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When a Gift Is Subject to Income Tax; Beneficiary Deemed-Owned Trusts; Making Large Taxable Gifts

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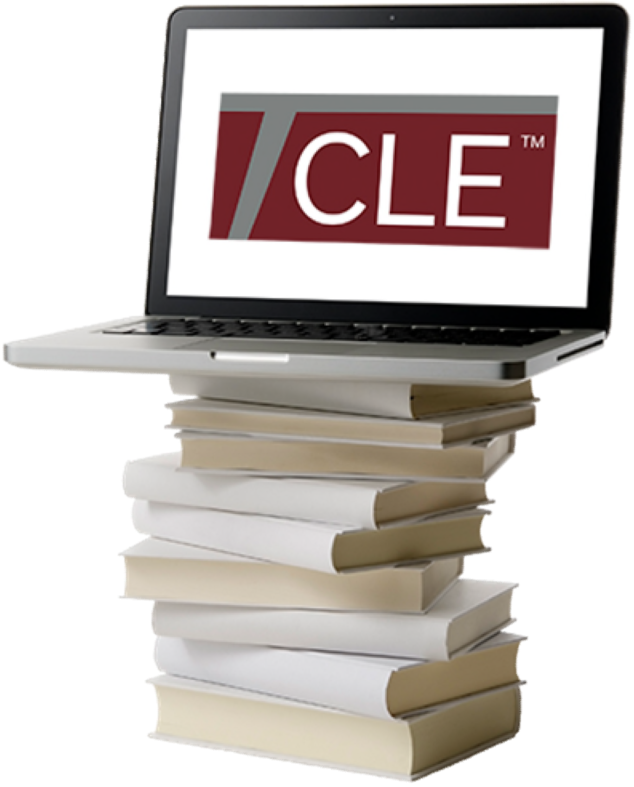

KNOWLEDGE WHERE YOU ARE™

Overview

- When a gift is subject to income tax
- Beneficiary deemed-owned trusts
- Making large taxable gifts

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When a Gift Is Subject to Income Tax

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- How bargain sales to individuals and charities work, including the effect of debt
- Unique 2020 opportunity to donate assets whose sale would generate UBTI
- When gifts of deferred income assets trigger gain recognition, including traps to avoid when transferring business interest

Bargain Sales to Individuals and Charities (III.B.1.c.i)

- Bargain sale: part sale and part gift
  - Sale for cash or note
  - Property subject to liabilities
- If to a noncharitable donee, then gain to the extent that sale proceeds and debt transferred exceed basis
- If to a charitable donee, then same calculation, except that basis is pro-rated between gift portion and sale portion

Donating Assets Whose Sale Generates UBTI (II.Q.6.d)

- Charities are subject to income tax to the extent a sale constitutes unrelated business taxable income (UBTI)
- UBTI related to a partnership or sole proprietorship (II.Q.6.d.i.)
- UBTI related to an S corporation (II.Q.6.d.ii.)

Charitable Deduction Against UBTI

(II.Q.6.d.iii.)

Donate business interest to a donor-advised fund or a supporting foundation to obtain charitable deduction against UBTI

- If trust, 50%-60% deduction (100% deduction in 2020) applied to income taxed at 20%-30% rate (higher for depreciation recapture on equipment, etc.)
- If corporation, 10% deduction applied to income taxed at 21% rate

Gifts of Deferred Income Assets (III.B.1.c.ii)

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- Notes from installment sales (II.G.16)
- If donee is not trust deemed owned by grantor, then these gifts may trigger income tax (also beware turning off grantor trust powers):
  - interest in an opportunity zone (such as a qualified opportunity fund)
  - direct or indirect gift of a carried interest

Beneficiary Deemed-Owned Trusts

- How Code § 678(a) works and relationship to Code § 678(b)
- How lapses of withdrawal rights affect design of Code § 678 trusts
- Planning for and structuring a sale to a Code § 678 trust
- Fiduciary income tax advantages and disadvantages of Code § 678 trusts

Code § 678 Mechanics (III.B.2.i.)

- Cannot be deemed owned by the grantor
- Withdrawal right usually required (III.B.2.i.iii)
- Code § 678(a)(2) uncertainty (III.B.2.i.xii)

Lapses of Withdrawal Rights

- Creditor and gift/estate tax issues regarding withdrawal rights, whether currently exercisable or lapsed (III.B.2.i.ix.)
- Lapse in excess of $5,000 or 5% of trust assets is gift (II.J.4.f)
- Designing trust wholly owned by beneficiary from inception (III.B.2.i.i)
- Determining portion owned when a withdrawal right does not lapse in full before any income is earned (III.B.2.i.vii.(a))

Sale To a Code § 678 Trust

- General description of GRAT vs. sale to irrevocable grantor trust (III.B.2.b.)
- Sale to a beneficiary grantor trust – when a traditional sale to an irrevocable grantor trust does not meet the client's objectives (III.B.2.i.iv.)
- Funding the Trust with Small Gifts (growing the trust vs loan guarantee) (III.B.2.i.vi)

Fiduciary income tax and Code § 678 trusts

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- Being taxed on income through annual right to withdraw (II.J.4.f) vs. being taxed by reason of owning entire trust (lapse of withdrawal right or QSST (QSST III.B.2.i.xiv)
- Consider relative federal and state income tax rates of trust compared to beneficiary (II.J.3.)
- Consider deductions allowable because a trust is a separate taxable entity (II.J.3.d.)
- Expanded version 1.0 hour Nov. 12 & 23

Making Large Taxable Gifts

- Effect of large taxable gifts on estate tax calculation and possible disallowance of that planning for certain arrangements
- Using preferred partnership that intentionally violates Code § 2701
- Grantor retained income trusts (GRITs)
- Triggering Code § 2519 in QTIPs

Making Large Taxable Gifts

- Spousal limited access trusts (SLATs)
- Basis step-up issues regarding the above ideas
- Planning for future transfers to family once lifetime gift/estate tax exemption is used up

Effect of large taxable gifts
(II.H.12.)

Anti-clawback regulations:

- Effect of taxable gifts on calculating estate tax, whether or not the gifted property is includible in the donor's gross estate
- Using lifetime gift/estate tax exemption that exceeds the estate tax exemption otherwise allowable when the donor dies

Possible Disallowance of that Planning For Certain Arrangements (II.H.12.a)

- Regs reserved a spot for an “anti-abuse rule” in response to comments from Tax Section of the New York State Bar Association
- Might attack GRITs and other taxable gifts resulting in estate inclusion
- Might revise regulations that apply when a preferred partnership violates Code § 2701

Preferred Partnership Violating Code § 2701 (II.H.11.e)

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- Violating Code § 2701 reduces or eliminates valuation of retained preferred interest for gift tax purposes but not for GST tax purposes
- The portion of the gift resulting from Code § 2701 artificial gift offsets future gifts, if any, from failing to take preferred distributions and any inclusion in the donor's estate
- Consider drafting to avoid any gift from failing to take preferred distributions

Grantor Retained Income Trusts (GRITs) (III.B.2.c)

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- Code § 2702 prevents valuing donor's retained interest
- A GRIT is an irrevocable grantor trust
- GST issue - estate tax inclusion period (ETIP)
- E. Eric Viehman, "Using an Enhanced Grantor Retained Income Trust (E-GRIT) to Preserve the Basic Exclusion Amount"
- Special trustee or independent person should have power to decant to a trust where donor is not a beneficiary

Triggering Code § 2519 in QTIP Trusts (II.H.2.c)

- Donee spouse renounce (not disclaim) 1% of income interest triggers gift of entire income interest
- If not want to accelerate entire trust, need to split before renunciation
- Query whether renunciation of income and principal accelerates remaindermen – query whether one can draft in anticipation of this issue
- Any retained interest triggers Code § 2036 inclusion
- Portability regulations provide using DSUE first and surviving spouse's own exemption last

Spousal limited access trusts (SLATs) (III.B.2.i.xiv)

- Can’t turn off grantor trust status
- Non-beneficiary trustee to make distributions for beneficiary-spouse’s welfare
- Consider effect of divorce
- SLAT or other irrevocable non-GRIT might give independent person a power of appointment broad enough to include grantor – query risk of creditor exposure

Basis Step-up Issues Regarding Large Taxable Gifts (II.H.5)

- Estate tax savings of growth compared to the income tax savings of basis step-up (II.H.5.a)
- But, we are also working on preserving benefit of estate tax exemption
- Consider GRIT, carving off high basis assets in excess of gift tax exemption used
- Consider using grantor's parent's exemption for basis step-up (II.H.5.d)

Future transfers to family once use up gift tax exemption (II.H.12.b.)

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- Include in one or more trusts distributions to family members who need more or in event of emergency
- Future sales or GRATs
- Client's parent set up (III.B.2.i):
  - – Beneficiary deemed-owned trust with up to $5,000 funding
  - – Bequest to identical trust to guarantee loan used when client sells assets to above trust

Conclusion

- CPA Academy webinar page, including Formula Transfers for Estate Planning November 5, 9, 19
- Blog: Business Succession Solutions
- Reports on Heckerling: http://www.thompsoncoburn.com/forms/gorin-heckerling
- Gorin's Business Succession Solutions
- January 26 webinar for Fourth Quarter Newsletter