c. Correct. To qualify for these benefits, the veteran as well as the person claiming education benefits (surviving spouse or dependent) must meet eligibility requirements.

d. Incorrect. The veteran must have died on active duty or from a service-connected disability, or be permanently disabled or meet certain other conditions.

10. a. Incorrect. Not all states treat military pensions as tax-free for their income tax purposes. Check with the state revenue/tax/finance department for details in a particular situation.

b. Incorrect. Only a few states fully tax military pensions.

c. Incorrect. Some of the states that exempt military pensions from their income taxes have dollar limits based on age.

d. Correct. Some states have no income tax, some fully exempt the pensions, some fully exclude them, and some have dollar limits based on age.

Chapter 4

LONG-TERM CARE

LEARNING OBJECTIVES

After reviewing this chapter, you should be able to:

- Explain the need for long-term care planning
- Name the activities of daily living for which long-term care may be needed
- Identify the three main ways to pay for long-term care
- Explain the tax rules for deducting long-term care insurance
- Describe eligibility requirements for Medicaid

OVERVIEW

It has been estimated that seven out of ten people aged 65 and older will need some type of long-term care in their lifetime. But even younger individuals, such as those with certain chronic conditions or who have been in an accident, may also require long-term care. The cost of this care can be very pricey, depending on where the person lives and the type of care obtained. According to Genworth's Cost of Care Survey for 2020 (https://www.genworth.com/aging-and-you/finances/cost-of-care.html), the average annual cost is $105,850 per year for a private room in a nursing home and $93,075 for a semi-private room. But in Alaska, for example, the cost for a private room for one year is $436,540. In-home care or care in a community or assisted living facility is still costly, with the average annual cost in the United States pegged at:

- Homemaker services: $53,770
- Home health aide services: $54,910
- Adult day health care: $19,240
- Assisted-living facility: $51,600

Medicare and private insurance for individuals too young for Medicare (e.g., coverage through employers; policies purchased on a government Marketplace) do not cover the cost of long-term care. Medicare only covers the medical costs for individuals requiring long-term care. This includes Medicare coverage for up to 100 days in a skilled nursing facility. (More information about what Medicare covers may be found at Medicare.gov.) The type of medical care covered by Medicare is referred to as acute care (e.g., care for cancer, heart disease). Long-term care is referred to as custodial care, defined below.

What Is Long-Term Care?

What constitutes long-term care may not be well understood. It is defined as custodial care for someone with the inability to perform on their own the everyday tasks of daily living, technically called activities of daily living (ADLs). The seven ADLs include:

1. Meal preparation and feeding
2. Dressing and undressing
3. Bathing and grooming
4. Functional transferring (e.g., getting in and out of bed)
5. Safe bathroom use and maintaining continence
6. Ambulation (e.g., walking about)
7. Memory care and stimulation, as well as substantial supervision for a person with a cognitive impairment, such as Alzheimer's disease or another form of dementia

ADLs do not include handling personal financial matters, even though help for this may be required by someone with one or more of the listed ADLs.

There are three basic options for paying the cost of long-term care:

- Paying out-of-pocket. This means using existing assets and income to pay for long-term care. This option is referred to as "self-insuring" because the individual or couple is assuming all the risk. This option is generally limited to wealthy individuals.
- Having long-term care insurance. This is a separate insurance policy specifically designed to pay for long-term care for the term provided in the policy or for life. The amount of the coverage, which provides a daily dollar amount, may be sufficient for all the costs or only part of the costs of care. This option is generally used by middle-class individuals.
- Relying on Medicaid. If an individual's income (including Social Security benefits) and assets (referred to as resources) are below a set amount, the government will pay the cost of long-term care through this federal/state program. This option is usually used by lower-income individuals.

There are some other options, such as benefits through the Veterans Administration and state-sponsored long-term care arrangements. These are discussed later in this course.

PAYING OUT-OF-POCKET

Someone who has sufficient assets and who is assured of sufficient income can pay the cost of long-term care out-of-pocket without the need for having long-term-care insurance or relying on Medicaid. What are sufficient assets? This is a difficult question to answer because it depends on a number of factors, including:

- The person's location (which impacts the cost of care)
- Where the care is provided (in the person's home, in a nursing home, etc.)
- How long the person needs care (which is impossible to know)
- Whether there is family assistance (a spouse, adult child, or adult grandchild may provide services for no cost)

In assessing asset sufficiency, only look at liquid assets (you can't pay a nursing home bill with an oil painting). Liquid assets include funds in brokerage firms, mutual funds, banks, and insurance companies in taxable accounts (e.g., funds invested with after-tax dollars in a stock held in a brokerage account). These funds can be easily tapped. Other liquid assets include funds held in tax-advantaged accounts, such as individual retirement accounts (IRAs), Roth IRAs, 401(k) plans, and health savings accounts (HSAs).

Some experts suggest that having over $1 million in liquid assets if single, or $2.5 million if married, may allow people to self-insure. Again, it depends on the factors listed earlier.

In addition to having sufficient assets, having sufficient income may also influence the ability to pay for long-term care out-of-pocket. Wealthy individuals usually generate income from investments in the form of dividends, interest (taxable, or tax-free on municipal bonds), and capital gain distributions. They may have rents and/or royalty income. Some may also have guaranteed income, which includes Social Security benefits, pensions from the government or private sector, and annuity

payments from a commercial annuity contract. Income may also result from an annuity or payout from a legal action (e.g., a malpractice claim).

Tax Implications of Paying Out-of-Pocket

There are two tax issues to consider in paying out-of-pocket: the tax cost of liquidating assets to pay long-term care bills and the tax savings from deducting long-term care costs.

The tax cost of liquidating assets to pay long-term care bills. Withdrawing cash from a bank account has no tax consequences. But tapping into other liquid assets, such as stocks, bonds, and mutual funds held in a taxable or tax-deferred account, may trigger taxable income and, in some cases, penalties from the IRS and/or the financial institution.

EXAMPLE

A certificate of deposit (CD) is cashed in prior to maturity. All of the interest income (not principal—the initial deposit) is included in the taxpayer's gross income, but there may be an interest penalty imposed by the bank. This penalty, which is a forfeiture of interest, is deductible as an adjustment to gross income (no itemizing is required); it does not reduce the amount of interest income reported in the income section of the tax return.

Selling assets from a taxable account usually results in capital gain or loss.

EXAMPLE

Selling a stock to get cash produces gain or loss, and this gain or loss is long-term or short-term, depending on how long the stock has been held. In reality, the amount of cash resulting from a sale that's available to pay long-term care costs must be reduced by the income tax (federal and, where applicable, state and local) that results from the sale.

While individuals with taxable income below set levels pay a zero tax rate on net long-term capital gains, the same is not true for those with taxable income above these levels. The levels are adjusted annually for inflation. Those with income above the applicable threshold (which depends on filing status) are taxed at 15% or 20% (or 25% if pending legislation is enacted) on their net capital gains from taxable accounts. The applicable rate depends on taxable income in the year in which assets are sold. The following table shows the threshold for the top tax rate in 2021:

Filing Status	20% rate applies if taxable income exceeds:
Married filing jointly	$501,600
Head of household	$473,750
Single	$445,850
Married filing separately	$250,800

In addition to the capital gains tax, there is a net investment income (NII) tax of 3.8% from taxable accounts. This tax applies not only to capital gains, but also to interest, dividends, capital gain distributions, rental and royalty income, commercial annuities, income from businesses involved in trading of financial instruments or commodities, and businesses that are passive activities to the owner. (Pending legislation may extend the treatment of business income to owners regardless of their level of participation in their businesses.)

The NII tax does not apply to gain on the sale of a residence up to the home sale exclusion amount ($250,000 for singles; $500,000 for joint filers). The NII tax does not apply to distributions from qualified retirement plans and IRAs, Social Security benefits, wages, unemployment compensation, alimony (whether or not taxable), and Alaska Permanent Fund dividends.

The NII tax is imposed only when there is net investment income (investment income minus investment expenses) and the taxpayer's modified adjusted gross income exceeds a set amount (not adjusted annually for inflation). The threshold is based on filing status:

Filing Status	**Modified Adjusted Gross Income**
Married filing jointly	$250,000
Head of household	$200,000
Single	$200,000
Married filing separately	$125,000

Tapping into pre-tax accounts, such as a traditional IRA or a 401(k) plan, generally produces ordinary income. Special rules apply to distributions from Roth IRAs and designated Roth accounts, which may make distributions tax-free. Again, the proceeds from a taxable distribution are reduced by taxes owed on the distribution, effectively leaving less cash on hand to pay long-term care costs.

It is likely that for long-term care needs, there is no tax penalty for taking a distribution from an IRA or qualified retirement plan, even if it is before age 59½. The penalty does not apply if the owner is totally and permanently disabled or if the funds are used to pay unreimbursed medical expenses above the itemized deduction threshold (explained next).

The tax savings from deducting long-term care costs. Taxpayers who itemize personal deductions may deduct out-of-pocket costs (amounts not reimbursed by insurance or other sources) to the extent they exceed 7.5% of adjusted gross income. This threshold applies regardless of age. While the standard deduction amounts are significant so that most taxpayers do not itemize, those paying long-term care costs (e.g., nursing home fees) may easily exceed the standard deduction amounts and want to itemize in order to deduct these costs.

HAVING LONG-TERM CARE INSURANCE

As with any type of insurance, long-term care insurance may never be needed, but having it can create peace of mind. It is designed for individuals with sufficient assets worth protecting for heirs but

not enough assets or income to pay for long-term care out of pocket. As of 2020, about 7.5 million Americans had some long-term care insurance (https://www.aaltci.org/long-term-care-insurance/learning-center/ltcfacts-2020.php#2020total).

Considerations in Selecting a Long-Term Care Policy

Long-term care insurance is a unique type of coverage. Special factors go into the selection of a policy, all of which impact the premiums. These factors include:

- Daily dollar amount—the amount paid by the policy each day ("per diem amount") that coverage is needed. This may be $100, $200, or more. In choosing a dollar amount, consider whether the insurance is meant to cover all costs or merely supplement out-of-pocket payments.
- Exclusion period—the time before which the coverage begins. Typically, a policy has a 90-day exclusion period, which means the insured (or the family) pays the cost of care for the first 90 days.
- Period of coverage—the time over which coverage applies. This may be for a set number of years or for life. A U.S. Department of Health & Human Services (HHS) report (https://www.cdc.gov/nchs/data/series/sr_03/sr03_43-508.pdf) in 2019 found the average stay in a nursing home to be 485 days. The Alzheimer's Association reports (https://www.alz.org/alzheimers-dementia/stages) that life expectancy—and the need for long-term care—for someone with the disease typically runs from four to eight years after diagnosis (although some live for 20 years). Some people choose a limited period; others prefer lifetime coverage.
- Inflation adjustment—an increase to the daily dollar amount as inflation increases.
- Type of policy—a traditional long-term care policy or a hybrid policy that also provides life insurance or commercial annuities (discussed later).

In addition to the features selected for the policy, your age at the time you purchase it impacts the premiums you pay for as long as you have coverage. Like whole life insurance, the premiums are based on your age when the policy begins. However, premiums for the long-term care policy may increase for all policy holders. In recent years, there have been substantial increases by many insurers because their initial actuary projections were not accurate enough to meet their liabilities with the premiums they collected. The result: premium increases of 50% or more in some cases.

Tax Considerations for a Long-Term Care Policy

Premiums for long-term care insurance are treated as deductible for federal income tax purposes as medical expenses up to set dollar limits for those who itemize. The same is true for self-employed individuals who deduct their health insurance premiums "above-the-line" from adjusted gross income (whether or not they itemize deductions). The limits for 2021 and 2022 are in the following table. These limits may be adjusted annually for inflation.

Age	2021/2022 limit
Age 40 and younger	$ 450
Over age 40 but not over age 50	850
Over age 50 but not over age 60	1,690
Over age 60 but not over age 70	4,520
Over age 70	5,640

The limits apply per individual. This allows married couples to each use their applicable limit if they each have a policy.

EXAMPLE

Assume spouses are 65 years old and each has a policy. The dollar limit on their joint return for 2021 would be $9,040 ($4,520 + $4,520).

If an employer pays for long-term care insurance on behalf of an employee, this is a tax-free fringe benefit. It is not subject to income tax and is exempt from payroll taxes (e.g., FICA) as well. If an employee is covered by a long-term care insurance policy through work and leaves the company, there may be an option to continue the coverage by paying the premiums.

If a retired public safety officer elects to pay long-term care premiums with tax-free distributions from a qualified retirement plan, the officer may not deduct the premiums. This bar to deductibility applies where the distributions are paid directly to the insurer but would otherwise be taxable if received by the officers.

Whether it is possible to pay long-term care insurance premiums from a tax-advantaged account depends on the type of account. Here's a rundown:

- Health savings accounts. Long-term care insurance premiums are a qualified expense. Distributions for them are tax-free and not subject to any penalty.
- Health flexible spending accounts (FSAs). Long-term care insurance premiums are not a qualified expense, so funds in the FSA may not be used for this purpose.
- Individual coverage health reimbursement arrangements (ICHRAs). If the ICHRA reimburses an employee for both basic health coverage and unreimbursed medical expenses, then long-term care insurance premiums are a qualified expense. Reimbursements, which are reviewed by the employer's plan administrator, to cover long-term care insurance premiums are not taxable.

State income tax rules for the treatment of long-term care insurance premiums may differ from federal.

EXAMPLE

New York allows a 20% tax credit (not a deduction) for premiums for long-term care insurance policies.

Long-Term Care Through Other Insurance Products

Life insurance contracts and commercial annuities may be combined with long-term care coverage (hybrid policies), typically with a rider on a whole life insurance policy or an annuity. This allows the insured (or the family) to have some benefit from the policy even if long-term care is never needed. Generally, the cost of adding long-term care coverage to another insurance product raises the cost by about 30%.

For income tax purposes, none of the premiums for hybrid policies are deductible if they are a charge against the cash surrender value of life insurance contracts or cash value of annuities.

RELYING ON MEDICAID

If a low-income person who requires long-term care cannot pay out-of-pocket and does not have long-term care insurance, there is institutional Medicaid for coverage in a nursing home, assuming the person can qualify for this assistance. Medicaid is a federal/state program designed to cover medical costs for general health coverage and nursing home services for those with a financial need.

Eligibility

The person must require the level of care for institutional Medicaid; this is referred to as functional criteria. This is having a need for nursing home level of care or meeting functional eligibility criteria. When a person has institutional Medicaid, Medicare still covers medical services required beyond the custodial care in a nursing home. Medicaid will pay for medical costs not covered by Medicare (e.g., co-payments) as well as the cost of nursing home care.

For example, if an elderly person with institutional Medicaid needs to go to a doctor or specialist's office, Medicare will pay for most of these medical services while Medicaid will cover the remaining costs, such as coinsurances, copayments, and deductibles.

To qualify for Medicaid, income and assets guidelines apply. These are referred to as financial criteria. These guidelines vary by state and can change from year to year. State criteria may be found at https://www.medicaidplanningassistance.org/state-specific-medicaid-eligibility/.

Income test. Income, for purposes of Medicaid eligibility, has no relation to taxable income. For example, all Social Security benefits are counted as income, regardless of whether or to what extent they are includible in gross income. Other examples of income for Medicaid purposes include employment wages, alimony payments, veterans' benefits, pension payments, IRA withdrawals, and stock dividends. Income does not include economic impact payments (EIPs), which were paid by the federal government in 2020 and 2021.

In most states, the income limit in 2021 was $2,382 per month for a single individual. The rules for married persons are more complicated. Usually, the income limit is applied per spouse, but special rules come into play if one spouse needs to be in a nursing home while the other remains in the couple's residence. If income is above the limit but not sufficient to pay for long-term are, a qualified income trust (QIT) may be used to meet eligibility requirements. QITs are discussed later.

Asset test. The limitation on assets also varies from state to state. In most states, it is $2,000, other than exempt assets. Some states have higher limits; New York's limit in 2021 was $15,900. Exempt assets, which are assets not counted in determining eligibility for Medicaid, include:

- A person's residence if the person resides in it or has an intent to return to it, provided the equity does not exceed a set amount (there is no equity limit in California)
- Household furnishings
- Personal belongings (clothing and wedding/engagement ring)
- Car
- Irrevocable trusts (explained later)
- Funeral/burial expenses set aside (up to $2,500, or $5,000 for an individual and spouse)
- Life insurance with a cash surrender value of no more than $1,500

There is a lookback period, requiring assets transferred without consideration (i.e., merely gifted) within this period to be taken into account in determining eligibility. This means it will not help for a person to transfer assets within this period in order to fall below eligibility guidelines. If assets are sold within the lookback period, the proceeds become assets for determining Medicaid eligibility.

Generally, the lookback period is 60 months (five years). For example, a person in Texas applies for Medicaid on January 1, 2022. The lookback period runs to December 31, 2016. However, some states have different periods. California has a 30-month (2.5-year) lookback period. New York, as of July 1, 2021, created a separate lookback period for purposes of community-based services (home health care, adult day care, personal care assistance, and assisted living services); it is 30 months (2.5 years). This period is phased in, starting with six months on July 1, 2021, and increasing by one month until it reaches the full 30 months by July 2023.

While the lookback period generally bars most transfers for purposes of Medicaid eligibility, some transfers are permissible. For example, a home may be transferred (gifted) to an adult child providing caregiver services and who has lived in the home for two years prior to the parent entering a nursing home. Also note that while assets may be exempt for purposes of Medicaid eligibility, it does not make them all free from a Medicaid recovery after death.

EXAMPLE

An individual living at home qualifies for Medicaid and receives in-home care. After death, Medicaid has a right of recovery from the home (i.e., it can recoup amounts spent on the care from the proceeds of a sale of the home).

Tax treatment of Medicaid benefits. Individuals are not taxed on any Medicaid benefits they receive.

Trusts to Protect Assets from Medicaid

Individuals with the foresight to plan for long-term care needs while anticipating that they'll require Medicaid may set up a Medicaid Asset Protection Trust (MAPT). If done correctly, and timely (before the lookback period), a MAPT, also called a Medicaid Planning Trust or simply a Medicaid Trust, can ensure that assets pass to named beneficiaries without disqualifying the grantor (the person setting up the trust) from Medicaid eligibility. The assets in the trust are not counted for purposes of determining Medicaid eligibility because they are no longer owned by the Medicaid applicant.

A MAPT is an irrevocable (non-cancelable) trust that holds assets which will pass to beneficiaries named by the grantor when the grantor dies. Assets may include the grantor's home as well as just about any other type of assets. However, because of income limits, it may not be wise to put income-producing assets in the trust, or at least limit them.

Rules for MAPTs vary considerably by state, so an experienced attorney is needed to set them up. Legal fees usually run from $2,000 to $10,000, or more, so it is advisable to create a trust only for someone with assets over about $100,000.

Trusts to Protect Income from Medicaid

It may be possible to use a special type of trust, referred to as a qualified income trust (QIT), if a person requiring the level of institutional care has too much income to qualify for Medicaid but not enough income to pay for care. The QIT can be used in about half the states. It also goes by several other names:

- Income assignment trust
- Income cap trust
- Income diversion trust
- Income-only trust
- Medicaid income-only trust
- Miller trust, which is named after the Colorado court case in which it arose (Miller v. Ibarra)

A QIT is an irrevocable (non-cancelable) trust that allows an individual or couple to put income into the trust without becoming disqualified for Medicaid. A trustee must be named to have control over the account. In most states, Medicaid is the trust beneficiary or, as a minimum, the trust must have a reversion clause providing that any funds remaining in the trust will be payable to Medicaid to the extent that that this benefit was provided.

A QIT must contain only income and essentially operates as an account from which the trustee must pay a monthly personal needs allowance fixed by state law, a spouse minimum monthly needs allowance, and any medical expenses if there is remaining monthly income. The trust is initially funded with a nominal amount of assets (e.g., $20) to cover fees and then receives the income each month that would otherwise disqualify a person from Medicaid. Typically, it costs about $1,000 or more in legal fees to create a QIT.

Taxwise, a QIT is a grantor trust even though it is irrevocable. As such, the assets are treated as belonging to the grantor and all the income is taxed to the grantor (the Medicaid recipient).

Other Medicaid Strategies

Working with an elder care attorney is advisable for Medicaid planning. The sooner that planning begins, the more options are available. Find an elder care attorney through the National Academy of Elder Law Attorneys (NAELA) at https://www.naela.org/. Other Medicaid strategies are as follows.

Spending down. Individuals with assets above the eligibility limit may qualify for Medicaid by "spending down." This means paying bills and other expenses to use up assets. It does not mean making gifts (see the earlier discussion of the lookback period).

Trusts protecting the community spouse. Special attention is needed when there is a couple where one spouse needs care while the other spouse, called the community spouse, does not. Different asset and income limits apply. And if trusts are used, special planning is essential to protect the community spouse.

Immediate annuities. When there is a community spouse, another option for protection is to purchase a single premium immediate annuity. This transforms assets (money used to pay the premium) into income payable to the community spouse. If done correctly, this will not prevent Medicaid eligibility for the spouse needing care. This means the annuity payments must be exhausted over the community spouse's life. Medicaid must be named as the beneficiary of the annuity and receives any outstanding funds upon the community spouse's death.

OTHER STRATEGIES FOR LONG-TERM CARE

In addition to the three basic ways to pay for long-term care discussed earlier, as well as the other programs mentioned, there are other options for handling long-term care.

Family Help

In the not too-distant past, care of an elderly infirm person was left to the family in most cases. Today, many family members continue to provide help for long-term care needs. Some give financial assistance. Others help the individual directly with personal care.

An individual (the donor) can give money to help with long-term care of another (the donee). From a tax perspective, gifts to a donee are not subject to federal gift tax if they are no more than the annual gift tax exclusion ($15,000 in 2021). The use of the funds (in this case for long-term care) has no impact on the tax treatment of the gift. Married persons may consent to "split gifts," which effectively doubles the annual exclusion amount. Larger gifts may be tax-free to the extent the donor uses his or her personal lifetime exemption amount ($11.7 million in 2021, but this could be changed dramatically under proposed legislation). Making large lifetime gifts permanently reduces the exemption amount available to the donor's estate.

Gifts made directly to providers of medical services or companies selling medical insurance are tax-free ("medical exclusion"). Medical care includes expenses incurred for the diagnosis, cure, mitigation, treatment, or prevention of disease, or for the purpose of affecting any structure or function of the

body, or for transportation primarily for and essential to medical care. Medical care also includes amounts paid for medical insurance on behalf of any individual. It also covers long-term care services, such as the costs of nursing homes or assisted living facilities, if provided by a licensed healthcare provider. The medical exclusion does not apply to amounts reimbursed by insurance.

EXAMPLE

A family member pays $25,000 toward the care of a relative in a nursing home. The payment is made directly to the facility. This gift qualifies for the medical exclusion; it is not subject to gift tax.

No gift tax return is required to be filed in this instance.

Finding Additional Income Sources

If a person needs to supplement existing assets and income to cover the costs of long-term care, there may be other ways to get money:

- Tapping home equity. Individuals who have owned their homes for a long time and have seen considerable appreciation in home values have equity in the home that can be borrowed. Using a home equity loan or home equity line of credit (HELOC), funds can be available to pay long-term care costs. The HELOC must be repaid, with interest. From a tax perspective, interest on a HELOC is not deductible through 2025 if the funds are used to pay long-term care expenses.
- Using a reverse mortgage. Seniors may be able to tap the equity in their home without immediate repayment. The principal, plus accrued interest, is repaid when the owner moves, sells the home, reaches the end of a pre-selected loan period, or dies. The receipt of the proceeds from a reverse mortgage are not taxable. Even though mortgage interest accrues, no deduction is allowed for the interest until it is actually paid.

Other Government Programs

Medicaid is not the only government program for long-term care assistance. Other programs include the following:

Veterans' benefits. Veterans may be eligible for certain assistance through the Veterans Administration to help with long-term care. This assistance is available through VA facilities or other facilities, and include:

- In-home care (24/7) at the veteran's home or special group homes
- Assisted living
- Nursing home care

The VA pays an attendant care allowance for the long-term care of veterans and their spouses. The attendant may be someone hired by the family who becomes an employee or is sent from an agency and remains the employee of the agency. The receipt of this benefit is not taxable to the veteran; it is taxable income to the attendant.

- If the attendant is an employee of the family, the family must ensure that employment tax obligations for a household employee are met (see IRS Publication 926, https://www.irs.gov/pub/irs-pdf/p926.pdf).
- If the attendant is an employee of an agency, there is an hourly fee paid to the agency, which may be a deductible medical expense.

But not all services for veterans are paid by the VA. Some require Medicaid or are paid through Medicare or private insurance.

State programs. Many states have recognized the long-term care problem for their residents. Thus far, there are two approaches being used by states:

- Long-term care partnership insurance
- Long-term care support services funded by payroll contributions from employees

Long-term care partnership insurance. Most states offer long-term care partnership insurance to enable middle-class individuals to buy insurance that covers long-term care costs up to set limits while protecting assets and ensuring eligibility for Medicaid (assuming income limits are met). The policy is called a partnership-qualified (PQ) policy and pays up to a set dollar amount (the amount purchased), as compared with traditional long-term care insurance that pays a per diem for a term of years or lifetime. For Medicaid purposes, the PQ policy is a disregarded asset on a dollar-for-dollar basis. In other words, every dollar that the PQ policy will pay for, a dollar of assets is protected from Medicaid.

EXAMPLE

An individual buys a PQ policy with a benefit up to $150,000. The individual may keep $150,000 of assets over the applicable Medicaid limit for eligibility (described earlier). If the asset limit is $2,000, then the individual keeps $152,000. Those assets are not subject to a Medicaid recovery when the individual dies.

- Qualified state long-term care programs. Almost all states offer PQ policies to cover in-home and/or nursing home care. Check a listing at the American Association for Long-Term Care Insurance at https://www.aaltci.org/long-term-care-insurance/learning-center/long-term-care-insurance-partnership-plans.php.
- States with reciprocity. If a policy is purchased by an individual in one state, who then relocates to another state, the original policy may or may not be recognized in the new state. Most, but not all states, offer reciprocity, which means recognizing the original policy.

There are some considerations for PQ policies. A health exam is required to buy a policy, so someone already experiencing a health condition, such as Parkinson's or Alzheimer's disease, will not be sold a policy. Also, buying a long-term care policy does not automatically make it a PQ policy. Check the terms of the policy.

For tax purposes, premiums for the PQ policy are deductible to the same extent as traditional long-term care insurance (discussed earlier).

Long-term care support services funded by payroll contributions from workers. Washington enacted the Long-Term Care Services and Supports (LTSS) Trust Act to help its residents with long-term care needs. The employee contribution to a state trust fund is 0.58% of wages beginning January 1, 2022. Self-employed individuals may opt into the trust. Those with private long-term care insurance may opt out. There are no employer contributions. While the IRS has not ruled yet, it is likely that workers who itemize deductions may treat these payments as deductible state taxes, subject to the cap on the deduction for state and local taxes ("SALT cap").

Starting in 2025, to receive benefits, a worker must have a need for assistance with ADLs within the state and contributed to the trust for at least 10 years without a break of 5 or more years, or 3 of the past 6 years. There is a lifetime cap on benefits of $36,500.

Whether other states will adopt similar programs remains to be seen.

IRS RESOURCES

The following IRS publications offer helpful information related to veterans and older taxpayers:

- IRS Publication 3, Armed Forces' Tax Guide
- IRS Publication 502, Medical and Dental Expenses
- IRS Publication 554, Tax Guide for Seniors

REVIEW QUESTIONS

1. Which of the following is not one of the seven activities of daily living?

a. Meal preparation and feeding

b. Functional transferring

c. Personal financial matters

d. Memory care and stimulation

2. Which of the following may trigger a tax implication when paying for long-term care out-of-pocket?

a. Withdrawing cash from a bank account

b. Liquidating stocks

c. Taking the standard deduction

d. Earning wages

3. A taxpayer sold stock in 2021 at a long-term capital gain and used the proceeds to pay for long-term care. The taxpayer is single and has taxable income of $500,000. At what rate will the long-term gain be taxed?

a. 0%

b. 15%

c. 20%

d. 25%

4. The time period before which coverage begins is:

a. The daily dollar amount

b. The period of coverage

c. An inflation adjustment

d. The exclusion period

5. The spouses in a married couple are ages 65 and 7 I, and each has a long-term care policy. What is the limit they can deduct on their 2022 federal income tax return as a medical expense?

a. $0

b. $5,640

c. $9,040

d. $10,160

6. For purposes of Medicaid eligibility, income includes:

a. Pensions

b. Only the taxable portion of Social Security benefits

c. IRA contributions

d. Economic impact payments

7. The Medicaid lookback period:

a. Takes into account assets that were transferred without consideration

b. Is generally 72 months

c. Bars all transfers for purposes of eligibility

d. Has no effect on assets that were sold during the applicable period

8. Which of the following is true regarding a Medicaid Asset Protection Trust (MAPT) used for the purpose of protecting assets from Medicaid?

a. It is a revocable trust.

b. The assets are still owned by the Medicaid applicant.

c. The assets in the trust pass to named beneficiaries.

d. Transfers of assets to these trusts are not subject to the lookback period.

9. Son pays $30,000 directly to a nursing home that is caring for his mother. Which of the following is a true statement regarding this payment?

a. The mother can deduct the $30,000 as an itemized deduction.

b. The payment qualifies for the medical exclusion.

c. A gift tax return must be filed.

d. The mother must pay tax on the $30,000.

10. Which of the following is true regarding sources of income for long-term care?

a. Medicaid is the only government program for long-term care assistance.

b. The receipt of veterans' benefits for long-term care assistance is taxable to the veteran.

c. Most states now have long-term care support services funded by payroll contributions from workers.

d. The use of a reverse mortgage may cover the costs of long-term care.

ANSWERS TO REVIEW QUESTIONS

1. a. Incorrect. Meal preparation and feeding as well as dressing and undressing are two of the seven ADLs.

b. Incorrect. Functional transferring (e.g., getting in and out of bed) as well as safe bathroom use and maintaining continence are two of the seven ADLs.

c. Correct. ADLs do not include handling personal financial matters, even though help for this may be required by someone with one or more of the seven ADLs.

d. Incorrect. Memory care and stimulation, as well as substantial supervision for a person with a cognitive impairment such as Alzheimer's disease or another form of dementia is one of the seven ADLs.

2. a. Incorrect. Withdrawing cash from a bank account to pay for long-term care out-of-pocket has no tax consequences.

b. Correct. Tapping into liquid assets such as stocks, bonds, and mutual funds held in a taxable or tax-deferred account may trigger taxable income and, in some cases, penalties from the IRS or the financial institution.

c. Incorrect. Taxpayers who itemize personal deductions may deduct out-of-pocket costs to the extent they exceed 7.5% of adjusted gross income. The standard deduction is not a tax implication of paying for long-term care out-of-pocket.

d. Incorrect. While earning wages is a taxable event, it is not the same as a tax implication of liquidating assets to pay for long-term care out-of-pocket.

3. a. Incorrect. Individuals with income below set levels pay a zero percent rate on net long-term capital gains. The same is not true for those with taxable income above these levels. The fact that the proceeds were used to pay for long-term care also does not change the rate at which the gain is taxed.

b. Incorrect. Long-term capital gains may be taxed at 15% depending on the taxpayer's taxable income and filing status. This taxpayer is above the 15% threshold.

c. Correct. The 20% capital gain tax rate applies to a single taxpayer with taxable income above $445,850 in 2021.

d. Incorrect. There is pending legislation that could raise the capital gain tax rate to 25% for certain taxpayers.

4. a. Incorrect. The daily dollar amount is the amount paid by the policy each day that coverage is needed.

b. Incorrect. The period of coverage is the time over which coverage applies. This may be a set number of years or for life.

c. Incorrect. An inflation adjustment is an increase to the daily dollar amount as inflation increases.

d. Correct. The exclusion period is the time before which the coverage begins. Typically, a policy as a 90-day exclusion period, which means the insured (or the family) pays the cost of care for the first 90 days.

5. a. Incorrect. Premiums for long-term care insurance are treated as deductible for federal income tax purposes as medical expenses up to set dollar limits for those who itemize.

b. Incorrect. Married couples can each use their applicable limit if they each have a policy.

c. Incorrect. This would be the limit if each spouse was over age 60 but not over age 70.

d. Correct. Married couples can each use their applicable limit if they each have a policy. The limit for individuals over age 60 but not over age 70 is $4,520; the limit for individuals over age 70 is $5,640. Therefore, the limit for their 2022 federal income tax return medical deduction for long-term care insurance is $10,160 ($4,520 + $5,640).

6. a. Correct. Income for purposes of Medicaid includes Social Security benefits, employment wages, alimony payments, Veterans' benefits, pension payments, IRA withdrawals, and stock dividends.

b. Incorrect. Income for purposes of Medicaid eligibility has no relation to taxable income. For example, all Social Security benefits are counted as income, regardless of whether or to what extent they are includible in gross income.

c. Incorrect. IRA withdrawals, not IRA contributions, are included as income for purposes of Medicaid eligibility.

d. Incorrect. Income for purposes of Medicaid eligibility does not include economic impact payments which were paid by the federal government in 2020 and 2021.

7. a. Correct. There is a lookback period, requiring assets transferred without consideration within this period to be taken into account in determining eligibility. This means it will not help a person to transfer assets within this period in order to fall below eligibility guidelines.

b. Incorrect. Generally, the lookback period is 60 months.

c. Incorrect. While the lookback period generally bars most transfers for purposes of Medicaid eligibility, some transfers are permissible. For example, a home may be transferred to an adult child providing caregiver services and who has lived in the home for two years prior to the parent entering the nursing home.

d. Incorrect. If assets are sold within the lookback period, the proceeds become assets for determining Medicaid eligibility.

8. a. Incorrect. A Medicaid Planning Trust (MAPT) is an irrevocable trust.

b. Incorrect. If done properly, the assets in the trust are not counted for purposes of determining Medicaid eligibility because they are no longer owned by the Medicaid applicant.

c. Correct. If done correctly and timely, a MAPT can ensure that assets pass to named beneficiaries without disqualifying the grantor from Medicaid eligibility.

d. Incorrect. The lookback period does apply to assets transferred to a MAPT. However, if done correctly and timely, the assets will not be counted for purposes of Medicaid eligibility.

9. a. Incorrect. It is possible that the son can deduct the payment as an itemized deduction if his mother is also his dependent. Since the mother is not making the payment, she cannot deduct the cost on her tax return.

b. Correct. Gifts made directly to providers of medical services or companies selling medical insurance are tax-free. This medical exclusion applies to the cost of nursing homes are assisted living facilities.

c. Incorrect. Even though the payment was more than the $15,000 gift-tax exclusion amount, the gift qualifies for the medical exclusion.

d. Incorrect. The $30,000 payment is a gift to the mother. Any tax to be paid would be paid by the son as a gift tax, if applicable.

10. a. Incorrect. Medicaid is not the only government program for long-term care assistance. Other programs include Veterans' benefits and state programs.

b. Incorrect. The receipt of Veterans' benefits is not taxable to the veteran. However, the attendant care allowance is taxable income to the attendant.

c. Incorrect. Washington is currently the only state with this program. Whether other states adopt similar programs remains to be seen.

d. Correct. If a person needs to supplement existing assets and income to cover the costs of long-term care, there may be other ways to get money such as tapping home equity or using a reverse mortgage.

Chapter 5

RETIREMENT PLANS

LEARNING OBJECTIVES

After reviewing this chapter, you should be able to:

- Distinguish between different types of retirement plans
- Calculate the maximum contribution that can be made to different types of retirement plans
- Understand the basics of periodic payments and rollovers
- Describe how required minimum distributions are calculated and when they must begin
- Explain the significance of beneficiary designations

GOALS, OBJECTIVES, AND ASSUMPTIONS

Retirement plans are the primary retirement savings vehicles in the United States, in part because they are treated favorably from a tax perspective. Employers are permitted to take a current deduction for amounts contributed to qualified retirement plans and, in some cases, may receive tax credits for eligible contributions. Employees, on the other hand, are permitted to defer recognition of income for tax purposes of any funds contributed to such plans until the funds are distributed (other than Roth contributions, which are subject to current income tax). Some distributions may further delay taxation if they are rolled over or transferred into other eligible retirement plans or arrangements. Additionally, employees enjoy watching their earnings in the plan grow on a tax-free basis.

To continue to benefit from this tax-favored status, plan sponsors must satisfy a litany of rules, a small fraction of which are discussed here.

> NOTE
>
> The Employee Retirement Income Security Act of 1974, as amended ("ERISA"), was enacted to implement protections for retirement plan participants, among other things. It sets forth minimum standards for retirement and health plans sponsored by private employers. It added provisions to the tax code, which are governed by the Internal Revenue Service. It also added provisions that are governed by the Department of Labor. It also created the Pension Benefit Guaranty Corporation.

TYPES OF PLANS

A wide variety of retirement arrangements are available to help individuals save for retirement. These arrangements can be set up by individuals for themselves, or by employers for the benefit of their employees.

Employer-Sponsored Plans

There are two categories of plans that employers may implement for their employees: (1) defined contribution plans and (2) defined benefit plans.

PREVALENCE OF DEFINED CONTRIBUTION VS. DEFINED BENEFIT PLANS

According to the U.S. Bureau of Labor Statistics, in March 2020, 67% of private industry workers had access to retirement plans sponsored by their employers. 52% of workers had access to a defined contribution plan. An additional 12% of workers had access to both a defined benefit and a defined contribution plan. Only 3% had access solely to defined benefit plans (https://www.bls.gov/opub/ted/2021/67-percent-of-private-industry-workers-had-access-to-retirement-plans-in-2020.htm).

A defined benefit plan promises a participant a specified monthly benefit at retirement. This may be expressed as an exact dollar amount (e.g., $500 each month at retirement until death). It is more common, however, for the benefit to be calculated according to a specified formula that takes into account years of service and historical compensation, among other things. An example of this type of formula would be 2% of average salary for the last 10 years of employment for every year of service with the employer. In defined benefit plans, the employer bears the risk for the performance of invested plan assets.

A defined contribution plan does not promise a specific benefit amount at retirement. Instead, it promises a set contribution for each year, which is then made to an employee's account and is typically invested in accordance with the participant's instructions. At retirement, the participant is entitled to his or her account balance. In this case, the employee bears the risk for the performance of the invested plan assets.

In a defined contribution plan, the employee can usually make contributions to the plan in addition to employer contributions. Employer contributions can be in the form of matching contributions (e.g., the employer will match employee deferral contributions up to 5% of an employee's compensation) or profit-sharing contributions (e.g., the employer will contribute a percentage of its profits to be shared among plan participants according to a set formula).

There are a wide variety of employer-sponsored defined contribution plans, including 401 (k) plans, 403(b) plans, profit-sharing plans, money purchase plans, employee stock ownership plans, and 457 plans.

401 (k) PLANS

A 401 (k) plan is a qualified profit-sharing plan that allows employees to contribute a portion of their wages to individual accounts. This feature is authorized in Internal Revenue Code Section 401 (k). In these types of plans, the elective salary deferrals made by employees are excluded from their taxable income (except for designated Roth deferrals, which are made on an after-tax basis).

Employers may also contribute to their employees' accounts. Distributions, including earnings, are included in an employee's taxable income when the employee begins receiving them at retirement (except for distributions of Roth accounts, which are not taxable at distribution since the original contributions were made on an after-tax basis).

There are also a variety of individual retirement arrangements. These include the following:

- Savings Incentive Match Plan for Employees IRA (SIMPLE IRA). This IRA allows employees and employers to contribute to a traditional IRA the employer establishes for employees. These are most common with small employers. A SIMPLE IRA is available to small businesses with 100 or fewer employees. In this type of plan, the employer is required to contribute either a 3% matching contribution (i.e., 3% of compensation that is not limited by the annual compensation limit) or a 2% nonelective contribution, which must be made to all employees even if an employee does not make a contribution to the plan (2% of compensation, which is limited by the annual compensation limit). Employers are permitted to have an automatic enrollment feature, whereby each employee does not affirmatively elect to make a set, minimum salary deferral

percentage. However, employees must have an opt-out option, or the option to change the salary deferral percentage.

- Simplified Employee Pension Plan (SEP-IRA). This is a plan that allows employers to contribute to a traditional IRA for employees. Any size employer can establish a SEP. This is common with individuals who are self-employed. Employers must contribute a set percentage of compensation for each employee, but they do not have to make a contribution every year.
- Salary Reduction Simplified Employee Pension Plan (SARSEP). This type of plan was established prior to 1997 and allows employee salary deferrals. A SARSEP may not be established after 1996. It is subject to certain participation requirements.
- Payroll deduction IRAs. With these plans, a traditional or Roth IRA is established at a financial institution. The employee then authorizes payroll deductions by their employer to fund it. Any business can establish this for their employees. The employee determines whether to contribute, when to contribute, and how much to contribute.

CALCULATING THE MAXIMUM CONTRIBUTION

Contributions to tax-favored retirement arrangements are subject to contribution limits. In other words, the IRS is only willing to defer the receipt of tax revenue on so much. There are different limits that apply to various IRAs and employer-sponsored plans.

Employer-Sponsored Plan Limits

Employer-sponsored plans are subject to two annual contribution limits. There is a limit on the amount an employee participant may contribute to the plan. The other places a cap on the total contribution an employer may make for each employee (including any employee contributions).

Salary deferral limits. A limit on employee contributions (known as elective deferrals, salary deferrals, or elective contributions) applies to 401 (k) plans, 403(b) plans, SARSEP IRAs, and SIMPLE IRA plans. These limits are subject to annual cost-of-living adjustments (in $500 increments). The limit attaches to an employee. In other words, the limit does not apply on a per plan basis.

Deferral Limit		
Year	401(k), 403(b) & 457 Plans	SIMPLE 401(k) & SIIMPLE IRA
2022*	$20,500	$14,000
2021	$19,500	$13,500
2020	$19,500	$13,500
2019	$19,000	$13,000

*Projected

Plan-based limits. The terms of the plan may further limit elective deferrals to a lower amount, such as by application of a percentage of compensation limit. The plan is also subject to certain nondiscrimination rules that limit the contributions made by highly compensated employees as compared to non–highly compensated employees. These rules may also require that contributions made by and for certain highly compensated employees be limited in order to pass such nondiscrimination tests.

Catch-up contributions. Plans may also allow participants aged 50 and older (by the end of the calendar year) to contribute an additional amount, over and above the maximum elective deferral amount. Eligible employees can contribute up to an additional $6,500 in 2022, 2021, and 2020 ($6,000 in 2015–2019). These amounts are also subject to annual cost-of-living adjustments. Catch-up contributions are not subject to these other contribution limits.

Overall employer contribution limit (annual additions limit). An employer is limited in the total amount of contributions that can be made to any one participant's account. The total of employee elective deferrals, employer matching contributions, employer nonelective contributions, and any forfeiture allocations are subject to this limit on an employee-by-employee basis. Catch-up contributions are not included in these limits.

The sum of each of these contributions (referred to as annual additions) cannot exceed the lesser of: (1) 100% of the participant's compensation, or (2) $58,000 for 2021 ($57,000 for 2020). The annual additional dollar limit is subject to annual cost-of-living adjustments. The maximum amount of compensation that can be taken into consideration for purposes of plan calculations is $290,000 for 2021 ($285,000 for 2020). The compensation limit is subject to annual cost-of-living adjustments. For 2022, the annual additions limit is projected to be $61,000, and the annual compensation limit is projected to be $305,000.

NOTE

The employer's deduction for contributions to a defined contribution plan may not exceed 25% of compensation paid (or accrued) to plan participants during the year.

For defined contribution plans, the highest compensation amount that may be used in calculating benefits is $230,000 for 2021 (and is projected to be $245,000 for 2022).

IRA Limits

The total contributions that can be made to IRAs is limited. The total contributions that can be made each year to all traditional and Roth IRAs may not exceed the lesser of: (1) $6,000 (for 2021, and projected for 2022), or (2) taxable compensation for the year. This limit is subject to annual cost-of-living adjustments in $500 increments. For 2021, 2020, and 2019, the dollar limit is $6,000 (or $7,000 if 50 years of age or older). For 2018, 2017, 2016, and 2015, the dollar limit was $5,500 (or $6,500

for those 50 or older). This limit does not apply to any qualified rollover contributions or qualified reservist repayments. These limits are projected to be the same for 2022.

NOTE

Prior to the passage of the SECURE Act, individuals age 70½ and older were prohibited from making contributions to traditional IRAs, although they were still permitted to make Roth IRA contributions. Rollover contributions to Roth or traditional IRAs were permitted regardless of age prior to 2020.

After 2020, the age limit on making regular contributions to traditional IRAs is eliminated.

PERIODIC PAYMENTS

Generally, early withdrawals of amounts in certain qualified retirement plans and IRAs, that is, before age 59½, are subject to a 10% excise tax. There are a few exceptions to this rule, which include, but are not limited to, permanent disability, amounts for a first-time home purchase, amounts to pay college tuition, and the payment of certain medical expenses.

However, this tax may be avoided if distributions are made as part of a series of substantially equal periodic payments (SEPPs) over a participant's life expectancy or the life expectancies of the participant and his or her designated beneficiary.

To elect to receive SEPPs from a qualified plan, a plan participant must separate from service with the plan sponsor prior to beginning payments. If the SEPPs are subsequently modified (other than due to disability or death) within five years of the date of the first payment, or, if later, age 59½, the exception to the 10% additional tax is inapplicable. If that occurs, the tax for the modification year is increased by the amount that would have been imposed but for qualifying for an exception to the additional tax, plus interest for the period of deferral.

There are three methods for determining the amount of SEPPs: (1) the required minimum distribution method, (2) the amortization method, and (3) the annuitization method. Each method requires the use of a life expectancy or mortality table. The amortization method and the annuitization method require an acceptable interest rate to be specified.

The required minimum distribution method employs the method used to calculate required minimum distributions (RMDs). It typically results in the lowest possible withdrawal requirement. It is determined by dividing the account balance by life expectancy. The resulting amount is what must be withdrawn in the first year. The amount is recalculated each year.

The amortization method calculates a fixed amount of annual payments by reference to a life expectancy factor and the federal mid-term interest rate. Distributions are not recalculated each year.

The annuity method calculates the distribution amount by reference to total account balance, the application of an annuity factor, the federal mid-term interest rate, and life expectancy.

ROLLOVERS

A rollover is a contribution made from one qualified retirement plan or IRA to another. Qualified rollovers preserve the tax-favored status of the assets. If a distribution is made from a qualified plan or IRA (prior to specified time periods, such as the attainment of age 59½) and it is not rolled over, the participant or account owner will be taxed on the proceeds and may be subject to an early withdrawal penalty.

For a rollover to be a qualified rollover, a distribution from the original qualified retirement plan or IRA must be deposited into another retirement plan or IRA within 60 days. Direct transfers between retirement plans and IRAs are also possible. A distribution between IRAs can be effectuated through a trustee-to-trustee transfer.

If a direct rollover is made, the plan administrator may either make the payment directly to the other retirement plan or IRA or may issue a check made payable to the new account. In this scenario, taxes are not withheld from the amount to be transferred.

If a trustee-to-trustee transfer is made, the financial institution that holds the IRA assets will make the payment directly to the recipient IRA or retirement plan. Like the direct rollover, taxes are not withheld from the amount to be transferred.

If a 60-day rollover is elected, the distribution is paid directly to the participant from the IRA or retirement plan. Then, the participant can choose what to do with the proceeds. The participant can deposit all or a portion of it in an IRA or retirement plan. Unlike a direct rollover or trustee-to-trustee transfer, the proceeds are subject to mandatory tax withholding, which means the participant must contribute other funds to roll over the full amount of the distribution. A retirement plan distribution paid to a participant is subject to 20% mandatory tax withholding. An IRA distribution is subject to 10% withholding unless the account holder elects out of withholding or elects to have a different amount withheld. If the full amount of the distribution before taxes is not rolled over within the 60-day period, the portion of the distribution that is not rolled over will also be subject to an additional 10% tax unless an exception applies. One such exception is if the participant is age 59½ or older.

EXAMPLE

Assume Trinity, age 38, received a $25,000 eligible rollover distribution from her 401(k) plan. Her employer withheld $5,000 from the distribution. If Trinity decides to roll over the $20,000, but not the $5,000 withheld, she will recognize $5,000 as ordinary income, $20,000 as a nontaxable rollover, and $5,000 as tax paid. She must also pay the 10% additional penalty unless she qualifies for an exception. This penalty would be $500. If Trinity chooses to roll over the full $25,000, she must contribute $5,000 that she procures from other sources. In this case, she would report $25,000 as a nontaxable rollover and $5,000 as tax paid. She would not be subject to the 10% additional penalty.

There are rules that govern the types of assets that may be rolled over into specific types of accounts. A Roth IRA, for example, may only be rolled over to another Roth IRA. A designated Roth account in a 401(k), 403(b), or 457(b) plan may only be rolled over to a Roth IRA or to a designated

Roth account in another 401(k), 403(b), or 457(b) plan that permits Roth contributions. Traditional IRAs may be rolled over to a Roth IRA, traditional IRA, SIMPLE IRA (after two years), SEP-IRA, governmental 457(b), qualified plan (pre-tax), or 403(b) (pre-tax).

Upon separation from employment, an employer must provide a rollover notice to each participant in a qualified plan. This should explain the options available to the participant. If a participant does not elect a rollover, plan administrators may choose to deposit plan funds in an IRA in the name of the participant if the participant's account balance is between $1,000 and $5,000. If the balance is below $1,000, the plan administrator may pay it to the participant—without the participant's consent—less the 20% mandatory tax withholding amount.

IRA limit on rollovers. For IRAs, there is a one-rollover-per-year rule that states that no more than one rollover can be made from the same IRA within a one-year period. A rollover from the IRA to which the distribution was rolled over may not be made during the one-year period. This applies regardless of how many IRAs are owned. For purposes of this limit, all IRAs are aggregated and treated as one IRA. The one-per-year limit does not apply to the following:

- IRA-to-plan rollovers
- Trustee-to-trustee transfers to another IRA
- Plan-to-IRA rollovers
- Plan-to-plan rollovers
- Rollovers from traditional IRAs to Roth IRAs (i.e., Roth conversions)

CALCULATING THE RMD

An RMD is the minimum amount a participant or IRA account owner is required to withdraw from his or her account each year. Because the funds in the accounts have been granted favorable tax treatment, the IRS is basically saying there is only so long it is willing to grant that relief. The IRS wants its tax revenue. and the RMD is how the IRS gets it. Consistent with this, Roth IRAs (which are after-tax contributions) don't require withdrawals until after the account owner dies.

The RMD rules apply to all employer-sponsored retirement plans. These include the following:

- Profit-sharing plans
- 401(k) plans
- 457(b) plans
- 403(b) plans (with a special rule for pre-1987 contributions)
- Traditional IRAs
- SEPs
- SARSEPs
- SIMPLE IRAs
- Roth 401(k) accounts
- Roth IRAs, but only after the death of the owner

An RMD is calculated by dividing the account balance on the immediately preceding December 31 by a life expectancy factor that is published by the IRS. These tables are published in Publication 590-B, Distributions from Individual Retirement Arrangements (IRAs).

The tables are broken down into three different categories: (1) joint and last survivor table, (2) uniform lifetime table, and (3) single life expectancy table. The joint and last survivor table is used if the participant's spouse is the sole beneficiary of the account and the spouse is more than 10 years younger than the participant. The uniform lifetime table is used where a participant's spouse is not the sole beneficiary or if the spouse is not more than 10 years younger than the participant. The single life expectancy table is used if the participant is the beneficiary of an account (an inherited IRA).

For plan participants and IRA owners who die after December 31, 2019, the entire account balance must be distributed within 10 years, with a few exceptions. These exceptions include: (1) a surviving spouse, (2) a child who has not yet reached the age of majority, (3) a disabled or chronically ill person, or (4) a person who is not more than 10 years younger than the account owner. This rule, introduced by the SECURE Act, applies at any time, even if the participant dies before the required beginning date.

RMD BEGINNING DATE

Beginning January 1, 2020, the required beginning date is April 1 of the year following the year in which a participant attains age 72 (or 70½ if before January 1, 2020), or if later, the year in which he or she retires. However, if the retirement plan is an IRA, or the account owner is a 5% owner of the plan sponsor, the RMDs must begin once the participant reaches age 72 regardless of retirement status.

CAUTION

If a person fails to timely take an RMD or fails to withdraw the full amount of the RMD, the amount that should have been timely withdrawn but was not, is subject to a 50% penalty. The participant is responsible for paying the penalty—not the plan sponsor, plan administrator, or custodian.

NOTE

The Setting Every Community Up for Retirement Enhancement (SECURE) Act of 2019 was enacted on December 20, 2019. The SECURE Act made significant changes to the RMD rules. Prior to 2020, the required beginning date was April 1 of the year following the year in which a person attained age 70½. The SECURE Act raised this age from 70½ to 72.

A person who reached age 70½ prior to January 1, 2020, is subject to the prior rule. If a person reached age 70½ in 2020 or later, the first RMD must be taken by April 1 of the year following the year age 72 is attained.

TAXATION OF RMDs

The account owner is taxed at ordinary income tax rates on the amount of the withdrawn RMD. However, if the withdrawal is a return of basis, or is a qualified distribution from a Roth IRA, it is not subject to tax.

BENEFICIARY DESIGNATION

A beneficiary is any entity or person that a plan participant or IRA account owner designates to receive the benefits of his or her account or IRA upon their death. The account owner may choose to name one or more primary beneficiaries, or one or more contingent beneficiaries. Primary beneficiaries are those who will receive the assets. Contingent beneficiaries are those who receive the assets if the primary beneficiaries are no longer living or do not exist (in the case of an entity). ERISA provides that if the account owner is married, they cannot name anyone other than their spouse unless that spouse consents to such designation in writing (and the consent is notarized).

Qualified Retirement Plan Beneficiaries

Beneficiaries of retirement plan accounts report income in the same way the participant would have and are subject to income tax on any taxable distributions they receive. However, there are a few exceptions to this general rule. First, a beneficiary may exclude from income the portion of any nonperiodic distributions he or she receives that fully relieve the payer from the obligation to pay an annuity. The beneficiary may exclude the cost of the annuity (i.e., the employee's investment in the annuity contract). If the beneficiary is entitled to a survivor annuity upon the employee's death, he or she may exclude a portion of each annuity payment as a recovery (tax-free) of the employee's investment in the annuity. If a beneficiary is entitled to benefits under a joint and survivor annuity, the full amount must be included in the surviving spouse's gross income as if the beneficiary were a retiree receiving such payments.

IRA Beneficiaries

If a surviving spouse inherits a traditional IRA, they may: (1) treat it as his or her own IRA by designating themselves as the owner of the IRA; (2) roll it over to their own traditional IRA or, to the extent it is taxable, into a qualified employer-sponsored retirement plan, a qualified employee annuity plan, a tax-sheltered annuity plan, or a local or state governmental deferred compensation plan; or (3) treat themselves as a beneficiary of such IRA.

If a traditional IRA is inherited by someone other than a spouse, the beneficiary may not treat the IRA as his or her own. They may not make contributions to their own IRA or roll it over to a qualified plan. They may, however, make a trustee-to-trustee transfer so long as the recipient IRA is in the name of the deceased IRA owner for the benefit of the beneficiary.

With respect to Roth IRAs, the entire interest must be distributed no later than the end of the fifth calendar year following the year of the owner's death unless the interest is payable to a designated beneficiary over such beneficiary's life or life expectancy. If it is paid as an annuity, the entire amount

must be payable over a period that is not greater than the beneficiary's life expectancy. Additionally, distributions are required to start before the end of the calendar year following the year of the owner's death. If the sole beneficiary of a Roth IRA is the surviving spouse, distributions are permitted to be delayed until the decedent would have obtained age 70½ or he or she may treat the Roth IRA as his or her own.

REVIEW QUESTIONS

1. In a SIMPLE IRA, employees and employers may contribute to a traditional IRA if the employer contributes either a 3% matching contribution or a ___ nonelective contribution.

a. 1%

b. 2%

c. 3%

d. 4%

2. Which of the following types of IRAs was established prior to 1997 and allows employee salary deferrals?

a. SIMPLE IRA

b. SEP-IRA

c. Payroll deduction IRA

d. SARSEP

3. The limit on salary deferral contributions to 401(k) plans in 2021 was:

a. $13,000

b. $13,500

c. $19,000

d. $19,500

4. The catch-up contribution limit for 401(k) plan participants aged 50 and older is what amount for 2021?

a. $1,000

b. $5,500

c. $6,000

d. $6,500

5. The annual additions limit for 2021 is the lesser of 100% of a participant's compensation or ____.

a. $54,000

b. $57,000

c. $58,000

d. $61,000

6. Judy is 60 years old. Her taxable compensation for 2021 is $5,500. What is the total contribution she can make to an IRA for 2021?

a. $0

b. $5,500

c. $6,000

d. $7,000

7. Required minimum distributions must generally be taken by individuals who reach what age?

a. 59½

b. 70½

c. 72

d. 75

8. The mandatory withholding rate applicable to distributions from a qualified plan to a plan participant who is younger than 59½ is:

a. 10%

b. 20%

c. 25%

d. 30%

9. Which of the following is a defined benefit plan?

a. Pension plan

b. 401 (k) plan

c. Money-purchase pension plan

d. Profit-sharing plan

10. If a taxpayer fails to timely take a required minimum distribution, he or she will be subject to a penalty in the amount of ___ of the amount that should have been withdrawn but wasn't.

a. 50%

b. 37%

c. 20%

d. 10%

ANSWERS TO REVIEW QUESTIONS

1. a. Incorrect. The mandatory nonelective contribution percentage is more than 1%.

b. Correct. If the employer chooses to make the 2% nonelective contribution, it must be made to all employees even if an employee did not make a contribution to the plan.

c. Incorrect. The mandatory nonelective contribution rate is not the same percentage as the matching contribution rate.

d. Incorrect. The mandatory nonelective contribution percentage is less than 4%.

2. a. Incorrect. The SIMPLE IRA allows employees and employers to contribute to a traditional IRA the employer establishes for employees. SIMPLE IRAs may be established after 1996.

b. Incorrect. The SEP-IRA is a plan that allows employers to contribute to a traditional IRA for employees.

c. Incorrect. The payroll deduction IRA allows an employee to determine whether to contribute, when to contribute, and how much to contribute. Any business can currently establish this for their employees.

d. Correct. The SARSEP may not be established after 1996 and is also subject to certain participation requirements.

3. a. Incorrect. This is the 2019 limit on deferrals to a SIMPLE 401(k).

b. Incorrect. This is the 2021 limit on deferrals to a SIMPLE 401(k).

c. Incorrect. This is the 2019 limit on salary deferral contributions applicable to 401(k) plans.

d. Correct. Participants may elect to make salary deferrals up to $19,500 for 2021.

4. a. Incorrect. This is the IRA catch up contribution limit.

b. Incorrect. This was the IRA limit that was applicable in years 2015–2018.

c. Incorrect. This was the 401(k) catch up contribution limit in years 2015-2019.

d. Correct. This is the catch-up contribution limit for 401(k) plan participants over age 50 for 2021 and 2022.

5. a. Incorrect. The dollar threshold for 2021 is higher than $54,000.

b. Incorrect. This is the threshold that was in effect in 2020.

c. Correct. The annual additions dollar limit is $58,000 for 2021. The annual additional dollar limit is subject to annual cost-of-living adjustments.

d. Incorrect. For 2022, the dollar threshold for annual additions is projected to be $61,000.

6. a. Incorrect. The total contribution that can be made may not exceed the lesser of (1) $6,000, plus the $1,000 catch-up contribution for taxpayers 50 years or older, or (2) taxable compensation for the year.

b. Correct. Judy's taxable compensation is $5,500 which is less than the $7,000 threshold contribution threshold available to taxpayers over age 50. Therefore, her IRA contribution limit is $5,500.

c. Incorrect. This is the maximum contribution for taxpayers less than 50 years old.

d. Incorrect. This is the maximum IRA contribution for taxpayers age 50 or over. However, this must be compared to the taxpayer's taxable compensation to determine the total contribution that can be made to an IRA.

7. a. Incorrect. This is the age threshold to which the early distribution penalty applies.

b. Incorrect. This was the applicable age prior to enactment of the SECURE Act.

c. Correct. RMDs must generally be taken by individuals who reach age 72.

d. Incorrect. The applicable age is less than 75.

8. a. Incorrect. This is the early distribution penalty tax.

b. Correct. This is the mandatory withholding rate. An IRA distribution is subject to 10% withholding unless the account holder elects out of withholding or elects to have a different amount withheld.

c. Incorrect. 25% of compensation paid (or accrued) to plan participants during the year is the limit for an employer's deduction for contributions to a defined contribution plan.

d. Incorrect. The mandatory withholding rate is less than 30%.

9. a. Correct. A pension plan is a defined benefit plan. It promises a participant a specified monthly benefit at retirement.

b. Incorrect. A 401 (k) is a qualified profit-sharing plan, which is a defined contribution plan.

c. Incorrect. A money-purchase plan, which has some similarities to pension plans, is still a defined contribution plan.

d. Incorrect. A profit-sharing plan is a defined contribution plan where the employer contributes a percentage of its profits to be shared among plan participants according to a set formula.

10. a. Correct. If a person fails to withdraw the full amount of the RMD, the amount that should have been timely withdrawn but was not is subject to a 50% penalty. The participant is responsible for paying the penalty, not the plan sponsor, plan administrator, or custodian.

b. Incorrect. The penalty for not withdrawing the full amount of the RMD is not based on the current highest tax rate.

c. Incorrect. 20% is the mandatory withholding rate applicable to distributions from a qualified plan to a plan participant who is under 59½.

d. Incorrect. Early withdrawals of amounts in certain qualified plans and IRAs are subject to a 10% excise tax.

Chapter 6

PERSONAL RESIDENCE

LEARNING OBJECTIVES

After reviewing this chapter, you should be able to:

- • Understand the mechanics of the home sale exclusion
- • Distinguish between the three types of reverse mortgages
-

HOME SALE EXCLUSION

Gross income does not include the gain from the sale or exchange of property if during the five-year period ending on the date of the sale or exchange, the property has been owned and used by the taxpayer as the taxpayer's principal residence for periods aggregating two or more years.

Principal Residence

An exclusion, full or partial, may only be available on the sale of a home that is the taxpayer's principal residence. This is the taxpayer's main home. An individual may only have one main home at a time. If a taxpayer owns and lives in one home, that home will be the taxpayer's principal residence. If a taxpayer owns or lives in more than one home, the property that will be considered the main home for these purposes is determined on the basis of the facts and circumstances test.

The facts and circumstances test requires an evaluation of a variety of factors, but the most important one is where the taxpayer spends most of his or her time. Other factors may include: (1) the address listed on the taxpayer's U.S. postal service address, voter registration card, federal tax returns, state tax returns, driver's license, or car registration; and (2) the home is located near the taxpayer's place of work, where the taxpayer's bank is located, the residence of one or more of the taxpayer's family members, or where the taxpayer has memberships in recreation clubs or religious organizations.

The exclusion can apply to a single-family home, condominium, co-op, mobile home, or houseboat.

EXAMPLES

Stephanie owns an apartment in New York City, where she works and lives in during the year. However, in the summers, she relocates to her beach house in the Hamptons. Stephanie's principal residence is her apartment in the city, not her beach house.

Miranda owns a house in Malibu, but she lives in a rental home in Los Angeles. The rental in Los Angeles is Miranda's principal residence.

Eligibility Tests

In determining whether a taxpayer is eligible for this exclusion, a six-step determination process should be followed.

First, determine if the taxpayer is automatically disqualified from eligibility. If any of the following is true, the taxpayer is disqualified from claiming the exclusion: (1) the taxpayer is subject to expatriate tax, or (2) the property was acquired through a like-kind exchange in the prior five-year period.

Second, determine whether the taxpayer satisfies the Ownership Test. The Ownership Test requires the taxpayer to have owned the home for at least two years (24 months) out of the previous five years leading up to the date of sale. The date of sale is the date of closing on the transaction. For taxpayers who file a joint return, only one spouse is required to meet the Ownership Test.

Third, determine whether the taxpayer satisfies the Use Test. This is the residence requirement. If the taxpayer owned the home and used it as his or her residence for two out of the five years prior to the sale, the residence requirement is satisfied. The 24 months of residency do not have to be consecutive and can fall anywhere within the five-year period. For taxpayers who file a joint return, both spouses must meet the Use Test.

Vacations or other short absences count toward time living at home, even if the home was rented out during such absence.

EXAMPLE

Alex bought a house on May 1, 2015. She moved in on May 1 and lived there until August 31, 2016. She moved out and rented the home. The home was rented from October 1, 2016, to June 30, 2018. Alex moved back into the house on July 1, 2018, and lived there until April 30, 2020, when she sold it. During the five-year period ending on the date of the sale (May 1, 2015, to April 30, 2020), Alex owned and lived in the house for more than two years.

Year 1: May 1, 2015, to April 30, 2016

Year 2: May 1, 2016, to April 30, 2017

Year 3: May 1, 2017, to April 30, 2018

Year 4: May 1, 2018, to April 30, 2019

Year 5: May 1, 2019, to April 30, 2020

	Used as Home	Used as Rental
Year 1:	12	–
Year 2:	5	7
Year 3:	–	12
Year 4:	10	2
Year 5:	12	–

Total Time Used as Home: 39 months

Total Time Used as Rental: 21 months

Alex satisfies the Use Test and can exclude gain of up to $250,000. However, she is not permitted to exclude gain in the amount of any depreciation she claimed in connection with the property while it was a rental.

If a taxpayer becomes physically or mentally disabled such that caring for oneself is not possible, and the residence is used as the principal residence for 12 months of the five-year period preceding the sale or exchange, time spent in a care facility counts toward the 24-month period so long as the facility is licensed by the state or other political entity to care for people with such condition.

Fourth, determine whether the taxpayer satisfies the Lookback Test. The exclusion will not apply to any sale or exchange by a taxpayer if, during the two-year period ending on the date of such sale or exchange, there was any other sale or exchange by the taxpayer to which the exclusion applied. If there was a sale, but the exclusion of the gain on the sale was not claimed, the Lookback Test may still be satisfied. Only one exclusion may be taken during any two-year period.

The Internal Revenue Code provides that the amount of gain excluded may not exceed $250,000 for single taxpayers. For those who file a joint return for the taxable year of the sale or exchange of the property, the limit is $500,000 if the following requirements are satisfied: (1) either spouse meets the Ownership Test, (2) both spouses meet the Use Test, and (3) neither spouse is ineligible for the benefits with respect to such property by reason of the Lookback Test. If these requirements are not satisfied, the limitation shall be the sum of the limitations to which each spouse would be entitled if such spouses had not been married. Each spouse is treated as owning the property during the period that either spouse owned the property.

Surviving Spouse Special Rule

If there is a sale or exchange of property by an unmarried individual whose spouse is deceased on the date of the sale, the $500,000 exclusion will apply if the sale occurs not later than two years after the date of death of the spouse and the requirements for the joint return amount were satisfied immediately before the date of death.

Partial Gain Exclusion

Taxpayers who do not satisfy the fifth Eligibility Test may still qualify for a partial exclusion of gain. If the primary reason for the sale of the home was a (1) change in workplace location, (2) a health condition, (3) an unforeseeable event, or (4) other facts and circumstances, a taxpayer may still qualify for a partial exclusion.

Change in workplace location. A partial exclusion may still be available to a taxpayer or taxpayers if any of the following events occurred while the taxpayer(s) owned or resided in the home: (1) the taxpayer took a new job, or was transferred to a new job, in a work location that is at least 50 miles farther from the home than the prior work location; (2) there was no previous work location and the new job was at least 50 miles from the home; or (3) either (1) or (2) was true of the spouse, or co-owner, of the home, or anyone else for whom the home was his or her primary residence.

EXAMPLE

Prior to January 1, Max worked in Location A, which was 10 miles from his home. On January 2, Max was transferred to a work location that was 70 miles from his home. Max would satisfy the Change in Workplace Location requirements.

Health condition. A taxpayer may qualify for a partial exclusion if he or she experiences any of the following health-related events while owning and residing in his or her home: (1) the taxpayer moves to obtain, provide, or facilitate diagnosis, cure, mitigation, or treatment of a disease, illness, or injury to the taxpayer or the taxpayer's family member; (2) the taxpayer moved to obtain or provide medical or personal care for a family member that is suffering from a disease, illness or injury; (3) a doctor recommended a change in residence as a result of a health problem; or (4) any of (1), (2), or (3) applies with respect to the taxpayer's spouse, a co-owner of the home, or anyone else for whom the home was his or her primary residence.

For these purposes, the term "family" includes a taxpayer's (1) parent, grandparent, stepmother, or stepfather; (2) child or grandchild (including adopted, foster, or step); (3) sibling, step-sibling, or half-sibling; (4) mother-in-law, father-in-law, sibling-in-law, son-in-law, or daughter-in-law; or (5) uncle, aunt, nephew, or niece.

Unforeseeable event. A taxpayer may also be eligible for a partial gain exclusion if any of the following events occurred during the time the taxpayer owner or resided in the home: (1) the home was destroyed or condemned; (2) the home suffered a casualty loss due to a natural or man-made disaster, or an act of terrorism, regardless of whether such loss is deductible on an income tax return; or (3) the taxpayer or the taxpayer's spouse, co-owner of the home, or anyone else for whom the home was his or her residence, (a) died; (b) became divorced or legally separated; (c) gave birth to two or more children from the same pregnancy; (d) became eligible for unemployment; or (e) became unable to pay basic living expenses for the household due to a change in employment status.

Other facts and circumstances. Some situations, outside of a change in workplace, health condition, or unforeseeable event, may be such that a partial gain exclusion would be permitted by the IRS. If a taxpayer can demonstrate that the primary reason for the sale, based on the relevant facts and circumstances, is work related, health related, or unforeseeable, may still be eligible for a partial exclusion.

The factors to be evaluated include the following: (1) the taxpayer could not have reasonably anticipated the situation when the home was purchased; (2) the situation causing the sale arose during the time the property was owned and used as the primary residence; (3) the taxpayer began to experience significant financial difficulties maintaining the home; (4) the home was sold not long after the difficult situation arose; or (5) the home became significantly less suitable as a primary home for the taxpayer and the taxpayer's family for a specific reason.

The sixth eligibility test is the final determination of eligibility. If the taxpayer meets the ownership, residence, and look-back requirements, taking the exceptions into account, then the taxpayer meets the eligibility test. Their home sale qualifies for the maximum exclusion.

If the taxpayer does not meet the eligibility test, then their home is not eligible for the maximum exclusion, but may qualify for a partial exclusion of gain.

Calculating Gain or Loss

In order to calculate the gain or loss on the sale of a primary residence, the following information is needed: (1) sales price, (2) amount realized, and (3) the adjusted basis in the property. The amount realized is the sales price less any selling expenses. The gain or loss is calculated by subtracting the adjusted basis from the amount realized.

Adjusted basis. The adjusted basis in the property is calculated by taking the purchase price of the home and adjusting it for certain costs associated with the purchase and maintenance of the home.

Fees and closing costs. Costs associated with the purchase of the home include certain fees and closing costs associated with the purchase transaction. Some fees and closing costs may not be included in the adjusted basis.

Fees and closing costs that can be included in calculating basis are: (1) abstract of title fees; (2) legal fees (including legal fees incurred in connection with a title search and the preparation of the sales contract and deed); (3) charges for the installation of utility services; (4) survey fees; (5) recording fees; (6) owner's title insurance; and (7) transfer or stamp taxes.

Fees and closing costs that cannot be included in a basis calculation are: (1) fire insurance premiums; (2) any fee or costs deducted as a moving expense; (3) rent for occupancy of the house prior to closing; (4) utility or other service charges related to occupancy of the house prior to closing; (5) charges related to getting a mortgage loan (including, but not limited to, mortgage insurance premiums, cost of a credit report, an appraisal fee, loan assumption fees); or (6) fees for a mortgage refinance.

Construction costs. If the house is new construction on owned land, the basis is equal to the cost of the land plus the cost to complete the construction of the house. These costs include (1) the cost of labor and materials; (2) building permit charges; (3) amounts paid to a contractor; (4) architect fees; (5) utility meter and connection charges; and (6) legal fees directly connected with the building of the home.

Costs include the down payment and any debt (first or second mortgage, or any notes given to the seller or builder). It also includes some settlement or closing costs. Points paid to the purchaser by the seller reduce the basis of the property.

If all or part of the home was built by the homeowner, the basis includes the costs to complete the construction. It does not include the value of the homeowner's labor or the value of other unpaid labor.

Costs paid by the purchaser that are owed by the seller. If the purchaser pays costs that the seller owes, so long as the purchaser is not reimbursed for the payment by the seller, these costs can be included in basis. Some examples of these types of payments include the following: (1) real estate taxes owed up through the day immediately preceding the sale date; (2) back interest the seller

owes; (3) the seller's title recording or mortgage fees; (4) sales commissions; and (5) charges for improvements or repairs that are the responsibility of the seller, such as the removal of lead paint.

Property improvements. Costs to make improvements to the home that add value to it, prolong its useful life, or adapt it to new uses may be added to the basis of the property. Any costs of repairs or maintenance that are required to keep the home in good working order, but that do not add to its value or prolong its life, are not improvements that increase basis.

However, repair work is done as part of a larger project, such as a remodeling or restoration project, can be included in basis. For example, while replacing broken windowpanes is a repair, replacing the same window as part of replacing all of the home's windows would be considered an improvement. Another example would be if the home suffers a casualty event, the amounts spent to restore the property to its pre-casualty condition may be included in basis.

Improvements That Increase Basis

- Additions: Bedroom, bathroom, garage, deck, patio, porch
- Systems: Heating, central air conditioning, duct work, central humidifier, sprinkler system, central vacuum, air or water filtration systems, wiring, security systems
- Plumbing: Septic, water heater, soft water system, filtration
- Lawn and Grounds: Landscaping, walkway, driveway, retaining wall, fence, pool
- Interior: Built-in appliances, flooring, wall-to-wall carpeting, fireplace, kitchen update
- Exterior: Storm windows, storm doors, new roof or siding, satellite dish
- Insulation: Attic, floors, pipes, duct work, walls

Improvements That Do Not Increase Basis

- Painting: Interior or exterior
- Repair and Maintenance: Fixing leaks, filling holes or cracks, replacing broken hardware
- Improvements No Longer Part of Home: Wall-to-wall carpeting that was installed and later replaced
- Improvements with a life expectancy of less than one year once installed

Amounts that reduce basis. If a homeowner receives energy credits or subsidies for the installation of energy-related improvements to the home, these amounts reduce the basis in the property.

Business or rental use of home. If a portion of the home is used for business or rental purposes during the period of ownership, the gain or loss calculation may be impacted. If part of the home has been used solely for business or rental purposes for more than three of the prior five years, a separate gain or loss calculation must be made for the business and residence portions of the property.

Some business or rental usage does not impact the gain or loss calculations. These types of usage include business or rental use of space in the home's living area and space that was formerly used for business or rental. These two types of usage won't impact the gain or loss calculations.

If the space used for business or rental purposes was within the living area of the home, such usage won't impact the gain or loss calculation. Examples include a rented extra bedroom or attic space used as a home office. An example of the rental or business use of a space not within the living area is a rented apartment in a duplex.

If a space was formerly used for business, it is considered residential space if all of the following are satisfied: (1) the homeowner wasn't using the space for business or rental at the time the property is sold; (2) no business or rental income was earned from the space in the year in which the property was sold; and (3) the space was used as residential space for two of the five years immediately prior to the sale. Former business use won't impact the gain or loss calculations unless the homeowner took, or was allowed to take, depreciation for use of the home for business or rental purposes.

Once it is determined what percentage of the property was used for personal and what percentage was used for business or rental purposes, this percentage is applied to the total gain to determine how much gain is personal and how much is business or rental use related. The portion of the gain that is personal is eligible for exclusion.

NOTE

Losses on the sale of a primary residence may not be deducted.

REVERSE MORTGAGES

A reverse mortgage is a financial product that allows a homeowner to convert part of the equity in the home into cash without being required to sell the home or pay additional monthly amounts. With a reverse mortgage, the borrower receives money from the lender and generally is not required to pay it back for as long as the borrower lives in the home. The loan is repaid when the borrower dies, sells the home, or when the home is no longer the borrower's primary residence.

The proceeds of a reverse mortgage are generally not subject to tax. They generally do not impact Social Security or Medicare benefits. Many reverse mortgages do not have restrictions on income in order to be eligible for them.

There are three types of reverse mortgages: (1) single-purpose reverse mortgage, (2) federally insured reverse mortgage, and (3) proprietary reverse mortgage. A single-purpose reverse mortgage is offered by some state and local government agencies, and nonprofit organizations. Federally insured reverse mortgages are backed by the U.S. Department of Housing and Urban Development (HUD). These are generally known as Home Equity Conversion Mortgages (HECMs). A proprietary

reverse mortgage is a private loan that is backed by the companies offering them.

Almost all reverse mortgages are nonrecourse loans. This means that borrowers will not be responsible for deficiency balances if the collateral value ends up being less than the outstanding balance when the loan is ultimately repaid. This scenario, which is referred to as cross-over risk, occurs when the amount of the debt increases beyond the value of the home.

A borrower is permitted to live in a nursing home or other medical facility for up to 12 consecutive months before being required to repay the loan.

Single-Purpose Reverse Mortgages

These are the least expensive types of reverse mortgages and can be used for a single, specified purpose. The lender or government specifies the applicable purpose. Examples of specified purposes include for home repairs, property taxes, or improvements to the home. Low- to moderate-income homeowners can typically qualify for these types of reverse mortgages.

Federally Insured Reverse Mortgages

To qualify for a HECM, a variety of requirements must be satisfied.

Borrower requirements. In order to be eligible for an HECM, the borrower must satisfy the following requirements: (1) be at least 62 years old; (2) own the property outright or have significant equity in the property; (3) occupy the property as the principal residence; (4) not be delinquent on any federal debt; (5) be able to continue timely paying for property taxes, insurance, homeowners association fees, and any other ongoing costs; and (6) participate in consumer counseling by a HUD HECM counselor.

HECMs require prospective borrowers to complete pre-loan counseling. As part of this counseling, prospective borrowers are educated regarding the nature of reverse mortgages and advised regarding costs and risks. This type of reverse mortgage is structured as nonrecourse credit, and consumers are protected from cross-over risk. Lenders are similarly protected because HECMs carry Federal Housing Administration (FHA) insurance.

Property requirements. In order to be able to take a HECM, the property used as collateral for the loan must be: (1) a single-family home or a two- to four-unit multifamily home in which the borrower occupies one unit; (2) a condominium project that is approved by HUD; (3) an individual condominium unit that meets certain FHA single unit approved requirements; or (4) a manufactured home that meets certain FHA requirements.

Financial requirements. There are certain financial requirements that must be demonstrated by the borrower. These include the verification of income, assets, monthly living expense, and credit

history. Additionally, the borrower must demonstrate that he or she has made timely real estate tax payments. The premiums for hazard and flood insurance must also be verified.

Mortgage amount. The amount a borrower may borrow depends on a variety of factors. These include: (1) the age of the youngest borrower or an eligible non-borrowing spouse, (2) the current interest rate, and (3) the lesser of: (a) the appraised value of the home, (b) the mortgage limit, or (c) the sales price (if the HECM is used to purchase a property). If there is more than one borrower and no eligible non-borrowing spouse, the youngest borrower's age is used for this purpose.

This type of reverse-mortgage has a maximum loan limit based on the location of the home. The limit is subject to cost-of-living adjustments. For 2021, the maximum loan limit is $822,375 (which is 150% of the national conforming limit of $548,250 by the Federal Home Loan Mortgage Corporation (Freddie Mac)). The same limit applies to Freddie Mac's special exception areas (Alaska, Hawaii, Guam, and the Virgin Islands). In prior years, the limits were as follows:

- 2017: $636,150
- 2018: $679.650
- 2019: $726,525
- 2020: $765,600

Payment options. There are several payment options with this type of loan: (1) term option (a fixed monthly cash advance amount for a specified period of time); (2) tenure option (fixed monthly cash advances for the period of time the borrower continues living in the home); (3) a line of credit allowing the borrower to withdraw loan proceeds at any time and in any amount until the line of credit is reached; (4) a modified term, which is a combination of the term option and a line of credit; or (5) a modified tenure, which is a combination of the tenure option and a line of credit.

Fees and costs. An HECM is more expensive and can have significant upfront costs. It is generally readily available, it can be used for any purpose, and it does not have any income or medical requirements.

The fees and costs for an HECM reverse mortgage are set by HUD. They consist of the following: (1) mortgage insurance premiums (MIPs), (2) origination fee, (3) servicing fees, and (4) third-party fees.

Mortgage insurance premiums. An initial 2% MIP is due at closing. Additionally, there is an annual MIP of 0.5% of the outstanding loan balance that is due. The MIPs can be rolled into the loan and financed.

Origination fee. Lenders are permitted to charge an origination fee for processing the HECM loan. They may charge the greater of $2,500 or 2% of the first $200,000 of the home's value, plus 1% of the amount that exceeds $200,000. This fee is subject to a cap, which is $6,000.

Servicing fees. Lenders are permitted to charge a monthly fee for the life of the loan. This is for maintaining and monitoring the loan. Monthly servicing fees may not exceed $30 for fixed-rate loans or loans with an annually adjusting rate, or $35 if the rate is adjusted on a monthly basis.

Third-party fees. There are third parties that may also charge fees in connection with the HECM. These can include fees for an appraisal, home inspection, credit check, title search, title insurance, or recording fees.

Interest rates. Interest rates on HECMs are typically higher than those on traditional mortgages.

Special deferment rule to benefit surviving spouses. There are special deferment rules that allow a deferment of the due and payable status of an HECM upon the death of the borrower if there is a surviving spouse. If a non-borrowing spouse does not meet any of the eligibility requirements, or if any other deferment requirements are not satisfied, the deferral will end, and the loan will immediately become due and payable. These requirements are extensive.

First, the non-borrowing spouse must have been disclosed to the lender, and named as a non-borrowing spouse, when the loan was originated.

Second, the non-borrowing spouse must have been legally married to the borrow at the time of the loan's closing and must have remained married until the death of the borrower. Whether there is a legal marriage is based on state law. If a same-sex couple was prohibited from legally marrying at the date of the loan's origination but the couple was living together in a committed relationship similar to marriage at that time, and they were subsequently married before the death of the borrower, and remained married until the borrower's death, this requirement will be satisfied. A non-borrowing spouse will not be eligible for deferral if his or her name was not on the deed and mortgage after marrying the borrower.

Third, the surviving spouse is required to have lived in the HECM property as his or her principal residence up to the date of the borrower's death.

Fourth, the lender must have received annual recertifications from the borrower regarding the borrower and non-borrower's marital status and their living in the property as their principal residence.

Fifth, the spouse must have obtained, or be able to obtain, good marketable title to the property, or the right to reside in the property for the remainder of his or her life.

Sixth, all property charges, insurance, and taxes must be timely paid.

Seventh, the surviving spouse must maintain the property and make repairs, as needed, for the life of the loan. The property maintenance must be made to FHA's standards.

Proprietary Reverse Mortgages

Proprietary reverse mortgages are offered by individual lenders. Some homeowners, with high-value homes that exceed the HECM amount limits seek private reverse mortgages. However, crossover risk is still an issue since there is no insurance available to cover possible deficiencies. As a result of the increased risk, these products tend to be more expensive. Costs and fees are subject to the discretion of the lender and are not set by HUD.

REVIEW QUESTIONS

1. The home sale exclusion eligibility tests require a taxpayer to own and use the home for at least how many years?

a. 1

b. 2

c. 5

d. 6

2. Which of the following statements regarding principal residence is correct?

a. An individual may only have one main home at a time.

b. If an individual owns more than one home, the determination regarding which home is the main home is based on which of the homes has the highest fair market value.

c. The principal residence must be a single-family home for the exclusion to apply.

d. If a taxpayer owns three or more homes, the exclusion is cut by two-thirds.

3. Which of the following reasons for selling a home would likely not qualify the taxpayer for a partial exclusion of gain?

a. A change in workplace location

b. A health condition

c. An unforeseeable event

d. The taxpayer wanted a change in scenery.

4. For a single taxpayer, the full principal residence exclusion amount is:

a. $100,000

b. $250,000

c. $500,000

d. $750,000

5. With respect to the allowance of a partial exclusion related to a change in workplace location, the taxpayer must have taken a new job, or been transferred to a new job, at least how many miles farther from the home than the prior work location?

a. 25

b. 50

c. 75

d. 100

6. Which of the following improvements will not increase basis for purposes of calculating gain on a principal residence?

a. Fixing leaks and filling holes

b. Updating a kitchen

c. Replacing a roof

d. Adding a retaining wall

7. Which of the following statements regarding reverse mortgages is correct?

a. The proceeds of a reverse mortgage will impact Social Security benefits.

b. There are four types of reverse mortgages.

c. The proceeds of a reverse mortgage are generally not subject to tax.

d. The FHA backs certain reverse mortgages.

8. If a borrower has a reverse mortgage, he or she is allowed to live in a nursing home or other medical facility for up to ___ consecutive months before being required to repay the loan.

a. 6

b. 9

c. 12

d. 18

9. For 2021, the maximum Home Equity Conversion Mortgage (HECM) loan limit is:

a. $548,250

b. $636,150

c. $765,600

d. $822,375

10. With respect to the fees and costs of an HECM reverse mortgage set by the U.S. Department of Housing and Urban Development (HUD), what percentage of mortgage insurance premiums is due at closing?

a. 0.5%

b. 1%

c. 2%

d. 4%

ANSWERS TO REVIEW QUESTIONS

1. a. Incorrect. The applicable period is longer than one year to be eligible for the home sale exclusion.

b. Correct. Gross income does not include the gain from the sale or exchange of property if during the five-year period ending on the date of the sale or exchange, the property has been owned and used by the taxpayer as the taxpayer's principal residence for periods aggregating two or more years.

c. Incorrect. The ownership and use tests require the taxpayer to own and use the property as their principal residence for at least a certain period of time out of a five year period. The taxpayer does not have to own and use the home as their principal residence for the entire five year period to meet the eligibility tests for the home sale exclusion, however.

d. Incorrect. The appropriate period is shorter than six years.

2. a. Correct. Only one main home is permitted at a time. If a taxpayer owns and lives in one home, the property will be the taxpayer's principal residence. If a taxpayer owns or lives in more than one home, the property that will be considered the main home for these purposes is determined on the basis of the facts and circumstances test.

b. Incorrect. The determination is based on a facts and circumstances analysis. The facts and circumstances test requires an evaluation of a variety of factors, but the most important one is where the taxpayer spends most of his or her time.

c. Incorrect. The exclusion can apply to a single-family home, condominium, co-op, mobile home, or houseboat.

d. Incorrect. There is no reduction in the exclusion based on the number of homes a taxpayer owns.

3. a. Incorrect. A partial exclusion may be available to a taxpayer if the taxpayer took a new job in a work location that is at least 50 miles farther from the home than the prior work location, there was no previous work location and the new job as at least 50 miles from the home, or either of these are true for the taxpayer's spouse, co-owner of the home, or anyone else for whom the home if their primary residence.

b. Incorrect. A taxpayer may qualify for a partial exclusion if the taxpayer experiences certain health-related events while owning and residing in their home.

c. Incorrect. A taxpayer may qualify for a partial exclusion if certain unforeseeable events occur during the time the taxpayer owns and resides in the home, such as the home being destroyed or condemned, the home suffers a casualty loss, the taxpayer dies, becomes divorced, or gives birth to two or more children from the same pregnancy, becomes eligible for unemployment, or is unable to pay basic living expenses for the household due to a change in employment status.

d. Correct. Taxpayers who do not satisfy the eligibility test may qualify for a partial exclusion of gain if the primary reason for the sale of the home was a (1) change in workplace location, (2) a health condition, (3) and unforeseeable event, or (4) other facts and circumstances. The taxpayer wanting a change in scenery would likely not pass one of these tests.

4. a. Incorrect. The exclusion amount is higher than $100,000.

b. Correct. The exclusion amount for single taxpayers is $250,000. For taxpayers that file jointly, the maximum exclusion is $500,000.

c. Incorrect. This is the exclusion amount for married taxpayers who file a joint return.

d. Incorrect. The exclusion amount is less than $750,000.

5. a. Incorrect. The distance requirement is more than 25 miles.

b. Correct. If a taxpayer has taken a new job at least 50 miles farther from the home than the prior work location, the taxpayer is eligible for a partial exclusion.

c. Incorrect. The applicable distance is not 75 miles.

d. Incorrect. The distance requirement is less than 100 miles.

6. a. Correct. Fixing leaks and filling holes is considered general repair and maintenance, which does not increase basis.

b. Incorrect. Improvements that increase basis include interior improvements such as built-in appliances, flooring, wall-to-wall carpeting, fireplace, or kitchen updates.

c. Incorrect. Improvements that increase basis include exterior improvements such as storm windows, storm doors, new roof or siding, or a satellite dish.

d. Incorrect. Improvements that increase basis include improvements to lawn and grounds such as landscaping, walkway, driveway, retaining wall, fence, or pool.

7. a. Incorrect. Proceeds of a reverse mortgage will generally not impact Social Security or Medicare benefit amounts.

b. Incorrect. There are three types of reverse mortgages.

c. Correct. Reverse mortgage proceeds are generally not subject to tax. With a reverse mortgage, the borrower receives money from the lender and generally is not required to pay it back for as long as the borrower lives in the home. The loan is repaid when the borrower dies, sells the home, or when the home is no longer the borrower's primary residence.

d. Incorrect. HUD backs certain reverse mortgages.

8. a. Incorrect. A borrower has more than six months in which to live in a nursing home or other medical facility before being required to repay the loan.

b. Incorrect. The borrower is still considered to be living in their home if they have lived in a nursing home or other medical facility for only nine months.

c. Correct. The borrower can live in a nursing home or other medical facility for 12 months before being required to repay the loan. After this 12-month period, the home is no longer considered the borrower's primary residence.

d. Incorrect. The maximum number of consecutive months is less than 18.

9. a. Incorrect. This is the national conforming limit by Freddie Mac, on which the maximum HECM loan limit is based.

b. Incorrect. This was the maximum loan limit in 2017.

c. Incorrect. This was the maximum loan limit in 2020.

d. Correct. The maximum loan limit for 2021 is $822,375 which is 150% of the national conforming limit.

10. a. Incorrect. In addition to the MIP percentage due at closing, there is an annual MIP of 0.5% of he outstanding loan balance that is due.

b. Incorrect. The origination fee formula includes a 1% factor, but this is not the rate of the MIP due at closing.

c. Correct. The MIP due at closing is 2%. Additionally, there is an annual MIP of 0.5% of the outstanding loan balance that is due.

d. Incorrect. The MIP percentage due at closing is less than 4%.

Chapter 7

DECEDENT'S FINAL INCOME TAX RETURN

LEARNING OBJECTIVES

After reviewing this chapter, you should be able to:

- Summarize final return filing obligations
- Identify filing statuses and standard deductions for a decedent
- Understand income, deductions, and carryover losses for a decedent
- Describe taxation of income in respect of a decedent
- Identify tax refunds for deceased taxpayers
- Describe the taxation of a decedent's personal residence
- Explain how to limit the executor's personal liability
-

FINAL RETURN FILING OBLIGATIONS

A deceased taxpayer's executor has the obligation of filing the decedent's final income tax return, and any other outstanding tax returns, for the taxpayer. Even though the taxpayer dies during the year, his or her final tax return will still be due on April 15 (as adjusted for holidays) of the year following date of death. The return cannot be filed early since the tax forms for the year of death are typically not released until late in the year and processing does not begin until late January.

If the taxpayer passes away early in the year before filing his or her Form 1040 for the prior year, the executor may be responsible for multiple returns. The term "executor" is often used to refer to a court-appointed administrator or personal representative. However, in the eyes of the IRS, any individual who has control over the deceased taxpayer's affairs and accepts the responsibility for the taxpayer's tax filing obligations is the effective "executor." This means that a surviving spouse, trustee, or primary beneficiary could be the executor even if this individual is not appointed to such a role by the probate court.

When assuming responsibility for the taxpayer's tax filing obligations, the executor should complete and submit Form 56 to the IRS. Form 56 does not update the address on record with the IRS for the deceased individual. The executor should also submit Form 8822 to change the mailing address of the deceased taxpayer to the executor's address. Doing so will ensure the executor does not miss important correspondence concerning filing obligations or outstanding tax liability.

An executor appointed by the probate court should attach a copy of the certificate from the court, often called Letters Testamentary, to Form 56. An executor who has not been appointed by a court can still submit Form 56 without the certificate. Once submitted, the executor can act as the deceased taxpayer. Professionals assisting the executor will need the executor to sign Form 2848 on behalf of the deceased taxpayer and attach Form 56 and any applicable court certificate before submitting to the IRS Centralized Authorization File (CAF) unit for processing. Some IRS representatives also request a copy of the decedent's death certificate. Submitting all available information will reduce delays in processing. If requesting information related to the deceased taxpayer's filing history and outstanding obligations, the decedent's name and Social Security number should be listed on Form 2848. This should not be confused with the estate's own tax identification number used for the income earned after date of death.

In addition to submitting Form 56, the executor should also submit a request for a Proof of Claim from the Collection Advisory Group. The executor or his agent simply must write to the address listed in IRS Publication 4235 associated with the location of the decedent. Letters should be directed to the attention of the Decedent Advisor. A sample letter is shown below. The Collection Advisory Group will write back in a relatively short amount of time informing the executor of any outstanding amounts due and missing income tax returns.

Dear Decedent Advisor:

I am the Executor of the Estate of [taxpayer]. I am writing to request the filing of a Proof of Claim for any and all tax liability owed by [taxpayer, SSN xxx-xx-xxxx]. [Taxpayer] passed away on xx/xx/xxxx. [A probate matter has been opened in xxxx County District Court, State, Case No. ####.] or [A probate matter has not been opened because this estate is under the small estate filing threshold;

however, I am handling all of the decedent's affairs on behalf of the heirs.] Please send your Proof of Claim in this matter to me as soon as possible so that we can evaluate all creditors and begin satisfying claims in order of priority.

If the Proof of Claim shows outstanding tax liability or unfiled tax returns, the executor should take action immediately to address outstanding liability and file the missing returns. If supporting tax documents are inaccessible, the executor should request wage and income transcripts from the IRS to assist in completing returns on behalf of the deceased taxpayer. If a decedent's estate is insufficient to satisfy a significant liability, the executor should consider submitting an offer in compromise to attempt to negotiate the liability—particularly if the decedent left minor children or a surviving spouse who relied on the taxpayer for support. If the decedent's estate is insolvent, the executor must review the state creditor priority statutes to ensure debts are paid in order of priority. While federal taxes typically have relatively high priority, administrative expenses and funeral costs usually have higher priority.

FILING STATUS AND STANDARD DEDUCTION

Clients who pass away in the middle of the year typically retain the filing status that would be in effect on the taxpayer's date of death. The executor for a taxpayer who qualifies for the "single" filing status on his date of death will use the single filing status for the taxpayer's final return. The surviving spouse of a taxpayer who passed away during the year will similarly use either the married filing jointly or the married filing separately filing status so long as the surviving spouse did not remarry before the end of the year.

A surviving spouse who files using the married filing jointly status for the year of the taxpayer's date of death may be eligible to use the qualifying widower filing status for the two years following the year of death, which provides the surviving spouse with the larger married filing jointly standard deduction instead of a lower single or head of household standard deduction. The surviving spouse must meet the following requirements in order to use the qualifying widower filing status:

- The surviving spouse must be able to use the married filing jointly status for the year the taxpayer passed away even if the surviving spouse actually filed a joint return for the year of death.
- The surviving spouse must not remarry before the end of the applicable tax year in which the qualifying widower status will be claimed.
- The surviving spouse must have a child, stepchild, or adopted child who qualifies as the surviving spouse's dependent for the year or would qualify as the surviving spouse's dependent except that the surviving spouse does not meet the gross income test, or does not meet the joint return test, or except that the surviving spouse may be claimed as a dependent of another taxpayer.
- The qualifying child must live in the surviving spouse's home for the full tax year, except for temporary absences.
- The surviving spouse must pay for more than half the cost of keeping up the home for the year.

A taxpayer who is responsible for dependents in the home who normally would claim the head of household filing status may be able to claim the head of household status in the year of death if the taxpayer meets the head of household filing requirements and no one else is able to claim the taxpayer's qualifying child or qualifying relative under the applicable tiebreaker rules. Since the head of household status depends on the qualifying child or qualifying relative residing in the taxpayer's home for more than half the year, taxpayers who pass away during the first half of the tax year may not be able to use the head of household status if the qualifying child or qualifying relative resides with another taxpayer during more than half the year. Special attention must be given to these situations since the facts and circumstances of the taxpayer's unique situation will be determinative.

Filing Status	Factors	2022 Standard Deduction
Single	Unmarried on date of death.	$12,950
Married Filing Jointly	Married on date of death and surviving spouse does not remarry prior to end of tax year.	$25,900
Married Filing Separately	Married on date of death and surviving spouse either (1) elects married filing separate status or (2) remarries before end of year.	$12,950
Head of Household	Meets qualifications for head of household status on date of death and wins tiebreaker for claiming qualifying child or relative.	$19,400
Qualifying Widower	Meets qualifying widower qualifications and does not remarry before end of applicable tax year.	$25,900

For clients who only live a few months during the year, the standard deduction is sometimes large enough to offset much of the income generated by the taxpayer during his or her final years of life—particularly if the taxpayer is retired. The taxpayer may report a full standard deduction on his or her final return regardless of whether the client lived only a few days during the year or lived the majority of the tax year. The standard deduction is not reduced just because the client did not live the entire year. Prior to the Tax Cuts and Jobs Act, a decedent's final return would also be eligible to claim a personal exemption for the decedent regardless of how many days he or she lived during the year. With the elimination of personal exemptions, the increased standard deduction now provides a similar reduction of income for the taxpayer.

INCOME AND DEDUCTIONS

Pre- and Post-Death Income

Income reported to the deceased taxpayer on Forms 1099 and W-2 and Schedules K-1 in the year of death will likely include income earned both prior to and after the date of death. Interest-bearing accounts, dividend-paying stocks, and managed investment accounts continue earning income and trading investments despite the death of the taxpayer. The executor of the estate rarely closes an account or changes the account's tax identification from the decedent's Social Security number to the estate's employer identification number until months after the taxpayer's death.

Tax preparers working with the executor of the decedent's estate must split the income reported on Forms W-2 or 1099 between the decedent's final Form 1040 and the estate or trust's Form 1041

income tax return. Notations should be made on both returns explaining the income reported under the decedent's Social Security number and adjustments made for post-death income. For interest and dividend income reported on a single Form 1099 that includes receipts from before and after death, consider reporting the post-death income as nominee income. The taxpayer should report the entire amount of the income on Schedule B followed by a negative entry subtracting the income paid after the taxpayer's death. Tax withholding made under the decedent's Social Security number should always be reported on Form 1040 regardless of whether the withholding occurred prior to or after date of death since the IRS will have such withholdings credited to the deceased taxpayer's account.

Year of Death RMD

After reaching the required beginning date under Code Section 401(a), taxpayers must withdraw their annual required minimum distribution (RMD) from any qualified retirement plans. Taxpayers frequently schedule these withdrawals at the end of the year to maximize the tax-free growth of the account during the year. The RMD for the year is calculated as of January 1 each year based on the year-end balance of the account. When a taxpayer passes away before withdrawing his full RMD, his estate or beneficiaries must ensure the distribution is withdrawn before the end of the year to avoid the 50% failure to withdraw penalty under Code Section 4974.

Any withdrawal made after the taxpayer's death must be claimed as income by the entity or individual making the withdrawal. The withdrawal for the year of death will still be calculated based on the taxpayer's age since the RMD is technically calculated on January 1 when the taxpayer was alive. If the estate makes the withdrawal, the estate should consider opting out of tax withholdings, particularly if the taxable income will flow through to the beneficiaries of the estate. Opting out of a withholding is often advisable since obtaining refunds calculated on Form 1041 is often time-consuming and can delay the completion of the estate administration.

Code Section 454 Election

Taxpayers who own U.S. Series EE or I bonds have the choice to report the taxable interest as it accrues annually or to wait until the bond matures to claim all the interest accrued at one time. If the taxpayer dies before the bonds mature, the executor may make an election under Code Section 454 to include all the accrued interest up to the taxpayer's date of death on his final Form 1040. The estate, trust, or individual beneficiaries who receive the bonds are then only responsible for reporting the interest accrued after the date of death in accordance with the procedures under Revenue Ruling 68-145. This election is particularly beneficial when the taxpayer was in a low tax bracket in comparison to the beneficiaries or had significant deductions in the final months of his life.

EXAMPLE

Taxpayer owned Series EE bonds, which had $75,000 of accrued interest on the date of death. Taxpayer died in February and incurred $140,000 in medical expenses prior to death, which were paid by his estate shortly after his death. The bonds passed to the taxpayer's trust for ongoing management. The trust cashes in the bonds six months after death, at which point the accrued

interest totals $77,000. If the taxpayer's executor makes the Code Sec. 454 election, $75,000 will be reported on his final Form 1040 and $2,000 will be reported on the trust's Form 1041.

Decedent's Medical Expenses

Clients who itemize their deductions may only claim deductions actually paid prior to the taxpayer's death. One exception to this rule is medical expenses incurred by the taxpayer prior to the date of death but paid after death. Medical expenses that are actually paid during the 12-month period after date of death are eligible to be claimed on Schedule A of the decedent's final income tax return. Amended tax returns may have to be filed for deceased taxpayers to claim these deductions if medical expenses are paid after the deceased taxpayer's final income tax return is due.

If the taxpayer's estate files a Form 706 Estate Tax Return, outstanding medical expenses can be claimed as a deduction against estate tax. Medical deductions claimed on Form 706 are not subject to the 7.5% adjusted gross income (AGI) threshold. For taxpayers whose estates are subject to estate tax, practitioners must consider whether claiming medical expenses paid after the date of death on the decedent's final Form 1040 provides a better tax benefit than claiming the expenses as a deduction on Form 706. The same expenses may not be claimed on both returns.

Carryover Losses

Taxpayers who report significant loss carryovers on their returns should plan carefully because most of these losses will be forever lost when the taxpayer passes away. Excess capital loss carryovers reported on the taxpayer's final income tax return that exceed the allowable $3,000 offset against ordinary income cannot be transferred to the taxpayer's estate or beneficiaries under Revenue Ruling 74-175, which also prevents net operating losses to be used after the taxpayer's date of death. If the taxpayer is married and his surviving spouse will file a joint return, the surviving spouse should consider triggering capital gains before the end of the tax year since the losses available as of date of death can still be used during the current tax year. After the end of the tax year, those losses will be disallowed for future years.

Previously disallowed passive activity losses will be allowed on the taxpayer's final income tax return subject to the limits under Code Section 469(g). The amount of passive activity loss allowed on the taxpayer's final tax return will be reduced by the amount of any tax basis adjustment allowed under Code Section 1014, which adjusts the tax basis of any asset owned by the taxpayer to the fair market value of such asset as of the date of death. Any excess passive activity loss is permanently lost.

EXAMPLE

Taxpayer owns a single-family rental. The property has an adjusted basis of $600,000, and its fair market value as of taxpayer's date of death is $650,000. Taxpayer has a passive suspended loss of $75,000 and has no other passive income. If taxpayer dies during the tax year, the deductible suspended passive loss on the taxpayer's final income tax return is limited to $25,000 ($75,000 - $50,000 step-up in basis). The available passive loss can be used to offset other income such as interest, dividends, and wages. The remaining $50,000 of passive loss is forever lost.

A taxpayer who has charitable deductions in excess of his income in his year of death cannot carry those deductions onto future year returns filed for his estate or pass the deductions out to a beneficiary under Treas. Reg. Sec. 1.170A-10(d). If the taxpayer has a surviving spouse, the spouse should consider triggering additional income to use the excess charitable deductions before they are lost at the end of the tax year.

INCOME IN RESPECT OF A DECEDENT

Assets owned by the decedent as of his date of death receive a tax basis adjustment to their fair market value as of the date of death. However, not all of a decedent's assets receive the basis adjustment. Code Section 691 describes a category of receipts known as income in respect of a decedent (IRD). Receipts falling within this category are taxed in the same manner as though the decedent were alive. A receipt falls into the IRD category if the decedent earned or was entitled to the income during life but was not entitled to take possession of it as of the date of death. The most common examples of IRD include the decedent's final paycheck or payments from the decedent's qualified retirement account. The table at the end of this section lists additional types of IRD commonly encountered for a decedent's estate, trust, and beneficiaries.

Under prior law (pre-1942), IRD was accrued on the decedent's final income tax return, which resulted in high income tax liability if the decedent had significant sources of IRD, such as large retirement accounts. After the passage of the modern-day IRD rules, these sources of income are now only taxed to the inheriting trust, estate, or beneficiary when actually received. The character of the income when received remains the same as though the decedent collected the income while alive.

After the taxpayer passes away, if IRD is payable to the estate, trust, or a named beneficiary, then the estate, trust, or named beneficiary will claim the income on its tax return for the year received. If the right to receive the income is distributed out from an estate or a trust to a qualified successor, then the qualified successor will claim the income on its tax return for the year received. A qualified successor is any beneficiary named under a will or state intestacy law or under a revocable trust that becomes irrevocable upon the decedent's passing.

If a trust or estate distributes the right to receive income in satisfaction of a debt or a specific pecuniary bequest, then the trust or estate realizes gain or loss on the transfer of the asset. Upon distribution (or sale), the estate or trust will include in gross income the greater of (1) the amount of the consideration, if any, received for the right to the future IRD or (2) the fair market value of the right to the future IRD at the time of the transfer.

EXAMPLE

Taxpayer A enters into an installment sale prior to date of death for the sale of land. Taxpayer A's basis in the land is $40, and the sale price is $100 payable over five years. Taxpayer A dies after receiving two payments. The estate is entitled to receive the remaining $60 over the next three years. Instead of waiting to receive these monies, the estate distributes the installment note to Taxpayer A's nephew, who was left a specific pecuniary bequest of $60 under Taxpayer A's will. The estate must recognize the remaining gain from the installment note in the year of distribution instead of passing the gain out for Taxpayer A's nephew to recognize when the

payments are received.

If instead Taxpayer A's nephew received the installment note as a residuary beneficiary, the estate would recognize no income on the distribution of the installment note to nephew. When nephew received the subsequent $20 installment payments, he would report $12 gain for each payment ($20 payment minus $8 basis using Taxpayer A's original gross profit percentage).

The same principle of acceleration applies if the qualified successor sells or gifts its right to receive IRD. If the right to IRD is sold, then the qualified successor must include as income the greater of (1) the fair market value of the right or (2) the amount received in the sale. If the right to IRD is gifted, then the qualified successor must include the fair market value of the right as income. The buyer or recipient then takes a basis of either the fair market value or the purchase price in the asset upon receipt.

For purposes of estate tax, IRD is also an asset that is includable as part of the gross estate. A beneficiary, trust, or estate may be eligible to claim an estate tax deduction under Code Section 691(c) if the estate or trust reports IRD on its estate tax return. The deduction is permitted only for estates that actually pay estate tax with Form 706. Since the current estate tax exemption is so high (over $11 million), very few estates actually pay estate tax—although an estate may still file Form 706 for purposes of portability or making certain tax elections. If an estate pays estate tax, then the estate tax paid on account of including the IRD asset as part of the taxable estate can be recovered over time as the IRD is included on the qualified successor's income tax return. While this deduction is not common, for those taxpayers subject to estate tax, it is a welcome consolation.

Common Types of IRD	
Decedent's final paycheck	Lawyer's contingent fees
Pre-tax retirement benefits (IRA, 401(k))	Post-death bonuses
Interest accrued on a bond	Accrued rent not yet due to be paid
Dividends announced prior to death but paid after death	Gains from installment sales where proceeds paid after death

TAX REFUNDS FOR DECEASED TAXPAYERS

If a deceased taxpayer is entitled to a refund on his final income tax return, his executor must attach Form 1310 to his return. If the decedent is also entitled to a state-level income tax return, a separate state-level form might also be required. Form 1310 asks for identifying information concerning the individual claiming the refund on behalf of the deceased taxpayer and then divides the claimants into three categories:

- Surviving spouse requesting reissuance of the refund
- Court-appointed representative
- Person other than the surviving spouse or court-appointed representative

When spouses file a joint return and are due a refund, the check is normally made out to Spouse 1 and Spouse 2. Many banking institutions will refuse to deposit such instruments unless the deposit is

being made to a joint account. If Spouse 1 passed away in February and the refund doesn't arrive until June of the following year, Spouse 2 may have already closed all joint accounts or removed Spouse 1's name from the accounts. Form 1310 can be used by a surviving spouse to request the refund be reissued solely in the name of the surviving spouse. While the form is often submitted along with the tax return, it can also be submitted separately or after the tax return is filed.

If a representative such as an executor or personal representative has been appointed by a state court to administer the decedent's estate, the executor or personal representative should attach the court certificate appointing them to this role to Form 1310. While the instructions indicate that only the certificate is necessary to accompany the originally filed Form 1040, in practice, the IRS frequently follows up requesting Form 1310 to be completed. Best practice would be to submit Form 1310 and the court certificate every time a return is filed for a deceased taxpayer. If option A or B is selected, Form 1310 cannot be filed electronically, so the tax return will need to be paper filed.

Not every deceased taxpayer requires a representative be appointed as executor or personal representative of their estate. Some taxpayers name beneficiaries on all their accounts, and other taxpayers use trusts to avoid the probate process. For these taxpayers who are due a tax refund, the person who assumes responsibility to file the tax return should complete Form 1310. In addition to identifying the individual claiming the refund, the individual must also identify whether the decedent left a will, state whether a court-appointed representative has been named, and confirm that the claimant will pay out the refund according to state law.

Refunds to a deceased taxpayer can take months, and sometimes years, to be processed. The family or estate representative must have patience when waiting for these refunds. If payment is expected to be made to the decedent's estate, the executor must ensure the estate retains an open bank account to deposit the refund. Very often the entire estate will be administered quickly but the estate account must remain open to deposit the refund when it is finally processed.

DECEDENT'S PERSONAL RESIDENCE

Prior to death, the taxpayer can claim up to a $250,000 gain exclusion when his personal residence is sold under Code Section 121. Married taxpayers can claim up to a $500,000 gain exclusion. To be eligible for this exclusion during life, the taxpayer must own the property and use it as his personal residence for at least two out of the last five years. The use and ownership time periods do not have to run concurrently.

Real estate can be titled in several different manners. A personal residence could be owned by the taxpayer individually or in a revocable trust for estate planning purposes. Upon the taxpayer's death, the property would become part of the taxpayer's estate or the trust would become irrevocable. Alternately, the personal residence could be owned by the taxpayer and his spouse as joint tenants (or tenants by the entirety). Upon the taxpayer's death, the surviving spouse automatically assumes title to the deceased owner's interest. If the property is sold after the taxpayer's death, the Code Section 121 gain exclusion may or may not be available depending on how the property was titled prior to date of death.

If the taxpayer owned his personal residence in his own name or in the name of his revocable trust, then the tax basis of the personal residence will be adjusted to the fair market value of the property as of the taxpayer's date of death. The taxpayer's estate or trust can then sell the personal residence or distribute it to the rightful beneficiaries or heirs. If the personal residence is sold, gain or loss is

calculated by subtracting the fair market value of the personal residence as of the taxpayer's date of death from the sale price. Adjustments for pre-sale improvements, closing costs, and commissions should also be incorporated. An estate or trust can never claim the personal residence gain exclusion under Code Section 121. A beneficiary inheriting the personal residence can only claim the personal residence gain exclusion if the beneficiary owns and uses the property as his own personal residence for at least two out of the five years preceding the sale of the property.

Since the value of real estate sold shortly after death rarely changes dramatically, it is unusual to report large gains on the sale of real estate after the owner's death. It is far more common for the sale to generate a loss—particularly due to realtor commissions and closing costs. So long as the estate, trust, or beneficiary selling the personal residence held the property for investment purposes, a loss on the sale may be claimed. The property need not be rented to be considered held for investment purposes. Instead, so long as the estate, trust, or beneficiary holds the property with the intent to ultimately realize the value of the property by selling it, the property is deemed to be held for investment purposes. A property will lose its investment purposes status if a beneficiary moves into the property and uses it as his personal residence.

EXAMPLE

Taxpayer purchased a home in 1990 for $75,000. In 2021, taxpayer passes away when the home is worth $450,000. Taxpayer's estate sells the home six months after taxpayer's death for $455,000 and pays $35,000 in commissions and closing costs. Taxpayer's estate reports a long-term capital loss of $30,000 ($455,000 – $450,000 – $35,000) on Form 1041 filed for the year of the sale.

If the personal residence is owned as joint tenants with the decedent's spouse, then both the tax basis adjustment and the Code Section 121 personal residence gain exclusion may apply. Upon the death of a joint tenant, one-half of the value of the personal residence is includable in the decedent's gross taxable estate under Code Section 2040. As a result, one-half of the tax basis of the personal residence is adjusted to the fair market value of the property as of the decedent's date of death. If the surviving spouse sells the property within two years of the decedent's date of death, the surviving spouse can claim two-times the Code Section 121 personal residence gain exclusion so long as the deceased owner owned the property and used it as his personal residence for at least two out of the five years preceding his death.

EXAMPLE

Taxpayer and his spouse purchased their home in 2000 for $200,000. The couple titled the property as joint tenants and used it as their personal residence until taxpayer's death in 2021. On taxpayer's date of death, the home is worth $900,000. Full title to the home transfers to the surviving spouse as a result of the joint tenancy designation. Taxpayer's half of the tax basis of the home is adjusted to $450,000. The surviving spouse still has a basis of $100,000 in the other half of the property. The total tax basis of the property is $550,000. If the surviving spouse sells the home for $900,000, gain of $450,000 will be triggered. If the home is sold within two years of taxpayer's date of death, the surviving spouse can offset up to $500,000 of gain by using

two-times the personal residence gain exclusion. If the property is sold more than two years after the taxpayer's date of death, then the surviving spouse can only offset $250,000 of gain using the personal residence gain exclusion.

LIMITING THE EXECUTOR'S LIABILITY

Liability for unpaid taxes or future tax liability does not transfer to the executor personally when he assumes a fiduciary role for the deceased taxpayer. However, if the executor distributes funds to other beneficiaries or pays debts with lower priority without first fully satisfying the outstanding tax liabilities that the executor knows or should know exist, then personal liability can transfer to the executor under Code Section 3713. As discussed earlier in this chapter, the executor or any individual assisting with the administration of the deceased taxpayer's affairs should submit Form 56 to the IRS to inform them of the existence of a fiduciary relationship between the taxpayer and the executor.

The executor must investigate whether the taxpayer was current with his tax filings. As discussed, a Proof of Claim letter can be helpful in assessing this determination. Additionally, the executor may consider submitting Form 4506, which will confirm whether the taxpayer filed his prior returns. Submitting Form 4506 also illustrates good faith on the part of the executor in his attempted investigation of whether the taxpayer was current with his filing obligations.

The statute of limitations for assessing additional income or gift tax is typically three years unless no return is filed or the return contains fraudulent information or fails to report significant amounts of income. Executors who want to limit their potential liability and complete the estate administration can request prompt assessment under Code Section 6501(d) to reduce the assessment period from three years to eighteen months. Form 4810 permits the executor to request prompt assessment by listing the tax returns for which assessment is requested. It should be noted that requesting prompt assessment can result in greater scrutiny by the IRS of the applicable returns, which may delay the administration further than simply waiting out the traditional three-year assessment period.

The executor may also wish to submit Form 5495 to request formal discharge from personal liability for the deceased taxpayer's income, gift, and/or estate tax. After the executor submits Form 5495, the IRS has nine months to respond, informing the executor of any outstanding tax liability. If tax is due and the executor pays the tax, then the executor will be immediately released from personal liability. If the IRS fails to respond to the executor's request within nine months, the executor is similarly released from personal liability. These requests are recommended for executors who wish to complete the estate administration before the normal statute of limitations passes and for executors who know that the income, gift, or estate tax return could contain aggressive positions.

If the executor filed Form 56 at the beginning of his fiduciary relationship, the executor should file Form 56 again at the end of his relationship indicating that his service has ended. This is particularly important if a successor executor or other fiduciary takes over the completion of any administration.

DECEDENT'S FINAL TAX RETURN SUMMARIZED

The final income tax return for the deceased taxpayer should be filed in the same manner as any other tax return. However, the executor must take special care to ensure the taxpayer is current on his or her tax filings and possible outstanding tax liability since liability can pass to the executor personally if proper precautions are not taken. The executor should also consider possible elections and income triggers when the deceased taxpayer has excess losses or deductions on his final return since these losses and deductions cannot be transferred to the taxpayer's estate or beneficiaries to claim on their own returns. The executor and ultimate beneficiaries will also need patience during the estate administration process since refunds to deceased taxpayers take extra time. For taxpayers who die early in the year, the final return can be an easy task to forget; therefore, practitioners should be prepared to remind taxpayers of this crucial final task.

REVIEW QUESTIONS

1. If the taxpayer passes away in July, when is his final income tax return, Form 1040, due?

a. November 15

b. December 31

c. April 15

d. July 15 of the following year

2. Which of the following should not be submitted to the IRS when an individual taxpayer dies?

a. Form 8822-B

b. Form 56

c. Form 8822

d. Request for Proof of Claim

3. Which of the following statuses is not appropriate for the surviving spouse of the taxpayer?

a. Married filing jointly

b. Married filing separately

c. Single

d. Qualified widower

4. Which of the following statements is true regarding deducting the taxpayer's final medical expenses?

a. Medical expenses paid prior to the date of death are deductible on the taxpayer's final Form 1040.

b. Medical expenses paid within 12 months after the date of death are deductible on the taxpayer's final Form 1040.

c. Neither A nor B.

d. Both A and B.

5. Which of the following losses can be carried over by the surviving spouse or to the deceased taxpayer's estate?

a. Capital loss carryover

b. Net operating loss

c. Excess charitable deduction

d. No losses may be carried over by the surviving spouse or to the deceased taxpayer's estate

6. Who pays income tax on payments under an installment sale signed before the taxpayer's death and ultimately distributed by the estate out to the taxpayer's only child?

a. Child

b. Taxpayer

c. Estate

d. The payments not taxable under Code Section 1014

7. Which of the following should not be submitted to the IRS when a taxpayer is due a refund on his final tax return?

a. Death certificate

b. Last will & testament

c. Form 1310

d. Court certificate

8. If the taxpayer's home was purchased for $250,000 and is worth $490,000 on the date of death, how much taxable gain is triggered when the estate sells the home for $500,000?

a. Zero

b. $10,000

c. $250,000

d. $500,000

9. Which of the following is not a tax benefit claimed by the surviving spouse on income tax returns filed after the deceased spouse's death?

a. Using the married filing jointly filing status

b. Claiming $500,000 personal residence gain exclusion

c. Deducting funeral expenses for the deceased taxpayer

d. Deducting medical expenses paid after date of death on Schedule A

10. An executor who wants to limit his personal liability should do all of the following except:

a. Request formal discharge from liability using Form 5495.

b. Request prompt assessment using Form 4810.

c. Pay the taxpayer's liability out of the executor's own funds.

d. Submit Form 56 to inform the IRS of the end of the fiduciary relationship.

ANSWERS TO REVIEW QUESTIONS

1. a. Incorrect. Although Form 1040 is due 3½ months after year end, a decedent's final year-end does not end in the month of death.

b. Incorrect. Regardless of when the taxpayer dies during the calendar year, his final Form 1040 will always be due on April 15 as adjusted for holidays (or pandemics) or later if extended by his executor.

c. Correct. The taxpayer's final Form 1040 will always be due at the same time living taxpayers' individual income tax returns are due, even though the taxpayer may die early or late in the year.

d. Incorrect. The decedent's final Form 1040 is not due one year after death.

2. a. Correct. Form 8822-B is filed on behalf of a business entity to change the mailing address and contact information for the entity. It should not be filed on behalf of an individual income taxpayer.

b. Incorrect. Form 56 should be filed as soon as an executor or other responsible party agrees to act in a fiduciary capacity on behalf of the taxpayer. This form will ensure the IRS knows that the named fiduciary is taking action in lieu of the taxpayer.

c. Incorrect. Form 8822 should be filed soon after the taxpayer passes away to update the mailing address with the IRS so that the executor or other responsible party receives all communication from the IRS concerning previously filed tax returns, outstanding tax liability, or other correspondence concerning the deceased taxpayer's account.

d. Incorrect. A letter requesting the IRS to produce a Proof of Claim should be sent soon after the taxpayer passes away to obtain a report containing any outstanding tax liability of the deceased taxpayer and to learn about any unfiled tax returns.

3. a. Incorrect. A surviving spouse who does not remarry prior to the end of the tax year may use the married filing jointly filing status if the surviving spouse and the taxpayer were married on the taxpayer's date of death.

b. Incorrect. A surviving spouse who does not remarry prior to the end of the tax year may use the married filing separately filing status if the surviving spouse and the taxpayer were married on the taxpayer's date of death.

c. Correct. If the surviving spouse and taxpayer were married on the taxpayer's date of death, the surviving spouse should not use the single filing status and must use one of the married taxpayer statuses. If the surviving spouse remarries before the end of the year, then they would use one of the married filing statuses with their new spouse, and the deceased spouse would file married filing separately.

d. Incorrect. A surviving spouse who does not remarry prior to the end of the tax year and who has a qualifying child living in the home may use the qualifying widower status for two years following the taxpayer's date of death, which enables the surviving spouse to claim the standard deduction equal to the married filing jointly status instead of the lower head of household status.

4. a. Incorrect. The taxpayer's medical expenses paid prior to the date of death are certainly deductible on the taxpayer's final Form 1040; however, expenses incurred prior to date of death but paid in the 12 months following the taxpayer's date of death are also deductible on the final return.

b. Incorrect. The taxpayer's medical expenses paid in the 12 months following the taxpayer's date of death are certainly deductible on the final Form 1040; however, the expenses paid prior to date of death are also deductible on the taxpayer's final return.

c. Incorrect. Just because the taxpayer passed away does not change the available medical deductions available to be claimed on his final income tax return, which include both the expenses paid prior to the date of death and those paid within 12 months of date of death.

d. Correct. Both the taxpayer's medical expenses paid prior to the date of death and the expenses incurred prior to the date of death but paid in the 12 months following the taxpayer's date of death are deductible on the final income tax return Form 1040.

5. a. Incorrect. Excess net operating losses reported on a deceased taxpayer's final individual income tax return must be used during the final tax year or they will be forever lost. If the deceased taxpayer has a surviving spouse, additional income should be triggered before year end or the excess losses will be forever lost.

b. Incorrect. Excess charitable deductions reported on a deceased taxpayer's final individual income tax return must be used during the final tax year or they will be forever lost. If the deceased taxpayer has a surviving spouse, additional income should be triggered before year end or the excess deductions will be forever lost.

c. Incorrect. To meet the adequate disclosure requirements, a detailed description (including all actuarial factors and discount rates) of the method used to determine the amount of the gift arising from the transfer, including the financial and other data used in determining value, must be provided.

d. Correct. None of the carryover losses reported on a deceased taxpayer's individual income tax return Form 1040 can be carried over to subsequent returns, carried out to the estate, or carried to any beneficiary. If the losses are not used by the triggering of additional income during the tax year, then the losses will be forever lost.

6. a. Correct. Code Section 691 describes a category of receipts known as income in respect of a decedent (IRD). Receipts falling within this category are taxed in the same manner as though the decedent were alive. Common types of IRD include the decedent's final paycheck, pre-tax retirement benefits, post-death bonuses, and gains from installment sales where proceeds are paid after death.

b. Incorrect. When a taxpayer dies owning assets categorized as income in respect of the decedent (IRD), the taxpayer is not required to claim as taxable income amounts that have not yet been paid. Instead, the beneficiary who collects the IRD is responsible for ultimately reporting the income on their own income tax return and paying any associated income tax.

c. Incorrect. When a taxpayer dies owning assets categorized as income in respect of the decedent (IRD), the estate could be responsible for claiming as income amounts of IRD paid to the estate. If no payments are paid during the estate administration, then the beneficiary who collects the IRD is responsible for ultimately reporting the income on their own income tax return and paying any associated income tax.

d. Incorrect. When a taxpayer dies owning assets categorized as income in respect of the decedent (IRD) those assets are ineligible for a tax basis adjustment under Code Sec. 1014 and the beneficiary who collects the IRD is responsible for ultimately reporting the income on their own income tax return and paying any associated income tax.

7. a. Incorrect. While not always required, the IRS (and many state taxing authorities) often request a copy of the death certificate to be submitted when a refund is due to a deceased taxpayer along with Form 1310 and a copy of the court certificate illustrating the executor's authority (if any).

b. Correct. The taxpayer's last will and testament should never be submitted to the IRS for any reason.

c. Incorrect. Unless the refund is being paid to the surviving spouse who is filing a joint return with the deceased taxpayer, Form 1310 must always be submitted to the IRS with a copy of the death certificate and a copy of the court certificate illustrating the executor's authority (if any) in order to claim a tax refund on behalf of a deceased taxpayer.

d. Incorrect. While not required if no executor has been appointed by the probate court, the court certificate (called Letters Testamentary or Letters of Administration) must accompany Form 1310 when a refund is due to a deceased taxpayer whose estate is being administered by a court appointed fiduciary.

8. a. Incorrect. The taxpayer's estate is not eligible for the personal residence gain exclusion under Code Section 121 because the taxpayer has passed away and the surviving spouse is not the surviving owner of the home. Therefore, the taxpayer's estate cannot extinguish all the gain on the sale of the house.

b. Correct. After the taxpayer passes away and his estate sells his home, the gain or loss on the sale is calculated by subtracting the date of death value according to Code Section 1014 from the sale price. The date of death value is $490,000 and the sale price is $500,000. The difference between the sale price and the gain is $10,000.

c. Incorrect. After the taxpayer passes away, the original cost basis of the property is irrelevant. Under Code Section 1014, the cost basis is adjusted to the fair market value of the property as of the deceased taxpayer's date of death.

d. Incorrect. The taxpayer's estate will always receive a cost basis in the property equal to the fair market value of the assets as of the deceased taxpayer's date of death. The adjusted basis is then subtracted from the amount realized to calculate the estate's gain or loss on the sale.

9. a. Incorrect. The surviving spouse can use the married filing jointly filing status for the year in which the taxpayer passed away regardless of the number of days during the year the deceased spouse lived. This will permit the surviving spouse to claim a much larger standard deduction than if filing as single.

b. Incorrect. The surviving spouse can claim two-times the personal residence gain exclusion on the surviving spouse's income tax return if the property is sold within two years of the decedent's date of death and on his date of death he satisfied the two out of five year rule for use and ownership of the property.

c. Correct. Funeral expenses are never deductible on Form 1040. The estate tax return, Form 706, is the only return on which funeral expenses can be deducted.

d. Incorrect. Medical expenses that are paid within one year after the deceased taxpayer's date of death can be claimed as a Schedule A itemized deduction on the deceased taxpayer's final income tax return. If the taxpayer was married as of the date of death, his surviving spouse can claim these deductions on their jointly filed return.

10. a. Incorrect. If an executor wants to limit his personal liability for possible tax liability assessed against the deceased taxpayer, he should request a formal discharge from liability for the applicable tax years using Form 5495.

b. Incorrect. If an executor wants to limit his personal liability for possible tax liability assessed against the deceased taxpayer, he should request a prompt assessment for the outstanding tax years to shorten the time limit for assessment using Form 4810.

c. Correct. The executor is never required to use his own money to satisfy the deceased taxpayer's tax liability; however, the executor is required to properly allocate all available assets of the estate to the expenses, including tax liability, of the estate. If funds are paid to beneficiaries or lower priority creditors, the IRS can require the executor to pay the outstanding liability from his personal funds.

d. Incorrect. After the fiduciary relationship ends, it is advisable to notify the IRS by submitting Form 56 that the relationship has ended and the fiduciary is no longer acting on behalf of the deceased taxpayer.

Chapter 8

BASIC OF ESTATES, TRUSTS & FIDUCIARY ACCOUNTING

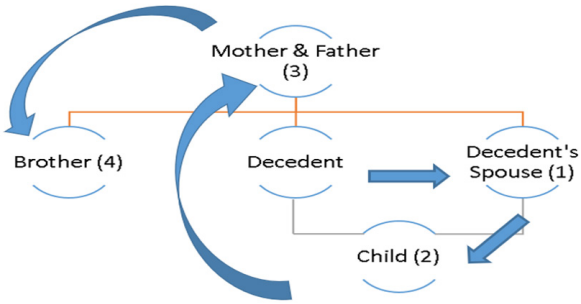
LEARNING OBJECTIVES

After reviewing this chapter, you should be able to:

- Describe the methods of transferring assets at death
- Explain how titling and beneficiary designations interact with estate planning documents
- Identify the main duties of an executor and trustee
- Analyze the possible creditor claims against a decedent's estate
- Recognize specific bequests and residuary distributions
- Name the primary fiduciary accounting rules and when they apply
- Discuss the interaction between fiduciary accounting and fiduciary income tax

TRANSFERRING ASSETS AT DEATH

When a client passes away, his assets will pass according to the terms of state law and his estate plan. Many individuals do not prepare for death and have no formal documents in place to control the ultimate distribution of their assets. When an individual passes away without a Last Will and Testament ("Will"), they are deemed to have died intestate. An individual who passes away with a Will is deemed to have died testate. When individuals die intestate, the laws of the state in which they were a resident at the time of their death control the disposition of their assets. These laws vary by state but typically devise assets to the next of kin including the surviving spouse, children, parents, or siblings of the decedent. For example, if the decedent in the following example passed away intestate, his spouse would inherit first. If his spouse predeceased him, the assets would pass to his child, followed by his parents and then siblings if the child or parents had also predeceased.



Transfers by Will

When an individual is married but has children from a prior relationship, assets are often divisible between the surviving spouse and the decedent's children. There may also be rules that share assets with the parents of a married person if the couple had no children. If a client has no immediate relatives, the laws of intestacy will follow the client's bloodlines out multiple generations to find the closest living relative to inherit. If no relatives are located, the client's assets pass to the state government through the process called escheatment. A basic understanding of the rules of intestacy controlling clients' estates is helpful when a practitioner is advising clients on whether to pursue estate planning.

Clients who do not want their assets to pass to the default heirs under state law will need to take action to prevent the laws of intestacy from applying to their estate. A Will is the most frequently used technique to avoid intestacy. State law governs whether a document is adequate to control the disposition of assets when a client passes away. The most common requirements for a valid Will are that the document must be (1) signed by the client, (2) signed by two witnesses, and (3) notarized. However, documents that do not meet these standards may still qualify as valid Wills under state law. Documents that are just signed or perhaps have only witnesses or a notary may be valid but might require additional administrative procedures to confirm the documents' validity. Wills can be amended using a document called a codicil. Together, the Will and any valid codicil will govern the administration and distribution of the decedent's assets.

Holographic Wills have long been accepted as valid documents to dispose of clients' assets. A holographic Will is a document that is in the client's own handwriting (not typewritten) and signed by the client. Clients who do not have the means to engage an attorney to prepare formal estate planning documents or who may not have time to complete formal documents before their death should consider writing a holographic Will to describe their testamentary intentions.

In this age of prevalent electronic communication and reliance on Internet services, states are beginning to adopt legislation permitting clients to prepare an electronic Will and to also sign their Will electronically. These concepts are fraught with questions related to security and integrity of the documents, and many practitioners are wary of adopting these new methods of estate planning—particularly given their untested nature in the courts. However, technology is undoubtedly a permanent fixture in society, and practitioners need to be open to using these methods to meet their clients' goals.

Transfers by Trust

Another method of transferring assets to a client's heirs is by using trusts. The creator of the trust is typically referred to as the grantor or the settlor of the trust. The grantor determines the parameters for how the trust assets are managed in the future. The manager of the trust is referred to as the trustee. It is common in some types of trusts for the grantor to also serve as the initial trustee, followed by named successor trustees who assume the role upon a future event such as the grantor's incapacity.

In its most basic form, a trust is simply an agreement between the grantor and the trustee regarding the administration of the trust assets for the benefit of one or more beneficiaries. Most trusts used to accomplish estate planning are revocable and amendable by the grantor. These are sometimes referred to as a living trust or revocable trust. However, the name of the trust is not necessarily determinative of its terms since the trust agreement controls the trusts. Living trusts do not expire at the death of their creator, and revocable trusts often become irrevocable at the death of the creator. Careful reading of the trust agreement terms and an understanding of the parties involved are necessary to accurately analyze these documents. Trusts can be amended by either fully restating the trust agreement and integrating the new terms into a new document, or certain sections or articles can be revised in a short document that is read alongside the original trust agreement. The trustee should ensure he has the original agreement and all amendments before beginning his administrative tasks.

A trust can be a substitute for a Will if the trust holds title to all the client's assets at death. Alternately, a trust can be named as the beneficiary of assets that will transfer to the trust upon the death of the owner. If the grantor pre-titles all the intended assets in the name of the trust, then it is referred to as being fully funded. A trust may also be partially funded if the grantor transfers some but not all of the intended assets into the name of the trust. Often a pour-over will is executed in conjunction with a trust document. Instead of naming individual beneficiaries, a pour-over will names the trust as the sole beneficiary of the client's assets, which ensures all the intended assets ultimately pass according to the terms of the trust upon the grantor's death.

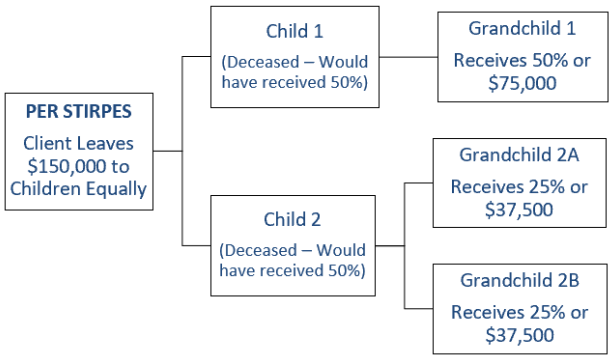
Clients who want their assets to pass to beneficiaries other than those described under the laws of intestacy or in different percentages must describe their wishes in either a Will or a properly funded trust. Clients who put off estate planning risk their assets passing into the wrong hands. Estate planning is particularly necessary for clients who have estranged relationships with children or parents and for clients who have no immediate relatives but who have close friends or meaningful charitable organizations. These individuals must take care to create effective estate planning documents to prevent relatives who may be generations removed from the decedent from inheriting the client's assets.

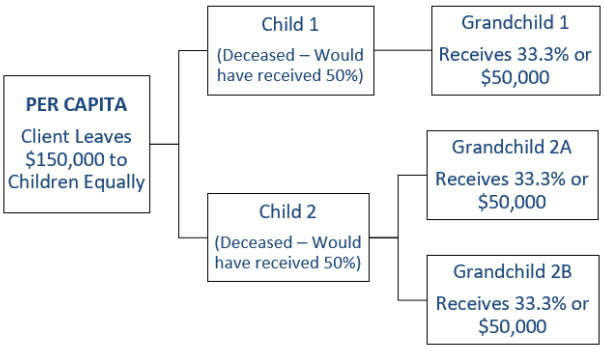
Predeceased Beneficiaries

Sometimes, the beneficiary named on an account, in a Will, or in a trust, dies before the client. The client may not have time to update his documents to account for the death of one of his beneficiaries. The governing document or state law controls how these funds are distributed when the intended beneficiary is already deceased.

There are two main distribution plans that apply in these situations—per stirpes and per capita. While per stirpes is uniformly defined across the county, per capita can have several variations and is sometimes referred to as by representation. The most common variation is described in this chapter. If a client leaves assets to his named beneficiaries followed by the words per stirpes, a predeceased individual's share (be it a percentage, a dollar amount, or a specific asset) will pass down to his descendants equally. If a client leaves assets to his named beneficiaries followed by the words by representation or per capita, a predeceased individual's share will similarly pass down to his descendants equally, unless more than one of the original beneficiaries predecease. If multiple beneficiaries predecease, their shares are combined and reallocated equally among their collective descendants instead of the deceased beneficiary's share following the bloodline.

–As shown in the illustrations to the right, the client's children would divide the assets left to them equally. Under both the per stirpes and per capital distribution plans, a predeceased child's share will be divided equally among the deceased child's own children. However, if both of client's children predecease the client, the amounts received by the grandchildren will differ depending on whether the terms of the document or state law adopts a per stirpes or per capita distribution plan.





Under per stirpes, even if both children predecease, the grandchildren receive their parent's share. However, under per capita, the entire bequest is divided equally among the beneficiaries at the grandchildren's generation. The per capita distribution plan ensures that beneficiaries at the same generation receive the same amounts. The terms of the governing document will always control whether the per stirpes or per capita distribution plan controls. If the governing document is silent, then state law will control.

Clients who do not want lower generations to inherit assets in the event their intended beneficiary predeceases should indicate their desire for the distribution to "lapse" in their governing documents. When a bequest or residuary distribution lapses, the intended transfer is ignored altogether, and the remaining beneficiaries' shares are typically augmented proportionately. The client may include alternate distribution patterns in this situation as well.

JOINT ASSETS AND BENEFICIARY DESIGNATIONS

The terms of a Will or the laws of intestacy control the disposition of assets titled in the decedent's own name. The terms of a trust control the disposition of assets titled in the name of the trust. However, clients will frequently own assets jointly with another owner or name a pay-on-death beneficiary for their assets. Titling and beneficiary designations can be used as substitutes for formal estate planning to pass assets to the intended recipients upon the owner's death. Titling and beneficiary designations can also be used alongside a Will or trust to streamline the estate administration process.

If an asset is titled jointly with another owner, the surviving owner will receive title to the full asset upon the death of the first joint owner. This is often referred to as owning property as joint tenants. Some states require the title to specifically state that the asset is owned as joint tenants with rights of survivorship to permit the surviving owner to take full ownership of the asset at death. Joint tenancy is contrasted by another common form of ownership known as tenants-in-common. When assets are titled as tenants-in-common, each owner is deemed to own their individual percentage of the asset and can devise their interest to their own heirs at death either through intestacy or the terms of a Will. The surviving owner of an asset titled as tenants-in-common does not automatically assume full ownership of the asset.

Another way to transfer assets directly to a survivor at death is by listing an individual as the pay-on-death beneficiary of the asset. Entities such as trusts or charities can also be named as beneficiaries. A beneficiary can be named on many different kinds of assets, including checking and savings accounts, brokerage accounts, retirement plans, and life insurance policies. Many states have also adopted beneficiary deeds or transfer-on-death (TOD) deeds, which allow owners of real property to name a beneficiary for real estate. Upon the death of the owner, the named beneficiary must complete claim paperwork and provide the owner's death certificate to claim the assets. Each financial institution will have a unique claim process that many beneficiaries may find cumbersome and time-consuming.

Clients must weigh the pros and cons of naming beneficiaries on their assets compared to allowing the assets to be distributed pursuant to the terms of a Will or trust. Assets titled as joint tenants or that name a pay-on-death beneficiary pass to the surviving owner or beneficiary at the death of the first owner automatically, regardless of the terms of the client's Will or trust or the laws of intestacy. Assets that name beneficiaries are subject to the outright control and disposition of the beneficiary who will not be required to first use those funds to pay administrative expenses or to share the funds with other family members. Clients who engage in estate planning and sign a Will or create a trust must coordinate the titling of their assets and the beneficiaries named on their accounts to ensure that the disposition of assets is coordinated. Many clients forget this step, which results in beneficiaries receiving far greater assets than the client may have intended.

POST-DEATH ADMINISTRATION

When a client passes away, the assets owned by the client and any governing documents must be examined. If a client dies intestate, the family must consult state law to determine who has priority to serve as the executor (sometimes called personal representative) of the estate and who are the heirs according to the laws of intestacy. If a client prepared a Will prior to death, the Will should describe who is nominated to serve as the executor and how the assets will be distributed. If a client prepared a trust, the titling of the client's assets must be examined to determine whether the trust already holds title to the assets or whether the assets must be transferred into the trust.

If all the decedent's assets were either titled jointly with a surviving owner or named a pay-on-death beneficiary, then the named beneficiaries or surviving owners simply claim the assets themselves without the assistance of an executor. As executor is also unnecessary when all the decedent's assets are titled in the name of a trust. The trustee of the trust, or the successor trustee named in the trust agreement, will simply assume the role of administering the assets titled in the name of the trust according to the terms of the governing document. Assets that are not jointly titled with a surviving owner, do not name a beneficiary, and are not pre-titled in the name of a trust must be transferred to the ultimate heirs through the estate administration process. In most states, that process is called probate.

Transfers By Probate

A common misconception is that having a Will avoids probate. Only beneficiary designations or a fully funded trust can avoid probate. Probate can be a lengthy, expensive, and complex task depending on the decedent's state of residence, the type of assets owned by the decedent, and disagreements among heirs regarding distribution. Probate typically begins by the executor, who is nominated in the Will, or the individual with priority under state statute, submitting an application to the probate court requesting to be appointed to the role of the executor. A misconception by family members is that the person named as the executor in the Will automatically has power to act in that role upon the decedent's death. Executors nominated in a Will have no power until they are appointed by the probate court.

Once an executor is appointed, the court will provide the executor with a document called Letters Testamentary or Letters of Administration. This document is basically a certificate that grants the executor the power to proceed with effectuating the terms of the Will or carrying out the laws of intestacy. Before making any distributions, the executor will first need to complete basic administrative tasks. These include identifying and gathering the decedent's assets, paying outstanding debts, filing the decedent's final income tax return, and analyzing whether the decedent's estate may owe estate tax. This process usually takes about a year but can last many years depending on whether the decedent was organized prior to death, whether the estate assets are easy to transfer or liquidate, whether the family and intended heirs agree on the proposed distribution of the assets, and whether creditor claims delay the administration. The executor should set expectations early among intended heirs. Even a well-designed estate plan requires a good deal of work on the part of the executor to complete all the necessary tasks.

After the basic administration requirements are complete, the executor may begin distributing assets according to the terms of the governing document. An executor will consult the laws of intestacy or the terms of the Will and any codicil (aka amendment) to determine how assets are distributed. The laws of intestacy typically require outright distribution of the decedent's assets. Depending on state law, distributions to minors may be delivered to the minor's guardian or deposited into a minor's account for safekeeping until the minor reaches the age of majority. The terms of a Will may instruct the executor to make distributions of the assets outright to a list of beneficiaries or to create trusts for ongoing management of assets. Before making distributions to beneficiaries, executors should obtain written acknowledgment from the beneficiaries confirming that the proposed distribution amount is correct and that the beneficiaries approve of the overall estate administration. Obtaining these acknowledgments limits the executor's liability for possible claims by disgruntled beneficiaries in the future.

Small Estate Procedures

If most of the client's assets already pass by beneficiary designation or are titled in the name of the trust, but one or two small assets remain in the client's own name, such as a modest bank account or a vehicle, the family may be able to avoid probate by using a small estate affidavit or other small estate procedure. In many states, non–real estate assets totaling less than a statutory sum (often around $70,000) can be claimed by the family through a simple affidavit or form. This is beneficial when the client has limited means or forgot to transfer a minor asset. If a client dies owning assets titled in his own name in excess of the small estate threshold, probate will be required.

Trust Administration

If the decedent pre-titled all his assets in the name of a trust or named the trust as the pay-on-death beneficiary of his assets, then probate may not be required. The successor trustee will complete most the tasks that would otherwise be completed by the executor. Once the trustee (and executor, if any) has addressed the basic estate administration tasks, including paying debts and filing tax returns, the executor or trustee may begin distributing assets according to the terms of the governing document. The terms of a trust may direct the trustee to make distributions of the assets outright to a list of beneficiaries. Alternatively, the trust may direct the trustee to withhold some or all of the trust assets and manage them indefinitely for the named beneficiaries of the trust, such as a surviving spouse, minor children, or other beneficiaries who may be incapable of managing their own affairs.

Ongoing management of assets inside a trust is also beneficial for future estate tax or generation-skipping transfer tax savings. When assets are managed inside a trust long-term, the trustee must become familiar with the fiduciary accounting rules (discussed later in this chapter) and the fiduciary income tax preparation process. Additionally, the trustee must understand his reporting obligations to beneficiaries under the terms of the trust agreement and state law in addition to his responsibilities to prudently manage the trust assets. Professional guidance for individuals serving as non-professional trustees is highly recommended since the role is fraught with pitfalls that can unknowingly lead to violations that can expose the trustee to personal liability and possible removal from his role.

Creditor Claims

Before distributions are made to beneficiaries, the executor or trustee must ensure all the outstanding debts owed as of the decedent's date of death are satisfied. If the assets of the decedent are less than the total debts, the estate is deemed insolvent. The beneficiaries, executor, and trustee are never personally liable to pay the debts of the decedent from their own assets so long as the applicable administration procedures are followed.

When an estate goes through the probate process, a notice to creditors is typically required to be published in a local newspaper giving creditors the opportunity to present claims against the estate. Most states have a statute of limitations (approximately one year after date of death) in which creditors must submit claims. Once the statute of limitations has passed, claims are forever barred.

The executor or trustee must take care to pay creditors in order of priority to ensure higher priority claims are fully paid before any payments to lower priority claims. It is advisable to wait to pay claims until all the assets and debts are analyzed. Creditor claims must be paid in order of priority, with higher priority claims being fully paid and lower priority claims going partially or wholly unpaid. Paying claims out of order can expose the executor or trustee to personal liability.

Certain assets owned by the decedent may be exempt from creditor claims. Exempt assets will be determined by state law. Examples of assets that might be exempt include the proceeds of life insurance, jointly owned real estate, and retirement plans. These assets must pass directly to the named beneficiaries or joint owners to be exempt from creditor claims. Assets paid to the estate will be required to be paid first to creditors before payments can be made to beneficiaries. Beneficiaries and fiduciaries should consult a professional before paying any creditors to avoid paying creditors out of order or exposing exempt assets to liability.

Estate Tax Liability

Regardless of whether assets pass directly to a beneficiary, are transferred by the executor, or are administered by a trustee, estate tax liability must be analyzed by the "executor." For tax purposes, the term executor is not the same as an executor appointed by the probate court. In the eyes of the IRS, the executor is anyone who is in control of the decedent's assets. This could be a direct beneficiary, a court-appointed executor, or a successor trustee.

Avoiding probate doesn't mean you avoid estate tax. Jointly titled assets and those naming direct beneficiaries are still part of the decedent's gross estate for estate tax purposes. Typical estate planning trusts are revocable until the grantor passes away. When the taxpayer retains the right to enjoy the assets of a trust or to revoke a trust up until his date of death, all the assets owned by that trust are includable as part of his gross estate for estate tax purposes. Direct beneficiaries, surviving joint owners, court-appointed executors, and/or successor trustees must carefully analyze the decedent's assets and all prior taxable gifts to ensure any necessary estate tax return is timely filed.

TYPES OF BENEFICIARIES

Distributions under the document or statutory scheme governing the disposition of assets typically fall under two categories—specific bequests and residuary distributions. Depending on the category of distribution, the income tax consequences could be drastically different. If a beneficiary is a charitable entity, additional analysis must be completed to accurately report the transfer. The timing of distributions when taxable assets are part of the estate can further complicate the administration of the estate or trust. The following describes some of the considerations that a fiduciary must examine during the administration process.

Specific Bequests vs. Residuary Distributions

When a specific asset or sum of money is identified for a specific person in the governing document or applicable statute, this transfer is referred to as a specific bequest. Debts and administrative expenses are typically paid last from recipients of specific bequests after all remaining monies or assets have been fully expended. Specific bequests also are not allocated any share of the distributable net income and pass income tax free to the beneficiary.

Distributions expressed in terms of a percentage or fraction of the remaining estate or trust assets are typically referred to as residuary distributions or remainder distributions. These shares are normally responsible for the payment of all administrative expenses, debts, and sometimes the estate tax liability, if any. Residuary or remainder beneficiaries have the distributable net income calculated on the fiduciary income tax return allocated among them. They also share in any excess deductible expenses incurred during the final year of administration.

The governing documents should be examined carefully to determine whether distributions are categorized as specific bequests or residuary distributions. The terms should also be analyzed to determine how expenses of administration, debts, and transfer tax should be shared among the recipients to ensure proper allocation during the administration and preferable timing of transactions.

Charitable Distributions

Among the potential recipients of a decedent's assets can be charitable entities. These entities may be given a specific asset or sum of money, or they could share in a percentage or fraction of the assets. Trusts and estates may claim a charitable deduction on the fiduciary income tax return for any income distributed to a charitable beneficiary during the tax year. To claim a charitable deduction, the distribution must be provided for under the governing document, and the distribution must come from the trust or estate's fiduciary accounting income (discussed later in this chapter). Donations of the decedent's personal property will never qualify for the charitable deduction because these donations are of principal, not income.

For these reasons, it is less common for a trust or estate to qualify to claim a charitable income tax deduction. Most often, charitable bequests are presented in terms of a defined dollar amount. Such bequests fall under the specific bequest rules, and income cannot be passed to these charitable beneficiaries. If a charity is named as a percentage beneficiary of the residuary, then the trust or estate will qualify to deduct that percentage of the trust or estate's income.

EXAMPLE

A trust earns $800 of interest and has no expenses. The trust has four equal beneficiaries—one charity and three grandchildren. The trust may deduct one-fourth of the interest income as a charitable deduction because the charity is a one-fourth beneficiary. The remaining interest income must be allocated proportionately among the grandchildren.

Estate planners can benefit their clients by including language in the estate planning documents that requires charitable bequests to be paid from income to the extent possible. For example, the document governing the distribution of the $800 in the preceding example could have included a provision that stated, "To the extent possible, any charitable share created hereunder shall be satisfied first from income and then from principal." If the charity is entitled to a distribution of at least $800 of the residuary trust, then the trust would qualify for a full charitable deduction of the $800 and no income would be allocated to the grandchildren. Practitioners should make note of any term governing a charitable distribution and take special care to ensure these distributions are made in the most tax advantaged manner possible.

Separate Share Rule

When an estate or single trust has more than one beneficiary and the estate or trust has substantially separate and independent shares for different beneficiaries (i.e., each beneficiary receives 50% of the residuary), the shares must be treated as separate trusts when determining the amount of distributable net income in the application of Code Sections 661 and 662. Executors and trustees must be mindful when timing distributions and income to ensure income is not trapped at the entity level as a result of the separate share rule.

EXAMPLE

An estate has three equal beneficiaries. The estate earns $3,000 of interest on a $90,000 savings account. The estate distributes $30,000 each to two of the beneficiaries in year 1. However, the third beneficiary does not receive a distribution until year 2. The separate share rule prohibits the estate from allocating the interest income entirely to the two beneficiaries who received distributions in year 1. Instead, the estate may allocate $2,000 of interest between the beneficiaries who received distributions in year 1. The additional $1,000 of interest must be retained at the estate level, and the estate must pay tax on this interest. The interest cannot be passed to the beneficiary who did not receive a distribution until year 2.

If instead the interest income is not earned until year 2, then the beneficiaries who received distributions during year 1 would not be allocated any interest income because their shares were fully satisfied before year 2. The third beneficiary who receives the distribution in year 2 will be allocated all the interest income.

Since the application of the separate share rule largely depends on the timing of income and distributions, fiduciaries can manipulate the ultimate tax impacts on beneficiaries. Careful planning is necessary to ensure the estate or trust does not unintentionally trap income at the entity level where tax rates are significantly higher or subject an unknowing beneficiary to more than its fair share of taxable income.

BASICS OF FIDUCIARY ACCOUNTING

Instead of simply making outright distributions of assets to beneficiaries, trusts often require assets to be managed over a period of time or for the lifetime of named beneficiaries such as a surviving spouse or children and grandchildren. The terms of the trust can be customized to meet the grantor's goals and the needs of the beneficiaries. A common provision in a trust document links the permissible distributions on the trust's fiduciary accounting income. Fiduciary accounting income is the opposite of fiduciary accounting principal. These concepts will be referred to in this section simply as Income and Principal.

Receipts that a trustee receives during the period of administration can be classified as either Income or Principal. Income is a concept that is unrelated taxable income. The trust agreement can classify certain receipts as either Income or Principal to achieve certain results. If the trust instrument is silent on the definition of Income and Principal or the terms are not wholly defined, the fiduciary accounting rules applicable to the trust's place of administration will control. Many states have

adopted a version of the Uniform Fiduciary Income and Principal Act, which defines which types of receipts are categorized as Income and which are Principal.

The most common types of receipts a trust will collect are interest, dividends, rents, royalties, capital gains, annuity distributions, refunds, reimbursements, and liquidating distributions. These are categorized as Income or Principal depending on the terms of the trust agreement or the fiduciary accounting income rules for the trust's place of administration. Under the Uniform Principal and Income Act (UPIA), which has been adopted in some form in most states, the following is the categorization of the below receipts:

Income	**Principal**
Interest^	Capital Gains^
Dividends^	Refunds^
Rents^	Reimbursements^
Mineral Payments*	Liquidating Distributions^
Annuity Distributions*	Insurance Proceeds^

Receipts that fall into only one category or the other are referred to as "not normally apportioned" because 100% of the receipt is either Income or Principal. Receipts that are not normally apportioned are marked with a ^. Receipts that are frequently divided into both categories are referred to as "normally apportioned," meaning that the receipt is usually split between Income and Principal. Receipts that are normally apportioned are marked with a *.

Mineral payments and annuity distributions, such as required minimum distributions from retirement accounts, are normally apportioned, or split, between Income and Principal. For example, receipts of mineral royalties under the UPIA are allocable 90% to Principal and the balance to Income. Clients normally consider royalty payments as Income because it is taxable income. If a client's intent is for the annual royalty payments from a particular source to be distributed to a beneficiary, the client will need to customize his document or consult state law to ensure his intent is honored.

Annuity and retirement accounts are also typically apportioned. The distribution rules depend on whether the trust is considered a "marital trust" or not. Calculating the portion allocable to Income versus Principal for an annuity or retirement account will require the fiduciary to first calculate the Income inside the fund itself and compare it to the required annual distribution. Sometimes calculating the fund's Income is not feasible given information readily available to the fiduciary, so a flat rate based on state law will apply. Again, if a client assumes a certain amount will be distributed to his beneficiary, care must be exercised during the drafting process to ensure his goals are met since fiduciary accounting rules are complex and do not mirror income tax rules.

When the terms of a trust require that all Income be distributed to a particular beneficiary, the trustee must analyze the fiduciary accounting rules and apply those rules to the receipts deposited into the trust during the applicable accounting period. The Income beneficiary will not be entitled to all receipts. Instead, the Income beneficiary is only entitled to those receipts that fall into the Income category.

For example, the surviving spouse beneficiary of a qualified terminable interest property (QTIP) trust must receipt all Income for the trust to qualify for the unlimited marital deduction for estate tax purposes. If the trust receives $100,000 in life insurance proceeds, $10,000 in rents, $5,000 in capital gains, and $100 interest, the surviving spouse is entitled to $10,100 from the rents and the interest. The life insurance and capital gains are categorized as Principal. If the terms of the trust do not permit distributions of principal to the surviving spouse, then those receipts must be added to the corpus of the trust for ongoing administration.

Expenses incurred during the period of administration are allocated against Income or Principal depending on the terms of the document or state law. Expenses often include fiduciary fees, professional fees, and advisory fees. Different types of receipts, such as rental income, may also have direct expenses like real estate taxes, insurance, or utilities. When an expense is directly related to a specific type of receipt, the default rule requires the expense to directly offset the receipt it relates to. However, when other expenses are incurred more generally, the terms of the trust or state law will control whether the expense is allocated to Income or Principal or partly to both.

Under the Uniform Fiduciary Income and Principal Act, expenses are categorized as shown in the following chart:

Income	Principal
One-Half Legal, Accounting and Trustee Fees	One-Half Legal, Accounting and Trustee Fees
Ordinary Repairs and Recurring Taxes	Fiduciary Compensation for Acceptance or Termination
Insurance Protecting Against Loss of Income	Costs to Sell Assets
Costs Related to Litigating Income Issues	Environmental Issues
Taxes Related to “Income”	Taxes Related to “Principal”

Expenses allocated wholly against Income or wholly against Principal reduce those categories by those sums. Expenses allocated equally between each category are divided accordingly.

EXAMPLE

A trust requires one-half of all Income to be distributed to the surviving spouse. During the year, the trust receives interest of $8,000 and capital gains of $10,000. The trustee fee is $2,000 and commissions on the sale of the capital gain assets total $200. Under the Uniform Principal and Income and Act, the interest is categorized as Income and the capital gains are categorized as Principal. One-half of the trustee fee is allocated against both Income and Principal. The commissions are solely allocated against the capital gains. The net Income is $8,000 – $1,000 = $7,000. The net Principal is $10,000 – $1,000 – $200 = 8,800. If the surviving spouse is entitled to one-half of Income, then they will receive $4,400. The remaining Income and all Principal will be added to the corpus for ongoing administration for future generations.

Tracking Income and Principal is important when two sets of beneficiaries have disparate rights to the same assets. When one beneficiary has the right to Income during their lifetime and another beneficiary has the right to the Principal at a later date, caution must be exercised to ensure the

Income beneficiary does not receive more than their share of the trust receipts and that any receipt allocable to Principal is saved for the remainder beneficiary. This most often occurs in marital or credit shelter trust situations but can appear in other scenarios as well.

Net taxable Income can pass to the Income beneficiary to claim on their own income tax return. Additionally, taxable Principal receipts can pass to Principal beneficiaries. Caution must be exercised when allocating the deductible expenses against the taxable income and principal since one type of beneficiary might unintentionally receive preferential tax treatment if deductible expenses are not allocated proportionately among beneficiaries of different types of receipts.

SUMMARIZING ESTATES, TRUSTS, AND FIDUCIARY ACCOUNTING

When a client passes away, the family or adviser's first task is to determine whether a document will control the disposition of the client's assets or whether state law will control. The individual nominated in the controlling document or the individual with priority under state law must then begin the task of gathering the decedent's assets, paying debts and administrative expenses, and making distributions to the intended beneficiaries. Depending on the type of distribution, tax benefits can be achieved through proper document drafting or the timing of distributions. Ongoing administration will require additional analysis of receipts and expenses pursuant to the terms of the governing document or state law to ensure beneficiaries with varying interests receive the proper asset allocation. Since these rules can differ from state to state and trust to trust, practitioners must be flexible and watchful.

REVIEW QUESTIONS

1. If a married man with one child dies without a will, who will inherit his estate?

a. Spouse

b. Child

c. Parent

d. Sibling

2. Which of the following will control the distribution of proceeds from a life insurance policy?

a. Beneficiary designation

b. Last Will and Testament

c. Revocable trust

d. State statute

3. Which of the following will not pass automatically to the intended recipient upon the owner's death?

a. Title to house titled as joint tenants with the intended recipient

b. Bank account naming the intended recipient as the pay-on-death beneficiary

c. Car designating the intended recipient in the owner's Last Will and Testament

d. Life insurance policy naming the intended recipient as the beneficiary

4. If a beneficiary is entitled to all income from a trust and the trust earns $1,000 interest, collects $3,000 life insurance, and pays $400 CPA fees, how much does the income beneficiary receive?

a. $800

b. $1,000

c. $3,600

d. $4,000

5. Which of the following is not a distribution method when a beneficiary predeceases the deceased client?

a. Per stirpes

b. Per capita

c. By representation

d. Intestate

6. Which of the following is true concerning the payment of a decedent's creditors?

a. Creditors must be paid in order of priority.

b. Certain assets are exempt from creditors.

c. The executor is not personally liable for the payment of creditors.

d. All of the above.

7. Which of the following is classified as Income for purposes of fiduciary accounting?

a. Life insurance proceeds

b. Interest

c. Capital gains

d. Utility refund

8. Which of the following is classified as Principal for purposes of fiduciary accounting?

a. Dividends

b. Rents

c. Capital gains

d. Interest

9. Which of the following charitable distributions achieves the best tax consequences?

a. 10% residuary paid solely from fiduciary accounting income

b. 25% residuary

c. $10,000 cash

d. $500,000 land

10. Which of the following expenses is wholly allocated to fiduciary accounting Principal?

a. Annual legal fees

b. Taxes on interest income

c. Expenses relating to selling a house

d. Annual accounting fees

ANSWERS TO REVIEW QUESTIONS

1. a. Correct. So long as the man's child is also the child of the spouse, then the surviving spouse will inherit everything under the uniform laws of intestacy.

b. Incorrect. So long as the surviving spouse is also the parent of the child, then the child will not receive anything from his deceased parent. If the surviving spouse is not the child's parent, then there may be a division of the assets between child and parent depending on the state laws of intestacy.

c. Incorrect. If a decedent has a surviving child, the decedent's parents will not stand to inherit under the laws of intestacy.

d. Incorrect. If a decedent has a surviving child or spouse, the decedent's siblings will not stand to inherit under the laws of intestacy.

2. a. Correct. A beneficiary designation will always control the disposition of a life insurance policy. Even if a Will or trust directs that the proceeds be paid to another individual, the named beneficiary on the policy will override any other provision.

b. Incorrect. The terms of the Last Will and Testament will only control the disposition of life insurance proceeds if no beneficiary is listed on the policy and the proceeds are paid to the decedent's estate. A beneficiary designation will always control the disposition of a life insurance policy.

c. Incorrect. The terms of the revocable trust will only control the disposition of life insurance proceeds if no beneficiary is listed on the policy and the proceeds are paid directly to the trust through the estate. A beneficiary designation will always control the disposition of a life insurance policy.

d. Incorrect. State statute will only control the disposition of life insurance proceeds if no beneficiary is listed on the policy and the decedent had no Will. A beneficiary designation will always control the disposition of a life insurance policy.

3. a. Incorrect. An asset that is titled as joint tenants passed entirely to the surviving owner after the first owner's death. The terms of a state statute, a Last Will and Testament, and a revocable trust will have no control over this disposition.

b. Incorrect. A pay-on-death beneficiary designation will always control the disposition of a bank account. The terms of a state statute, a Last Will and Testament, and a revocable trust will have no control over this disposition, though the monies may be subject to creditor claims if the assets of the estate are insufficient to satisfy all the outstanding debts.

c. Correct. Assets listed in a Will or trust do not pass automatically to the intended beneficiaries. Assets passing under the terms of a Will require the personal representative or executor to first obtain permission from the probate court to transfer. Assets passing under the terms of a trust require the authorization and action of the trustee to complete the transfer.

d. Incorrect. A beneficiary named directly on a policy of life insurance simply must complete the claim forms to claim the policy. The terms of a state statute, a Last Will and Testament, and a revocable trust will have no control over this disposition and, depending on state law, the proceeds of life insurance may be exempt from the claims of creditors.

4. a. Correct. The fiduciary accounting income of the trust includes all interest but does not include life insurance proceeds, which would be allocable to principal. General expenses, such as CPA fees, are allocated equally between Income and Principal. Therefore, the $1,000 interest Income less one-half of the CPA fees equals $800 distribution to the Income beneficiary.

b. Incorrect. The fiduciary accounting income of the trust includes all interest but does not include life insurance proceeds, which would be allocable to Principal. General expenses, such as CPA fees, are allocated equally between Income and Principal. Therefore, the $1,000 interest Income must be reduced by one-half of the CPA fees.

c. Incorrect. The fiduciary accounting income of the trust includes only the interest but does not include life insurance proceeds, which would be allocable to Principal. Therefore, the $1,000 interest Income is the only Income generated by the trust that would also bear one-half of the CPA fees.

d. Incorrect. The fiduciary accounting income of the trust includes all interest but does not include life insurance proceeds, which would be allocable to Principal. Expenses such as CPA fees must be allocated against Income and Principal according to the trust terms or state law and cannot be ignored altogether.

5. a. Incorrect. If a client predeceases his intended beneficiary, the distribution method provided under the governing instrument or state law will control how assets are distributed. If assets are distributable "per stirpes," the beneficiary's share will pass to his or her descendants proportionately without regard to whether other intended beneficiaries have also predeceased.

b. Incorrect. If a client predeceases his intended beneficiary, the distribution method provided under the governing instrument or state law will control how assets are distributed. If assets are distributable "per capita," the beneficiary's share will pass to his or her descendants. The proportion distributable will depend on whether other intended beneficiaries have also predeceased.

c. Incorrect. If a client predeceases his intended beneficiary, the distribution method provided under the governing instrument or state law will control how assets are distributed. Assets distributable "per capita" are sometimes also referred to as "by representation." The results of such distribution method will depend on whether other intended beneficiaries have also predeceased.

d. Correct. A client who dies intestate simply means the client died without a Will. State law will control the disposition of the client's assets, which could be under the per stirpes, per capita, or by representation distribution models.

6. a. Incorrect. While creditors must be paid in order of priority, additional parameters govern the administration of an estate or trust and the payment of creditors, including the requirement that creditors be given notice of probate proceedings, the exemption of certain assets from the payment of debts, and the fact that the executor and trustee are never personally liable to pay the decedent's debts unless they improperly administer the assets.

b. Incorrect. While creditors are barred from reaching exempt assets, additional parameters govern the administration of an estate or trust and the payment of creditors, including the requirement that creditors be given notice of probate proceedings, be paid in order of priority, and the fact that the executor and trustee are never personally liable to pay the decedent's debts unless they improperly administer the assets.

c. Incorrect. The executor and trustee are never personally liable to pay the decedent's debts unless they improperly administer the assets; however, creditors must also be paid in order of priority, must be given notice of probate proceedings, and must relinquish claims to assets that are exempt from claims.

d. Correct. Even though the executor and trustee are not personally liable for the payment of the decedent's debts, the decedent's non-exempt assets must first be used to pay the creditors in order of priority.

7. a. Incorrect. Insurance proceeds are classified as Principal and are not normally apportioned between Income and Principal.

b. Correct. For purposes of fiduciary accounting, interest, dividends, and rents are classified as Income.

c. Incorrect. Capital gains and liquidating distributions are classified as Principal.

d. Incorrect. Refunds and reimbursements are classified as Principal.

8. a. Incorrect. Dividends are classified as Income and are not normally apportioned between Income and Principal.

b. Incorrect. Rents are classified as Income and are not normally apportioned between Income and Principal.

c. Correct. Capital gains, refunds, reimbursements, liquidating distributions, and insurance proceeds are classified as Principal.

d. Incorrect. For purposes of fiduciary accounting, interest is classified as Income and is not normally apportioned between Income and Principal.

9. a. Correct. Distributions to charities will only qualify for an income tax deduction if they are paid out of the residuary or if the document requires the distribution to be paid from income. This bequest is both from the residuary and is required to be paid from fiduciary accounting income, maximizing the ability to deduct the amount paid on the entity's fiduciary income tax return.

b. Incorrect. A distribution from the residuary to a charity will allow for a partial charitable deduction equal to the percentage distributed to charity multiplied by the amount of net taxable income earned by the entity. While this achieves better tax consequences than a specific bequest, it does not achieve the best tax consequences.

c. Incorrect. A distribution of a specific sum of money will qualify as a specific bequest for fiduciary income tax purposes which allows for no income distribution deduction. This method will achieve no favorable tax consequences for the entity.

d. Incorrect. A distribution of a specific sum asset will qualify as a specific bequest for fiduciary income tax purposes which allows for no income distribution deduction. This method will achieve no favorable tax consequences for the entity.

10. a. Incorrect. Annual legal fees related to the general administration of the assets are allocated one-half to Income and one-half to Principal unless the governing document provides otherwise.

b. Incorrect. Taxes related to fiduciary accounting Income are allocable wholly against such Income and not against Principal.

c. Correct. Expenses related to selling an asset belonging to the estate or trust are wholly allocable against Principal because the proceeds from the sale of such assets are also allocable wholly to Principal.

d. Incorrect. Annual accounting fees related to the general administration of the assets are allocated one-half to Income and one-half to Principal unless the governing document provides otherwise.

Chapter 9

INCOME TAXATION OF ESTATES AND TRUSTS

LEARNING OBJECTIVES

After reviewing this chapter, you should be able to:

- Explain when Form 1041 is used and the associated filing thresholds and tax rates
- Identify characteristics of simple, complex, and grantor trusts
- Name the tax year options available to estates
- Describe the Section 645 election for combining a taxable trust and an estate
- Identify the types of income a trust or estate may earn
- Explain how trusts and estates calculate deductions
- Describe when trusts and estates can claim deductions such as income distribution deductions and charitable deductions
- Define income in respect of a decedent and how it is accrued
- Identify distributions that qualify as specific bequests and how they are funded

WHAT IS FORM 1041?

The taxation of trusts and estates is governed by Internal Revenue Code Sections 641 through 685 and the associated regulations.

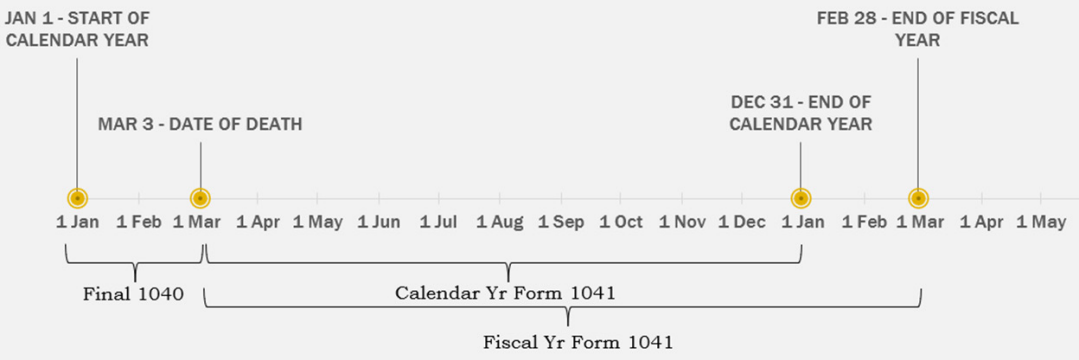
Form 1041 is an income tax return filed on behalf of an estate or trust that earns income during the period of administration. An estate is an entity that comes into existence as a result of the death of an individual taxpayer. Upon the death of a taxpayer, income earned after the date of death is no longer income that can be reported on the individual's Form 1040. However, income generated by the individual's assets does not simply cease on the date of death. While W-2 income will cease because the taxpayer can no longer work, interest-bearing accounts or dividend-paying stocks continue to earn income in the months, and sometimes years, following the individual's death. Form 1041 is used to report this post-death income.

Box A at the top of Form 1041 indicates that the form can be used to report income generated by multiple types of entities, including the decedent's estate, simple trust, complex trust, qualified disability trust, electing small business trust (ESBT), grantor type trust, chapter 7 and 11 bankruptcy estate, and pooled income fund. This chapter is focused on the use of Form 1041 for the decedent's estate, simple and complex trusts, and grantor-type trusts.

WHEN TO USE FORM 1041

Timeline

Form 1041 is filed by an estate after the taxpayer passes away. For example, if the taxpayer passes away on March 3, income generated from January 1 to March 3 will be reported on the taxpayer's final Form 1040. The estate of the taxpayer will report any income generated from March 3 through the end of the estate's tax year, which may be filed on a fiscal or a calendar year.



Form 1041 is filed by a trust when assets titled in the name of the trust generate income. Simple and complex trusts are irrevocable trusts that have assets which earned income during the tax year. Trusts may be irrevocable immediately upon creation, or they may become irrevocable upon the taxpayer's death. For example, a taxpayer may create an irrevocable trust for the benefit of a grandchild and transfer 100 shares of common stock to the trust. The taxpayer has no interest in the trust, and distributions may only be made to the grandchild. Upon the creation of this trust and the transfer of the common stock to the trust, the trust becomes a tax-paying entity that must file Form 1041 annually to report dividends paid on the stock, sales of the stock, and distributions to the grandchild.

Contrast this example with a revocable trust created by a taxpayer to effectuate the taxpayer's ultimate estate planning goals. During the taxpayer's life, the taxpayer may alter the terms of the trust and revoke the trust at any time. If assets are titled in the name of the revocable trust, such assets will report income using the taxpayer's Social Security number and all income earned during the taxpayer's life will be reported on the taxpayer's Form 1040. When the taxpayer passes away, the terms of the trust traditionally provide that the trust will then become irrevocable. At this time, the successor trustee of the trust will apply for an employer identification number (EIN) for the trust and all future income is reportable under this number using Form 1041.

In the months immediately following a taxpayer's death, income generated by assets titled in the name of the taxpayer or the trust may continue to be reported under the taxpayer's Social Security number until the executor or trustee closes or retitles the accounts. Income reported on Forms 1099 or other tax reporting documents must be allocated between the months prior to date of death and after death—timing of the income and not the tax identification number controls whether to report this income on Form 1040 or Form 1041. Practitioners will need to manually review tax reporting documents and calculate pre- and post-death income to properly allocate the income sources between the applicable taxpaying entities.

Filing Thresholds

Form 1041 is required to be filed for every estate earning gross income for the taxable year of $600 or more. Trusts are required to file Form 1041 if the trust earns any taxable income or if it has gross income of $600 or more. Additionally, any trust or estate that has a nonresident alien as a beneficiary must file Form 1041 regardless of the amount of gross or taxable income. These thresholds are very low, which means that nearly every estate or trust will be required to file an annual Form 1041. Even when a trust or estate is not required to file, it can be a good practice to still submit a "zero" return since the IRS often sends inquiries to the trustee in later years to determine why the fiduciary did not file a return for a particular year. Simply filing zero returns for years in which no income was earned can avoid these unnecessary communications from the IRS later on.

Tax Rates

Estates and trusts are subject to very compressed tax rates. For example, for tax year 2021, an estate or trust will reach the highest tax bracket (37%) when it has taxable income of $13,050. Single taxpayers will not reach this rate until well over $500,000 of taxable income. For this reason, it is highly undesirable to trap income at the trust or estate level. Instead, taxpayers should utilize the income distribution deduction (discussed later in this chapter) to push taxable income out from the estate or trust to the beneficiaries to ensure tax is not paid at these high rates.

TYPES OF TRUSTS

Simple Trust

A simple trust is defined as a trust that is required by the terms of the trust to distribute all fiduciary trust accounting income annually and does not distribute any trust principal during the tax year or make any distributions to charity. A trust agreement may permit distributions of principal or distributions to charity, but the trust will still be defined as a simple trust if no such distributions are

made during the tax year. This means that a trust may file Form 1041 as a simple trust in one year and as a complex trust in the next, depending on the transactions that took place during the year.

Complex Trust

A complex trust is defined as a trust that is not a simple trust. This means that either the trust agreement does not require the distribution of all fiduciary trust accounting income annually or the trust actually makes distributions of principal or distributions to charity during the tax year.

Grantor Trust

A grantor trust is a type of trust in which the grantor (the creator of the trust) retains one or more powers over the trust or its assets, which causes the trust's income to be taxable to the grantor instead of to the trust itself. The most common type of grantor trust is the revocable trust (sometimes called living trust), which is typically used by taxpayers as a substitute for a last will and testament. However, several types of irrevocable trusts, including grantor retained annuity trusts, qualified personal residence trusts, and intentionally defective grantor trusts, may also qualify as grantor trusts. Intentionally defective grantor trusts are created when the grantor retains one or more powers over the trust or the terms of its future administration. These powers might include the power to substitute trust assets, add charitable beneficiaries, borrow trust assets without full consideration, or swap out trustees.

Grantor trusts come in two varieties. The first variety is a grantor trust in which all assets report earned income under the grantor's Social Security number. This is most common with a revocable trust. In this situation, the trust is not required to file Form 1041. The grantor simply includes the income directly on the grantor's Form 1040. Here, the tax identification number and not the titling of the account controls.

The second variety is a grantor trust that has obtained its own employer identification number (EIN). This is most common with an irrevocable trust. When income is reported under the trust's EIN, then the trust must file Form 1041. However, a statement will be attached to Form 1041 listing all the sources of income for the year, the character of the income, and the amount. This statement is then given to the grantor to use when preparing the grantor's Form 1040. It should be noted that the grantor statement is simply an attachment to the Form 1041 and is not a Schedule K-1 (which is the document provided to trust beneficiaries receiving a share of the trust's distributable net income, discussed later in this chapter). The front page of the return will contain a declaration stating "See Grantor Statement" in place of any items of income or deductions actually being reported on the return.

TAX YEAR OPTIONS AND DUE DATES

Trusts are required to file based on a calendar year unless an election is made under Code Section 645 (discussed later in this chapter). Estates have the option of filing on either a calendar year or a fiscal year. For the year of death, an estate choosing the calendar year files an initial short-year return followed by annual full-year returns. For example, the estate of a taxpayer dying on August 14 would file its initial calendar year return starting on August 14 and ending on December 31. The second tax year would then begin on January 1. If the same estate chooses to file based on a fiscal year, the first tax year would start on August 14 and end on July 31 of the following year. The second tax year would then begin on August 1. If the estate administration is completed before the end of

the tax year, the tax year can end on the last day of the month administration is complete. A tax year will never end in the middle of a month and must always end on the last day of the month.

There are several benefits of choosing a fiscal year for an estate. First, the estate can often file just a single return since many estate administrations can be completed within a 12-month period. Second, there are often many deductible estate expenses paid at the beginning of the administration, followed by income-triggering events such as asset liquidation at the end of the administration. By filing the return on a fiscal year, the estate can combine the expenses and income on a single return, allowing the income and expenses to offset one another.

Consider the following examples for a taxpayer who dies on October 23. As you can see, the estate incurs significant expenses during Year 1 with modest income that results in the estate having net losses at the end of the first short calendar year. Losses from administrative expenses do not carry over. Only capital losses carry over to the subsequent tax year. In Year 2, the estate generates significant capital gain income and pays few expenses, resulting in taxable income on which the estate or its beneficiaries must pay tax.

If the estate elects to file on a fiscal year, the expenses paid at the beginning of the estate administration are claimed on the same return as the income generated near the end of the fiscal year, enabling the two to offset one another. This results in a significant reduction in the overall net income of the estate and saves income tax for the estate or its beneficiaries.

Estate Selects Calendar Year				**Estate Selects Fiscal Year**	
Year 1		Year 2		Years 1 and 2 Combined	
Oct 19 Attorney Fees Nov 1 Property Taxes Dec 30 Dividends	($9,000) ($3,000) $6,000	Mar 3 Capital Gains Apr 15 CPA Fees Jun 1 Interest	$15,000 ($2,000) $500	Oct 19 Attorney Fees Nov 1 Property Taxes Dec 30 Dividends Mar 3 Capital Gains Apr 15 CPA Fees Jun 1 Interest	($9,000) ($3,000) $6,000 $15,000 ($2,000) $500
Net Income	($6,000)	Net Income	$13,500	Net Income	$7,500

Returns filed on a calendar year are due on April 15 following the end of the calendar year. Returns filed on a fiscal year are due three-and-a-half months after the end of the fiscal tax year. For example, if a decedent died on September 7 and the estate selects a fiscal tax year, Form 1041 will be due on December 15 of the following year. Both estates and trusts are eligible for an automatic five-and-a-half-month extension. An extension is requested by filing Form 7004.

COMBINING THE TAXABLE TRUST AND ESTATE

A trust may file on a fiscal year only when an election is made under Code Section 645. This election is available when an estate and a qualified revocable trust are administered together. A qualified revocable trust is a trust which the decedent had the power to revoke up until the decedent's date of death. This election is frequently made for a decedent who has a pour-over will that transfers all the decedent's assets to a trust that contains all the dispositive provisions of the estate plan.

The primary benefit of the Section 645 election is that it allows the executor and trustee to combine all income and expenses of both the estate and the trust onto a single fiduciary income tax return. This reduces the number of tax returns required to be filed, but also allows for excess expenses

paid by one entity to be used to offset the income earned by the other entity. The following table illustrates the tax savings that can be achieved by making this election:

Trust and Estate File Separately				**Trust and Estate File Together**	
Trust		Estate		Years 1 and 2 Combined	
Mar 2 Attorney Fees	($9,000)	Jan 5 Capital Gains	$15,000	Jan 5 Capital Gains	$15,000
July 7 Court Fees	($1,000)	Apr 15 CPA Fees	($2,000)	Mar 2 Attorney Fees	($9,000)
Nov 1 Property Taxes	($3,000)	Aug 1 Interest	$500	Apr 15 CPA Fees	($2,000)
Dec 30 Dividends	$6,000	Dec 21 Royalties	$3,000	July 7 Court Fees	($1,000)
				Aug 1 Interest	$500
				Nov 1 Property Taxes	($3,000)
				Dec 21 Royalties	$3,000
				Dec 30 Dividends	$6,000
Net Income	($7,000)	Net Income	$16,500	Net Income	$9,500

To make the Section 645 election, Box G on Form 1041 should be checked and the trust's EIN entered. Note that either the trust or the estate may be the electing entity. So although Form 1041 requests the "Trust TIN" be entered next to Box G, this can be the estate's TIN if the trust is the primary electing entity. In addition, Form 8855 should be completed and attached to the return.

If the trust's Form 1041 is due and the trustee is still uncertain whether the Section 645 election will be made, then the trustee should take care to timely file a Form 1041 for the trust. If the trust later elects to make the Section 645 election, the trust can then amend its initial return and move all income and deductions over to the combined reporting return.

The Section 645 election is not recommended if the trust entity will continue long-term unless the tax savings that can be achieved are significant. The reason for this is the combined filing by the estate and trust must be terminated within two years from the date of death. If the estate filed a Form 706 estate tax return, then the Section 645 election may stay in place until six months after a final determination is issued by the IRS for the estate's Form 706.

At the end of the two-year term, if both the trust and estate are terminating, the trust must file a blank Form 1041 to notify the IRS of its termination. All income and expenses should be reported on the combined trust and estate return. If the trust is continuing, then the trust should file a short-year return reporting income earned and expenses incurred after the combined Form 1041 filing. If the estate is also continuing after the election terminates, the estate must continue filing on the same schedule as before.

TYPES OF INCOME

A trust or estate may earn any of the same types of income that an individual may earn. Just because a taxpayer passes away does not mean the taxpayer's savings account stops earning interest or tenants stop paying rent. This means that an estate must report all income earned by the deceased taxpayer's assets on the estate's Form 1041. Similarly, once an income-producing asset is contributed to a trust, the trust must report all income earned by the contributed assets on the trust's Form 1041.

Tax-Exempt Income

Tax-exempt interest or dividends earned by a trust or estate are reported on Line 1 of the Other Information section of Form 1041, which is somewhat hidden on page 3 of the return. Although tax-exempt sources of income retain their tax-exempt status at the trust and estate level, the existence of tax-exempt income requires administrative expense deductions to be reduced proportionately in comparison to the trust or estate's total income. For example, if a trust earns $100 of tax-exempt interest and $300 of taxable dividends, the deduction of $100 of attorney fees is reduced by 25% to $75. This is because 25% of the attorney fees are allocated to the tax-exempt income.

If certain administration expenses are specifically not related to the earning of tax-exempt income, the trust or estate may claim these deductions in full. An override of the tax preparation software will likely be necessary to achieve this calculation. The fiduciary should be prepared to provide ample justification for not proportionately reducing these expenses in relation to the tax-exempt income.

Capital Gains and Code Section 1014

The sale of capital assets by an estate or a trust is reported on Form 1041, Schedule D. Note that Schedule D is the only income schedule that uses a different version compared to the schedule attached to a Form 1040. Capital gains are still separated into short-term and long-term gains, which are netted against each other. Up to $3,000 of capital losses may be used to offset ordinary income annually. Excess capital losses can be carried forward from year to year. When an estate or trust files its final year Form 1041, any unused capital losses are allocated to the beneficiaries on Schedule K-1. Losses cannot pass to beneficiaries in any tax year prior to the final tax year.

Code Section 1014 eliminates any appreciation or depreciation of the decedent's assets. Therefore, large capital gains or losses are uncommon to report on Form 1041, Schedule D unless a trust has been in existence for many years. Practitioners should take care to verify that any cost basis reporting on an estate's or trust's Form 1099-B has been properly adjusted to the fair market value as of the date of death. If a 1099-B is issued under the decedent's Social Security number, transactions taking place after the taxpayer's date of death must be reported on Form 1041. The cost basis reported by the financial institution will often still reflect the taxpayer's original cost basis. The tax preparer must manually adjust these figures on the Form 1041, Schedule D, to ensure the fair market value as of the decedent's date of death is reflected.

Any asset that receives a basis adjustment under Code Section 1014 will also be deemed to have been held for at least one year by the transferor under Code Section 1223(9). This means that any sales of the decedent's assets after the date of death will be considered long-term transactions regardless of how long the decedent owned the assets prior to the date of death or how long the estate or trust held the asset after the date of death.

Income from Partnerships and S Corporations

Estates and trusts frequently receive Schedule K-1 documents reporting their share of pass-through income from partnerships and S corporations. Even though taxable income may be reported from a partnership or S corporation to a trust or estate, the trust or estate may not actually receive a

distribution of funds from the pass-through entity. In these situations, a trust or estate will have phantom income. As discussed later in this chapter, taxable income can be passed to a beneficiary to claim on the beneficiary's own tax return if the beneficiary receives an actual distribution of cash or assets from the trust or estate. However, if a trust or estate is allocated taxable income on the pass-through entity's Schedule K-1 but does not receive a corresponding cash distribution, the trust or estate may not be able to distribute funds to the beneficiary. If no distribution is made to a beneficiary, then no income distribution deduction may be claimed. In this situation, the trust or estate must have sufficient cash or liquid assets on hand to pay the tax on the income since it cannot be flowed through to a beneficiary.

TYPES OF DEDUCTIONS

Interest

Interest paid toward mortgages on the decedent's personal residence after death is deductible on Line 10 by the estate or inheriting trust entity. Mortgage interest paid on a trust asset used as the personal residence of a beneficiary may also be deducted on Form 1041. After the passage of the Tax Cuts and Jobs Act (TCJA) in 2017, interest may only be deducted for the first $750,000 of debt (or $1 million if the indebtedness occurred before December 16, 2017). If the decedent had a home equity line of credit, the interest associated with this debt may be deducted so long as the total debt does not exceed the $750,000 threshold. To be deductible, the line of credit debt must have been used to improve or repair the residence instead of paying down credit cards or traveling.

Taxes

Property taxes and state income taxes paid during the tax year are deductible on Line 11 of Form 1041. After the passage of the TCJA, the deduction of state and local taxes is limited to a maximum of $10,000 per year. Taxes specifically related to rental properties should still be reported on Schedule E and are not limited by the annual $10,000 threshold.

Administrative Expenses

Administrative expenses are deductible on Lines 12, 14, and 15 of Form 1041. Form 1041 divides these deductions into categories, including fiduciary fees (personal representative, executor, and trustee fees); attorney, accountant, and return preparer fees; and other deductions; however, all are governed under Code Section 67.

Prior to the TCJA, the Other Deductions category was divided between miscellaneous deductions and miscellaneous deductions subject to 2% of adjusted gross income. After the passage of the TCJA, trusts and estates are no longer permitted to deduct miscellaneous expenses subject to 2% of adjusted gross income.

Notice 2018-61 was issued shortly after the passage of the TCJA to clarify that not all miscellaneous deductions are temporarily disallowed for trusts and estates. Those expenses that previously qualified for the not-subject-to-2% of adjusted gross income reduction are still permitted to be deducted in full. They include any deduction that is unique to a trust or estate and would not

normally be incurred by an individual taxpayer. The following summary lists the most common estate and trust expenses and the category typically assigned to each:

Miscellaneous Not Subject to 2%	Miscellaneous Subject to 2% (Disallowed for Tax Years 2018–2025)
Death certificates Court filing fees Certified copies of will Mailing trust property to beneficiary Investment advisory fees (if higher than individual fees) Disposal of personal property	Investment advisory fees (unless a higher fee is charged on account of the trust or estate status) Insurance Checks Safe deposit box fees Homeowners' associations fees and utilities

Fiduciary fees, including personal representative, executor, and trustee fees, are fully deductible to the extent not already claimed on Form 706. The same fees cannot be claimed on both returns, but the fees can be divided between the two returns. The same principle applies to attorney fees and CPA fees. Tax preparation costs for the decedent's final Form 1040, Form 709 gift tax return, and any necessary generation-skipping tax returns are fully deductible. However, CPA fees charged for the preparation of late filed returns fall under the category of miscellaneous deductions subject to 2% and are temporarily disallowed.

Allocation of Expenses Against Income

Most tax preparation software allocates deductions proportionately against the various types of income reported on Form 1041. For example, if a trust reports $25 of interest income, $75 of long-term capital gain, and $40 of trustee fees, the interest would be reduced to $15 and the capital gain to $45. However, under Treasury Reg. Sec. 1.652(b)-3, the fiduciary is permitted to allocate deductible expenses against any type of income (with the exception of the mandatory tax-exempt income allocation). Therefore, since long-term capital gain is taxed at a preferential rate, it is usually recommended to first offset income taxed at ordinary income tax rates before allocating expenses against long-term capital gain. The trustee in this example should first offset all the interest income and then use the remaining $15 of trustee fees to offset the capital gain, leaving only $60 of capital gain subject to taxation.

The fiduciary must always allocate a proportionate share of the deductible expenses against any tax-exempt income. A trustee may not allocate all deductions against taxable income, leaving the tax-exempt income fully intact. Consider the same example as above, except the interest is now tax-exempt interest. The trustee would be required to allocate 25% of the deductions against the tax-exempt interest, leaving the remainder to be allocated at the trustee's discretion.

INCOME DISTRIBUTION DEDUCTION

The income distribution deduction is unique to estates and trusts. Fiduciary income tax can essentially be simplified into the following formula:

Total Income

– Deductions

= Adjusted Total Income

– Income Distribution Deduction (Schedule K-1)

– Personal Exemption

= Taxable Income

Unlike other types of tax returns that report total income, minus deductions and exemptions, to arrive at taxable income, fiduciary income tax returns may claim an additional deduction referred to as the income distribution deduction. When a trust or estate makes a distribution of income to a beneficiary, the trust or estate may claim a deduction under Code Section 661. The beneficiary is then required to include that income on the beneficiary's income tax return under Code Section 662. Since trusts and estates pay tax at significantly higher rates than individuals, overall income tax savings can be achieved by allocating taxable income to beneficiaries to claim on their personal income tax returns.

The income distribution deduction is limited to a trust's distributable net income (DNI). DNI is the maximum amount received by a beneficiary that is taxable; any amount above this figure is tax-free. DNI is calculated on Schedule B of Form 1041. The calculation takes into consideration the estate or trust's taxable income (prior to any income distribution deduction) with certain modifications related to tax-exempt income and capital gains.

A trust can never take an income distribution deduction that is more than DNI. Additionally, a beneficiary can never be taxed on an amount that is greater than DNI. This means that a beneficiary can never be taxed on more than the beneficiary receives. More often, a beneficiary will receive an amount as a distribution that is far greater than the entity's income. For example, an estate may distribute $100,000 to a beneficiary; however, during the year, the estate only earns $700 of interest and incurs no expenses. The estate can claim an income distribution deduction of $700, and the beneficiary will include the $700 in its income. The remaining $99,300 is tax-free to the beneficiary.

Schedule K-1

When a trust or estate claims an income distribution deduction, a Schedule K-1 is created. The Schedule K-1 reports the beneficiary's share of all income allocated to the beneficiary for the tax year. The Schedule K-1 must be submitted with the tax return, and a copy must be sent to the beneficiary. If the trust or estate files based on a fiscal tax year, the beneficiary includes the income reported on the Schedule K-1 in the tax year in which the trust or estate's tax year ends. For example, if an estate files Form 1041 based on a fiscal tax year that starts in July 2021 and ends in June 2022, a beneficiary receiving a Schedule K-1 from this estate will report the income on the beneficiary's 2022 income tax return (even though the Schedule K-1 will have a clearly printed 2021 tax year at the top of the form).

Excess losses generated by a trust or estate may pass to the beneficiaries on the final Form 1041 only. These losses can include capital losses, net operating losses (NOLs), and excess administrative expenses. Capital losses carry over for a trust or estate at the entity level until the final year return, when they can pass to the beneficiaries. Excess administrative expenses will not carry over from year to year. Only excess administrative expenses paid during the final tax year can pass out to the beneficiaries.

Since the passage of the TCJA, the IRS issued Treas. Reg. 1.642(h)-2, which provides further guidance regarding beneficiaries claiming excess administrative expenses on their personal Form 1040. This regulation is effective for tax years starting after October 19, 2020, but taxpayers may rely on the regulations for tax years starting after December 31, 2017. The regulation divides excess administrative expenses into two categories for purposes of beneficiaries claiming the deductions on their own Form 1040. The first category is deductions classified as "Section 67(e) expenses," which include deductions listed on Lines 12, 14, and 15a. The second category is deductions classified as "Non-miscellaneous itemized deductions," which include deductions listed on Lines 10 and 11.

A beneficiary receiving a Schedule K-1 reporting excess Section 67(e) expenses reports these expenses as a deduction on Schedule 1, Line 22 as a write-in above-the-line deduction. A beneficiary receiving a Schedule K-1 reporting excess non-miscellaneous itemized deductions reports these deductions in the appropriate categories—state and local taxes or interest—on the beneficiary's Schedule A.

If the trust or estate has income during its final tax year, the fiduciary has the right to choose which category of deductions to use first to offset the reported income. Tax software will default to proportionately allocate each type of deductions against the available income before passing excess deductions out to beneficiaries. A fiduciary should analyze whether to override this allocation since Section 67(e) expenses that can be deducted above-the-line would be far more valuable to a beneficiary than non-miscellaneous itemized deductions.

EXAMPLE

The Estate is filing its final income tax return. The return reports $1,000 of interest income, $1,000 of property taxes, and $1,000 of attorney fees. If the deductions are allocated proportionately against the income, then the beneficiary's Schedule K-1 will report a $500 excess property tax deduction (reportable on Schedule A as an itemized deduction) and a $500 attorney fee deduction (reportable on Schedule 1, Line 22 as an above-the-line deduction). The executor could choose to allocate only the property taxes to offset the interest income. As a result, the beneficiary's Schedule K-1 will report a $0 excess property tax deduction and a $1,000 attorney fee deduction. For a beneficiary who claims the standard deduction and does not itemize, this expense allocation at the estate level results in an additional $500 above-the-line deduction.

Section 663(b) Election

The Code Section 663(b) election permits a trust or estate to count distributions made during the first 65 days of the following tax year as having been made in the prior tax year. This election is helpful when a trust or estate earns income at the end of the tax year (often year-end dividends)

and does not have time to make distributions of the income before the end of the tax year. This election is also helpful for fiduciaries who want to analyze potential tax savings that can be achieved by allocating taxable income to beneficiaries compared to paying tax at the trust or estate level. Practitioners should be mindful of this deadline to ensure taxable income is not trapped unnecessarily at the trust or estate level, where it will be subject to the trust or estate's high income tax rates.

SPECIFIC BEQUESTS

Distributions that qualify as specific bequests prohibit the trust or estate from claiming an income distribution deduction and passing income from the entity to the specific bequest beneficiary. Under Code Section 663, a specific bequest must (1) be provided for in the governing document, (2) identify a sum of money (or property), and (3) be paid in three installments or less. If a distribution qualifies as a specific bequest, then the distribution will not be eligible for the entity to claim an income distribution deduction upon distribution. The beneficiary will also never receive a Schedule K-1.

The most common examples of specific bequests include "The sum of $10,000 to my son" or "My house shall be distributed to my daughter." However, specific bequest language can be hidden in complex estate planning documents. A good understanding of these rules is necessary to properly allocate the net taxable income to the residuary beneficiaries of the trust or estate in comparison to the specific bequest recipients. Without a solid understanding of these concepts, unintended tax consequences can be triggered when specific bequests are satisfied with substitute property under Code Section 1040.

EXAMPLE

If the son is entitled to the sum of $100,000 under his mother's will and the executor instead distributes to him stock that had a date of death value of $90,000 and a fair market value on the date of distribution of $100,000, the estate must recognize $10,000 of gain on the distribution of the stock to the son in satisfaction of his specific bequest. The son takes the property with a tax basis equal to the fair market value at distribution, and his holding period starts as of the day of distribution. This deemed sale only applies when substitute property is distributed in satisfaction of a specific bequest.

Section 643(e)(3) Election

Often, residuary or percentage beneficiaries receive property as part of their share of an estate or trust. Such distributions do not trigger the mandatory deemed sale under Code Section 1040 discussed earlier. However, a fiduciary may elect to treat the property as though it was sold to the beneficiary by making an election under Code Section 643(e)(3). This election permits the fiduciary to recognize gain or loss on the distribution of property to a beneficiary as if the property distributed had been sold to the beneficiary at its fair market value on the date of the distribution. If such an election is made, the income tax basis of the property received by the beneficiary is the adjusted

basis of such property in the hands of the estate or trust prior to distribution adjusted by the gain or loss recognized by the estate or trust on the distribution.

When a trust or estate makes this election, it applies to all property distributed during the tax year. The fiduciary may not pick and choose which asset will be deemed to have been sold and which will take a transferred basis and holding period. Additionally, losses generated on a deemed sale to a beneficiary may only be claimed by an estate and not a trust due to the related-party rules. Once made, the election is irrevocable. This election is typically recommended when losses at the entity level may go unused or when the fiduciary is attempting to create equality among beneficiaries receiving assets with significantly different tax attributes. Careful analysis is necessary before making this election.

SUMMARY

Trusts and estates calculate income and deductions in much the same way as individuals do. However, the timing of the receipt of income, payment of deductions, and distributions to beneficiaries can create dramatically different tax results. It is important to consider all aspects of the estate or trust administration and to plan ahead to ensure the best tax results can be achieved for the taxpayer. Estate planners would also do well to consider the post-death income tax consequences when drafting documents to reduce overall tax liability and avoid unintended tax burdens.

REVIEW QUESTIONS

1. Under which of the following circumstances will a tax preparer advise a client to file a Form 1041?

a. A deceased taxpayer has assets that continue to generate taxable income after the taxpayer's date of death.

b. A deceased taxpayer has assets that exceed the lifetime gift and estate tax exemption amount.

c. A trust has one sole asset of the family home in which the taxpayer's spouse continues to reside after the taxpayer dies.

d. A deceased taxpayer's estate collects a $50,000 life insurance policy as its sole asset. No interest is reported on the policy.

2. Filing on a fiscal year provides all of the following benefits except:

a. Fewer overall tax returns

b. Maximized use of expenses to offset income to reduce tax liability

c. Delayed taxation to beneficiaries

d. Simplified tax preparation process

3. Which of the following types of income requires a mandatory allocation of expenses?

a. Interest

b. Tax-exempt interest

c. Dividends

d. Rents

4. Which of the following can you deduct on a Form 1041 filed for tax year 2021?

a. Court filing fees

b. Investment advisory fees

c. Insurance for non-rental real estate

d. Income taxes totaling $15,000

5. Which of the following trusts may claim an income distribution deduction?

a. Trust with $1,000 of income and $2,000 of deductions

b. Trust with $20,000 of net income and $10,000 of distributions of income to beneficiaries during the taxable year

c. Trust with net income of $5,000 and no distributions to beneficiaries during the year

d. Trust with net income of $5,000 and distributions from principal to the beneficiaries of $10,000

6. If Taxpayer bought real estate for $40,000 worth $100,000 on his date of death that is sold by his estate for $105,000, what should be reported on Schedule D?

a. Nothing

b. Short-term capital gain of $5,000

c. Long-term capital gain of $5,000

d. Long-term capital gain of $65,000

7. Which of the following qualifies as a specific bequest?

a. "One half of all my net assets to my son"

b. "The residuary of my entire estate to my daughter"

c. "My coin collection to my grandchild"

d. "$10,000 to my son for the next five years"

8. Which of the following would be reported on a beneficiary's Schedule K-1?

a. Proceeds from a life insurance policy naming the beneficiary as the direct payee

b. Remainder interest on jointly held real estate

c. Interest of $500 paid to the estate and then distributed to the beneficiary

d. Distribution of a house to the beneficiary as a specific bequest

9. If a trust has $10,000 of interest income, $15,000 of capital gain, and $5,000 of deductions, how should the trustee allocate the deductions to minimize tax liability?

a. Equally to interest and capital gains

b. Entirely against interest income

c. Entirely against capital gains

d. Proportionately between interest and capital gains

10. A trustee should consider making an election under Code Section 643(e)(3) under which of the following scenarios?

a. The trust distributes a house to a beneficiary with a date of death value of $400,000 and a date of distribution value of $450,000.

b. The trust distributes a house to a beneficiary with a date of death value of $450,000 and a date of distribution value of $400,000.

c. The trust distributes a house to a beneficiary with a date of death value of $450,000 and a date of distribution value of $450,000.

d. The trust distributes $450,000 cash to a beneficiary.

ANSWERS TO REVIEW QUESTIONS

1. a. Correct. Income generated after a taxpayer passes away must be reported on either an estate or trust income tax return filed by the entity controlling the assets after the death.

b. Incorrect. Taxpayers with assets that exceed the lifetime gift and estate tax exemption amount must file Form 706 to report the total assets. The estate of such a taxpayer may also file Form 1041; however, the necessity to do so would be based on income earned, not the size of the estate.

c. Incorrect. If the assets of the trust do not generate any income, no Form 1041 needs to be filed.

d. Incorrect. Life insurance is tax-exempt and, as such, does not need to be reported on Form 1041.

2. a. Incorrect. Filing on a fiscal year enables the fiduciary to file fewer income tax returns because more transactions can be lumped onto a single return instead of filing multiple short-year returns.

b. Incorrect. Filing on a fiscal year maximizes the use of expenses to offset income by conglomerating all income and expenses onto a single return.

c. Incorrect. Filing on a fiscal year allows beneficiaries to delay the payment of taxation until the following tax year because beneficiaries claim the income in the year in which the fiscal year ends.

d. Correct. Filing on a fiscal year does not simplify the tax preparation process because the tax preparer will need to examine both tax reporting documents and statements to determine in which year the income was actually earned.

3. a. Incorrect. The fiduciary has the discretionary ability to allocate expenses against interest income or any other type of income according to the terms of the trust and the best interest of the entity.

b. Correct. The fiduciary must always allocate a proportionate share of the deductible expenses against any tax-exempt income.

c. Incorrect. The fiduciary has the discretionary ability to allocate expenses against dividend income or any other type of income according to the terms of the trust and the best interest of the entity.

d. Incorrect. The fiduciary has the discretionary ability to allocate expenses against rental income or any other type of income according to the terms of the trust and the best interest of the entity.

4. a. Correct. Court filings fees are categorized miscellaneous deductions, which are not subject to the 2% adjustment. These deductions are not limited by the Tax Cuts and Jobs Act because they are special to an estate or trust and not normally incurred by an individual.

b. Incorrect. Investment advisory fees are categorized as a miscellaneous deduction subject to the 2% adjustment, unless a higher fee is charged on account of the trust or estate status. For tax years 2018–2025, deductions falling in this category are disallowed.

c. Incorrect. Insurance on non-rental real estate is categorized as a miscellaneous deduction subject to the 2% adjustment. For tax years 2018–2025, deductions falling in this category are disallowed.

d. Incorrect. For tax years 2018–2025, income tax deductions are limited to $10,000.

5. a. Incorrect. Since the trust's deductions are greater than the income, there is no net income to pass from the trust to the beneficiaries.

b. Correct. A trust that made distributions to beneficiaries of income during the taxable year may claim an income distribution deduction of up to the amount of income distributed. In this example, the trust would be eligible to take a distribution up to $10,000.

c. Incorrect. A trust may only take an income distribution deduction if it actually makes distributions to the beneficiaries.

d. Incorrect. If a distribution is specifically made from principal and not income, then the distribution is not eligible for an income distribution deduction.

6. a. Incorrect. All sales by an estate of real estate, unless it is used in a trade or business, must be reported on Schedule D of Form 1041 and the gain or loss calculated using the date of death value according to Code Section 1014 and the amount received.

b. Incorrect. Under Code Section 1223(9), the holding period for all assets received as an inheritance is long term regardless of when the decedent purchased the property.

c. Correct. Under Code Section 1014, the cost basis of an asset owned by the decedent as of date of death is its fair market value on date of death. The difference between the date of death value ($100,000) and the sale price ($105,000) is the gain or loss on the disposition. Under Code Section 1223(9), the holding period will be long-term because the asset was received by inheritance.

d. Incorrect. Under Code Section 1014, the cost basis of an asset owned by the decedent as of date of death is its fair market value on date of death. The decedent's original cost basis is wholly replaced by the new date of death cost basis.

7. a. Incorrect. A percentage or fraction of the decedent's net assets does not identify a specific asset to be distributed to the beneficiary.

b. Incorrect. The residuary of an estate does not identify a specific asset to be distributed to the beneficiary.

c. Correct. The bequest meets the three factors to be considered as a specific bequest because (1) it is provided for under the document, (2) it identifies a specific asset, and (3) it is to be paid in three installments or less.

d. Incorrect. This bequest violates the "paid in three installments or less factor" because the sum is to be paid for the next five years.

8. a. Incorrect. When a beneficiary is named as the direct payee on a life insurance policy, the proceeds do not flow through the estate or trust and are paid directly to the beneficiary. No Schedule K-1 would be issued to the beneficiary on account of the life insurance proceeds.

b. Incorrect. When a beneficiary jointly holds real estate with the decedent and receives the remainder interest, such interest does not flow through the estate or trust and passes directly to the beneficiary. No Schedule K-1 would be issued to the beneficiary on account of a beneficiary receiving a remainder real estate interest.

c. Correct. Taxable income paid to an estate can be passed through to the beneficiary on the Schedule K-1 so long as the beneficiary actually receives a distribution from the estate.

d. Incorrect. A trust or estate may never claim an income distribution deduction for payment of a specific bequest. As such, the recipient of a specific bequest will never pay tax on account of receiving the specific bequest.

9. a. Incorrect. Since capital gains are taxed at a preferential rate, tax savings can be achieved by allocating deductions against types of income subject to ordinary income rates instead of capital gain rates. However, if the trust has beneficiaries with different rights to income or principal, the trustee may need to ensure one set of beneficiaries is not favored when allocating deductions.

b. Correct. Since interest is taxed at some of the highest ordinary income tax rates, a trustee can minimize tax liability by allocating all the deductions against the interest income or other types of income subject to ordinary income tax rates before allocating the deductions against capital gains which are taxed at preferential rates. This is permissible under Treas. Reg. Sec. 1.652(b)-3.

c. Incorrect. Since capital gains are taxed at a preferential rate, tax savings can be achieved by allocating deductions against types of income subject to ordinary income rates instead of capital gain rates.

d. Incorrect. Since capital gains are taxed at a preferential rate, tax savings can be achieved by allocating deductions against types of income subject to ordinary income rates instead of capital gain rates. By default, most tax preparation software will allocate the deductions proportionately among all types of income, so preparers should identify these opportunities to alter this default setting.

10. a. Correct. When a trust holds appreciated assets to distribute to beneficiaries, the trustee should consider making the Code Section 643(e)(3) election to reset the tax basis of the asset for the beneficiary.

b. Incorrect. A trust may not claim a loss on the distribution of assets under the related-party rules. Therefore, it would not be advisable to make the Code Section 643(e)(3) election in this scenario because the loss could not be used.

c. Incorrect. When an asset has not appreciated or depreciated during the period of administration, there would be no reason to make the Code Section 643(e)(3) election because the tax basis in the hands of the beneficiary would be the same under either scenario.

d. Incorrect. The Code Section 643(e)(3) election is applicable to distributions of assets that have changed in value during the period of administration. Cash distributions are unaffected by the election.

Chapter 10

FEDERAL GIFT TAX

LEARNING OBJECTIVES

After reviewing this chapter, you should be able to:

- Identify gift tax exemptions
- Understand the mechanics of gift tax and generation-skipping transfer tax
- Recognize what constitutes a gift
- Identify the items excluded from gift tax
- Understand how to calculate gift and generation-skipping transfer tax
- Identify transfers that are subject to gift and generation-skipping transfer tax
- Recognized common gift tax deductions
- Identify when IRS Form 709 is used and when it is due

OVERVIEW OF THE TRANSFER TAX SYSTEM

Gift and estate tax are transfer taxes—meaning that a tax is imposed on the transferor for the privilege of transferring an asset to or for the benefit of another individual. Gift tax is imposed on transfers made by the donor during life. Taxable gifts are reported on Form 709, which is filed on an annual basis to report all gifts made during the prior calendar year. Estate tax is imposed on transfers made upon the donor's death. Except in unique circumstances, gift tax and estate tax are paid by the transferor. The recipient of the gift or inheritance receives the asset tax-free.

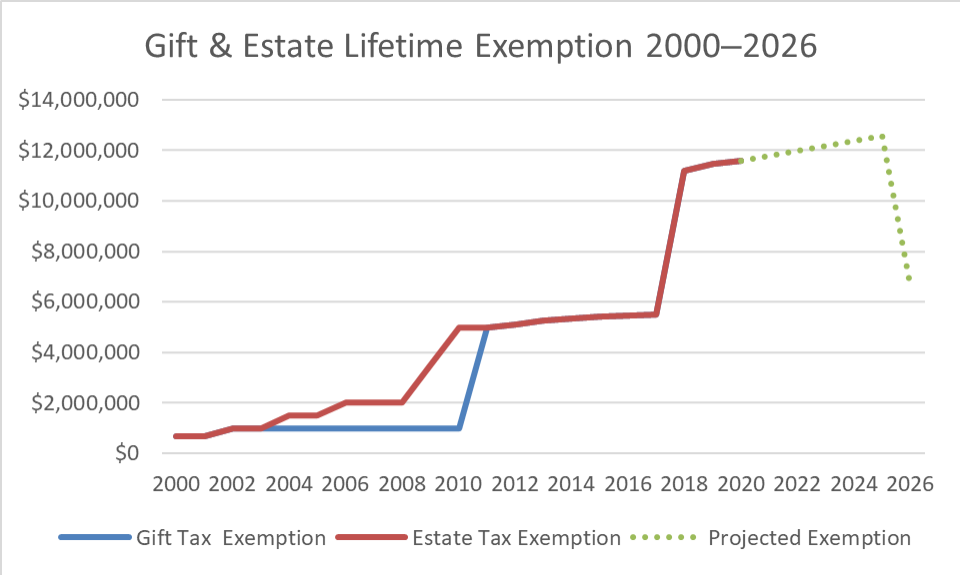
Both gift tax and estate tax are controversial primarily because the taxpayer already paid income tax when the taxpayer earned the assets. A general sense of unfairness related to the seeming "double taxation" surrounds the payments of gift and estate tax. However, proponents claim these taxes prevent massive accumulations of wealth within families and provide a significant source of revenue for government programs. In spite of constant attacks, gift and estate tax has remained a fixture in the U.S. tax system for over 100 years. Readers should be mindful that legislation introduced in 2021 may impact the contents of this chapter.

GIFT TAX EXEMPTIONS

Lifetime Gift Tax Exemption

Gifts and inheritances are currently taxed at a top rate of 40%. This rate has been as high as 77% in years past. Taxing every transfer by taxpayers, however, would be draconian and difficult to administer. Therefore, Code Section 2010 provides each taxpayer with a lifetime exemption, which can be used to shelter gifts during life, transfers at death, or both. Taxpayers filing gift tax returns keep a running tally of how much of their exemption they have used over time. At death, all prior gifts are added to the decedent's gross estate assets to determine if the taxpayer's total transfers both during life and at death exceed the lifetime exemption. If these transfers exceed the exemption, the decedent's estate pays the necessary tax before distributing assets among the heirs.

The lifetime gift and estate tax exemption has changed dramatically in the past 20 years. Prior to 2001, the lifetime exemption increased modestly every few years but remained nominal in comparison to today's exemption. Families with average wealth around $1 million had to plan carefully to minimize the impact of gift and estate tax. When the Economic Growth and Tax Relief Reconciliation Act passed in 2001, the lifetime exemption began increasing exponentially, plateauing at $5 million in 2010 and increasing annually thereafter with inflation. In 2017, the Tax Cuts and Jobs Act temporarily doubled the lifetime gift and estate tax exemption to $10 million, adjusted for inflation, for tax years 2018–2025 (the exemption for tax year 2021 is $11.7 million).



Barring legislative intervention, the lifetime exemption will return to the $5 million threshold in 2026. Treas. Reg. Sec. 20.2010-1 clarifies that gifts made by taxpayers during the temporarily increased lifetime exemption will be grandfathered and not subject to estate tax when the taxpayer dies even if the lifetime gifts exceed the available lifetime exemption on the taxpayer's date of death. Taxpayers seeking to minimize exposure to estate tax after the exemption decreases should contemplate making gifts up to the current lifetime exemption in order to lock-in the increased exemption since the increased exemption is essentially a "use it or lose it" benefit.

EXAMPLE

Taxpayer gifts $11M in 2021 when the basic exclusion amount is $11.7M. Taxpayer dies in 2027 when the basic exclusion amount is $6M. Taxpayer's basic exclusion amount for purposes of calculating estate tax will be $11M. If instead taxpayer gifts $4M in 2021, taxpayer's basic exclusion amount for purposes of calculating estate tax in 2027 will only be $6M. Therefore, maximizing gifting during this temporary increase is advisable for taxpayers with sufficient assets.

A surviving spouse can elect to claim the unused portion of the deceased spouse's lifetime exemption for their own use. This election is frequently referred to as portability. When a surviving spouse who has elected portability makes taxable gifts, Treas. Reg. Sec. 20.2010-1 provides that the deceased spouse's unused exclusion will be deemed to offset the taxable portion of the gift first, followed by the use of the taxpayer's own lifetime exclusion. Only the unused exclusion of the taxpayer's most recently deceased spouse may be used to offset lifetime gifts or transfers at death. Strategic planning is necessary for taxpayers making gifts after the death of a spouse, and proper reporting must be made on Form 709, Schedule C.

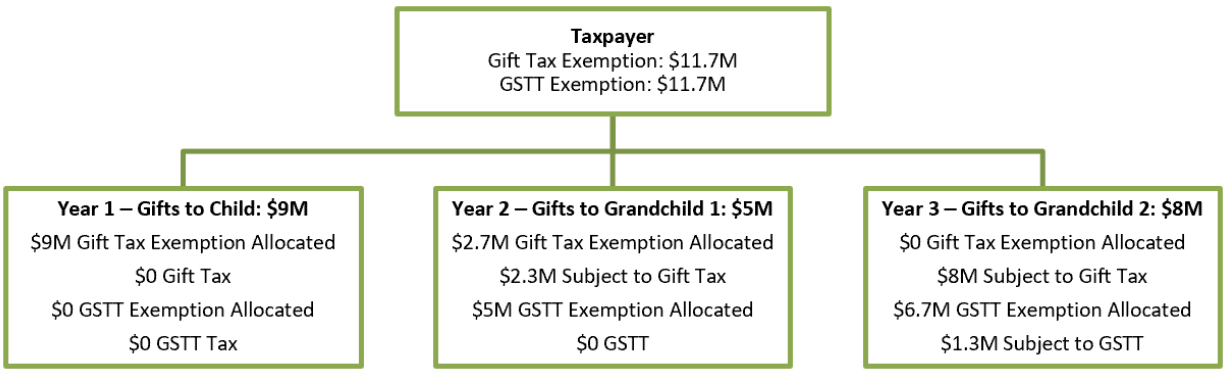
Annual Gift Tax Exemption

Tracking every transfer made by a taxpayer during the tax year would be a daunting task for both the taxpayer and the IRS. Taxpayers certainly would not want their CPA attending holiday gatherings or birthday celebrations to catalog every gift between family members and friends. To relieve this burden, Code Section 2503 provides each taxpayer with an annual exemption in addition to the lifetime exemption. The annual exemption amount applies on a per recipient basis and is intended to cover de minimis transfers between taxpayers during the year. The annual exemption amount is linked to inflation and increases in $1,000 increments every few years. Taxpayers may transfer up to the annual exemption amount to anyone during the tax year. For example, in tax year 2021, the annual exemption is $15,000. If a taxpayer has three children, A, B, and C, the taxpayer may transfer $15,000 to each child for a total of $45,000. If the taxpayer does not exceed the annual exemption for any one recipient, then the taxpayer is not required to file Form 709. Additionally, these transfers do not count against the taxpayer's lifetime gift tax exemption. If the taxpayer instead transfers $20,000 to child A, and $10,000 to child B and C, the taxpayer must file Form 709 to report all three transfers. The transfer to child A will be partially offset by the taxpayer's annual exemption, leaving a $5,000 excess that will count against the taxpayer's lifetime exemption. The transfers to child B and C will be fully offset by the annual exemption.

Generation-Skipping Transfer Tax Exemption

In addition to gift and estate tax, generation-skipping transfer tax (GSTT) is levied on transfers to individuals who are deemed skip persons. GSTT is equal to the highest gift and estate tax rate (currently 40%). A skip person is anyone who is two or more generations below the transferor, such as a grandchild or great-niece, or an unrelated party more than 37½ years younger than the transferor. The predeceased ancestor rule moves individuals up a generation when their parent predeceases. For example, if a taxpayer's child passes away, the child's children are no longer skip persons for purposes of analyzing the transfer tax implications of gifts from the taxpayer to the grandchildren.

A lifetime exemption for GSTT equal to the lifetime gift and estate tax exemption is available for taxpayers making generation-skipping transfers. This allows a taxpayer to make transfers totaling the lifetime exemption to a grandchild tax-free. If the taxpayer uses part of his exemption to shelter transfers to non-skip persons, later transfers to skip persons may be subject to gift tax but protected from GSTT. The following graphic illustrates a scenario when transfers may be wholly or partially exempt from gift tax and GSTT.



In addition to the lifetime GSTT exemption, taxpayers also have an annual GSTT exemption equal to the amount of the annual gift tax exemption. This allows taxpayers to give gifts annually to skip persons up to the annual exemption amount free from both gift tax and GSTT.

CALCULATING GIFT AND ESTATE TAX

Even though the lifetime gift and estate tax exemption is presented in terms of the value of the assets that can be transferred tax-free, in reality, gift and estate tax is calculated by applying a lifetime credit against the tax calculated on the total transfers. The unified credit amount provided for under Code Section 2010 is equal to the tax due on the taxpayer's basic exclusion amount. This means that changes in the applicable tax rates over time can impact the actual amount of the assets that can pass tax-free under the lifetime exclusion.

Since gift and estate tax is based on a taxpayer's lifetime of transfers, gift tax returns must report all previous gifts made by the taxpayer on each return. Maintaining accurate gift tax records for a taxpayer for his entire life is crucial because upon the taxpayer's death, every gift reported on the taxpayer's gift tax returns must be included on the taxpayer's estate tax return. The total of the lifetime transfers and transfers occurring at death are then compared to the taxpayer's lifetime exemption to determine if tax is due. If these total transfers are less than the taxpayer's basic exclusion amount, no tax is paid. For those few unfortunate taxpayers, when the gross estate plus all lifetime transfers exceeds the basic exclusion amount, the estate must remit the tax due before dividing the estate among the taxpayer's heirs.

WHAT IS A GIFT?

For purposes of gift tax, the IRS defines a gift as any transfer to an individual, either directly or indirectly, where full consideration is not received in return (Reg. Sec. 25.2511-1). The applicability of the gift tax rules focuses solely on whether a transfer for less than fair market value occurred. Contrast this analysis with the rules set forth in Duberstein v. Commissioner, 363 U.S. 278 (1960), which relate to whether a gift should be included as part of the recipient's taxable gross income. Under the Duberstein test, a detached and disinterested generosity on the part of the transferor is necessary to exclude the gift from the recipient's gross income. For gift tax purposes, however, the IRS focuses solely on the analysis of whether a transfer for less than fair market value occurred. For purposes of transfer tax, the IRS is unconcerned with the transferor's motivation in making the gift.

Transfers Subject to Gift Tax

Any outright transfer of cash or property to an individual will qualify as a gift for gift tax purposes. For example, giving a neighbor $500 to fix his car, paying the daycare bill for a grandchild, or giving concert tickets to a friend all qualify as gifts if nothing is received by the transferor in return. These outright transfers are easily identifiable and occur more often than most taxpayers realize.

Gifts are valued at their fair market value as of the date of transfer. Taxpayers are encouraged to obtain appraisals of any gifts of property to substantiate the fair market value of the gift for gift tax reporting purposes. Gifts of publicly traded stocks are valued by averaging the high and low trading values of the stock on the date of the gift. Gifts of interests in a closely held business may be

eligible for discounting, which can minimize the impact of the gift on the transferor's lifetime gift tax exclusion. However, the taxpayer and tax preparer must carefully examine the adequate disclosure rules set forth in Treas. Reg. Sec. 301.6501(c)-1 to ensure such gifts are adequately reported so the statute of limitations for examination is not tolled indefinitely.

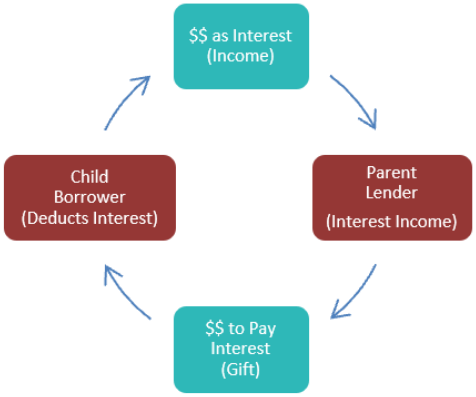
Real estate transactions. There are a number of less obvious transfers that can surprise unknowing taxpayers. The most common is a transfer in which the transferor receives only partial compensation. Any transfer for less than fair market value will still qualify as a gift.

EXAMPLE

Mom and Dad are downsizing and decide to sell their home to their son for his growing family. Unfortunately, the son cannot afford to pay fair market value for the home, so Mom and Dad sell it to him at a discount. The difference between the price at which Mom and Dad could have sold the property to a third party and the price paid by son is a gift subject to tax.

Consider other real estate transactions often entered into between family members. A common transaction by elderly parents hoping to avoid probate is adding a child to the title of real estate as a joint tenant. Even though the child never moves in and may not know that their name has been added to the title, the titling change is considered a gift since the parent does not receive fair market value consideration from child in exchange for being added to the title of the property.

Below-market rate loans. No- or low-interest loans and the forgiveness of debt are other frequently ignored gifts. If a friend tells his neighbor to just forget about repaying a loan made last year, the forgiveness is a gift subject to gift tax. Similarly, under Code Section 7872, lenders must charge a statutory amount of interest linked to the applicable federal rate and cannot make "interest-free" or below-market rate loans. If such loans are made, the IRS imputes interest income to the lender and considers the foregone interest as an additional gift to the borrower. The following illustration demonstrates the relationship between the lender and borrower when interest is imputed on a low- or no-interest loan.



There are two exceptions to the imputed interest rules. First, the IRS does not impute interest when aggregate loans are under $10,000 and the loan is not used by the borrower to purchase income-producing assets. The second exception is when the aggregate loans are under $100,000 and the borrower's net investment income is less than $1,000. If the borrower's net investment income is greater than $1,000, then the imputed interest is the lesser of the actual imputed interest or the borrower's net investment income. These limits apply to each borrower and lender relationship, meaning that one lender could make multiple loans up to $10,000 or $100,000 to different borrowers and fall within the stated exceptions.

Crummey transfers. Taxpayers frequently want to make gifts using the annual gift tax exemption; however, taxpayers do not want the recipient to control the gifted asset. Instead, the taxpayer wants the gifted asset to be held inside a protective trust and managed by a responsible trustee. Under Code Section 2503(b), taxpayers may only use the annual exemption to offset gifts of present interests. For example, gifting $10,000 cash to the taxpayer's child would be the gift of a present interest because the child receives and can immediately enjoy the cash. Transfers to trusts where the enjoyment is delayed until a need arises or an event occurs is a gift of a future interest to which the annual gift exemption cannot be applied.

In the flagship case of Crummey v. Commissioner, 397 F.2d 82 (9th Cir. 1968), the taxpayer made transfers to a trust and applied his annual gift tax exemption against the transfers. Upon making transfers to the trust, the beneficiaries had a temporary right to withdraw the contributed funds from the trust. After the right to withdraw lapsed, the funds were added to the corpus of the trust to be administered according to the terms of the trust agreement. The court ruled in favor of the taxpayer and permitted the use of the annual exemption against the transfers to the trust.

As a result of this case, so called Crummey trusts are a frequent estate planning tool, especially for the creation and funding of irrevocable life insurance trusts (ILITs). To qualify, the following four factors must be met:

1. After receiving assets from the transferor, the trustee must give the beneficiary(ies) reasonable notice regarding their withdrawal right.

2. The beneficiary must have adequate time following notice in which to exercise the withdrawal right (usually at least 30 days).

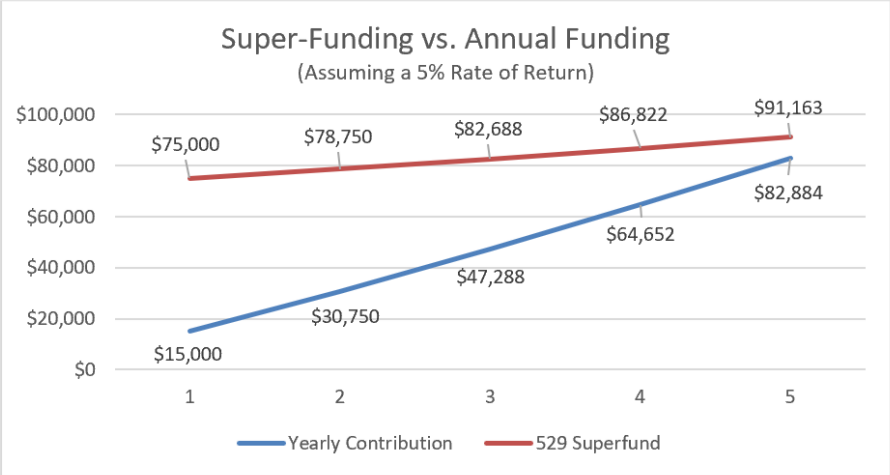
3. Upon exercising the withdrawal right, the beneficiary must have the immediate and unrestricted right to receive the funds or assets subject to the withdrawal right.

4. There must be no understanding or agreement, expressed or implied, that a beneficiary will not exercise the withdrawal right.

If these factors are met, the transferor may apply the annual gift tax exemption against the value of the funds or assets transferred to the trust. Key to the success of the Crummey trust is that the transferor may multiply the annual exemption by the number of trust beneficiaries holding a right to withdraw funds from the trust. For example, if the trust names the transferor's three children and five grandchildren as beneficiaries with a current right to withdraw contributed funds from the trust, the transferor may offset his transfer by the annual gift tax exemption multiplied by eight, thus allowing the transferor to remove significant sums from his taxable estate without using any of his lifetime exemption.

Caution must be exercised when grandchildren or skip persons are beneficiaries of a Crummey trust. For purposes of GSTT, Code Section 2562(c)(3) permits transferors to shelter annual generation-skipping transfers equal to the annual gift tax exemption permitted under Code Section 2503 (i.e., $15,000 may be sheltered annually for both gift tax and GSTT). Unfortunately, the annual generation-skipping transfer exemption may only be applied when a transfer is made to a trust that qualifies as a GSTT trust. As explained in Treasury Reg. Sec. 26.2612-1, a GSTT trust has only one beneficiary and must be included in the gross estate of that beneficiary for estate tax purposes—meaning that beneficiary has a general power of appointment over the assets. GSTT trusts are uncommon since they are administratively intensive compared to a Crummey trust having multiple beneficiaries. For this reason, the taxpayer must allocate part of his lifetime GSTT exemption to cover transfers to Crummey trusts even though the transfer may be exempt for gift tax purposes. It is common to find taxpayers with their lifetime exemption fully intact but their GSTT exemption partially used. When preparing gift tax returns reporting gifts to grandchildren or to trusts that benefit grandchildren or other skip persons, caution must be exercised to ensure the taxpayer's GSTT exemption is properly allocated to ensure complete protection from tax in the future.

Super-funding a 529 plan. Under Code Section 529(c)(2)(B), a taxpayer may elect to ratably allocate contributions to a Section 529 savings plan over five years for purposes of applying the annual gift tax exemption. This rule, which is frequently referred to as "super-funding a 529 plan," uses the time value of money by allowing a taxpayer to make a large contribution to the 529 plan in year 1 but report the contribution for gift tax purposes as though one-fifth of the contribution was made in each of the five years. For example, a transfer of $50,000 in year 1 to the 529 plan would be treated as though $10,000 was contributed in years 1 through 5. Since $10,000 is less than the annual gift tax exemption, the taxpayer pays no gift tax and does not have to use any of his lifetime gift tax exemption. A gift tax return must be filed for the first year reporting the gift. If no other taxable gifts are made in years 2 through 5, then no gift tax return must be filed in those years. However, if taxable gifts are made that require filing a Form 709, the taxpayer must report the value of the 529 super-fund amount allocated to that year. The following illustration demonstrates the benefit of super-funding a 529 plan with $75,000 in year 1 compared to making an annual contribution of $15,000 in years 1 through 5:



If a taxpayer dies during the five-year period after super-funding a 529 plan, the amount of the transfer allocated to the 529 plan for the years after the date of death must be included as part of the taxpayer's gross estate for purposes of analyzing estate tax liability. For example, in the previous illustration, if the taxpayer died in the middle of year 2, then the transfers allocated to years 3 through 5 (a total of $45,000) would be includable as part of the decedent's gross estate. The growth on those funds is not includable. This technique can be useful for taxpayers of all ages and is popular for parents and grandparents.

Gift splitting. Married taxpayers may agree to split gifts for purposes of calculating gift tax under Code Section 2513. A gift will be considered as having been made one-half by each spouse if the spouses are married to one another at the time of the gift and consent to split the gift. Additionally, both spouses must be alive at the time of the gift. Gifts made after the death of one spouse cannot be split after the other spouse passes away or if the surviving spouse (or former spouse in the case of divorce) remarries before the end of the tax year.

EXAMPLE

Spouse 1 gifts $25,000 to grandson on his 25th birthday in February. Spouse 2 agrees to split the gift. In May, Spouse 2 passes away. Keeping with family tradition, Spouse 1 gifts $28,000 to granddaughter on her 28th birthday in October. The executor of the estate of Spouse 2 can sign Form 709 for Spouse 1 authorizing the split of the gift to grandson in February, but the gift to granddaughter in October is fully reportable by Spouse 1 and will require the allocation of a portion of any remaining lifetime exemption because the gift exceeded the annual exemption for Spouse 1 and is not eligible to be split with Spouse 2.

If spouses elect to split gifts, the spouses must affirmatively consent to the split by signing on Line 18 of the electing spouse's Form 709. Except for gifts made between spouses, all gifts for the entire tax year must be split—a spouse cannot elect to split one gift but not another made in the same tax year. If spouses elect gift-splitting in one year, they are not required to split gifts in subsequent years. Gift tax returns filed by married taxpayers should be mailed to the IRS in the same envelope.

If a gift totals less than two times the annual gift tax exemption (i.e., $15,000 × 2 = $30,000), then only the transferor spouse must file Form 709. The non-transferring spouse need only sign the transferor spouse's Form 709 indicating acceptance of the split.

EXAMPLE

If Spouse 1 gifts $20,000 to his son, Spouse 2 may sign Spouse 1's Form 709 agreeing to the split. Spouse 2 is not required to file Form 709. If instead Spouse 1 gifts $40,000 to his son, $20,000 will be deemed gifted by both spouses. Since $20,000 exceeds the annual gift tax exemption, Spouse 2 must also file Form 709 and allocate $5,000 of their lifetime gift tax exemption against the gift since Spouse 2's one-half share of the gift exceeds the annual exemption.

The primary benefit of gift splitting is that it allows a couple to utilize both of their annual gift tax exemptions to shelter the same gift and avoids unnecessary transfers from spouse 1 to spouse 2 using the unlimited marital deduction (discussed below) prior to making the gift. Electing gift splitting is not necessary when the gifted asset is community property or titled in joint tenancy since the asset is already deemed to belong one-half to each spouse. However, gift tax returns would be required for both spouses if the value of the community property or jointly owned asset exceeds two times the annual gift tax exemption.

Transfers Not Subject to Gift Tax

Under Code Section 2503(e), qualified transfers are excluded from the definition of a gift and are not considered a transfer for purposes of gift tax. There are two types of qualified transfers. The first is tuition payments made directly to an educational institution. The educational institution is not limited solely to postsecondary education and includes any educational organization that normally maintains a regular faculty and curriculum.

The second type of qualified transfer is a payment to any person who provides medical care for another individual. These two exceptions to the definition of a gift allow family members to pay for tuition or medical expenses without deducting these payments from the donor's annual or lifetime gifting exemptions. Key to both the medical and tuition exceptions is that the payment must come directly from the donor to the educational institution or the medical care provider. The monies should not first pass through the student or patient and then be remitted to the school or doctor—doing so will negate the exception. Before making payment directly to a provider or school, the donor should analyze whether payments should instead be made to the student, the patient, or a parent if income tax deductions or credits associated with the medical expenses or tuition payments would benefit one party over another. Preparers should familiarize themselves with these income tax rules.

TAX ATTRIBUTES OF GIFTED ASSETS

The tax attributes of assets gifted by a taxpayer during life are governed under Code Sections 1015 and 1223(2). The general rule under Code Section 1015 is that the tax basis of an asset received by gift is same as it would be in the hands of the donor or the last preceding owner by whom it was not acquired by gift. This is frequently referred to as a transferred basis. However, if the transferor's tax basis is greater than the fair market value of the gifted asset at the time of the gift, then for purposes of calculating loss on the sale of an asset by the recipient, the tax basis will be the fair market value of the asset at the time of the gift.

For purposes of calculating the holding period of an asset disposed of by the recipient to determine whether gains or losses should be characterized as long-term or short-term, Code Section 1223(2) includes the time the asset was held by the donor in the recipient's holding period. If the two time periods exceed one year, then the asset would be eligible for long-term treatment.

EXAMPLE

Taxpayer makes a gift of the family cabin worth $100,000 to his child. Taxpayer's original purchase price was $50,000, and he put $10,000 of improvements into the property. Taxpayer has owned the cabin since 1975. Child sells the property a month later for $110,000. Child's tax basis is $60,000, and his holding period will be long-term.

If instead the cabin was worth $45,000 on the date of gift, child's tax basis for calculating gain would be $60,000, but his tax basis for calculating loss would be $45,000. If child sells the cabin for $42,000, he will claim a $3,000 loss. If he sells the cabin for $62,000, he will claim a $2,000 gain. Sales between $45,000 and $60,000 would incur neither a gain nor a loss.

GIFT TAX DEDUCTIONS

Similar to income tax returns, gift tax returns also permit taxpayers to claim a series of deductions. The deductions for purposes of calculating gift tax are set forth in Code Sections 2522 through 2524—namely, the unlimited marital deduction and the unlimited charitable deduction discussed in the following sections.

Unlimited Marital Deduction

Spouses may make unlimited transfers to one another both during life under Code Section 2523 and at death under Code Section 2056. On Form 709, transfers to spouses are reported similar to all other transfers; however, transfers to spouses are then deducted on Part 4, Line 4 from the total gifts. Transfers to spouses will not count against the transferor's lifetime exemption as long as the transfer is made to the taxpayer's spouse and not to a third party or other beneficial entity.

The unlimited marital deduction is not available to taxpayers married to non-U.S. citizens. Instead, taxpayers may transfer an annual exemption amount to a non-U.S. citizen spouse similar to the annual gift tax exemption. The spousal annual exemption is based on $100,000 adjusted for inflation. For tax year 2021, taxpayers may transfer up to $159,000 to a non-U.S. citizen spouse. Any additional transfers require a reduction in the taxpayer's lifetime gift exemption unless such transfers are made to a qualified domestic trust that qualifies under Code Section 2056A.

Many taxpayers choose to make outright transfers to their spouse, allowing the surviving spouse unfettered control over the use and ultimate disposition of the deceased spouse's assets. However, sometimes a taxpayer may want to control the management or use of those assets by the taxpayer's spouse. A qualified terminable interest property (QTIP) trust enables the transferor to gift assets to the receiving spouse using the unlimited marital deduction while still maintaining a level of control over the use and ultimate disposition of those assets. So long as the trust meets the requirements set forth in Code Section 2523, the assets transferred to the QTIP will be eligible for the unlimited marital deduction and no tax will be due on those lifetime gifts.

Restored Exclusion Amount

Prior to the issuance of the decision by the Supreme Court in the case of Obergefell v. Hodges, 576 U.S. 644 (2015), same-sex couples transferring assets to one another were ineligible to claim the unlimited marital deduction. Instead, same-sex couples were required to report gifts to one another in the same manner as gifts to any other third party. The donor of a gift in excess of the annual gift tax exemption had to use his lifetime gift tax exemption to fully shelter the gift. As a result of the Obergefell decision, transferors who previously used a portion of their lifetime exemption to make a gift to their same-sex spouse are eligible to restore the exclusion so long as the couple met the requirements for the unlimited marital deduction at the time of the gift. The restoration of this previously used exclusion is reported on Form 709, Schedule C, Line 3.

Unlimited Charitable Deduction

Taxpayers may also make unlimited transfers to charitable organizations both during life and at death under Code Sections 2522 and 2055. The entities that qualify for the unlimited charitable deduction are similar to those entities that qualify for individual income tax deductions. Taxpayers who make no taxable gifts during the year but make significant charitable contributions are not required to file a Form 709 gift tax return solely to report the charitable giving. If a taxpayer makes taxable gifts to individuals and files Form 709, all charitable transfers should be reported even though the taxpayer is eligible to claim a full deduction for those transfers. If many small charitable contributions are made throughout the year, consider attaching a summary sheet to the tax return instead of listing each contribution independently.

Taxpayers seeking income tax savings and transfer tax savings tax may consider using charitable remainder trusts, charitable lead trusts, donor advised funds, or family foundations to make gifts, particularly of appreciated assets. Doing so allows the charitable recipient to sell the appreciated assets without triggering payment of income tax and also provides the donor with an income tax deduction in the year of the donation. Transfers to charitable trusts or entities must be reported on Form 709 for gift tax purposes in addition to claiming any available income tax deduction on Schedule A of the transferor's Form 1040.

DUE DATES AND PENALTIES

Gifting is analyzed and reportable on the calendar year. Form 709 is due on April 15 in the year after a gift has been made. If the taxpayer made any gifts that exceed the annual gift tax exemption or that qualify as a future interest (such as a Crummey transfer), Form 709 must be filed. If all the taxpayer's gifts during the year were under the annual gift tax exemption, then no return is required. It is common for a taxpayer to only file a handful of gift tax returns during his lifetime or no gift tax returns at all.

If the taxpayer files for an extension to file his Form 1040, Individual Income Tax Return, then Form 709 is automatically extended too. However, if the taxpayer timely filed Form 1040 yet needs an extension to file Form 709, he should file Form 8892 to request an automatic six-month extension.

The penalties for late filing (5% per month up to 25%) and late payment of tax (0.5% per month up to 25%) are set forth in Code Section 6651. The late filing and late payment penalties are based on the

taxable gifts after all exemptions are applied. Since the annual and lifetime gift tax exemptions offset most taxpayers' gifts, late gift tax returns usually result in no actual penalties because a penalty multiplied by zero tax is zero. However, certain gifts may require revaluation to determine their current value instead of the value as of the date of the gift when a late return is filed. Additionally, certain elections, such as a QTIP transfer, must be made timely or they are forfeited. Therefore, timely filing gift tax returns is always recommended.

SUMMARY

The annual and lifetime exemptions drive most taxpayers' decisions relating to lifetime giving and ultimate disposition of assets at death. The exponential increase in the lifetime exemption has freed most taxpayers from having to structure their transfers to avoid taxation. However, even though gifts may ultimately be fully covered by the lifetime exemption, taxpayers must still file gift and estate tax returns to comply with their reporting obligations. Additionally, crucial elections, such as the QTIP election and allocation of the GSTT exemption, are dependent on timely filing these returns. Therefore, even though the lifetime exemption has dramatically changed the practice of gift and estate tax planning in the past 20 years, accurately reporting these transactions is still relevant today. Congressional proposals to reduce the lifetime exemption and modify certain gifting rules have also renewed taxpayers' interest in gifting and planning strategically, so practitioners must be ready to accurately report transactions completed by their clients during the year.

REVIEW QUESTIONS

1. The unlimited marital deduction may not be claimed for which of the following transfers?

a. Transfer of $1 million to a non-U.S. citizen spouse

b. Transfer of $1 million outright to a surviving spouse who is more than 37½ years younger than the taxpayer

c. Transfer of $1 million in trust for a spouse who has an income-only interest

d. Transfer of $1 billion outright to the surviving spouse

2. Which of the following transfers is exempt from gift tax but subject to generation-skipping transfer tax (GSTT)?

a. Transfer of $5,000 to a child

b. Transfer of $5,000 to a grandchild

c. Transfer of $5,000 to a trust for the transferor's two grandchildren who each have a withdrawal right

d. Transfer of $5,000 to a trust for transferor's only grandchild who has a withdrawal right and general power of appointment

3. Which of the following Forms 709 will be subject to payment of penalties and interest?

a. Return filed on July 15 reporting a $10,000 gift

b. Return filed on March 15 reporting a $100,000 gift

c. Return filed on August 15 reporting a $1M gift

d. Return filed on November 15 reporting a $15M gift

4. Which of the following is not subject to gift tax?

a. Gift of $1,000 to a daughter for her wedding

b. Sale of a used car worth $10,000 to a neighbor for $7,000

c. Adding a child as joint owner to a personal bank account holding $25,000

d. Paying the outstanding bill to the surgeon who performed liposuction on the taxpayer's son

5. Which of the following transactions does not have to be reported on a gift tax return?

a. Gift of a house to a homeless woman

b. Sale of a house to a neighbor for 80% of fair market value

c. Sale of a house to a child in exchange for a promissory note payable over 10 years

d. Sale of a house to a co-worker for an interest-free promissory note

6. Under which of the following scenarios would a taxpayer elect gift splitting?

a. Gift of $10,000 to a son

b. Gift of $50,000 from a couple's joint checking account to their son

c. Gift of a boat worth $25,000 to a daughter titled solely in the wife's name

d. Gift of a painting worth $20,000 from a wife to her grandchild shortly after her husband passes away

7. Which of the following is true regarding the gift of a house worth $200,000 with a cost basis of $125,000?

a. The recipient will report gain of $50,000 if the house is sold for $175,000.

b Gifts of appreciated assets are not reportable on Form 709.

c. Gain of $75,000 is triggered on the gift of the house.

d. No loss can be claimed if the recipient sells the house for $100,000.

8. Which of the following can be claimed as a deduction on Form 709?

a. Transfer of cash to the Salvation Army

b. Tax preparation fees

c. Medical expenses paid directly to the hospital

d. Gift of a vehicle to taxpayer's fiancé

9. Which of the following is not required to make a qualifying Crummey transfer?

a. After receiving assets from the transferor, the trustee must give the beneficiaries reasonable notice regarding their withdrawal right.

b. The beneficiary must have adequate time following notice in which to exercise the withdrawal right.

c. Upon exercising the withdrawal right, the beneficiary must have the immediate and unrestricted right to receive the funds or assets subject to the withdrawal right.

d. The beneficiary must agree ahead of time to leave the transferred assets in trust.

10. Which of the following loans violates the adequate interest rules under Code Section 7872?

a. A loan of $150,000 bearing .0001% interest used to buy stock

b. A loan of $150,000 bearing 5% interest used to buy a business

c. A loan of $8,000 bearing 0% interest used to buy a car for school

d. A loan for $60,000 bearing 0% interest used to buy a personal residence

ANSWERS TO REVIEW QUESTIONS

1. a. Correct. A taxpayer may not transfer an unlimited sum to a non-U.S. citizen. Instead, the taxpayer must transfer assets to a qualified domestic trust to ensure that such assets are ultimately subject to both income and estate tax.

b. Incorrect. The age of a surviving spouse does not impact the eligibility of the spouse for the unlimited marital deduction. Additionally, transfers to significantly younger spouses are not subject to GSTT.

c. Incorrect. The QTIP election may be made for a trust so long as the surviving spouse has an income interest in the trust and no one other than the surviving spouse has a power of appointment over the trust.

d. Incorrect. The marital deduction is truly an unlimited deduction. Therefore, the transfer of $1 billion would still be eligible for the deduction. The IRS will wait patiently to impose tax upon the surviving spouse's death.

2. a. Incorrect. A child is not a skip person, and therefore transfers to a child are not subject to GSTT. This transfer is exempt from gift tax because it is under the annual gift tax exemption amount ($15,000 for tax year 2021).

b. Incorrect. This transfer is exempt from gift tax because it is under the annual gift tax exemption amount ($15,000 for tax year 2021). It is also exempt from GSTT because the transfer was made directly to the grandchild, so the taxpayer may apply the annual GSTT exemption, which is equal to the annual gift tax exemption.

c. Correct. When a trust beneficiary has a withdrawal right over the transferred assets, the transfer will qualify under the Crummey rules and the taxpayer may offset the transfer using the annual gift tax exemption. However, since there are two beneficiaries of the trust, it does not qualify as a GST trust and the transferor may not use the annual GSTT exemption. Therefore, the transferor must allocate part of the lifetime GSTT exemption to fully cover the transfer.

d. Incorrect. When a trust beneficiary has a withdrawal right over the transferred assets, the transfer will qualify under the Crummey rules and the taxpayer may offset the transfer using the annual gift tax exemption. Since there is only one trust beneficiary who has a general power of appointment over the trust assets, the trust qualifies as a GST trust and the transferor may also allocate the annual GSTT exemption to cover the transfer for GSTT purposes.

3. a. Incorrect. Gifts less than the annual gift tax exemption do not require the filing of Form 709. If gifts do not exceed the annual gift tax exemption, no tax will be due and no penalties assessed.

b. Incorrect. Gifts that exceed the annual gift tax exemption must be reported on Form 709 due on April 15. Returns that are timely filed and necessary tax paid are not subject to penalties for late filing, late payment, and interest.

c. Incorrect. Gifts that exceed the annual gift tax exemption must be reported on Form 709. However, if the taxpayer's available lifetime exemption is sufficient to fully shelter the gift, no tax will be due and no penalties assessed if the return is filed after the April 15 due date.

d. Correct. Gifts that exceed the lifetime gift tax exemption must be reported on Form 709 and all tax due must be paid by April 15. A gift reported after the deadline will be subject to late filing penalties. All tax due if not paid by the filing deadline will also be subject to late payment penalties and interest.

4. a. Incorrect. Any outright transfer of money, regardless of the reason, for less than full consideration is subject to gift tax. If total gifts for the year are less than the annual exemption, then no gift tax may be paid; however, the gift is technically still subject to gift tax.

b. Incorrect. Any transfer for less than fair market value is subject to gift tax. In this scenario, a gift of $3,000 has been made to the neighbor.

c. Incorrect. Adding a joint owner to the title is the same as giving the asset to the individual outright. Even though most taxpayers do not consider this a gift, by law, changes in titling qualify as gifts and must be reported for gift tax purposes.

d. Correct. Payment of medical bills or tuition bills directly to the provider on behalf of another individual does not qualify as a gift and should not be reported for gift tax purposes. Monies must go directly to the doctor or the school. If monies are given to the patient or student to then remit to the doctor or school, then this exception does not apply and the transfer is subject to gift tax.

5. a. Incorrect. Any gift of cash or real estate for less than full consideration must be reported on Form 709 if the value of the gift exceeds the annual gift tax exemption.

b. Incorrect. Even when a transfer is structured as a sale for value, the transferor must still transfer the asset for fair market value. Any discount applied to the sale is a gift that must be reported on Form 709 if the value of the discount exceeds the annual gift tax exemption.

c. Correct. A sale for fair market value is not a gift. If the transferor receives a promissory note in exchange for the value of the property transferred, the transferor has received an asset of value, which he may then either wait to collect the proceeds or sell on the open market.

d. Incorrect. Although the sale of the house for fair market value is not a gift, the imputed interest accruing on the promissory note is a gift that must be reported on Form 709 if the total interest exceeds the annual gift tax exemption. In addition, the lender must report the imputed interest on his annual income tax return.

6. a. Incorrect. Since this gift is under the taxpayer's annual gift tax exemption, the taxpayer can fully shelter the gift without using his spouse's annual exemption.

b. Incorrect. Transfers from jointly owned assets are deemed to be made one-half from each joint owner. Therefore, the gift-splitting election is unnecessary even if only one spouse signed the check making the gift.

c. Correct. The non-transferor spouse must consent to split this gift on the wife's Form 709. Doing so allows both spouses' annual gift tax exemptions to offset the value of the gift. If no other transfers are made by either spouse during the year, only the wife must file Form 709 and the non-transferring spouse may simply sign the wife's Form 709 consenting to the split.

d. Incorrect. Both spouses must be alive at the time of the gift to elect gift splitting. In the year of one spouse's death, only gifts made before the date of death may be split. If the surviving spouse remarries before the end of the year, then none of the gifts made while the deceased spouse was alive may be split.

7. a. Correct. The tax basis of gifted assets transfers from the donor to the recipient. Gain on the subsequent sale of a gifted asset is calculated by subtracting the donor's basis ($125,000) from the amount realized ($175,000).

b. Incorrect. All gifts are reportable on Form 709, including gifts of appreciated and depreciated property. Gifts that are less than the annual gift tax exclusion do not necessitate a Form 709 filing but must be reported if the taxpayer is otherwise required to file.

c. Incorrect. Gifts of appreciated assets do not trigger gain or loss at the time of the gift. Instead, the recipient takes the donor's tax basis and adds the donor's holding period onto the time the asset is owned by the recipient for purposes of calculating gain or loss and long-term versus short-term holding periods.

d. Incorrect. The recipient may claim a loss on the sale of the house based on the cost basis of the transferor if the value of the asset is greater than its cost basis at the time of the gift. The loss is limited to the difference between the sale price and the fair market value if gifts of depreciated property are made.

8. a. Correct. Transfers to organizations that qualify as tax-exempt charities under 501(c)(3) are eligible for the unlimited charitable deduction under Code Section 2522 and can be deducted on Form 709.

b. Incorrect. Tax preparation fees are not deductible on Form 709.

c. Incorrect. Medical expenses paid directly to the provider are not considered gifts and should not be reported on Form 709. Since such transfers are not reportable on Form 709, they are similarly not deductible.

d. Incorrect. Gifts made to a partner prior to the actual marriage ceremony are not eligible for the unlimited marital deduction under Code Section 2523. Couples should wait until they are legally married to make significant gifts to one another to avoid the use of their lifetime gift tax exemption to shelter the gifts from tax.

9. a. Incorrect. A qualifying Crummey transfer requires that the trustee of the Crummey trust contact the beneficiaries to inform them of the receipt of assets subject to the withdrawal right.

b. Incorrect. A qualifying Crummey transfer requires that the trust beneficiaries be given adequate time following their receipt of notice in which to exercise their withdrawal right.

c. Incorrect. A qualifying Crummey transfer requires that if the beneficiary exercises his withdrawal right, he must have immediate and unrestricted control over the transferred assets.

d. Correct. For a transfer to qualify under the Crummey transfer requirements, there may be no understanding or agreement among the beneficiaries and the transferor or the trustee that the beneficiary will not exercise his withdrawal right.

10. a. Incorrect. Code Section 7872 requires any loan to bear interest at the applicable federal rate or higher in order to avoid imputed interest and phantom gifts. Interest of .0001% is less than the applicable federal rate and violates the adequate interest rules.

b. Correct. Loans that bear an interest rate of at least the applicable federal rate do not violate the adequate interest rules and will not result in any imputed income or phantom gifts.

c. Incorrect. Interest-free loans between a lender and a borrower that total less than $10,000 are exempt from the adequate interest rules so long as the borrower does not use the loan to purchase income-producing assets.

d. Incorrect. Interest-free loans between a lender and a borrower that total less than $100,000 are exempt from the adequate interest rules so long as the borrower does not use the loan to purchase income-producing assets and the borrower's net investment income is less than $1,000.

Chapter 11

FEDERAL ESTATE TAX RETURNS

LEARNING OBJECTIVES

After reviewing this chapter, you should be able to:

- Identify estate and generation-skipping tax exemptions
- Understand the mechanics of the generation-skipping transfer tax
- Describe the assets and interests includable in a decedent's gross estate
- Identify the items excluded from the gross estate
- Understand how to calculate estate and generation-skipping transfer tax
- Recognize common estate tax deductions
- Identify when IRS Forms 706 and 8971 are used and when they are due

OVERVIEW OF THE TRANSFER TAX SYSTEM

Estate and gift tax are transfer taxes, meaning that a tax is imposed on the mere privilege of transferring an asset to or for the benefit of another individual. While gift tax is imposed on transfers made during the donor's life, estate tax is imposed on transfers made upon the donor's death. The gross estate of the taxpayer is reported on Form 706, which is filed only once when the taxpayer passes away. Except in unique circumstances, estate tax is paid by the estate prior to the distribution of assets to the beneficiaries. For federal estate tax purposes, the recipient of an inheritance receives the asset tax-free. Some states also apply a state-level estate tax, and several states impose inheritance tax, which may require recipients to report and pay tax. The discussion in this chapter focuses solely on federal estate tax, but practitioners should be aware that state-level taxes may also apply.

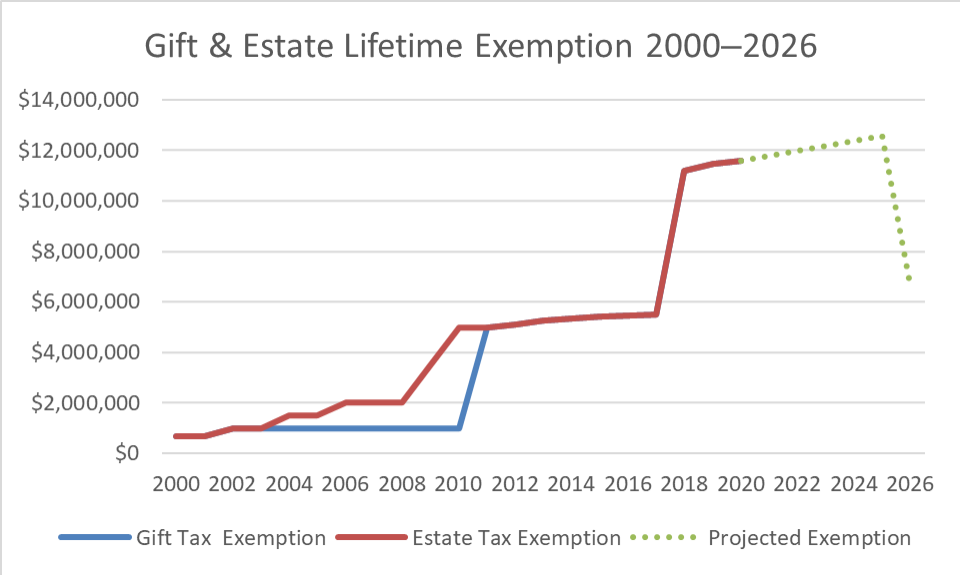
Estate tax is under constant attack because taxpayers view it as "double taxation" of assets that were taxed once already when earned. However, since few taxpayers actually pay estate tax, it is a popular taxation method among proponents seeking to prevent accumulations of wealth within families and provide revenue for government programs. The estate tax rules discussed in this chapter are currently subject to revision by Congress and may be modified by the end of 2021. Care must be used when analyzing these rules in light of changing laws.

GIFT, ESTATE, AND GSTT EXEMPTIONS

Lifetime Gift and Estate Tax Exemption

Assets passing from a taxpayer to his heirs are taxed at a top rate of 40%. This rate has been as high as 77% in years past. To alleviate the tax burden on taxpayers of modest means and to minimize the reporting obligations, each taxpayer has a lifetime exemption, which can be used to shelter gifts during life, transfers at death, or both. Taxpayers filing gift tax returns keep a running tally of how much of their exemption they have used over time. At death, all prior gifts are added to the decedent's gross estate assets to determine if the taxpayer's total transfers both during life and at death exceed the lifetime exemption. If these transfers exceed the exemption, the decedent's estate pays the necessary tax before distributing assets among the heirs.

The lifetime gift and estate tax exemption has changed dramatically in the past 20 years. Prior to 2001, the lifetime exemption increased modestly every few years but remained nominal in comparison to today's exemption. Families with average wealth around $1 million had to plan carefully to minimize the impact of estate tax. When the Economic Growth and Tax Relief Reconciliation Act passed in 2001, the lifetime exemption began increasing exponentially, plateauing at $5 million in 2010 and increasing annually thereafter with inflation. In 2017, the Tax Cuts and Jobs Act temporarily doubled the lifetime gift and estate tax exemption to $10 million, adjusted for inflation, for tax years 2018–2025 (the exemption for tax year 2021 is $11.7 million). Barring legislative intervention, the lifetime exemption will return to the $5 million threshold in 2026.



This temporary increase in the lifetime exemption means that very few estates will actually be subject to estate tax. According to the Institute on Taxation and Economic Policy, only six estates per 10,000 in 2018 were subject to estate tax as a result of this exponential rise in the estate tax exemption.

Taxpayers who make large gifts during this period when the lifetime exemption is temporarily increased may be able to lock-in the larger exemption if they pass away after the exemption decreases. Treas. Reg. Sec. 20.2010-1 clarifies that a taxpayer's exemption available at death will be the greater of the exemption available at death or the amount of the exemption actually used during life through gifting. Taxpayers can transfer significant wealth in spite of the projected decrease in the exemption by making gifts up to the current increased lifetime exemption in order to lock-in the increased exemption even if they live past the date on which the exemption decreases.

Practitioners should note that legislation was introduced on September 13, 2021, which proposes decreasing the lifetime exemption as early as January 1, 2022. Practitioners should always check the status of legislative updates before advising clients.

Portability

If a taxpayer's total lifetime gifts and gross estate are less than the taxpayer's lifetime exemption, a taxpayer's surviving spouse may request the deceased spouse's unused exemption be added to the surviving spouse's own exemption. The deceased spouse's unused exemption (DSUE, pronounced "dee-soo") is sometimes referred to by practitioners as portability—meaning that the unused exemption is portable to the surviving spouse. Portability provides the surviving spouse with additional protection from gift and estate tax. The surviving spouse may use the deceased spouse's exemption to shelter gifts made by the survivor during life or transfers made at death. Since many spouses leave their assets to their spouse, the portability of any excess exemption prevents the surviving spouse from encountering a significant tax bill at death on account of having both spouses' assets included as part of one estate.

The executor of the deceased spouse's estate must timely elect portability by filing Form 706 claiming the deceased spouse's unused exemption for the surviving spouse. The mere action of filing Form 706 is effective to elect portability. This may require Form 706 to be filed even if the estate would not otherwise have a filing obligation. Treas. Reg. Sec. 20.2010-1 confirms that the amount of the portable exemption will not be affected by future decreases in the lifetime exemption for living taxpayers. Surviving spouses concerned about future reductions in the lifetime exemption may choose to file Form 706 for their deceased spouse simply to ensure that if the lifetime exemption is significantly reduced or even eliminated, their deceased spouse's exemption will always be available to them to use either during life to make taxable gifts or at death.

EXAMPLE

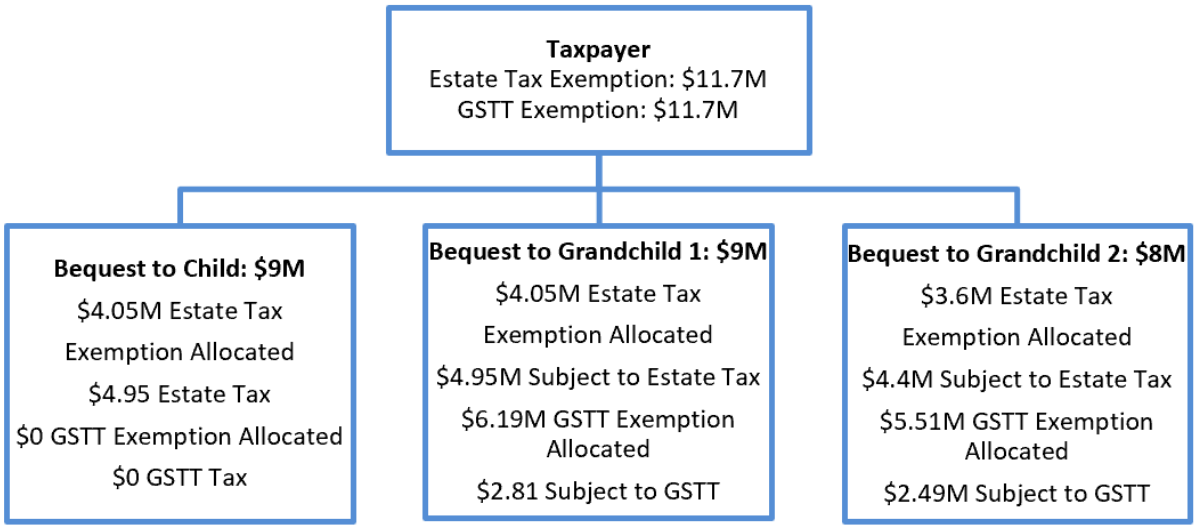
Spouse 1 dies in 2021 when the lifetime exemption is $11.7M with $1M in assets, which he leaves to his child. Spouse 2 has assets of her own totaling $10M. Spouse 2 files Form 706 claiming portability of Spouse 1's unused exemption of $10.7M. If Spouse 2 also dies in 2021, the total available exemption will be $21.7M (Spouse 1's $10.7M and Spouse 2's 11.7M). If Spouse 2 dies in 2028 when the lifetime exemption has been reduced to $6M, the total available exemption will be $16.7M.

When the portability election is made, Form 706 of the deceased spouse is subject to examination after the statute of limitations runs when the surviving spouse's estate files the second Form 706 on which the portable election is reported. To avoid this second examination by the IRS at the second spouse's death, executors of an estate may want to elect out of portability. Such election is made on Part 6, Section A of Form 706 and is irrevocable once made. Electing out of portability may be advisable if the amount of portable exemption is small or the valuation of assets reported on Form 706 is aggressive.

Generation-Skipping Transfer Tax Exemption

In addition to estate tax imposed at death, generation-skipping transfer tax (GSTT) is levied on transfers to individuals who are deemed skip persons. GSTT is equal to the highest gift and estate tax rate (currently 40%). A skip person is anyone who is two or more generations below the transferor, such as a grandchild or great-niece, or more than 37½ years younger than the transferor. The predeceased ancestor rule moves individuals up a generation a parent predeceases. For example, if a taxpayer's child passes away, the child's children are no longer skip persons for purposes of analyzing the transfer tax implications of gifts from the taxpayer to the grandchildren.

A lifetime exemption for GSTT equal to the lifetime gift and estate tax exemption is available for taxpayers making generation-skipping transfers. This allows a taxpayer to make transfers totaling the lifetime exemption to a grandchild tax-free. If the taxpayer uses part of his exemption on transfers to non-skip persons, later transfers to skip persons may be subject to gift tax but protected from GSTT. The following graphic illustrates a scenario when transfers may be wholly or partially exempt from gift tax and GSTT.



The unused portion of the lifetime GSTT exemption is not portable from the deceased spouse to the surviving spouse. Taxpayers seeking to maximize the protection of the GSTT exemption to shelter assets from tax for future generations typically employ dynasty or generation-skipping trusts that enable them to fully use their available GSTT exemption at death even if assets pass to trusts for the lifetime benefit of a surviving spouse. Practitioners must be very cautious when preparing Form 706 for an estate with trusts and possible generation-skipping transfers to ensure the available lifetime exemption is properly allocated among the available beneficial interests. Failing to adequately allocate this exemption can have costly results when funds are ultimately distributed to skip persons years later.

CALCULATING ESTATE TAX

Even though the lifetime gift and estate tax exemption is often discussed in terms of the value of the assets that can be transferred tax-free, in reality, Form 706 calculates estate tax by applying a lifetime credit against the tax calculated on the total transfers. The unified credit amount provided for under Internal Revenue Code Section 2010 is equal to the tax due on the taxpayer's basic exclusion amount plus any deceased spouse's unused exclusion amount. This means that changes in the applicable tax rates over time can impact the actual amount of the assets that can pass tax-free under the lifetime exclusion.

Since gift and estate tax is based on a taxpayer's lifetime of transfers, the estate tax return must list all prior taxable gifts made by the decedent and attach copies of all filed gift tax returns. The total of the lifetime transfers and transfers occurring at death are then compared to the taxpayer's lifetime exemption to determine if tax is due. If these total transfers are less than the taxpayer's basic exclusion amount, no tax is paid. For those few unfortunate taxpayers, if the gross estate plus all lifetime transfers exceeds the basic exclusion amount, the estate must remit the tax due before dividing the estate among the taxpayer's heirs.

TAX ATTRIBUTES OF INHERITED ASSETS

The tax attributes of assets transferred by a taxpayer at death are governed under Code Sections 1014 and 1223(9). The general rule under Code Section 1014 is that the tax basis of an asset received by inheritance is equal to the fair market value of the asset as of the date of death. This basis adjustment is frequently referred to as a "step-up in basis" because the tax basis of appreciated assets is "stepped up" to the value of the asset as of date of death—thus erasing potentially years of appreciation that ultimately go untaxed when the asset is later sold after the original owner's death. Assets that have depreciated in value, however, will suffer a "step-down in basis," and built-in losses will be erased forever upon the death of the taxpayer.

Any asset that is included in the gross estate is eligible for the basis adjustment under Code Section 1014 unless the asset was gifted to the taxpayer and returns to the original donor within a year of the date of the gift. Hence, children trying to step-up the basis of their own assets cannot make deathbed transfers to their parents with the plan of receiving the assets immediately back upon the parent's death.

Treas. Reg. Sec. 1.1014-2(b) provides that the step-up in basis will apply to any asset includable in the gross estate regardless of whether Form 706 must be filed. Therefore, if a taxpayer's gross estate includes assets owned in his own name, a revocable trust, jointly, etc., all of which are part of his gross estate, each asset will receive a tax basis adjustment to the fair market value of the assets as of the date of death.

Code Section 1223(9) provides that the holding period for inherited assets will always be long-term. The amount of time the taxpayer owned an asset prior to death is irrelevant when determining the holding period of the recipient since the holding period will always be long-term for the disposition of assets after death.

EXAMPLE

Taxpayer purchased stock for $100 and bonds for $200 three months before he passed away. On taxpayer's date of death, the stock is worth $120 and the bonds are worth $190. Taxpayer's estate sells the stock for $125 and the bonds for $192 two months after taxpayer's death. The taxable gain to the estate on the sale of the stock is $5 long-term capital gain and on the sale of the bonds is $2 long-term capital gain.

The step-up in basis is a significant tax benefit that many taxpayers build their entire estate plan around. Taxpayers who do not have taxable estates typically try to retain possession or control over as many assets as possible to ensure the assets are included in their gross estate to obtain the step-up in basis. If these assets were gifted during life, the recipient would take a transferred basis and the benefit of erasing years of taxable appreciation would be lost. Code Section 1014 has been the target of recent legislative proposals but has since escaped unscathed.

WHAT IS THE GROSS ESTATE?

Code Sections 2031 through 2046 describe the assets and interests includable in a decedent's gross estate for purposes of calculating estate tax due upon the death of the taxpayer. Naturally, the gross estate includes the value of any asset titled in the name of the decedent, such as personal bank

accounts, real estate, retirement accounts, and life insurance owned by the decedent. These assets are usually easy to identify. The manner in which these assets pass to heirs and beneficiaries does not impact their status as part of the gross estate. Even though an asset may pass directly to a beneficiary by a transfer on death designation or pass through a trust instead of a will, the asset is still part of the gross estate for estate tax purposes. An asset does not need to be subject to the state court probate process to be considered part of the gross estate for tax purposes.

In addition to the recognizable gross estate assets, many potentially hidden assets are includable in the decedent's gross estate. The inclusion of these assets is subject to a complex series of Code sections and regulations outside the scope of this material; however, the most common hidden assets includable in a decedent's gross estate are described in the following sections.

Section 2038—Revocable Transfers

Many taxpayers use revocable trusts to accomplish their ultimate estate planning goals. Taxpayers often pre-title assets in the name of these trusts to streamline the post-death administration process. Doing so can avoid the probate process—the court-supervised method of transferring assets from the name of the decedent to the name of the ultimate heirs. However, these revocable trusts do not prevent the assets titled in the name of the trust from being included in the taxpayer's gross estate for estate tax purposes. This is a common misconception for many taxpayers.

Revocable trusts are the most common type of revocable transfers includable in the gross estate under Code Section 2038. However, any type of transfer in which the transferor retains the right to take back the property will fall within the same definition. The value of the property over which the transferor held this power as of date of death is includable in the gross estate. Additionally, if the transferor relinquished the power to revoke the transfer at any time within three years of the date of death, the relinquishment will be ignored and the assets subject to revocation will be includable in the gross estate under Code Section 2035. This three-year lookback period also applies when the taxpayer relinquishes powers over retained life estates, transfers taking effect at death, and ownership of life insurance within the three years leading up to death.

Section 2040—Joint Interests

The general rule under Code Section 2040 requires the taxpayer's estate to include 100% of the value of any jointly owned property unless the estate can show that the other joint owner contributed funds toward the purchase of the property and did not receive their interest from the decedent for less than fair market value. For example, if a father and son own a mountain cabin together, the entire value of the cabin is includable in the father's gross estate unless the son contributed funds toward the purchase of the cabin. The upside of this rule for most taxpayers whose estates do not exceed the estate tax exemption is that by including the entire value of the joint asset in the taxpayer's gross estate, the tax basis of the entire asset is adjusted to the date of death value under Code Section 1014.

The general rule does not apply to property owned jointly between spouses. Instead, only one-half of the date of death value of property owned by a taxpayer and the taxpayer's spouse is includable in the decedent's gross estate. Accordingly, the tax basis of only one-half of the jointly owned asset is adjusted to the date of death value. This exception to the general rule applies only when property

is owned solely by the two spouses. If a third party is also a joint owner of the property (i.e., father, mother, and child), then the general rule that examines who contributed funds toward the purchase of the property applies.

Married taxpayers living in community property states enjoy the benefit of receiving a basis adjustment on the entire jointly owned asset so long as one-half of the asset is includable in the deceased spouse's gross estate. This means that a couple residing in a community property state who owns real estate purchased for $100,000 but worth $800,000 on date of death will receive a full basis adjustment to $800,000 on the death of Spouse 1 even though only $400,000 is includable in Spouse 1's gross estate. Clients who previously lived in community property states can retain this coveted status for assets purchased in separate property states with careful planning. Practitioners should be mindful of these rules to ensure optimal tax results at the death of their clients.

Section 2041—Powers of Appointment

If the decedent was a beneficiary of a trust, it is important to examine the trust language to determine if the decedent held a power of appointment over any remaining trust assets. Frequently, beneficiaries may control the ultimate disposition of trust assets either upon their own death or at various points during their life.

There are two types of powers of appointment: general powers of appointment and limited or special powers of appointment. A general power of appointment allows the power holder to appoint the assets to the power holder himself or to his estate. A limited or special power of appointment prohibits such exercise. Limited powers of appointment often place additional limitations on the power holder, such as requiring the power to be exercised in favor of the power holder's descendants or prohibiting the exercise in favor of creditors.

If the beneficiary is granted a general power of appointment over the trust assets, then any assets remaining within the trust and subject to the power of appointment as of the beneficiary's date of death are includable in the gross estate of the beneficiary. It is immaterial whether the beneficiary actually exercised the power of appointment. The simple existence of the power includes the assets in the holder's gross estate. The existence of a limited power of appointment does not trigger the inclusion of the trust assets in the beneficiary's estate.

Note that powers of appointment may be granted to nonbeneficiaries or in contexts other than the trust setting. However, the most common application of these rules is for a beneficiary to exercise the power of appointment over trust assets at death. If the power is exercisable during life, any exercise of such power during life can trigger a taxable gift transaction.

In addition to a general power of appointment, a beneficiary may have a more limited general power of appointment referred to as the "five and five power." Under Code Section 2041, a beneficiary may be granted the power to appoint or withdraw assets equal to the greater of $5,000 or 5% of the aggregate value of the trust assets. Such limitation will prevent the entire trust estate from being included as part of the gross estate of the power holder. However, if the power holder dies prior to fully exercising this withdrawal right, the greater of $5,000 or 5% of the trust assets at the time of death will be includable in the gross estate of the power holder. The existence of this power must be disclosed on Form 706, Part 4, and the value of the power listed on Schedule H.

Section 2042—Proceeds of Life Insurance

Life insurance owned by the decedent is includable as part of the decedent's gross estate even though the proceeds are not paid until after date of death. Interest or dividends generated on proceeds after date of death are taxable income to the beneficiary but are not includable in the gross estate for estate tax purposes. If life insurance is part of the gross estate, Form 712 must be attached to the estate tax return. The life insurance company issues Form 712 to the estate. Issuance of this form usually takes several weeks or months, so planning ahead to meet filing deadlines in crucial.

When the lifetime estate tax exemption was much lower than it is today, taxpayers frequently utilized a technique called the irrevocable life insurance trust (ILIT). The ILIT is usually structured as a Crummey trust and holds title to a life insurance policy on the life of the taxpayer. Since the ILIT is an irrevocable trust, the life insurance and death benefit proceeds are excluded from the decedent's gross estate. However, the existence of the policy must be reported on the estate tax return filed for the decedent's estate.

The cash value of insurance owned by the decedent insuring the life of another person is also includable as part of the gross estate. For example, Spouse 1 owns a policy that insures the life of Spouse 2. The cash value of the policy is $75,000, and the policy will pay $500,000 if Spouse 2 dies. Upon the death of Spouse 1, the gross estate will include $75,000 as an asset of the estate. The existence of these policies is sometimes unknown by the family, so practitioners must thoroughly investigate all assets to ensure potentially hidden assets are not forgotten.

Section 2044—Certain Property for Which Marital Deduction Was Previously Allowed

Taxpayers receive a deduction against gift and estate tax for transfers to the taxpayer's spouse. The IRS's justification behind granting this deduction is that assets transferred to a taxpayer's spouse will eventually be subject to estate tax upon the second spouse's death. Therefore, upon the death of the surviving spouse, any assets the surviving spouse received from their former spouse are includable in the surviving spouse's gross estate.

Assets falling within this category include assets transferred directly to the surviving spouse and titled in the surviving spouse's name. However, they also include any assets transferred to a trust for the benefit of the surviving spouse if a marital deduction was claimed by the estate of the first deceased spouse on account of those trust assets. These trusts are frequently referred to as marital or QTIP (qualified terminable interest property) trusts and must contain precise provisions, described later in this chapter. Practitioners should examine any related trust documents and investigate the terms to ensure these trust assets are included as part of the gross estate if the marital deduction was previously claimed to offset tax on the transfer.

Date of Valuation

The value of the assets includable in the gross estate is the fair market value of those assets on the date of death. Under Code Section 2032, the executor may elect to apply the alternate valuation date, which is exactly six months after the taxpayer's date of death if by using this date (1) the value of the gross estate and (2) the sum of the estate and GSTT are reduced. This election is helpful

when significant swings in the market occur or assets, such as the decedent's business, significantly depreciate during the six months after death.

The fair market value for stocks and bonds is calculated by averaging the high and low trading values for the decedent's date of death. If the decedent passes away on a day on which no trades occur (such as a Saturday, Sunday, or holiday), then a weighted average for the closest trading day before and after the date of death must be calculated. Financial institutions can create date of death value summaries on request.

The gold standard for valuing real estate is an appraisal from a licensed real estate appraiser. Clients may balk at the added administrative cost to obtain these valuations, so market analyses prepared by realtors and tax assessor estimates are sometimes used to establish the date of death value. These shortcut valuation methods should only be considered if Form 706 is filed for portability or the QTIP election. Clients should be cautioned that taking shortcuts in valuing assets could draw unwanted attention from the IRS. Formal appraisals should always be obtained if the estate exceeds the lifetime tax exemption.

If the decedent owned an interest in a business, the decedent's interest in that business must be valued—not necessarily the underlying assets owned by the business.

EXAMPLE

If a decedent is a 50% owner of an LLC that owns an apartment complex, the asset requiring valuation is the decedent's 50% membership interest. This may require the valuation of the underlying apartment complex but may also require the analysis of the annual income stream and potential future income potential of the apartment complex.

Valuing a business interest requires specialized training and may employ a variety of techniques, including discounting the value of the interest for lack of marketability, minority ownership, and lack of control factors, among others. These valuations can be costly, so preparing your client early on for these administrative expenses is important. Business valuations can also take weeks or even months to draft, so planning ahead to meet filing deadlines is crucial.

While cash, real estate, stocks, and business interests are the most common assets, clients may also own mineral interests, promissory notes, or collectibles that require valuation for purposes of preparing an accurate return. Undervaluing assets could result in significant underpayment penalties. Undervaluation can also deprive the taxpayer of a full basis adjustment under Code Section 1014. Overvaluing assets could result in the taxpayer paying significantly more tax than necessary. Therefore, proper valuation is important and should not be overlooked.

Special Use Valuation

When a significant portion of a taxpayer's estate consists of real property used in a family business, Code Section 2032A permits the estate to value the asset at its current use value instead of the highest and best use value normally required for estate assets. This provision of the Code was implemented to reduce the burden estate tax places on family farms and businesses. To qualify, the

business must be a significant percentage of the total estate, the decedent or a family member must have worked in the business for five out of the prior eight years, the property must pass to a qualified heir, and the family must participate in the business for 10 years following the decedent's date of death. If the family ceases to participate in the business during the 10-year term, the estate tax savings is recaptured by the IRS. A tax lien is placed on the property for the 10-year term to ensure compliance with the rule. Since the maximum reduction in the value of the business property is only $750,000 (adjusted for inflation), special use valuation will not significantly reduce estate tax for large family businesses but can provide a modest tax reduction for families committed to continue the business for years after the taxpayer's date of death.

ESTATE TAX DEDUCTIONS

Taxpayers can claim certain deductions to offset gift and estate tax. The deductions for purposes of calculating estate tax are set forth in Code Sections 2053 through 2058. The most common deductions are discussed in the following sections.

Unlimited Marital Deduction

Spouses may make unlimited transfers to one another both during life under Code Section 2523 and at death under Code Section 2056. This allows taxpayers to defer tax on assets transferred to one another at death. The unlimited marital deduction is not a tax avoidance tool but rather a tax deferral tool since all the assets owned by the surviving spouse on date of death are includable in their gross estate. On Form 706, the unlimited marital deduction is calculated by summarizing the assets transferring to the surviving spouse on Schedule M.

The unlimited marital deduction will apply both to outright transfers to the surviving spouse and transfers to a qualified terminable interest property trust (QTIP). For assets passing to a QTIP trust to qualify for the unlimited marital deduction, those assets must be listed in the QTIP section of Schedule M. By listing the assets passing to the QTIP trust on Schedule M, the QTIP election requirements will be met.

The unlimited marital deduction is not available to taxpayers married to non-U.S. citizens. Instead, taxpayers must use their lifetime exemption to shelter transfers to a non-citizen spouse at death just like transfers to non-spousal recipients. Taxpayers wishing to delay taxation on assets passing to a non-citizen surviving spouse can direct assets to a qualified domestic trust (QDOT) where assets will be held for the benefit of the surviving spouse. Upon the distribution of principal from a QDOT, estate tax will be paid on the amounts distributed.

If an estate is filing Form 706 solely for purposes of claiming portability or to make the QTIP election, the executor may choose to list only the estimated values of the assets includable in the gross estate. Treas. Reg. Sec. 20.2010-2 permits the executor to list a general estimate of the value of the assets instead of full appraisals for any asset passing to the surviving spouse or charities. This can save the estate significant cost in preparing Form 706. This reporting mechanism is only available for estates that total less than the lifetime exemption, including lifetime gifts, and is not available for taxable estates. The surviving spouse will also need to obtain accurate date of death valuations in order to accurately calculate gain or loss on the sale of any asset sold after date of death.

Unlimited Charitable Deduction

Taxpayers may also make unlimited transfers to charity both during life and at death under Code Sections 2053 and 2523. The entities that qualify for the unlimited charitable deduction are similar to those entities that qualify for individual income tax deductions. Taxpayers who make no taxable gifts during the year but make significant charitable contributions are not required to file a Form 709 gift tax return solely to report the charitable giving. If a taxpayer makes taxable gifts to individuals and files Form 709, all charitable transfers should be reported even though the taxpayer is eligible to claim a full deduction for those transfers. If many small charitable contributions are made throughout the year, consider attaching a summary sheet to the tax return instead of listing each contribution independently.

Taxpayers who are particularly averse to estate tax may structure their estate plan to avoid estate tax by using the unlimited charitable deduction. Such estate plans typically provide that the amount of any remaining lifetime exemption shall pass to the taxpayer's heirs or named beneficiaries and any excess assets shall pass to charity. Using this technique ensures that no estate tax is paid upon the taxpayer's death. Many times, these charities are actually family foundations created by the taxpayer and managed by the surviving family members. This allows the family to still benefit after death from the charitable contribution by drawing salaries from the foundation and continuing to direct the final charitable recipients.

Indebtedness, Funeral Costs, and Administration Expenses

Various debts and administrative expenses may be deducted on the taxpayer's Form 706 estate tax return. Since Form 706 is similar to a balance sheet for the decedent, any debts owed by the decedent as of the date of death are deducted from the gross estate to determine the taxpayer's precise "equity." Debts may be obvious, such as an outstanding mortgage on the family home or credit card bills. Debts may also be more obscure, such as unpaid medical expenses from the decedent's final illness, property taxes due in arrears, or accrued income tax liability. For an estate exceeding the lifetime exemption and subject to the 40% estate tax rate, practitioners should be diligent to claim any possible deduction on the return.

Costs of administering the decedent's estate are deductible on either the Form 706 estate tax return or Form 1041 fiduciary income tax return filed for the decedent's estate or associated trust. Administrative expenses most often include attorney fees, CPA fees, and trustee or personal representative fees. The same administrative expenses may not be deducted on both returns, so a thoughtful allocation is necessary to achieve an optimal tax result for the client.

Funeral costs, including embalming, cremation, casket, memorial service, and reception, are only deductible on the decedent's Form 706 estate tax return. Costs to transport the taxpayer's body and travel expenses for one family member to accompany the body are also deductible on Form 706. Travel expenses for out-of-state relatives to attend the funeral services are not deductible. None of these expenses are deductible on Form 1041, so any expense incurred should be deducted on Form 706.

DUE DATES AND PENALTIES

Form 706

Form 706 is due exactly nine months after the taxpayer's date of death. If the taxpayer dies on February 22, then Form 706 is due on November 22. If the taxpayer's gross estate is less than the taxpayer's remaining lifetime estate tax exemption, no Form 706 is required to be filed. The taxpayer's estate may still wish to file Form 706 for purposes of portability of the deceased spouse's unused exemption for the surviving spouse or for making elections such as the QTIP election.

If the estate needs additional time to file Form 706, a six-month automatic extension may be requested by filing Form 4768. If the estate is filing Form 706 solely for purposes of portability and does not exceed the lifetime exemption, the Form 706 may be filed within two years of the decedent's date of death without requesting any specific extension. The tax preparer should write "Filed Pursuant to Rev. Proc. 2017-34 to Elect Portability under §2010(c)(5)(A)" at the top of the return to ensure the IRS recognizes that the return is being filed in accordance with the exception created by Rev. Proc. 2017-34. Similar to individual income tax extensions, the estate must pay any tax it estimates will be due with the extension request to avoid late payment penalties. Under Code Section 6651, the same late filing and late payment penalties apply to Form 706.

Form 8971

Any estate that exceeds the lifetime estate tax exemption must also file Form 8971. The purpose of Form 8971 is to inform recipients of the taxpayer's assets of the date of death value of those assets. Code Section 1014 adjusts the tax basis of any asset included in the taxpayer's gross estate to its date of death value—essentially erasing any pre-death appreciation or depreciation. Under Code Section 1014(f), a beneficiary must use the value reported on Form 706 as the tax basis of an inherited asset, and the executor must report the date of death values to the beneficiaries under Code Section 6035. Form 8971 was developed to assist executors in their reporting obligation.

Form 8971 is due 30 days after the earlier of the due date of Form 706, including extensions, or the date Form 706 is filed. Estates filing Form 706 solely for portability that do not exceed the lifetime estate tax exemption are not required to file Form 8971. Additionally, assets such as cash, income in respect of a decedent, tangible personal property valued less than $3,000, and property sold by the estate prior to distribution need not be reported on Form 8971. Significant penalties are imposed on estates failing to file or late filing Form 8971 and are imposed on a per beneficiary basis—for estates with a significant number of beneficiaries, these penalties can be substantial.

SUMMARY

The annual and lifetime exemptions drive most taxpayers' decisions relating to lifetime giving and ultimate disposition of assets at death. The exponential increase in the lifetime exemption has freed most taxpayers from having to structure their transfers to avoid taxation. Instead, taxpayers may now transfer assets during life or at death without incurring significant tax. However, even though the transfers may ultimately be fully covered by the lifetime exemption, taxpayers must still file gift and estate tax returns to comply with their reporting obligations. Crucial elections, such as the QTIP or portability election, are dependent on timely filing these returns. Therefore, even though the lifetime exemption has dramatically changed the practice of gift and estate tax planning in the past 20 years, accurately reporting these transactions is still relevant today.

REVIEW QUESTIONS

1. The unlimited charitable deduction may not be claimed for which of the following transfers?

a. Transfer of $1 billion to the Red Cross

b. Transfer of $1 million to a Family Foundation

c. Transfer of $1 billion to a Donor Advised Fund

d. Transfer of $1 million to a Political Action Committee

2. Which of the following is true regarding claiming the deceased spouse's unused exclusion (portability)?

a. Form 706 is only required to claim portability if the gross estate exceeds the lifetime exemption.

b. Form 706 must be filed within 9 months of date of death or 15 months if an extension is requested.

c. Form 706 must be filed within 2 years of date of death

d. The deceased spouse's unused exclusion transfers to the surviving spouse automatically.

3. If the taxpayer's estate files Form 706 solely for purposes of portability and the gross estate does not exceed the lifetime exemption, what is the latest date the estate tax return may be filed?

a. 9 months after the taxpayer's date of death

b. 15 months after the taxpayer's date of death

c. 2 years after the taxpayer's date of death

d. 2½ years after the taxpayer's date of death

4. Which of the following is not subject to estate tax?

a. House owned by the taxpayer in his own name

b. Car jointly owned with taxpayer's spouse

c. Life insurance owned in an irrevocable life insurance trust

d. Business owned by revocable trust

5. A taxpayer buys a house for $150,000. As of the taxpayer's date of death, the house is valued at $350,000. The taxpayer's estate sells the house for $400,000. What is the taxable gain on the sale?

a. $50,000

b. $250,000

c. $0

d. $400,000

6. Form 8971 must be filed for which of the following estates?

a. Gross estate totals $5M transferred to children

b. Gross estate totals $10M transferred to charity

c. Gross estate totals $12M consisting only of cash transferred to friend

d. Gross estate totals $15M transferred to surviving spouse

7. Which of the following properties will be 100% includable in the taxpayer's gross estate?

a. House jointly owned with a son who contributed 25% of the purchase price

b. House jointly owned with a spouse who contributed 0% of the purchase price

c. House inherited from parents for which the taxpayer added his siblings' names to title four years after the parents passed away

d. House jointly owned with a spouse and child if the spouse contributed 20% of the purchase price

8. Which of the following expenses cannot be claimed as a deduction on Form 706?

a. Funeral costs

b. Tax preparation fees deducted on Form 1041

c. Medical expenses deducted on Form 1040

d. Credit card bills

9. Which of the following transfers made by a taxpayer would be included in his gross estate?

a. Sale of house to third-party buyer for fair market value

b. Transfer of a life insurance policy to an irrevocable life insurance trust two years before date of death

c. Monies transferred to a Section 529 plan subject to the super-funding provision if the taxpayer dies six years after the transfer

d. Charitable gift made two weeks prior to the date of death

10. Which method of valuing real estate should be used if the taxpayer's gross estate exceeds the lifetime exemption?

a. Appraisal from qualified real estate appraiser

b. Realtor market analysis

c. Tax assessor value

d. Sale price

ANSWERS TO REVIEW QUESTIONS

1. a. Incorrect. A taxpayer may claim an unlimited deduction for the value of assets transferred to an organization that qualifies as a charitable organization even if such amount is well over the lifetime exemption.

b. Incorrect. So long as a family foundation is organized in accordance with the tax-exempt entity rules and regulations, transfers to such entity will qualify for the unlimited charitable deduction for purposes of calculating the taxable estate.

c. Incorrect. Donor advised funds qualify for the unlimited charitable deduction since they are categorized as charitable entities, thus making them a good recipient for clients wishing to use the charitable deduction without deciding on which charities will receive distributions at the time of death.

d. Correct. Political action committees are not charitable organizations, so transfers to such organizations at death would not qualify for the unlimited charitable deduction.

2. a. Incorrect. An estate of any size must still file Form 706 in order to claim the deceased spouse's unused exclusion, or portability. There is no other simplified method to claim the exemption other than using the streamlined reporting procedures provided under Treas. Reg. Sec. 20.2010-2.

b. Incorrect. While ideally the surviving spouse will file Form 706 as soon as possible after the deceased spouse's date of death, Form 706 can actually be filed up to two years after the deceased spouse's date of death in order to claim portability.

c. Correct. As a result of Rev. Proc. 2017-34, the executor may file Form 706 up to two years after the deceased spouse's date of death to claim the deceased spouse's unused exemption and transfer it to the surviving spouse to use to offset lifetime gifts and transfers at death.

d. Incorrect. The executor of the deceased spouse's estate must file Form 706 in order to claim the deceased spouse's unused exclusion. It will not pass automatically to the surviving spouse.

3. a. Incorrect. The traditional due date for Form 706 is nine months after the taxpayer's date of death. However, the nine-month deadline does not take into consideration potential extension requests or the extended due date for purposes of portability provided under Rev. Proc. 2017-34.

b. Incorrect. For an estate that exceeds the lifetime exemption without consideration of deduction (including the marital and charitable deduction), the due date for Form 706 may be extended by six months. However, if Form 706 is being filed solely for purposes of portability, Rev. Proc. 2017-34 provides an extended deadline.

c. Correct. Under Rev. Proc 2017-34, the estate of a taxpayer whose gross estate and prior taxable gifts is less than the lifetime exemption may file Form 706 within two years after the taxpayer's date of death.

d. Incorrect. The maximum amount of time permitted to file Form 706 under Rev. Proc. 2017-34 is two years from the taxpayer's date of death. The estate is not eligible to request a six-month extension in addition to this two-year filing period.

4. a. Incorrect. All property owned in the taxpayer's own name will be includable in the gross estate of the taxpayer and will be subject to estate tax.

b. Incorrect. Assets owned jointly between spouses are 50% includable in the gross estate of the taxpayer and will be subject to estate tax. If the asset is owned jointly with a non-spouse, the default rule requires the entire asset to be included in the gross estate if the other joint owner(s) did not contribute to the purchase of the asset.

c. Correct. Assets, including life insurance policies, owned inside irrevocable trusts are typically not includable in the gross estate of the taxpayer unless the governing document contains some fatal flaw or the taxpayer retained too many powers over the assets held in the irrevocable trust.

d. Incorrect. Assets titled in the name of revocable trusts are fully includable as part of the gross estate of the taxpayer because the taxpayer retains the right to revoke or amend the distribution terms for the assets held inside the revocable trust.

5. a. Correct. Under Code Section 1014, the tax basis of the asset is adjusted to the date of death value. The taxable gain is calculated by subtracting the date of death value from the sale value. Therefore, $400,000 – $350,000 = $50,000.

b. Incorrect. Since the taxpayer died while holding the property, the original tax basis of $150,000 is replaced with the date of death value for purposes of calculating gain or loss.

c. Incorrect. Any appreciation of an asset as of the date of death is taxable to the estate. The gain is calculated by subtracting the date of death value from the sale value. You will often encounter situations where the taxable gain is $0 if there is no appreciation after death.

d. Incorrect. The taxpayer's estate must compare the date of death value to the sale price. The difference between the two sums is the taxable gain.

6. a. Incorrect. Since the taxpayer's gross estate is less than the lifetime exemption, Form 706 is not required to be filed and Form 8971 is unnecessary.

b. Incorrect. Since the taxpayer's gross estate is less than the lifetime exemption, Form 706 is not required to be filed. Even though Form 706 is filed for portability, Form 8971 is unnecessary because the gross estate did not reach the required level to require filing.

c. Incorrect. The estate is required to file Form 706 because the taxpayer's estate exceeds the lifetime exemption. However, certain transfers, including cash, do not have to be reported on Form 8971 because cash has a cost basis equal to its date of death basis, so basis tracking is unnecessary.

d. Correct. Any time the gross estate exceeds the lifetime exemption, Form 706 is required to be filed even if all the assets are eligible for one of the unlimited deductions, such as the unlimited marital deduction. When Form 706 is required due to the size of the estate, Form 8971 must be filed.

7. a. Incorrect. Since the son contributed 25% to the purchase price of the house, only 75% of the value of the house is includable in the taxpayer's gross estate.

b. Incorrect. Only 50% of jointly owned assets between spouses is includable in the deceased spouse's gross estate regardless of the amount contributed by either spouse toward the purchase price.

c. Correct. If all the siblings had inherited the property directly from the parents, then each child would include only his proportionate share of the value of the property upon the child's death. However, since the taxpayer inherited the entire property from the parents and then added his siblings' names to the title, the entire value of the property is includable in the taxpayer's estate because the siblings did not contribute funds to the purchase of the property.

d. Incorrect. The 50% rule applicable to joint ownership between spouses only applies if the spouses are the sole owners of the property. If additional owners are added to title, the general rule that examines the contribution of each owner to the purchase price applies. Therefore, 80% of the value of the property is includable in the taxpayer's gross estate.

8. a. Incorrect. Funeral costs may only be claimed on Form 706. They are not deductible on any income tax return. These costs will include the burial of the body, services and receptions, and transportation for the decedent.

b. Correct. Tax preparation fees paid after date of death that are already deducted on the Form 1041 fiduciary income tax return may not be doubly claimed as a deduction on Form 706. If the tax preparation fees are not claimed on Form 1041, then they may be claimed as a deduction on Form 706.

c. Incorrect. Medical expenses are one of the only deductions that may be claimed on either the decedent's final Form 1040 or as an outstanding debt on Form 706. To be deductible on the decedent's Form 1040, the medical expenses must be paid within one year after the decedent passed away.

d. Incorrect. Outstanding credit card debt existing as of the decedent's date of death is an eligible deduction for purposes of calculating the decedent's gross estate that may be subject to estate tax.

9. a. Incorrect. The sale of an asset for fair market value is not includable in the gross estate. The proceeds from the sale of the asset would be includable in the gross estate.

b. Correct. Transfers of the ownership of life insurance policies within three years of date of death are includable in a decedent's gross estate even though the asset may be titled in an irrevocable trust or the name of a third party as of the date of death.

c. Incorrect. The super-funding rules require the transfer to be ratably allocated over five years including the year of transfer. If the transferor dies during the fifth year or a year subsequent thereto, none of the transfer is required to be included in his gross estate.

d. Incorrect. The three-year lookback rule only applies to a specified set of transfers. Not every transfer made by the decedent within three years of the date of death will be brought back into the gross estate.

10. a. Correct. If the decedent's gross estate exceeds the lifetime exemption, the estate tax return is much more likely to be subject to an IRS audit than a return filed for an estate under the lifetime exemption. Therefore, precisely determining the date of death value is important and an appraisal should be attached to the return.

b. Incorrect. While a realtor market analysis can provide a good indication of the date of death value, it provides the current market condition, which may be vastly different if too much time has elapsed since the taxpayer's death.

c. Incorrect. While the tax assessor's value will provide an indication of the date of death value, the assessor does not take into consideration the many factors, such as condition of the property, which can greatly impact the property's value.

d. Incorrect. When property belonging to the decedent sells very shortly after the date of death, some estates may use the contract price as the date of death value for purposes of filing the estate tax return. While this is certainly a good indication of the fair market value of the property, other conditions, such as the estate's need for liquidity, may impact a sale price that would not indicate a true appraisal value.

Chapter 12

TOOLS OF ESTATE PLANNING

LEARNING OBJECTIVES

After reviewing this chapter, you should be able to:

- Describe the interrelation between the use of trusts and estate tax liability
- Analyze how to allocate the decedent's generation-skipping transfer tax credit
- Identify the differences between QTIP and QDOT trusts and how each can mitigate transfer taxes
- Discuss popular types of irrevocable trusts and their primary terms
- Describe the purpose of valuation discounts and the utilization in estate planning
- Explain the adequate disclosure rules and compliance requirements

ESTATE TAX AND TRUSTS

Historically, estate tax concerns drove the creation of trusts by taxpayers wishing to avoid a hefty tax liability at death. Each taxpayer has a lifetime estate tax exemption to shelter transfers to the next generation (or to other friends and family members). Any asset titled in the name of the deceased taxpayer or subject to the taxpayer's control at death is includable in the taxpayer's gross estate and subject to estate tax. Prior to the exponential rise in the lifetime estate tax credit, even modest estates paid estate tax. For these taxpayers, planning was crucial to ensure the maximum amount of assets ultimately passed to the taxpayer's heirs.

The gold standard of estate planning for married taxpayers wishing to avoid estate tax at the first spouse's death employs the use of a credit shelter or family trust in conjunction with a marital trust. Taxpayers whose estates significantly exceed the lifetime exemption may require more aggressive planning through the use of irrevocable trusts. The classic family and marital trust planning as well as some of the most common irrevocable trusts are discussed in the following sections.

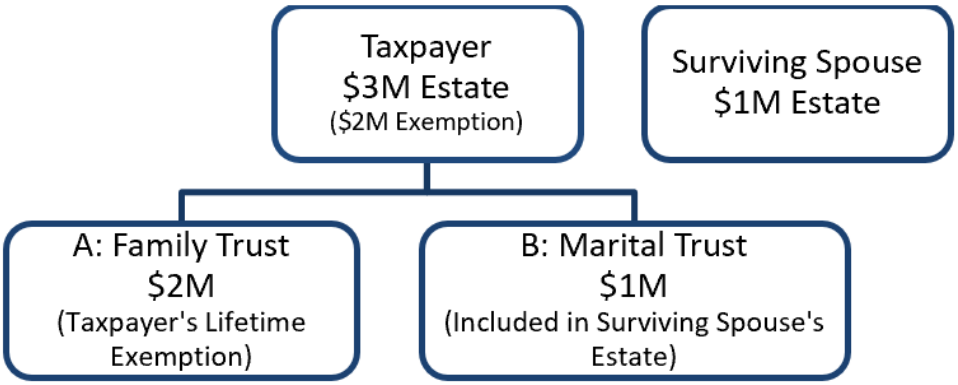
Family and Marital Trusts

Prior to 2010, taxpayers whose estates exceeded $1 million often adopted estate plans providing for the creation of a family trust and marital trust upon the death of the first spouse. This is often known as AB trust planning. The family trust is known by several names, including credit shelter trust or family bypass trust. The goal of AB trust planning is to fully use the deceased spouse's lifetime exemption and transfer the remaining assets to the surviving spouse tax-free by using the unlimited marital deduction. As discussed later in this chapter, many taxpayers want to avoid outright transfers to the surviving spouse and prefer instead to transfer funds in trust. The unlimited marital deduction can be claimed for assets transferred to eligible trusts such as qualified terminable interest property (QTIP) trusts. This technique permits the deceased taxpayer's estate to claim the unlimited marital deduction but prevents the surviving spouse from having unfettered control of the assets.

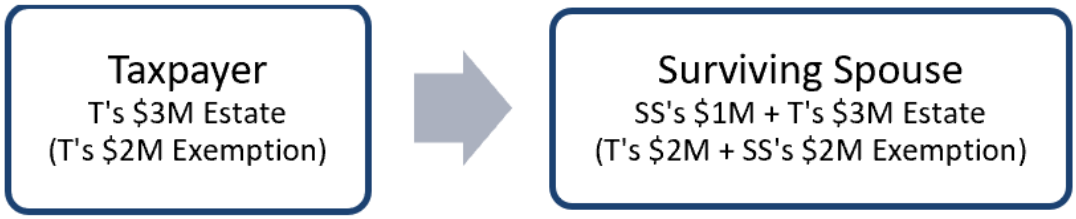
EXAMPLE

Taxpayer died in 2006 when the estate tax exemption was $2 million. Taxpayer's gross estate totals $3 million, and his spouse separately owns $1 million. Taxpayer can leave all his assets to his spouse and pay no tax due to the unlimited marital deduction. If the spouse dies when the exemption is still $2 million, then spouse's total estate is $4 million. The spouse will pay tax on the $2 million, which exceeds the estate tax exemption in 2006.

To fully utilize the first spouse's estate tax exemption and not lose this valuable protection, Taxpayer would adopt AB trust planning. Upon taxpayer's death, $2 million of his total $3 million would transfer to the family trust. The family trust is an irrevocable trust, which usually makes distributions for the ongoing support of the surviving spouse and descendants. The excess $1 million is then transferred to the marital trust and is exempt from estate tax due to the unlimited marital deduction. Any assets remaining in the marital trust are included in the surviving spouse's gross estate upon death and subject to estate tax at that time. The following illustrates the split of assets for this taxpayer using AB trust planning:



AB trust planning has fallen out of fashion for most clients because the lifetime exemption is enormous and because surviving spouses can claim portability, which was not available until 2011. Since the deceased spouse's lifetime exemption is now transferrable, there is no longer a rush to use it at death. Instead, the surviving spouse can claim the deceased spouse's unused exclusion to use upon the spouse's own death—sheltering both estates in a similar manner as the family trust protects the deceased taxpayer's estate from tax.



Of course, careful analysis is necessary to determine whether portability will adequately protect the surviving spouse's estate from estate tax. For example, if the surviving spouse is younger than the deceased spouse, the assets may continue appreciating for several years and result in the surviving spouse's estate exceeding the total combined exemption. If AB trust planning is adopted, appreciation of the assets inside the family trust is not subject to estate tax when the surviving spouse passes away.

In today's estate tax environment, few taxpayers exceed their own lifetime exemption, much less exceed both the taxpayer's and surviving spouse's exemptions. However, many taxpayers fail to update their estate plans for the tax-friendly environment. If the same taxpayer passes away in 2021 with $3 million in assets, all $3 million would pass to the family trust if the taxpayer's estate plan still provides for AB trust planning. While this structure can still achieve the taxpayer's goals, the taxpayer gives up the second basis adjustment under Code Section 1014 that can be achieved if the assets instead pass to a marital trust and are includable in the surviving spouse's gross estate. Assets passing to the surviving spouse or a marital trust that qualifies under Code Section 2056 are included in the gross estate of the surviving spouse. As a result, the tax basis of those assets is adjusted a second time when the surviving spouse passes away. Assets titled in a family trust are not included in the surviving spouse's estate. As such, the tax basis is not adjusted again when the surviving spouse

passes away.

As a result of the current exaggerated estate tax exemption and the date of death basis adjustment, many couples choose to simply transfer all assets to the surviving spouse or to a marital trust upon the first spouse's death. By doing so, the taxpayer's assets receive a basis adjustment at both spouse's deaths. Additionally, the two lifetime exemptions are usually more than enough to adequately protect the total assets from estate tax. While marital trust planning is likely ideal for most taxpayers, practitioners will still frequently encounter AB trust planning whether the client needs the estate tax protection or not.

Generation-Skipping Trusts

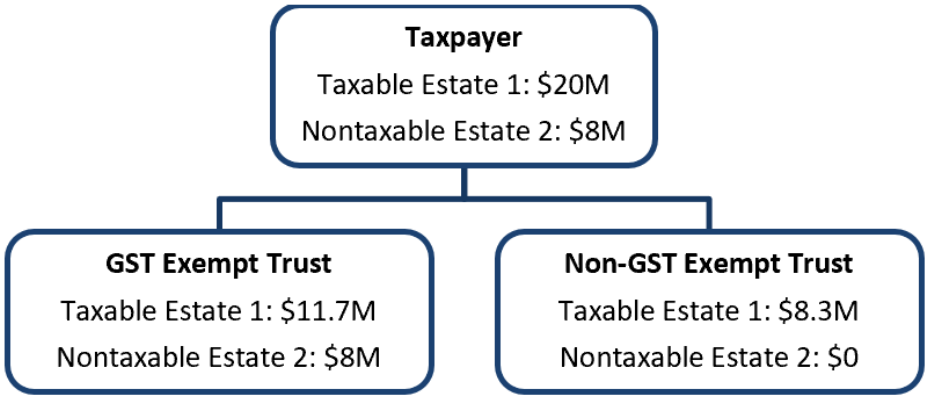
In addition to sheltering assets from estate tax, clients will also want to consider methods to minimize generation-skipping transfer (GST) tax. GST tax is a separate transfer tax imposed on transfers to individuals who are more than one generation below or more than 37½ years younger than the transferor. Most taxpayers do not make significant lump-sum transfers to grandchildren during life. However, taxpayers frequently leave legacies in trust for children and grandchildren and even great-grandchildren. To achieve optimal tax savings, family trusts and marital trusts are often divided into separate GST exempt and non-GST exempt shares. The goal being to distribute asset from the non-exempt share first to non-skip persons and save exempt assets for future generations.

EXAMPLE

Father dies in 2021 and transfers $15 million to a trust for the benefit of daughter and her children when the lifetime exemption for both estate and GST tax is $11.7 million. Father's estate must pay estate tax immediately on the $3.3 million taxable portion of his estate. GST tax is paid only when a skip person actually receives a distribution. Father's $11.7 million GST exemption is allocated to the trust when he dies, which partially shelters it from GST tax. The inclusion ratio for purposes of calculating GST tax on distributions to grandchildren is .22 (1 – ($11.7M / $15M)). For purposes of calculating GST tax, the inclusion ratio is multiplied by the tax rate of 40% to determine the trust's applicable rate. For Father's trust, the applicable rate is 8.8%. This means that every time a distribution is made from the trust to a grandchild, the trustee must remit GST tax equal to 8.8% of the distribution to the IRS. Distributions to daughter are tax-free because she is not a skip person. Upon the termination of the trust, 8.8% of the remaining assets passing to the grandchildren is paid to the IRS as a GST taxable termination.

To avoid this accounting headache and achieve potential tax savings, most estate planning documents for clients exceeding the lifetime GST tax exemption contain provisions requiring the division of the decedent's assets into GST exempt and non-exempt trusts. Instead of transferring the entire $15 million to a single trust, $11.7 million transfers to the GST tax-exempt trust to which the taxpayer's entire GST tax exemption is allocated. Any distribution from this trust to a grandchild is fully exempt from GST tax. The remaining $3.3 million is transferred to the non-exempt trust. Any distribution from this trust to a grandchild is subject to 40% GST tax. Trust terms usually direct the trustee to make distributions to daughter from the non-exempt trust first in an effort to fully deplete the non-exempt trust during daughter's lifetime. The GST exempt trust can then pass to grandchildren free from GST tax regardless of how large those assets may grow during the term of administration.

Since the exemptions for both estate and GST tax are so large, very few taxpayers encounter situations requiring the allocation of assets between exempt and non-exempt trusts; however, it is still common to find complex GST planning language in taxpayers' trust documents if their plan was not updated in recent years. In those situations, most the language can be ignored and only the requisite trusts funded. The following diagram illustrates the asset allocation for both a taxable and a nontaxable estate that contains GST tax planning provisions.



Practitioners must remember that even though the lifetime estate tax exemption is portable to the surviving spouse, the lifetime GST tax exemption is not. As discussed in the next section, any unused GST tax exemption left after fully sheltering a family trust should be allocated against the marital trust in a "reverse-QTIP election."

TRUSTS FOR THE SURVIVING SPOUSE

The unlimited marital deduction and portability are excellent tools to avoid or delay payment of estate tax. While most couples trust one another to responsibly manage and ultimately distribute the first spouse's assets, second marriage situations and concerns regarding creditors or incapacity are prevalent. Spouses want to give the survivor access to assets but ultimately want remaining assets distributed to their children from prior relationships instead of being subject to the surviving spouse's own estate plan.

The unlimited marital deduction is further only available to surviving spouses who are U.S. citizens. Instead, taxpayers must use their lifetime exemption to shelter transfers to a non-citizen spouse at death just like transfers to non-spousal recipients. The following discusses how clients can protect assets in trust for the surviving spouse while still availing themselves of the unlimited marital deduction under Code Section 2056.

Qualified Terminable Interest Property (QTIP) Trust

Code Section 2056 provides two mechanisms for transfers to trusts to qualify for the unlimited marital deduction. First, the taxpayer may use a trust that grants the surviving spouse (1) a lifetime interest in all income and (2) a general power of appointment over the trust assets. While more palatable than a direct transfer to the surviving spouse, this option allows the surviving spouse to transfer assets to their own estate at death, which could result in assets passing to a new romantic

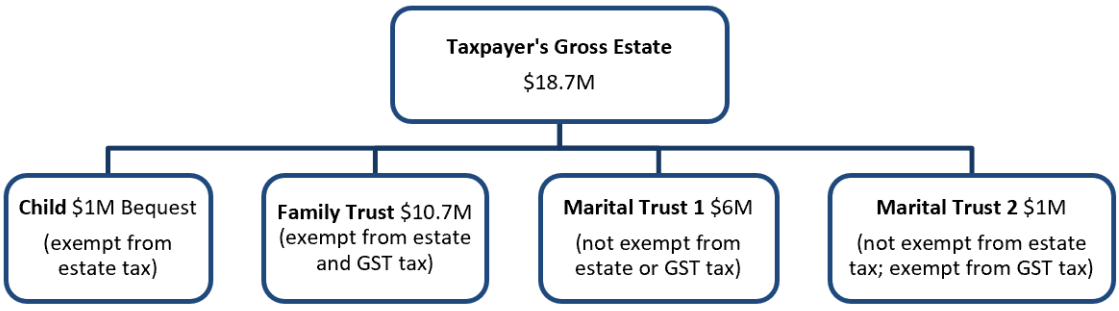
interest or the surviving spouse's own children from a prior relationship. Hence, this first option is rarely used.

The second mechanism used by taxpayers to qualify transfers to trusts for the unlimited marital deduction is the qualified terminable interest property (QTIP) trust. A QTIP trust, frequently referred to generically as a marital trust, must grant the surviving spouse an interest in all income generated by the trust. Additionally, no one other than the surviving spouse may possess a power of appointment over the trust assets. Key here is that the surviving spouse is not required to possess this power either.

The QTIP trust rules simply set a baseline for the rights a surviving spouse must receive to qualify the transfer for the unlimited marital deduction. Frequently, taxpayers grant additional rights to the surviving spouse to receive distributions from principal for health, education, maintenance, and support. As long as the trust requires all trust accounting income to be distributed annually and no one other than the surviving spouse has a power of appointment over the trust assets, these trusts will qualify for the unlimited marital deduction.

To qualify for QTIP trust treatment, an election must be made on Form 706. A successful QTIP election is made by listing the assets passing to the QTIP trust in the appropriate section of Schedule M of Form 706 and timely filing the Form 706 estate tax return. If assets pass to a marital trust and the QTIP election is not made, they are deemed to have used part of the decedent's lifetime exemption. When the surviving spouse of a qualified QTIP trust passes away, the fair market value of the assets titled inside the QTIP trust are included in their gross estate and are subject to estate tax if the surviving spouse's lifetime exemption and any portable election is not sufficient to shelter the gross estate from tax. Assets includable in the gross estate are eligible for a second basis adjustment under Code Section 1014, which can be extremely beneficial if assets appreciated inside the trust since the death of the first spouse.

In addition to making the QTIP election for assets passing to the marital trust for the benefit of the surviving spouse, practitioners should consider making the reverse-QTIP election, which proactively allocates the deceased spouse's remaining GST tax exemption to the marital trust. If assets passing to the marital trust exceed the remaining GST tax exemption, the marital trust should be divided between an exempt and non-exempt trust. These two trusts are often referred to as Marital Trust 1 and Marital Trust 2. As illustrated below, Marital Trust 1 contains assets that are fully taxable for GST tax purposes, while Marital Trust 2 is fully exempt as a result of the allocation of the taxpayer's remaining GST tax exemption. Ideally, Marital Trust 1 would be depleted first for the surviving spouse's benefit, enabling Marital Trust 2 to grow for the benefit of future generations.



Additionally, by dividing the marital trust into two shares, the exempt trust can be excluded from the surviving spouse's estate for purposes of GST tax. A timely allocation of the deceased spouse's GST tax exemption must be made on Form 706 Schedule R to achieve this result since the automatic allocation rules will instead proportionately split the available exemption among remaining trusts, which will result in partially exposing assets in both trusts to GST tax upon future distribution to skip persons.

Qualified Domestic Trusts

When the surviving spouse is not a U.S. citizen, the deceased taxpayer's estate may not claim the unlimited marital deduction for transfers to the surviving spouse. The deceased taxpayer's estate must instead allocate part of the decedent's lifetime estate tax exemption similar to any other beneficiary. However, if the deceased taxpayer's estate exceeds the lifetime exemption, the unlimited marital deduction cannot be used to offset any excess.

The reason non-U.S. spouses are ineligible for the unlimited marital deduction is because non-U.S. citizens are not subject to U.S. tax laws. If the deceased taxpayer transferred all his assets to the non-U.S. citizen spouse using the unlimited marital deduction, then upon the non-U.S. citizen spouse's death, those assets could then be transferred to the ultimate beneficiaries entirely tax-free. To prevent transfer tax avoidance, the unlimited marital deduction is disallowed for these couples.

Taxpayers can defer estate tax liability in these situations by employing qualified domestic trusts (QDOTs) to create a marital trust–style entity for the benefit of the non-U.S. spouse. A QDOT does not avoid estate tax entirely; instead, a QDOT delays the payment of estate tax. Upon the first spouse's death, assets are transferred to the QDOT for the benefit of the surviving spouse. Careful timing and elections are required to ensure the trust qualifies. During the term of the trust, the surviving spouse may receive distributions of income generated by the trust subject only to income tax and not estate tax. If the trustee distributes principal, the trustee must remit the estate tax that would have been due on those distributed assets or allocate any unused estate tax lifetime exemption still available from the deceased spouse's estate. For example, if the estate tax rate was 40% when the taxpayer died, a distribution of $100,000 from the QDOT to the surviving spouse would require a payment of $40,000 of estate tax to the IRS concurrent with the distribution. These distributions are reported on Form 706-QDT. Certain exceptions are permitted for hardship encountered by the surviving spouse.

To ensure taxes are paid upon distributions from or termination of the trust, a QDOT must name a U.S. citizen or domestic corporation as the trustee. Additionally, trustees must post a bond with the IRS to ensure the ultimate payment of the estate tax due. The amount of the bond depends on the size of the QDOT. Upon the surviving spouse's death, estate tax on the remaining corpus of the QDOT is remitted to the IRS as though the assets were included in the deceased taxpayer's original gross estate.

IRREVOCABLE TRUSTS

With the threat of the reduced lifetime exemption looming, taxpayers who want to lock-in the increased exemption or shelter future appreciation from estate tax look to irrevocable trusts to complement traditional family and marital trust planning. Irrevocable trusts have long been

the answer to achieving tax-saving goals. However, the key feature of irrevocable trusts is their irrevocability. Most taxpayer's dislike the idea of permanently giving up the right to use or control their assets, so irrevocable trusts are normally used only when estate tax liability is certain.

When drafting irrevocable trusts, practitioners must take care not to accidentally reserve an unintentional power over the trust, which could trigger its inclusion in the taxpayer's gross estate. Some of the powers to avoid include the power to enjoy or use the trust assets, control who receives distributions, replace the trustee with a related party, or direct the distribution of assets. Retaining one of these powers for practical purposes could cause irreversible tax liability for the taxpayer years later upon his death.

An upside to careless drafting of old irrevocable trusts is the potential ability to include the trust assets as part of a taxpayer's estate to obtain the basis adjustment under Code Section 1014. A keen estate administrator should thoroughly review irrevocable trusts to determine whether any of these poignant powers may have accidentally been retained by the taxpayer, causing inclusion in the taxpayer's estate. For most taxpayers whose estates are well within the lifetime exemption, including additional assets in the gross estate is of no consequence, but the basis adjustment can erase years of taxable appreciation.

While irrevocable trusts come in many shapes and sizes and can be customized to the taxpayer's specific goals, some of the most popular styles of irrevocable trusts receive catchy names and acronyms commonly used in the estate planning industry. Some of the most common of these irrevocable trusts are described in the following sections.

Irrevocable Life Insurance Trusts

The irrevocable life insurance trust (ILIT) is one of the most common irrevocable trusts that is still used with some regularity by estate planners. The ILIT is frequently structured as a Crummey trust. The basic premise of the ILIT is for the taxpayer to create an irrevocable trust agreement. The trust then purchases a life insurance policy on the life of the taxpayer. Since the trust is irrevocable and the taxpayer retains no rights over the trust, the life insurance policy and proceeds collected upon death are excluded from the taxpayer's gross estate for estate tax purposes.

ILITs are frequently used by clients who have illiquid assets within their estates. For example, a taxpayer may own a family home valued at $1 million, modest cash and investments worth $500,000, and a thriving family business worth $18.5 million. In total, the taxpayer's estate is $20 million. If the estate tax exemption is $11.7 million, the taxpayer's estate will owe $3.32 million in estate tax. The taxpayer may not want his family to be forced to sell off the family home and business to meet the tax obligation. The taxpayer could purchase life insurance in his own name to offset the expected estate tax. However, doing so only further increases his estate tax problem since 40 cents of every dollar of life insurance must be paid toward estate tax on the policy proceeds. Therefore, it is desirable to obtain a policy of insurance that can provide the liquidity necessary to pay the tax yet not further exacerbate the estate tax dilemma.

By structuring the ILIT as a Crummey trust, the taxpayer can continue to deplete his taxable estate by annually transferring funds from his estate to pay the annual premium on the policy. The taxpayer can also multiply his annual gift tax exemption by the number of beneficiaries to transfer additional sums to the ILIT without decreasing his lifetime exemption. The taxpayer and trustee of the ILIT

must take care to provide the beneficiaries with the required withdrawal notices to ensure the trust continues to qualify under the Crummey trust factors.

Spousal Lifetime Access Trusts

Since the introduction of the temporary increase in the estate tax exemption, clients have sought out ways to use the increased exemption without decreasing their lifestyle and use of their assets. A somewhat happy compromise is an irrevocable trust referred to by practitioners as the spousal lifetime access trust (SLAT). In essence, SLATs are simply "family trusts" that are created during the transferor's life instead of at death. Traditionally, transfers to a spouse or for a spouse's benefit (such as a QTIP trust) qualify for the unlimited marital deduction. As such, transfers to a spouse will not actually use any of the transferor's lifetime exemption. Taxpayers wanting to use their exemption instead of lose it when it decreases are creating irrevocable trusts for the benefit of their spouse (and oftentimes descendants). In order to use the lifetime exemption, transferors are not granting the surviving spouse those key powers that would qualify the trust for the unlimited marital deduction. By limiting the surviving spouse's rights over the trust, the assets must be sheltered by the transferor's lifetime exemption but will not be includable in the surviving spouse's estate at death. While the spouse is alive, the spouse can receive distributions to augment their lifestyle, which can indirectly benefit the transferor spouse.

EXAMPLE

Taxpayer has $15 million and spouse has $10 million. Both taxpayer and spouse expect to live past the decrease in the lifetime exemption. Spouse transfers all $10 million to a trust for the benefit of grandchildren. Spouse uses the estate and GST tax exemptions to fully shelter the transfer. Taxpayer transfers $10 million to a SLAT for the benefit of spouse and children. This transfer is also fully exempt from estate and GST tax. Taxpayer and spouse first use Taxpayer's remaining $5M to pay living expenses since those funds will be subject to estate tax upon Taxpayer's death. Once these funds are nearly depleted, spouse can receive distributions from the SLAT to pay for expenses like groceries, utilities, property taxes, mortgages, travel, and other household expenses. Taxpayer must retain enough funds to pay for personal medical expenses and other personal necessities—particularly in the event spouse dies. Upon the death of spouse, funds transfer to children or other named beneficiaries.

Caution must be used when recommending these types of trusts. If the transferor spouse is significantly younger than the beneficiary spouse, the transferor must consider the fact that upon the beneficiary spouse's death, the transferor will no longer be able to indirectly benefit from distributions from the trust. Additionally, if the marriage ends in divorce after the creation of the trust, the rights of the beneficiary spouse may be locked in. Frequently, amendments to pre-marital agreements or the creation of post-marital agreements are signed alongside these trusts to avoid a windfall for the beneficiary spouse.

Irrevocable Grantor Trusts

The term grantor trust describes an entire category of trusts, both revocable and irrevocable, in which the income generated by the trust assets is taxed to the grantor instead of the trust. This taxation arrangement can last for the lifetime of the grantor, for a term of years, or until a specified event occurs. Irrevocable grantor trusts are frequently employed to achieve estate tax savings, whereas revocable grantor trusts are used to achieve estate administration convenience. Grantor trusts are governed by Code Sections 671–679 and come in many different varieties. By transferring assets to an irrevocable grantor trust, the assets appreciate outside the grantor's estate, mitigating future estate tax burden. By requiring all trust income to be taxed to the grantor, the grantor's assets outside the trust are further depleted by the tax paid by the grantor on income the grantor never receives.

Grantor trusts that retain significant powers for the grantor, such as the ability to amend or revoke the trust, the right to income, or the power to choose beneficiaries, will result in the entire trust being included in the grantor's gross estate at death. Clients trying to avoid estate tax want the best of both worlds—exclusion from the gross estate but inclusion in income tax. Code Section 675 provides the answer to these clients by allowing them to retain minor administrative powers that cause the income to be taxed to the grantor without including the corpus as part of the gross estate of the grantor at death. Trusts that accomplish this delicate balance are referred to as intentionally defective grantor trusts (IDGTs). The goal of an IDGT is to reserve a small enough power over the trust to ensure the trust's income is taxed to the grantor, but not so large to require the trust assets to be included in the grantor's gross estate for estate tax purposes. The most common types of administrative powers retained to qualify the trust as an IDGT are the power to add a charitable beneficiary or the power to swap out trust assets of equal value.

EXAMPLE

Consider Taxpayer, who owns $1 million of stock generating $50,000 of dividends annually and growing at a rate of 5%. If Taxpayer held the stock in his own name for 5 years, his taxable estate would have appreciated by $373,006 ($215,506 + $250,000 – $92,500), costing Taxpayer an additional $149,202 in estate tax. If instead Taxpayer transfers the $1 million of stock to an irrevocable grantor trust, the appreciation and dividends accrue outside his estate and the tax is paid from Taxpayer's own assets, thus further depleting his gross estate for estate tax purposes. The IDGT saves Taxpayer $223,202 in estate tax by excluding $558,006 from Taxpayer's gross estate.

	Stock	Dividends	Income Tax
Year 1	$1,000,000	$50,000	$18,500
Year 2	$1,050,000	$50,000	$18,500
Year 3	$1,102,500	$50,000	$18,500
Year 4	$1,157,625	$50,000	$18,500
Year 5	$1,215,506	$50,000	$18,500
Total	**$215,506**	**$250,000**	**$92,500**

Taxable Transfer
$1M Stock to Trust
Nontaxable Transfers
$215,506 Stock Appreciation
$250,000 Dividends
$92,500 Tax Paid

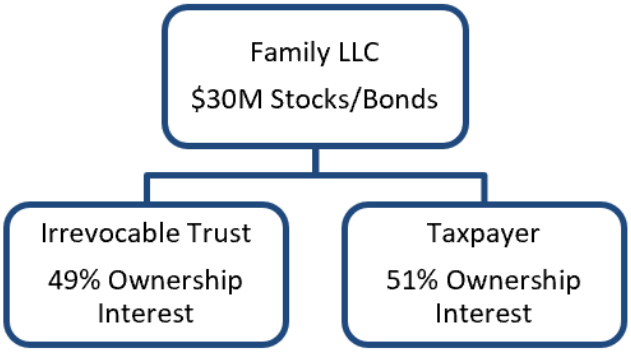
For purposes of estate tax savings, removing post-transfer appreciation and income can significantly mitigate estate tax for the grantor. The income tax paid by the grantor further depletes the grantor's taxable estate and allows the trust assets to continue growing without depleting the trust assets to pay income tax on growth and income. Therefore, irrevocable grantor trusts that retain small administrative powers for the grantor can create significant estate tax savings opportunities.

DISCOUNTING TRANSFERS TO TRUSTS

When the taxpayer decides to pursue one of the irrevocable trust options described earlier, he could transfer cash, stocks, or real estate into the trust. At the time of the transfer, the fair market value of the transferred assets is evaluated. The value of the assets will be reported as a taxable transfer subject to the gift tax rules. Clients wanting to maximize their current $11.7 million exemption may want to consider using a valuation technique called discounting to fit more assets into the exemption than may appear to fit on the surface.

Consider a client who owns $30 million of stocks and bonds. He could evaluate the average of the high and low trading value on the date of transfer to his irrevocable trust and transfer $11.7 million worth of the stocks and bonds tax-free using his lifetime exemption. The remaining $18.3 million will be includable as part of his gross estate. Alternately, he could transfer his $30 million of stocks and bonds to an LLC or other similar partnership entity. He then can gift an ownership interest in the LLC to the trust. The LLC ownership interest, not the stocks and bonds, is the gifted asset and will be valued for gift tax reporting purposes.

By employing this technique, the valuation expert can potentially apply discounts to the gifted ownership interest. The primary discounts applicable in estate planning transfers are lack of marketability discounts and lack of control discounts. The idea is that a trust will have a tough time selling an LLC ownership interest compared to selling publicly traded stocks and bonds. Similarly, if the LLC does not own a voting interest or owns an insufficient interest to control the direction of the company, the value of the ownership interest should be reduced to take this passive investor status into consideration. Discounting percentages for lack of marketability and lack of control can range between 5% and 50% depending on the facts.



If the client above chooses to transfer his $30 million of stocks and bonds to the Family LLC, the valuation of the gift to the irrevocable trust of a 49% interest starts by analyzing the assets inside the LLC and multiplying their value by the gifted ownership interest ($30M × 49% = $14.7M). Without discounting, the taxpayer would pay tax on the excess $3 million transferred to the irrevocable trust at a cost of $1.2 million in gift tax. However, if the taxpayer applies a conservative 15% discount for lack of marketability ($14.7M × 85% = $12.49M) and another 15% discount for lack of control ($12.49M × 85% = 10.62M), he has suddenly changed a $14.7 million taxable gift to a $10.62 million gift fully exempt with the taxpayer's available lifetime gift tax exemption. The client could also own real estate or a family business (or multiple businesses) and utilize this same technique with potentially even larger discounts.

Clients must consult experienced professionals to evaluate these entities and calculate the appropriate discounts. The services of valuation experts can be expensive, with valuation reports often starting at around $10,000 per report. The potential benefit of applying discounting to a gift can save millions of dollars in tax. As a result, these gifts are highly scrutinized by the IRS and the topic of several recent tax court opinions. Additionally, the taxpayer must consider whether or not to retain the controlling interest in these types of entities. Retaining the controlling interest allows the taxpayer to apply lack of control discounts to the gifted interest. However, the IRS is consistently examining these transfers for purposes of totaling the taxpayer's gross estate to determine whether the taxpayer ever really gave up control when he gifted the ownership interest to the irrevocable trust. Under Code Section 2036, when the taxpayer has control over an asset at death, the asset is included as part of his gross estate. These arrangements should not be entered into lightly and must be examined from all angles to prevent unexpected tax consequences down the road.

Adequate Disclosure

When clients make gifts of interests in closely held entities or to trusts in which the grantor retains certain rights, the taxpayer must ensure the details of the transaction are thoroughly described on Form 709, Gift Tax Return. If details are lacking, then under Treas. Reg. Sec. 301.6501(c)-1, the statute of limitations for examining the transaction remains open indefinitely and gift tax may be assessed or a proceeding in court for the collection of unpaid tax may begin at any time. Not all transfers are subject to the adequate disclosure rules. The transfers that must contain detailed descriptions include: (1) transfers of interests in family-owned corporations or partnerships subject to the special valuation rules of Code Section 2701; (2) transfers to trusts in which the grantor retains certain rights subject to Code Section 2702; and (3) transfers that trigger qualified payment rights under Treas. Reg. Sec. 25.2701-4.

Taxpayers can ensure their transfers are adequately disclosed and begin the tolling of the statute of limitations by providing the following information with the gift tax return:

- A description of the transaction, including a description of the transferred and retained interests and the method used to value each transferred interest;
- The identity of and relationship between, the transferor, transferee, all other persons participating in the transaction, and all parties related to the transferor holding an equity interest in any entity involved in the transaction; and
- A detailed description (including all actuarial factors and discount rates) of the method used to determine the amount of the gift arising from the transfer, including the financial and other data used in determining value.

As taxpayers look for ways to minimize the size of their estates, these rules will apply more frequently, particularly to transfers in closely held entities. However, practitioners must not forget that the adequate disclosure obligations also apply to certain trust entities such as grantor retained annuity or income trusts, qualified personal residence trusts, charitable remainder and lead trusts, and traditional life estates. Since valuation experts are typically very busy, clients must plan ahead to ensure they have the necessary documentation to support their transaction and to make the required disclosures.

SUMMARY

Taxpayers should consider using trusts to mitigate administration hurdles and income and estate tax liability. The increased lifetime estate and gift tax exemption has made some of the classic trust vehicles obsolete for the majority of taxpayers. However, for wealthy taxpayers seeking methods to minimize their overall tax liability, irrevocable trusts, grantor trusts, and discounting techniques are valuable tools. These tools will become increasingly relevant when the lifetime exemption decreases. Implementing these planning opportunities requires careful analysis since unintended consequences can be triggered by ineffective drafting. This should not discourage practitioners from recommending these opportunities, because the savings that can be achieved by successfully implementing these techniques can be significant.

REVIEW QUESTIONS

1. Which of the following trusts does not provide the taxpayer with protection from estate tax?

a. Revocable trust

b. Spousal lifetime access trust (SLAT)

c. Intentionally defective grantor trust (IDGT)

d. Irrevocable life insurance trust (ILIT)

2. To qualify for the annual gift tax exclusion, the beneficiaries of an irrevocable life insurance trust (ILIT) must have which of the following rights?

a. Withdrawal right

b. Right to annual income

c. Right to revoke the trust

d. Right to remove the trustee

3. Under current estate tax exemption limits, AB trust planning is most effective for which of the following taxpayers?

a. Couple with combined estate of $5 million

b. Couple with combined estate of $15 million

c. Couple with combined estate of $25 million

d. Couple with combined estate of $25 million and one spouse is a non-U.S. citizen

4. A single taxpayer with an estate valued at $20 million who wants to transfer his assets to his children and grandchildren should use which of the following techniques?

a. Generation-skipping transfer (GST) tax-exempt trust

b. Marital trust

c. AB trust

d. Charitable remainder trust (CRT)

5. To meet the adequate disclosure requirements, which of the following does not have to be reported?

a. A description of the transaction and the method used to value each transferred interest

b. The identity of and relationship between the transferor and transferee

c. A description of the method used to determine the amount of the gift

d. The transferor's reason for giving the gift to the transferee

6. Which of the transfers is currently subject to generation-skipping transfer tax?

a. Gift of a pony to a granddaughter

b. Gift of cash to a child

c. Transfer of real estate to a trust for a spouse

d. Transfer of securities to a trust for a child and grandchildren

7. Which of the following trusts can be used in place of a marital trust for a taxpayer married to a non-U.S. citizen?

a. Family bypass trust

b. Qualified domestic trust

c. Credit shelter trust

d. GST trust

8. Which of the following is true relating to a spousal lifetime access trust (SLAT)?

a. The grantor spouse may receive distributions from the trust.

b. The grantor's lifetime gift and estate tax exemption must be allocated to the trust to lock-in the larger lifetime exemption before it decreases.

c. The assets are includable in the recipient spouse's estate at death.

d. The assets are automatically exempt from generation-skipping transfer tax.

9. Which of the following discounts would apply to a gift of a 20% ownership interest in a partnership owned by Mother, Father, Son, and Grandson?

a. Lack of control discount

b. Lack of marketability discount

c. Lack of control and lack of marketability discount

d. Majority owner discount

10. Which of the following trusts requires the grantor to report all income earned by the trust?

a. Intentionally defective grantor trust

b. Irrevocable life insurance trust

c. Charitable lead trust

d. Credit shelter trust

ANSWERS TO REVIEW QUESTIONS

1. a. Correct. Assets titled in the name of a revocable trust will always be included in the grantor's gross estate for estate tax purposes. Under the grantor trust rules, the income generated by the assets will also be taxable to the grantor during his lifetime.

b. Incorrect. A spousal lifetime access trust is intended to shelter assets transferred to the trust from estate tax by utilizing the grantor's lifetime gift and estate tax exemption. Additionally, since this trust is not a QTIP marital trust, the assets will not be includable in the spouse's gross estate.

c. Incorrect. An intentionally defective grantor trust is intended to shelter assets transferred to the trust from estate tax by utilizing the grantor's lifetime gift and estate tax exemption. This trust can also further deplete the grantor's assets by causing all income generated by the trust assets to be included as part of the grantor's annual income requiring tax to be paid from non-trust assets.

d. Incorrect. An ILIT is designed to exclude assets from the taxpayer's gross estate by permitting a taxpayer to purchase a life insurance policy inside the trust. The policy is managed by the trustee of the trust and is ultimately excluded from the gross estate.

2. a. Correct. Under the Crummey trust rules, beneficiaries must have the right to withdraw funds contributed to an ILIT if the transferor wants to use the annual gift tax exemption to offset the transfers for gift tax purposes. If assets are contributed in excess of the annual exclusion, beneficiaries are not required to receive a withdrawal right over the excess assets.

b. Incorrect. After the withdrawal right lapses, the beneficiaries are not required to hold any other right over the trust. The terms can be customized by the grantor to fulfill the grantor's estate planning goals.

c. Incorrect. Usually, a beneficiary is never granted the right to revoke a trust. Doing so would likely cause the beneficiary to be taxed on all the trust's income, similar to the grantor of a grantor trust. A beneficiary is not required to be able to revoke the trust for it to qualify as a Crummey trust.

d. Incorrect. A beneficiary is never required to be permitted to remove the trustee for the trust to qualify as a Crummey trust.

3. a. Incorrect. A couple with a combined estate of $5 million should use portability and the marital trust or outright transfers to the surviving spouse in order to achieve optimal tax savings by obtaining a basis adjustment at both spouse's deaths.

b. Incorrect. A couple with a combined estate of $15 million should use portability and the marital trust or outright transfers to the surviving spouse if the first spouse may pass away prior to 2026 and the surviving spouse is not significantly older than the first deceased spouse in order to achieve optimal tax savings by obtaining a basis adjustment at both spouse's deaths.

c. Correct. When a couple's combined estate exceeds their individual lifetime exemptions, it is wise to use AB trust planning (in addition to perhaps more aggressive forms of estate planning) to lock-in the estate tax exempt assets in the family trust on the first spouse's death to prevent unnecessary appreciation from accumulating in the surviving spouse's estate.

d. Incorrect. A couple with a non-citizen spouse must use a qualified domestic trust (QDOT) to achieve estate tax savings on the death of the citizen spouse to delay the payment of estate tax on the assets passing for the benefit of the non-U.S. citizen spouse.

4. a. Correct. When multiple generations are beneficiaries of the same assets, it is wise to separate the assets into GST exempt trusts and non-GST exempt trusts. Distributions should be made to non-skip persons first from the non-GST exempt trust to avoid later subjecting those assets to 40% GST tax upon transfer to grandchildren.

b. Incorrect. An unmarried taxpayer is unable to utilize the marital trust to claim the unlimited marital deduction.

c. Incorrect. AB trust planning is premised on the idea of transferring the estate tax credit to the A – family trust and the remainder to the B – marital trust. An unmarried taxpayer cannot utilize this method of estate planning.

d. Incorrect. While a CRT is helpful for avoiding estate tax, the remaining assets ultimately pass to a charity and not the taxpayer's heirs. A charitable lead trust (CLT) might be a better option for this taxpayer since the remainder passes to heirs instead of charity.

5. a. Incorrect. To meet the adequate disclosure requirements, the transferor must provide a description of the transaction, including a description of the transferred and retained interests and the method used to value each transferred interest with his gift tax return.

b. Incorrect. To meet the adequate disclosure requirements, the identity of and relationship between the transferor, transferee, all other persons participating in the transaction, and all parties related to the transferor holding an equity interest in any entity involved in the transaction, must be reported.

c. Incorrect. To meet the adequate disclosure requirements, a detailed description (including all actuarial factors and discount rates) of the method used to determine the amount of the gift arising from the transfer, including the financial and other data used in determining value, must be reported.

d. Correct. The IRS does not necessarily care about the reason for a gift but is only concerned about whether a transfer for less than fair market value consideration in return occurred. The transferor is not required to disclose the exact reason for why the transfer is made so long as the transaction meets the adequate disclosure requirements.

6. a. Correct. A transfer to an individual who is related to the transferor and is more than one generation below the transferor or a transfer to an unrelated individual who is greater than 37.5 years younger than the transferor is subject to generation-skipping transfer tax at the time of the transfer.

b. Incorrect. A transferor's child is not a skip person even if the child is more than 37.5 years younger than the transferor.

c. Incorrect. A transfer to a trust for the benefit of the transferor's spouse will not be currently subject to generation-skipping tax. If distributions are made from the trust to the transferor's grandchildren or other skip persons in the future, such transfers will be subject to generation-skipping transfer tax at the time of the distribution.

d. Incorrect. A transfer to a trust for the benefit of the transferor's child and grandchildren will not be currently subject to generation-skipping tax. If distributions are made from the trust to the transferor's grandchildren or other skip persons in the future, such transfers will be subject to generation-skipping transfer tax at the time of the distribution.

7. a. Incorrect. While a non-U.S. citizen may be a beneficiary of a family bypass trust, the family bypass trust requires the allocation of the taxpayer's lifetime exemption and does not qualify for the unlimited marital deduction.

b. Correct. Since the unlimited marital deduction is unavailable for non-U.S. surviving spouses, a QDOT can be used in place of a traditional marital trust. While the QDOT will not totally avoid estate tax on assets passing for the benefit of the surviving spouse, it will delay tax until the surviving spouse's death.

c. Incorrect. The credit shelter trust is another name for the family bypass trust and requires the allocation of the taxpayer's lifetime exemption to protect the assets from estate tax. A credit shelter trust does not qualify for the unlimited marital deduction.

d. Incorrect. A GST trust is intended to protect against the payment of GST tax, which is charged against transfers to skip persons. A GST trust is not eligible for the unlimited marital deduction.

8. a. Incorrect. The grantor of the trust must not retain any ability to receive distributions directly from the SLAT in order to ensure the assets are not includable in the grantor's estate at death. However, the grantor can indirectly benefit from distributions that are made to the grantor's spouse if the spouse uses the distributions to pay joint expenses such as the couple's mortgage, real estate taxes, utilities, etc.

b. Correct. A primary purpose for creating a SLAT is for the grantor to make gifts of his full lifetime gift tax exclusion before the exclusion is reduced while, at the same time, not fully giving up the ability to indirectly benefit from the assets, since distributions can be made to the grantor's spouse that conceivably could be used to pay joint expenses.

c. Incorrect. Since the grantor will allocate his lifetime gift and estate tax exemption to shelter the trust assets and will not rely on the unlimited spousal deduction by employing a QTIP transfer, the assets are not includable in the gross estate of the recipient spouse.

d. Incorrect. If the grantor wants the assets to be exempt from generation-skipping transfer tax, the grantor will need to allocate his lifetime generation-skipping transfer tax exemption to the SLAT in addition to his lifetime gift and estate tax exemption. The trust will not automatically be exempt from generation-skipping transfer tax.

9. a. Incorrect. While the lack of control discount will apply to this gift because a 20% interest would not have the ability (barring other factors) to be able to control the company since it is not greater than 50%, it is not the only discount that would apply to this gift.

b. Incorrect. While the lack of a marketability discount will apply to this gift because ownership interests in companies that are not publicly traded are difficult to sell, it is not the only discount that would apply to this gift.

c. Correct. The lack of control discount will apply to this gift because a 20% interest would not have the ability (barring other factors) to be able to control the company since it is not greater than 50%, and the lack of marketability discount will also apply to this gift because ownership interests in companies that are not publicly traded are difficult to sell.

d. Incorrect. When an ownership interest grants the recipient the majority ownership, no discount would apply since being the majority owner would be a benefit to the recipient, not a detriment deserving of a discount.

10. a. Correct. Grantor trusts require the grantor to report all income earned by the trust. A grantor who wants to exclude the trust assets from the grantor's gross estate for estate tax purposes but pay tax on the annual trust income can retain specific powers over the trust, such as the right to replace trust assets or add charitable beneficiaries to achieve this goal.

b. Incorrect. An ILIT is created to hold title to a life insurance policy, which does not generate income until the death of the grantor when the life insurance policy proceeds are paid. Income is normally not generated by the ILIT during the lifetime of the grantor.

c. Incorrect. A charitable lead trust pays an income interest to the charity during the term of the trust followed by distributions to the grantor's chosen ultimate beneficiaries. The grantor does not report income earned by the CLT.

d. Incorrect. The credit shelter trust or family bypass trust is created after the taxpayer passes away and provides a mechanism to protect assets from estate tax in the estates of trust beneficiaries.

Chapter 13

ETHICS AND PROFESSIONALISM IN SERVING AGING CLIENTS

LEARNING OBJECTIVES

After reviewing this chapter, you should be able to:

- Determine who is the client
- Know how to interact with clients exhibiting diminished capacity
- Protect clients with diminished capacity
- Avoid potential conflicts of interest
- Navigate confidentiality issues
- Acquire a working knowledge of ethics and professional practices

NTRODUCTION

An advisor to individuals seeking advice on planning for retirement is in a rare and unique position.

Sources of Tax Practice Standards

- Code of Ethics of the Accreditation Council for Accountancy and Taxation ("Code"). The Code is established by Accreditation Council for Accountancy and Taxation as part of the Accredited Retirement Advisor Certification. ACAT credential holders agree to abide by the Code of Ethics as a prerequisite to holding a credential. This Code of Ethics is a condensation of the principles contained in the ACAT Rules of Professional Conduct and Official Interpretations which are binding in detail on all accredited individuals.
- Common law. Common law is established by court cases to decide issues not specifically addressed by statutory authority. It is also considered the law of the land.

Organization of This Chapter

The sources above will be organized and discussed in three sections:

- The Retirement Specialist's Responsibility to the Client
- Dealing with Clients with Diminished Capacity
- The Common Law Standard of Care and Legal Liability for Fiduciaries

THE RETIREMENT SPECIALIST'S RESPONSIBILITY TO THE CLIENT

It is vital that a practitioner act in a manner that puts the client's needs before his or her own interests. An advisor's fiduciary duty to the client requires him or her to act for the benefit of the client, demonstrating good faith, integrity, dependability, transparency, discretion, and care during this representation, all of which arises from the unique trust relationship between the parties.

Fiduciary duty is defined by common law and will be discussed later in this chapter. Typically, though, a practitioner who has acted in a reasonable manner, which includes meeting practice standards as enumerated by the Code of Ethics, will be treated as having upheld his or her fiduciary duty. Accredited individuals must additionally perform engagements in a professional and objective manner, while paying heed to regulations promulgated by federal and state regulators, such as the Securities and Exchange Commission (SEC) and state insurance boards. To that end, the service provider cannot have divided loyalties. This could potentially put an individual in a difficult position if, by upholding a regulation, an unhappy client is prevented from taking a desired course of action. Pleasing the client at the expense of the rules, another client, or the advisor's own agenda will put the practitioner in the position of having a conflict of interest. The accredited individual instead should maintain objectivity, which requires an unbiased and honest look at a situation. The practitioner should fairly assess when he or she is trying to rationalize undermining the rules in order to benefit himself or herself and/or please the client. Additionally, an accredited advisor is charged with mastering the difficult and complex rules so that services can be rendered with competence. A

client should also be provided services in a timely, efficient, and professional manner, and should be charged only a reasonable fee. This, along competence, is the essence of due care.

These responsibilities that a practitioner owes to the client and the authorities in carrying out an engagement are explained in the Code of Ethics and in common law. We will be looking in this section at the Code of Ethics as it pertains to how we need to conduct ourselves as accredited retirement advisors. An overview of common law will be covered in the second section of this chapter.

Confidentiality

Practitioners are charged with holding the affairs of their clients in confidence. A client is a person who has contracted with you (formally or informally) for your services and for whom you owe a fiduciary duty. Generally, a service provider cannot disclose a client's information without permission. Exceptions where a practitioner can reveal information even without consent include when the practitioner is subpoenaed, summoned, or under court order.

The Code states that accredited individuals "shall not violate the confidential relationship between themselves and their clients or former clients." This necessitates the practitioner keeping in mind who is the client and not bowing to pressure from the client's relatives or other outside parties.

EXAMPLE

Francine has been an advisor to Edna, an elderly individual. One of Edna's children, Jo, calls Francine without Edna's knowledge and demands details on Edna's stock holdings. Francine cannot reveal this information without Edna's permission even if Jo becomes threatening. Francine should keep in mind that Edna is her client, not Jo.

EXAMPLE

A debt collector for some of Edna's outstanding loans calls Francine for Edna's account information. Francine similarly cannot reveal this information unless Edna gives permission for Francine to do so.

Contingent Fees and Commissions

The ATA Code states that accredited individuals "shall not offer or render a professional service for a contingent fee . . . [for] an audit engagement, a review engagement or a compilation engagement . . . further, a member shall not offer to accept or accept a contingent fee for the preparation of original or amended tax returns or claims for tax refunds." As long as the practitioner is not performing assurance work or preparing the client's original tax return, the ATA Code seems to indicate that a retirement advisor may accept a contingent fee. In the event that the retirement advisor receives a commission for selling the client an investment or insurance product or for managing the client's

portfolio, the advisor's actions must be consistent with his or her fiduciary duty of objectivity and being free of conflicts of interest, as discussed below.

EXAMPLE

Retirement Advisor Kenneth is advising Angela on possible investments. He has two possible mutual funds and an insurance product to recommend to Angela. Fund A will reap a 2.0% commission to Kenneth, and Fund B has a 1.25% commission. Both funds are similarly managed and have an equal rate of return. The insurance product would pay him a 10% commission and has a lower anticipated return than the funds. Kenneth is obligated to recommend Fund B to Angela since this is the investment that would benefit Angela the most.

Independence

The ATA Code states that accredited individuals "shall not express an opinion on financial statements of an enterprise unless they and their firm are independent of such enterprise." This means that a practitioner's focus cannot be merely his own gain (e.g., continuing fees), but the practitioner must provide an objective assessment in reviewing the financial statement of a potential investment.

EXAMPLES

Bruce is a developer who is seeking investors for a real estate project. He anticipates receiving handsome ongoing management fees as the promoter of the deal. A close look at the proforma financial statements shows that there are many unknowns inherent in this project. The estimated return to the investor is lackluster considering the business risks involved in commercial property leasing in the current market. Bruce has told Daniella, a retirement specialist, that she would receive an 8% commission for every investor she is able to steer Bruce's way. Daniella should not be swayed by the commission and should only recommend an investment that has a return that, at a minimum, is commensurate with its inherent risk.

Advertising and Solicitation

The ATA Code states that accredited individuals "shall not permit their names to be used in conjunction with any special purpose statement prepared for their clients that anticipates results of future operations, unless they disclose the source of the information used and what assumptions they have made, and unless they indicate they do not vouch for the accuracy of the forecast."

EXAMPLE

Angie, a retirement advisor, proposes to Eli the purchase of a variable annuity. She prepares projections of the amount Eli might be able withdraw when he retires assuming he contributes $10,000 per year for the next 20 years. She is obligated to clearly state the assumptions made in calculating the withdrawal amount. Angie should ensure that Eli understands whether the

assumptions are within reason or are an aggressive stance. He should also be clearly informed that the forecast may not be accurate because of unexpected market forces. Angie should also inform Eli in writing that she will receive a commission on each payment he makes.

The ATA Code also states that licensees "shall not seek to obtain clients by advertising or other forms of solicitation in a manner that is false, misleading or deceptive."

EXAMPLE

Peggy, a retirement advisor, posts leaflets in a local senior citizen center and hands out cards to its members. In her printed materials, Peggy claims that she has access to certificates of deposits that will pay 8%, even though the national average is 1% when she does not, in fact, have access to the 8% CDs. Peggy also claims she has an MBA from an Ivy League school and many years of experience at a prestigious investment bank, none of which is true. This type of advertising constitutes a violation of the Code.

Firm Name

It is essential in serving the public that firm names are not confusing or misleading as to the ownership, legal organization, partners, or specializations possessed by the firm. The ATA Code states that accredited individuals "shall not allow any person(s) to practice in their corporate, partnership or individual name who is not a partner, professional corporation co-shareholder or in their employ." The ATA Code goes on to state that individuals "who engage in the practice of accounting as a sole proprietor shall not use a plural term in the name of their firm, as 'and company' or 'and associates' or any other terms which would indicate anything other than individual ownership."

EXAMPLE

Haley Smith is the sole practitioner of a consulting firm that specializes in retirement planning. She cannot name her firm Smith and Associates or Smith and Brown, L.P. (the firm's name prior to Mr. Brown retiring) since it implies that there is more than one practitioner working in the firm.

Conflict of Interest

A conflict of interest can exist when one client's interests are adverse to another client, or the practitioner has a personal interest or responsibility to someone else that will compromise the professional services rendered. The ATA Code states that accredited individuals "who render professional services . . . shall not at the same time engage in any business or occupation which would create a conflict of interest while performing the aforementioned professional services."

EXAMPLE

James, a retirement advisor, has a fee-based client with $100,000 to invest. He has a business contact, Kenza, who has told him that she will pay him $2,000 for every client James refers to invest in the real estate investment trust (REIT) that she manages. The REIT has historically produced mediocre returns, well below the average return from other investments in its asset class. James has a conflict of interest with respect to Kenza's REIT. He should avoid recommending this investment to his clients under the circumstances.

Due Diligence

The ATA Code requires accredited individuals to "be diligent, thorough and completely candid in expressing an opinion or other assurance on financial statements they have audited, reviewed or compiled."

EXAMPLE

Krishna was asked to analyze the financial statements of Acme, Inc. by her client, Dinesh, who wanted to make sure the company was on solid footing because he is contemplating buying some of its stock. Dinesh also wants Krishna to render an opinion on whether Acme's recently patented Alzheimer's disease medication would become a market leader, thereby driving up Acme's stock in the near future. Krishna takes a cursory look at Acme's financial statements and its external CPA's audit opinion. Krishna provides her own audit report to Dinesh on Acme's financial statements and tells him it is a solid investment. Krishna has failed to demonstrate due diligence in this case because she cannot purport to express an opinion on financial statements that she has not audited.

DEALING WITH CLIENTS WITH DIMINISHED CAPACITY

A conundrum faced by an advisor from time to time is how to carry out his or her fiduciary duty when a client is potentially demonstrating diminished capacity. Diminished capacity is defined as "the decline of one's skills or the ability to make sound decisions, which can be caused by diseases such as Alzheimer's or dementia."

Possible signs of diminished capacity include the following:

- Being forgetful
- Showing increasing disorganization, e.g., bills going unpaid
- Compromising hygiene or self-care
- Spending or gifts that do not fit the client's values or plans
- Disorientation with surroundings or social setting
- Unexpected requests that put the client's financial security at risk

- Erratic behavior
- Refusal to follow appropriate advice, especially if the advice is consistent with previously stated objectives, long-term goals, or commitments
- The presence of a new person wielding outsized influence on the client
- Inability to complete simple tasks such as signing a form
- New problems with speaking or writing words
- A pattern of not remembering advice or recent conversations
- Lack of awareness or understanding about recently completed transactions

Dealing with a client who potentially may be experiencing mental competency issues can put the advisor in a difficult position. On the one hand, the practitioner must show a duty of loyalty and must carry out a client's wishes to the best of his or her ability. On the other hand, the advisor must also fulfill his or her fiduciary duty and must act in the client's best interest. The right course of action will depend on the client's facts and circumstances. The advisor should prepare a game plan only after thoroughly vetting the situation and potentially involving the court system, social services, and the client's attorney or a guardian ad litem. The practitioner will have to walk a careful line in order not to reveal confidential information unless required and until it is absolutely necessary. To protect your clients, yourself, and your practice, consider having the following tools in place prior to needing them:

- Train your staff on the signs of diminished capacity and establish policies clarifying to whom to report these areas of concern.
- Encourage your clients to document their wishes and share them with you before the risk of diminished capacity or competence arises.
- Discuss whether the client should be protected by:
- Having a power of attorney, conservator, or guardian appointed to act on behalf of the client;
- Having the client select individuals that the client authorizes to speak with you in case of an emergency;
    - Executing some or all of the following types of documents:
    - Designations of a Preneed Guardian,
    - Medical healthcare power of attorney,
    - Durable power of attorney,
    - Declaration for mental health treatment,
    - Appointment of a representative payee to manage public benefits, and
    - A joint bank account, check management or special needs trusts.

An advisor should also consider the wishes and values of the client to the extent known, the client's best interests, and minimizing the intrusion into the client's decision-making autonomy.

If a client is exhibiting signs of diminished capacity, you should hold off on taking drastic actions for the client until you have been able to fully investigate the situation. You may want to consult with an attorney when determining the appropriate action you should take.

THE COMMON LAW STANDARD OF CARE AND LEGAL LIABILITY FOR FIDUCIARIES

In the previous section of this chapter, we discussed the ATA Code of Ethics, which governs the retirement advisor's interactions with the client and the profession. We will now be looking at how the courts define what is reasonable behavior for a retirement advisor. These judicial pronouncements are known as common law, where typically court opinions answer questions of law that are not otherwise specified in the written law, or statutes. These court opinions establish de facto rules or standards that if violated will result in the party allegedly committing the wrongful act, the defendant, being required to pay damages or to carry out an ordered action called specific performance to the complaining party, the plaintiff.

While common law is specific to a state or specific geographical area, there are many commonalities between these jurisdictions. If a practitioner violates these common law rules, the plaintiff may have what is called a cause of action, which means that they may have grounds to sue. Common causes of action in professional malpractice cases can fall within torts or contract claims. The following section will discuss the general requirements of breach of fiduciary duty and negligence, the most common torts asserted against retirement advisors. Be aware, however, that the specific requirements in your jurisdiction may slightly vary from the general requirements discussed below.

Breach of Fiduciary Duty

A fiduciary relationship exists when one person is under a duty to give advice for the benefit of another within the scope of the relationship. This includes situations where one person places a special confidence in another who is bound to act in good faith and in the interest of the other person. A plaintiff must prove all the following elements to prove that an advisor has breached a fiduciary duty owed to a client:

1. The plaintiff and the defendant had a fiduciary relationship.
2. The defendant breached its fiduciary duty to the plaintiff.
3. The defendant's breach resulted in:
    a. Injury to the plaintiff, or
    b. Benefit to the defendant.

Negligence

The issue of whether an advisor has violated his duty of reasonable care usually arises when a client claims that the practitioner has been negligent. The elements of a cause of action for negligence are well-established and are as follows:

1. A legal duty owed by one person to another;
2. A breach of that duty;
3. The breach was an actual cause of injury (known as proximate cause); and
4. Actual injury.

The standard of care in negligence claims is often defined by the characteristics of that inherent fiduciary relationship. As a result, courts refer to these fiduciary standards to define the standard of care required of retirement advisors.

Standard of Care: Duty to Act as a Fiduciary to the Client and to Act Reasonably Under the Circumstances

In general, a fiduciary duty is a duty or responsibility to act in the best interest of someone else. It is a unique relationship predicated on the fact that the client is depending on the advisor's specialized knowledge and skills to either protect the client's interests or solve a specific problem the client is facing. This relationship calls for a unique trust relationship between the parties. The advisor is charged with acting for the benefit of the client, demonstrating good faith, integrity, dependability, transparency, discretion, and care during this representation. Additional examples of fiduciary duties owed to clients include the duty to be loyal and to charge reasonable, fair, and conscionable fees only for services actually rendered or work actually performed. The fiduciary may not benefit personally at the client's expense. A breach occurs if the fiduciary behaves in a manner that would be construed as against the best interests of the client.

Courts have held in various opinions over the years that fiduciary duty includes the following:

- Showing loyalty to the client
- Acting with integrity and fidelity
- Displaying full disclosure
- Showing the client openness and honesty, abundant good faith, and perfect candor
- Avoiding concealment or deception
- Rendering a full and fair disclosure of facts material to the client's representation
- Not using client confidential information improperly, or engaging in self-dealing
- Not subordinating a client's interests to the advisor's interests

- Avoiding improper behavior such as wrongfully retaining the client's funds, taking advantage of the client's trust, or making misrepresentations
- Making reasonable use of the confidence that the client places in the advisor
- Fairly disclosing all important information to the client concerning the transaction

An advisor's fiduciary duty may arise from either a formal relationship—such as the advisor assuming the role of a trustee or agent for the benefit to the client—or an informal one. The courts have stated, "an informal relationship may give rise to a fiduciary duty where one person trusts in and relies on another, whether the relation is a moral, social, domestic, or purely personal one."

The common-law duty of reasonable care requires the practitioner to exercise the degree of care, skill, and competence that reasonable members of the profession would exercise under similar circumstances. It follows that a reasonable retirement advisor will at a minimum fulfill his or her fiduciary duties to the client. Failure to do so would violate an advisor's standards of care and could potentially give rise to a negligence cause of action. If it can be proven that the advisor fails to demonstrate reasonable care and/or has violated his or her fiduciary duty to the client, the advisor may also be held liable for a breach of contract or fraud claim.

EXAMPLE

Robert, a retirement advisor, actively promoted an investment strategy to wealthy clients and earned generous fees as a result. In reality, Robert was aware that the strategies would quite likely be considered a tax shelter by the IRS and, therefore, would be disallowed, resulting in the clients being subject to tax assessments, penalties, and interest. Robert could be sued under breach of fiduciary duty, negligence, and other causes of action.

CASE STUDY: DONALD RICE

Donald R. Rice, a former CPA from Middletown, DE, was sentenced to four years in federal prison after pleading guilty to two counts of wire fraud and one count of making false statements on tax returns. He had been discovered stealing from a $3 million trust account and looting an estate to which he owed a fiduciary duty.

In the first case, a trust had originally been formed to liquidate the assets of a closely held investment company. Rice had been appointed trustee. He purportedly diverted money from the trust and used approximately $3 million to pay for personal expenses, including a BMW 550i and the acquisition of several tax preparation franchises. Rice failed to report the stolen proceeds on his 2013, 2014, and 2015 tax returns.

In the second case, Rice became the executor of the estate of one of his estate planning clients. Because he had signature authority over her bank accounts, Rice looted the client's CD and continued to collect her pension benefits for 18 months after her death. Furthermore, he stole about $120,000 out of the estate account over which he also had signatory authority. In addition to violating his duty owed to the public as a CPA, Rice also breached his fiduciary duty since he did not display reasonable care, integrity, objectivity and succumbed to a conflict of interest (source: "Former CPA Gets Four Years in Connection with Diversion of Trust Fund and Estate Proceeds," June 8, 2018, Delaware Business Now, https://delawarebusinessnow.com/2018/06/former-cpa-gets-four-years-in-connection-with-diversion-of-trust-fund-and-estate-proceeds/, retrieved on March 29, 2020.)

REVIEW QUESTIONS

1. Which of the following is true regarding an advisor's fiduciary duty to the client?

a. The advisor can have divided loyalties.

b. The advisor must do anything to please the client.

c. It is defined by the Code of Ethics.

d. It requires the advisor to act for the benefit of the client.

2. Who is considered a client?

a. Relatives and other outside parties who have a relationship with a person for whom you provide advisory services

b. A person who has contracted with you for your services and for whom you owe a fiduciary duty

c. Any investment funds you recommend

d. Attorneys that you consult

3. According to the ATA Code:

a. Advertising is not allowed by a retirement advisor.

b. Accredited individuals can vouch for the accuracy of forecasted financial information.

c. Advisors cannot engage in business that would create a conflict of interest.

d. Client information is not confidential.

4. A possible sign of diminished capacity includes:

a. The desire to learn a new language

b. Erratic behavior

c. The inability to understand the latest technology

d. Not enjoying social situations

5. Which of the following is not a sign of diminished capacity?

a. Being forgetful

b. Showing increasing disorganization

c. Compromising hygiene or self-care

d. Starting a new hobby

6. Which of the following should you consider putting in place to deal with clients with diminished capacity?

a. Train your staff on the signs of diminished capacity.

b. Encourage your clients to document their wishes, but do not show them to anyone.

c. Open a joint checking account with your client.

d. Become the client's emergency contact.

7. When dealing with a client with diminished capacity:

a. An advisor should hold off on taking drastic actions for this client.

b. An advisor should make changes to the client's account that the advisor thinks are best suited for the client.

c. Confidential client information can be provided to any interested party.

d. An advisor no longer has a fiduciary duty to that client.

8. The elements of a cause of action for negligence are:

a. A legal duty owed by one person to another; that duty was not breached, but an injury did occur

b. A legal duty owed by one person to another; a breach of that duty; the breach resulted in incredible gain for the client

c. A legal duty owed by one person to another; a breach of that duty; the breach was an actual cause of injury; and actual injury

d. A legal duty owed by one person to another; a breach of that duty; but no injury was sustained

9. A fiduciary duty includes:

a. Engaging in self-dealing

b. Subordinating a client's interests to the advisor's interests

c. Showing loyalty to the client

d. Not being too transparent so as not to confuse the client with too many facts

10. A common-law duty of a fiduciary includes:

a. Fraud detection

b. Professional skepticism

c. Perfection

d. Reasonable care

ANSWERS TO REVIEW QUESTIONS

1. a. Incorrect. The service provider cannot have divided loyalties. This could potentially put an individual in a difficult position if, by upholding a regulation, an unhappy client is prevented from taking a desired course of action.

b. Incorrect. Pleasing the client at the expense of the rules, another client, or the advisor's own agenda will put the practitioner in the position of having a conflict of interest.

c. Incorrect. Fiduciary duty is defined by common law. Typically, though, a practitioner who has acted in a reasonable manner, which includes meeting practice standards as enumerated by the Code of Ethics, will be treated as having upheld his or her fiduciary duty.

d. Correct. An advisor's fiduciary duty to a client requires him or her to act for the benefit of the client, demonstrating good faith, integrity, dependability, transparency, discretion, and care during this representation, all of which arises from the unique trust relationship between the parties.

2. a. Incorrect. Relatives and other outside parties who have a relationship with a person for whom you provide advisory services is not a client. The practitioner must keep in mind who is the client and not bow to pressure from the client's relatives or other outside parties.

b. Correct. A person who has contracted with you, formally or informally, for your services and for whom you owe a fiduciary duty is a client. Generally, a service provider cannot disclose a client's information without permission.

c. Incorrect. You do not owe a fiduciary duty to investment funds that you recommend, so the funds are not considered a client.

d. Incorrect. In this case, you would be a client of the attorney.

3. a. Incorrect. Advertising is allowed. However, the ATA Code states that licensees "shall not seek to obtain clients by advertising or other forms of solicitation in a manner that is false, misleading or deceptive."

b. Incorrect. The ATA Code states that accredited individuals "shall not permit their names to be used in conjunction with any special purpose statement prepared for their clients that anticipates results of future operations, unless they disclose the source of the information used and what assumptions they have made, and unless they indicate they do not vouch for the accuracy of the forecast."

c. Correct. The ATA Code states that accredited individuals "who render professional services . . . shall not at the same time engage in any business or occupation which would create a conflict of interest while performing the aforementioned professional services."

d. Incorrect. Practitioners are charged with holding the affairs of their clients in confidence. Generally, a service provider cannot disclose a client's information without permission.

4. a. Incorrect. A sign of diminished capacity includes new problems with speaking or writing words, not the desire to learn a new language.

b. Correct. Possible signs of diminished capacity include being forgetful, showing increasing disorganization, and being erratic.

c. Incorrect. A sign of diminished capacity includes the inability to complete simple tasks such as signing a form, not the inability to understand the latest technology.

d. Incorrect. A sign of diminished capacity includes disorientation with surroundings or social settings. Not enjoying social settings is not a sign of diminished capacity.

5. a. Incorrect. Being forgetful and experiencing disorientation with surroundings or social settings are signs of diminished capacity.

b. Incorrect. Showing increasing disorganization, such as bills going unpaid, is a sign of diminished capacity.

c. Incorrect. Compromising hygiene or self-care and erratic behavior are signs of diminished capacity.

d. Correct. Starting a new hobby is not a sign of diminished capacity. However, the presence of a new person wielding outsized influence on the client is a sign of diminished capacity.

6. a. Correct. Train your staff on the signs of diminished capacity and establish policies clarifying to whom to report these areas of concern.

b. Incorrect. Encourage your clients to document their wishes and share them with you before the risk of diminished capacity or competence arises.

c. Incorrect. You should discuss whether the client should execute a joint bank account, check management, or special needs trust. However, you should not suggest opening a joint checking account with the client.

d. Incorrect. Discuss whether the client should be protected by having the client select individuals that the client authorizes to speak with you in case of an emergency.

7. a. Correct. If a client is exhibiting signs of diminished capacity, you should hold off on taking drastic actions for this client until you have been able to fully investigate the situation. You may want to consult with an attorney when determining the appropriate action you should take.

b. Incorrect. When dealing with a client with diminished capacity, an advisor should consider the wishes and values of the client to the extent known, the client's best interests, and minimizing the intrusion into the client's decision-making autonomy.

c. Incorrect. The practitioner will have to walk a careful line in order not to reveal confidential information unless required and until it is absolutely necessary.

d. Incorrect. The practitioner must show a duty of loyalty and must carry out a client's wishes to the best of his or her ability. However, the advisor must also fulfill his or her fiduciary duty and must act in the client's best interest.

8. a. Incorrect. The advisor has breached his duty if the advisor has been negligent.

b. Incorrect. A cause of action for negligence involves actual injury, not a gain to the client.

c. Correct. The elements of a cause of action for negligence are well established and are: (1) a legal duty owed by one person to another, (2) a breach of that duty, (3) the breach was an actual cause of injury (known as proximate cause), and (4) actual injury.

d. Incorrect. Actual injury must be sustained.

9. a. Incorrect. A fiduciary duty includes not using client confidential information improperly, or engaging in self-dealing.

b. Incorrect. A fiduciary duty includes not subordinating a client's interests to the advisor's interests and avoiding improper behavior such as wrongfully retaining the client's funds, taking advantage of the client's trust, or making misrepresentations.

c. Correct. Among other things, a fiduciary duty includes showing loyalty to the client, acting with integrity and fidelity, and displaying full disclosure.

d. Incorrect. A fiduciary duty includes rendering a full and fair disclosure of facts material to the client's representation.

10. a. Incorrect. Detection of fraud resides with the management of a company.

b. Incorrect. Professional skepticism is a term used in auditing which involves an attitude that enhances the auditor's ability to identify and respond to conditions that may indicate possible misstatement.

c. Incorrect. In law, perfection relates to the additional steps required to be taken in relation to a security interest in order to make it effective against third parties or to retain its effectiveness in the event of default by the grantor of the security interest.

d. Correct. Reasonable care required the practitioner to exercise the degree of care, skill, and competence that reasonable members of the profession would exercise under similar circumstances.

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