INCOME TAX AND ESTATE TAX UPDATE 2021

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Contents

I. Introduction 1
II. Paycheck Protection Program Second Draw Loans 1
  A. Overview 1
  B. Full Forgiveness Terms 1
  C. Targeted Eligibility 1
  D. Maximum Loan Amount for Accommodation and Food Services Businesses 2
  E. How and When to Apply 2
III. Supreme Court Hears Arguments on the Affordable Care Act 2
IV. IRS Enforcement Targets 3
  A. Overview 3
  B. IRS's Strategic Priorities. 3
    1. Nonfliers top the list. 3
    2. Wealthy Taxpayers 3
    3. Abusive Easement Deals 3
    4. Marijuana Businesses 3
    5. Return Preparers 3
    6. Among other enforcement priorities 3
  C. Data Analytics 4
V. The Biden Tax Plan 4
  A. Individual Tax Provisions 4
    1. Individual Tax Rates 4
    2. Capital Gains Rates 4
    3. Pease Limitation 4
    4. Earned Tax Credit 4
    5. Child Care Credit 4
    6. First-Time Homebuyers Tax Credit 5
    7. Social Security Tax Increase 5
  B. Business Provisions 5
    1. Corporate Tax Rate 5
    2. Minimum Tax on Book Profits 5

3. Qualified Business Income Deduction 5
4. Double Tax Rate on GILTI 5
5. Manufacturing Communities Tax Credit 5
6. Renewable Energy-Related Tax Credits 6
7. Other Provisions 6
C. Estate Tax Provisions 6
1. Step Up in Basis - Eliminate Step up in basis. 6
2. Estate Tax Exemption 6
VI. Income Tax Update 6
A. What's New on 2020 Returns 6
1. Individuals 6
2. Business Expenses 7
3. Code Sec. 179 Expensing 7
4. Tax Credits 7
5. Retirement Plans 7
6. Withholding ' 8
7. Estate, Gift, and Generation-Skipping Transfer Tax 8
B. CARES Act 8
1. Payroll Tax Deferral 8
2. Employee Retention Credit 8
3. Retirement Plans 9
4. Charitable Contributions 9
5. Student Loans 9
6. Business Losses 10
7. Other Business Provisions 10
8. Aviation Taxes 10
9. Hand Sanitizer 11
C. Taxpayer Certainty and Disaster Tax Relief Act of 2020 11
1. Overview 11
2. PPP-funded Expenses Are Now Deductible 11
3. Tax Treatment Clarifications for Loan Forgiveness and Other Financial Assistance 11
4. Additional 2020 Recovery Rebates for Individuals 12
5. Employee Retention Tax Credit Extension, Expansion, and Clarification 12

6. Full Deductions for Business Meals 12
7. Extension of Employee Portion of Certain Deferred Payroll Taxes 12
8. Increased Deductions for Charitable Contributions 13
9. Tax Extensions 13
10. Temporary Extensions Through 2025 13
11. Additional Extensions 14
12. Additional Provisions 15
13. Disaster-Relief Provisions 15
D. The SECURE Act 16
1. Overview 16
2. Retirement provisions of the SECURE Act. 16
3. Non-retirement provisions of the SECURE Act. 16
VII. Estate Tax Update 17
A. What's New for 2021 17
1. Estate Tax Exemption 17
2. Gift Tax Exclusion 17
3. New Regulations Impacting Fiduciary Income Tax Issued 17
4. Nelson 17
5. Estate of Jones 17
6. Loans Were Gifts. 17
7. Willing Buyer/Willing Seller 18
8. Family Limited Partnership Disregarded 18
9. Transfers between Grantor Trusts 18
10. Valuation of Beneficial Interests 18
12. Estate Tax Basic Exclusion Amount 18
13. Modification – GST 18
14. Trust Reformation 19
B. New Regulations Impacting Fiduciary Income Tax 19
C. Estate Planning With an Elusive Estate Tax Exemption 20
1. Taking Advantage of the Current Exemption Amount 20
2. Taking Advantage of "Leverage" Gift Techniques 25

Income Tax and Estate Tax Update -2021

I. Introduction

This program will cover the following significant developments in the year 2020:

– Paycheck Protection Program Update
– Supreme Court Hears Arguments on Obama Care
– IRS Enforcement Targets
– The Biden Tax Plan
– Income Tax Update
– What's New on 1040s
– The Cares Act
– Taxpayer Certainty and Disaster Tax Relief Act of 2020
– The Secure Act
– Estate Tax Update
– What's New for 2021
– Estate Planning in 2021

II. Paycheck Protection Program Second Draw Loans

A. Overview

The Paycheck Protection Program (PPP) now allows certain eligible borrowers that previously received a PPP loan to apply for a Second Draw PPP Loan with the same general loan terms as their First Draw PPP Loan. Second Draw PPP Loans can be used to help fund payroll costs, including benefits. Funds can also be used to pay for mortgage interest, rent, utilities, worker protection costs related to COVID-19, uninsured property damage costs caused by looting or vandalism during 2020, and certain supplier costs and expenses for operations.

B. Full Forgiveness Terms

Second Draw PPP Loans made to eligible borrowers qualify for full loan forgiveness if during the 8- to 24-week covered period following loan disbursement:

– Employee and compensation levels are maintained in the same manner as required for the First Draw PPP loan;
– The loan proceeds are spent on payroll costs and other eligible expenses; and
– At least 60 percent of the proceeds are spent on payroll costs.

C. Targeted Eligibility

A borrower is generally eligible for a Second Draw PPP Loan if the borrower:

- Previously received a First Draw PPP Loan and will or has used the full amount only for authorized uses;
- Has no more than 300 employees; and
- Can demonstrate at least a 25% reduction in gross receipts between comparable quarters in 2019 and 2020.

D. Maximum Loan Amount for Accommodation and Food Services Businesses

For most borrowers, the maximum loan amount of a Second Draw PPP Loan is 2.5x average monthly 2019 or 2020 payroll costs up to $2 million. For borrowers in the Accommodation and Food Services sector, the maximum loan amount for a Second Draw PPP Loan is 3.5x average monthly 2019 or 2020 payroll costs up to $2 million.

E. How and When to Apply

Borrowers can apply for a Second Draw PPP Loan until March 31, 2021, through any existing SBA 7(a) lender or through any federally insured depository institution, federally insured credit union, eligible non-bank lender, or Farm Credit System institution that is participating in PPP.

All Second Draw PPP Loans will have the same terms regardless of lender or borrower.

III. Supreme Court Hears Arguments on the Affordable Care Act

On November 10, 2020, the Supreme Court heard about two hours of oral argument over the constitutionality of the individual mandate and the fate of the entire Affordable Care Act (ACA). A prior post summarized the background of the case and key arguments and issues to watch. This post focuses on the questions asked by the Justices and potential outcomes.

The argument touched on all three core issues of the litigation: whether the plaintiffs have standing to sue, the continued constitutionality (or not) of the individual mandate, and whether the rest of the ACA can be severed if the mandate is unconstitutional. Both sides were asked pointed questions on standing and constitutionality. Texas and the DOJ fielded challenging questions about severability and their argument that the entire ACA must be invalidated alongside the mandate. Both Chief Justice Roberts and Justice Kavanaugh expressed skepticism about the plaintiffs' severability argument, pointing to the Court's long-standing presumption that statutes are severable and disputing the challengers' characterizations of the ACA's legislative findings as an in severability clause. There was virtually no discussion of the ACA's substantive provisions beyond the mandate and the preexisting condition protections (with no references by the Justices to, say, Medicare, biosimilars, or menu labeling).

It is notoriously difficult to predict the outcome of a case from oral argument alone, and the Court could rule in any number of ways. It is unclear how the Court will rule on standing and the constitutionality of the mandate. But the comments and questions on severability, especially those posed by the Chief Justice Roberts and Justice Kavanaugh, suggest that the rest of the ACA will be upheld even if the mandate is unconstitutional. A decision is expected next spring at the earliest, or before the end of the current term in summer 2021 at the latest. Until then, we watch and wait.

IV. IRS Enforcement Targets

A. Overview

The 2019 overall audit rate was only 0.4% and it's expected to drop even lower for 2020. Because of the COVID-19 pandemic, IRS put on hold most of its enforcement activities from mid-March through July 15. And even though IRS officials say they are planning to slowly start audits up again, it will be a long time before things get back to normal.

B. IRS's Strategic Priorities.

1. Nonfliers top the list.

The primary emphasis is on individuals who receive income in excess of $100,000 but don't file returns. Collections officers work with them to help resolve the issue and increase compliance.

2. Wealthy Taxpayers

Very wealthy individuals are once again in the agency's crosshairs. IRS has been lambasted for putting too much scrutiny on lower-income taxpayers who take refundable credits and ignoring wealthy taxpayers. Partly in response to this criticism, IRS's high-wealth exam squad is getting back into the action.

3. Abusive Easement Deals

Abusive syndicated conservation easement deals are another top priority. Agents are targeting promoters, taxpayers, appraisers, preparers and advisers. As a result of IRS clamping down, there are about 100 syndicated easement cases on the Tax Court docket. IRS is now offering a settlement to ease the Court's load. Eligible taxpayers will receive a letter setting forth the settlement terms.

4. Marijuana Businesses

Marijuana businesses make the list. IRS takes the view that even in states where it is legal to sell and use marijuana, a federal tax statute bars tax write-off for sellers of controlled substances that are considered illegal under U.S. law. Agents eye dispensaries that deduct expenses, and courts generally side with IRS. Other focus areas include marijuana firms that don't file or pay their taxes.

5. Return Preparers

Return preparer noncompliance is a continual problem for the Service. IRS routinely mails letters to preparers who flout the due diligence rules on client returns that claim refundable credits or head-of-household filing status. Also on IRS's radar are preparers who inflate deductions or credits on client returns.

6. Among other enforcement priorities

- Noncompliance with tip reporting and withholding rules in the casino industry.
- Promoters of abusive tax shelters and other abusive tax schemes.

– Small firms with micro captive insurance companies.

– Better identification and development of potential civil and criminal fraud cases.

– Virtual currency transactions.

– Nonreporting of foreign accounts by U.S. persons.

– Payroll tax dodges and worker misclassification.

– Also, backup withholding.

C. Data Analytics

Data analytics are increasingly the norm in IRS's enforcement arsenal. Data-mining software can sift through taxpayer information, expose suspicious activity, identify cases for audit and pull together evidence for cases that go to court. The technology also boosts efficiency, a bright spot for an agency lacking in resources.

V. The Biden Tax Plan

A. Individual Tax Provisions

1. Individual Tax Rates

– Reverts the top individual income tax rate for taxable incomes above $400,000 from 37 percent under current law to the pre-Tax Cuts and Jobs Act level of 39.6 percent.

– Comment: Would also require adjustment lower brackets to ensure no tax increase for those making less than $400,000.

2. Capital Gains Rates

Taxes long-term capital gains and qualified dividends at the ordinary income tax rate of 39.6 percent on income above $1 million and eliminates step-up in basis for capital gains taxation.

3. Pease Limitation

– Restores the Pease limitation on itemized deductions for taxable incomes above $400,000.

– Caps the tax benefit of itemized deductions to 28 percent of value for those earning more than $400,000, which means that taxpayers earning above that income threshold with tax rates higher than 28 percent would face limited itemized deductions.

4. Earned Tax Credit

Expands the Earned Income Tax Credit (EITC) for childless workers aged 65+; provides renewable-energy-related tax credits to individuals.

5. Child Care Credit

– Expands the Child and Dependent Care Tax Credit (CDCTC) from a maximum of $3,000 in qualified expenses to $8,000 ($16,000 for multiple dependents) and increases the maximum reimbursement rate from 35 percent to 50 percent.

- For 2021 and as long as economic conditions require, increases the Child Tax Credit (CTC) from a maximum value of $2,000 to $3,000 for children 17 or younger, while providing a $600 bonus credit for children under 6. The CTC would also be made fully refundable, removing the $2,500 reimbursement threshold and 15 percent phase-in rate.

6. First-Time Homebuyers Tax Credit

Reestablishes the First-Time Homebuyers' Tax Credit, which was originally created during the Great Recession to help the housing market. Biden's homebuyers' credit would provide up to $15,000 for first-time homebuyers.

7. Social Security Tax Increase

- Imposes a 12.4 percent Old-Age, Survivors, and Disability Insurance (Social Security) payroll tax on income earned above $400,000, evenly split between employers and employees.
- This would create a "donut hole" in the current Social Security payroll tax, where wages between $137,700, the current wage cap, and $400,000 are not taxed.

B. Business Provisions

1. Corporate Tax Rate

Increases the corporate income tax rate from 21 percent to 28 percent.

2. Minimum Tax on Book Profits

Creates a minimum tax on corporations with book profits of $100 million or higher. The minimum tax is structured as an alternative minimum tax—corporations will pay the greater of their regular corporate income tax or the 15 percent minimum tax while still allowing for net operating loss (NOL) and foreign tax credits.

3. Qualified Business Income Deduction

Phases out the qualified business income deduction (Section 199A) for filers with taxable income above $400,000.

4. Double Tax Rate on GILTI

- Doubles the tax rate on Global Intangible Low Tax Income (GILTI) earned by foreign subsidiaries of US firms from 10.5 percent to 21 percent.
- In addition to doubling the tax rate assessed on GILTI, Biden proposes to assess GILTI on a country-by-country basis and eliminate GILTI's exemption for deemed returns under 10 percent of qualified business asset investment (QBAI).

5. Manufacturing Communities Tax Credit

- Establishes a Manufacturing Communities Tax Credit to reduce the tax liability of businesses that experience workforce layoffs or a major government institution closure
- Expands the New Markets Tax Credit and makes it permanent.

– Offers tax credits to small business for adopting workplace retirement savings plans.

6. Renewable Energy-Related Tax Credits

Expands several renewable-energy-related tax credits, including tax credits for carbon capture, use, and storage as well as credits for residential energy efficiency, and a restoration of the Energy Investment Tax Credit (ITC) and the Electric Vehicle Tax Credit. The Biden plan would also end tax subsidies for fossil fuels.

7. Other Provisions

– Imposing a new 10 percent surtax on corporations that "offshore manufacturing and service jobs to foreign nations in order to sell goods or provide services back to the American market." This surtax would raise the effective corporate tax rate on this activity up to 30.8 percent.

– Establishing an advanceable 10 percent "Made in America" tax credit for activities that restore production, revitalize existing closed or closing facilities, retool facilities to advance manufacturing employment, or expand manufacturing payroll.

– Equalizing the tax benefits of traditional retirement accounts (such as 401(k)s and individual retirement accounts) by providing a refundable tax credit in place of traditional deductibility.

– Eliminating certain real estate industry tax provisions.

– Expanding the Affordable Care Act's premium tax credit.

– Creating a refundable renter's tax credit capped at $5 billion per year, aimed at holding rent and utility payments at 30 percent of monthly income.

– Increasing the generosity of the Low-Income Housing Tax Credit.

C. Estate Tax Provisions

1. Step Up in Basis - Eliminate Step up in basis.

2. Estate Tax Exemption

– Reduce the estate tax exemption to $3,500,000.

– Increase top rate to 45%.

VI. Income Tax Update

A. What's New on 2020 Returns

The following are highlights of the changes in 2020 with the greatest impact on individual and business tax returns.

1. Individuals

– The thresholds at which individuals must file income tax returns have increased for 2020

– "Kiddie tax amount is $2,200 for 2020

– The basic standard deduction amounts for 2020 are $24,800 for married filing jointly and surviving spouses, $18,650 for head of household filers, and $12,400 for married filing separately and single filers

– The itemized deduction of medical and dental expenses is limited to 7.5 percent of the taxpayer's adjusted gross income (AGI)for 2020

– The itemized deduction of state and local taxes is limited to$10,000 ($5,000 if married filing separately) for 2020

– The taxable income levels at which tax rates on net capital gains and qualified dividend income apply to individuals, estates, and trusts have increased for 2020

2. Business Expenses

– The standard mileage rate for all business use of a car is 57.5cents per mile for 2020

– Per diem rates under the high-low method of substantiating travel expenses are $292 for high-cost localities and $198 for low-cost localities for travel after September 30, 2020

– The W-2 wage/capital limit for deducting qualified business income (QBI) under Code Sec. 199A for 2020 is $326,600 if married filing jointly and $163,300 if married filing separately, head of household, or single

3. Code Sec. 179 Expensing

– The maximum Code Sec. 179 deduction is $1,040,000 for 2020.

– The Code Sec. 179 investment limitation is $2,590,000 for 2020

– The maximum amount of the cost of a sport utility vehicle (SUV)that may be expensed under Code Sec. 179 if the SUV is exempt from the luxury car depreciation caps is limited to$25,900 for 2020

4. Tax Credits

– The child tax credit is $2,000 for a qualifying child under age 17and $500 for any other dependent. The refundable portion of the credit for qualifying children under age 17 is limited to$1,400 for 2020

– For 2020, the maximum earned income credit for eligible taxpayers with no qualifying children is $538, with one qualifying child is $3,584, with two qualifying children is$5,920, and with three or more qualifying children is $6,660

5. Retirement Plans

– The limit on elective deferrals to a 401(k), 403(b), 457 and Federal Thrift plan is $19,500 for 2020, with a catch-up contribution limit of $6,500 for individuals age 50 and over

– The limit on elective deferrals to a SIMPLE 401(k) and IRA plan is $13,500 for 2020, with a catch-up contribution limit of $3,000for individuals age 50 and over

– The contribution limit for traditional and Roth IRAs is $6,000 for2020, with a catch-up contribution limit of $1,000 for individuals age 50 and over

6. *Withholding ‘*

– The 2020 OASDI wage base for FICA and self-employment tax purposes is $137,700

– The 2020 wage threshold for “Nanny Tax reporting is $2,200

7. *Estate, Gift, and Generation-Skipping Transfer Tax*

– The applicable exclusion amount for estate and gift taxes is$11,580,000 for 2020 providing an applicable credit amount against the taxes of $4,577,800

– The annual exclusion amount for gifts made in 2020 is $15,000,with an annual maximum of $30,000 per donee for spouses who use gift-splitting

B. CARES Act

1. *Payroll Tax Deferral*

– The Act would defer employer payroll and railroad retirement tax payments through the end of 2020. Deferred funds would be paid over two years in 2021 and 2022. The delay would provide businesses with about $300 billion of cash flow, according to a summary from House Ways and Means Committee Republicans.

– Deferral wouldn’t apply to employers with small business loan debt forgiven under the bill.

– The Act would defer 50% of self-employed Social Security tax payments.

– The Act would appropriate funds to cover any forgone revenue to the Social Security and disability insurance trust funds and Social Security Equivalent Benefit Account.

2. *Employee Retention Credit*

– The Act would establish a refundable credit against employer payroll and railroad retirement taxes for certain employers that are hurt by the coronavirus but retain their employees. The credit would be for 50% of eligible employee wages paid after March 12, 2020, and before Jan. 1, 2021. It would be provided for as much as $10,000 of compensation, including health benefits.

– Employers could receive the credit if a government order related to the pandemic requires them to partially or fully suspend operations, or if their gross receipts declined by certain thresholds. Alternate rules would apply for tax-exempt organizations.

– Employers with more than 100 full-time employees in 2019 would receive credits for wages paid to employees while they aren’t providing services. Employers with fewer employees would receive credit for wages paid while operations were suspended or during the quarter in which the company had a significant decline in gross receipts.

– Employers couldn’t receive the credit if they receive a loan under the SBA Paycheck Protection Program for 7(a) loans established by the bill (see above).

– Employers couldn't use the credit for wages for which they also receive a credit under the work opportunity tax credit or a paid leave credit established by the 2017 tax overhaul (Public Law 115-97). Wages taken into account for the paid leave credits established under the second coronavirus response law (Public Law 116-127) couldn't also be used for the employee retention credit.

– The credit wouldn't apply to federal, state, or local government employers.

– The Act would appropriate funds to the Social Security and disability trust funds and the Social Security Equivalent Benefit Account to offset the reduction in revenue.

3. Retirement Plans

– The Act includes several retirement plan allowances that are often provided in legislation after major disasters.

– Individuals could withdraw as much as $100,000 from their retirement accounts in 2020 without being subject to a 10% penalty. Funds would be treated as a tax-exempt rollover contribution if repaid in the next three years. If funds weren't repaid, they would be taxed as income over three years.

– Individuals would be eligible to make withdrawals if they, their spouse, or their dependent are diagnosed with Covid-19, or if the pandemic hurts their finances, such as through layoffs or reduced hours.

– Eligible individuals could receive loans for the lesser of $100,000 or the present value of their vested benefits in their employer retirement accounts in the 180 days after the bill's enactment. The limit is currently $50,000 or half the account's value.

– Individuals affected by the coronavirus with retirement plan loans due by Dec. 31, 2020, would have an extra year to repay them.

– The Act would modify certain retirement plan and account minimum distribution rules for 2020.

4. Charitable Contributions

– The Act would create a $300 above-the-line individual charitable contribution allowance for individuals who don't itemize their returns for tax years beginning in 2020.

– The Act also would suspend for 2020 the limit on the individual charitable deduction, which is available to filers who itemize. The deduction is limited to 60% of individual taxpayers' adjusted gross incomes through 2025.

– The corporate charitable deduction limit would be increased in 2020 to 25% of taxable income, from 10%. A deduction for food inventory contributions would be increased to 25%, from 15%.

5. Student Loans

– Employer student loan repayment assistance paid after the bill's enactment and before Jan. 1, 2021, would be excluded from employees' income tax.

– Repaid amounts would count toward a $5,250 limit on other forms of employer-provided education assistance, such as tuition and related expenses, that can be excluded from income.

6. Business Losses

– The Act would allow business losses from tax years after Dec. 31, 2017, and before Jan. 1, 2021, to be carried back five years.

– Net operating loss carrybacks were eliminated for most businesses by the 2017 tax overhaul. Separate rules would apply to real estate investment trusts and life insurance companies.

> The Act would allow the full amount of net operating loss carryovers and carrybacks to be used for tax years beginning before Jan. 1, 2021. The deduction was limited to 80% of taxable income under the 2017 tax overhaul. A separate deduction limit would be established for tax years beginning after Dec. 31, 2020.
>
> The Act would modify the effective date of changes to the net operating loss deduction included in the 2017 tax overhaul. Republicans have previously sought changes to the date language, which they say doesn't reflect congressional intent.
>
> The Act would also modify net operating loss deduction limits for pass-through businesses and sole proprietorships.

7. Other Business Provisions

– The Act would allow companies to more quickly access their remaining alternative minimum tax credits. The 2017 tax overhaul eliminated the corporate AMT but made remaining AMT credits refundable over several years, ending in 2021.

– Allow businesses to deduct 50% of their interest expenses in 2019 and 2020, with adjustments, instead of 30%. Separate rules would apply for partnerships.

– Address the "retail glitch" from the 2017 tax overhaul, in which the depreciation schedule for certain restaurant and retail businesses' qualified improvement property was inadvertently lengthened to 39 years. The bill would classify qualified improvement property as 15-year property, or 20-year property under an alternative depreciation system. The classification would make the property eligible for temporary "bonus depreciation" established by the 2017 tax law, which would allow it to be written off immediately.

8. Aviation Taxes

– The Act would suspend the 7.5% passenger ticket tax and 6.25% cargo tax until Jan. 1, 2021.

– Kerosene used for commercial aviation also wouldn't be taxed during that period. The proceeds from those taxes are deposited in the Airport and Airway Trust Fund.

9. *Hand Sanitizer*

- The Act would exempt hand sanitizer from an excise tax on distilled spirits. It would apply to hand sanitizer produced and distributed in 2020 in response to coronavirus. The provision would help distilleries that have begun producing hand sanitizer.
- The federal alcohol excise tax is currently set at $2.70 per gallon for the first 100,000 gallons produced in a calendar year. Manufacturers pay $13.34 a gallon up for every additional gallon up until they make 22.23 million gallons. Any alcohol produced beyond that threshold is taxed at $13.50 a gallon.
- The Act would also waive bulk sales and labeling requirements.

C. Taxpayer Certainty and Disaster Tax Relief Act of 2020

1. *Overview*

President Donald Trump on December 27, 2020, signed into law the Consolidated Appropriations Act, 2021 (the Act). The Act includes the long-awaited COVID-related Tax Relief Act of 2020, which resolves a key area of contention related to the deductibility of PPP-funded expenses. It also includes the Taxpayer Certainty and Disaster Tax Relief Act of 2020 that extends or makes permanent numerous tax provisions. Following is an overview of the key tax-related provisions.

2. *PPP-funded Expenses Are Now Deductible*

- The Act overrides IRS guidance that provided no deduction was permitted for otherwise deductible expenses if the payment of such expenses results in forgiveness of a Paycheck Protection Program (PPP) loan.
- Lawmakers from both parties supported that the original intent of the PPP loan provisions wasn't to exclude the deduction of the PPP-funded expenses if the loan was forgiven, but the IRS took an alternative view based on existing tax law.
- This provision resolves an area of contention between taxpayers, Congress, and the IRS. Importantly, state tax treatment of PPP-funded expenses will continue to vary depending upon each jurisdiction's conformance to the Internal Revenue Code; the Coronavirus Aid, Relief, and Economic Security (CARES) Act; and the Consolidated Appropriations Act, 2021.

3. *Tax Treatment Clarifications for Loan Forgiveness and Other Financial Assistance*

- In addition to the PPP, the CARES Act provided for direct financial assistance for existing Small Business Administration (SBA) borrowers, including direct Section 1112 payments of borrowers' SBA 7(a) and 504 small business loans. The Act overrides recent SBA guidance that provided that this direct financial assistance would be treated as taxable income to borrowers.
- This provision instead aligns the treatment of these payments with the treatment of forgiven PPP loans, treating financial assistance as tax-exempt income and permitting the deduction of related expenses by the borrower.

– Additionally, it provides matching tax-exempt and deductible expense treatment for the forgivable portion of Economic Injury Disaster Loans (EIDL) Advance loans.

4. Additional 2020 Recovery Rebates for Individuals

– The Act provides for a second round of recovery rebate payments. Eligible individuals will receive an additional tax credit, paid in advance, of up to $600—or $1,200 in the case of married filing joint taxpayers—plus $600 for each qualifying child.

– Similar to the CARES Act, the credit is paid as an advance refund and calculated based on the taxpayer's adjusted gross income (AGI) on its 2019 income tax return. To receive the full credit, taxpayers must have an AGI that doesn't exceed:

$75,000 for single filers

$150,000 for married filing-joint filers

$112,500 for head-of-household filers

– The credit is phased out by 5% for every dollar AGI exceeds these thresholds. The Act clarifies that nonresident alien individuals and adult taxpayers who qualify as a dependent for tax purposes aren't considered to be eligible individuals.

5. Employee Retention Tax Credit Extension, Expansion, and Clarification

– The Act extends the employee retention tax credit eligibility period by six months to apply to qualified wages paid before July 1, 2021.

– In addition, it increases:

The allowable credit percentage from 50% of qualifying wages to 70% of qualifying wages

The maximum allowable credit per employee from $10,000 for all calendar quarters to $10,000 for any calendar quarter

The Act also makes other favorable changes for taxpayers. These changes would apply to calendar quarters beginning after 2020. Other clarifications would retroactively apply to the effective date of the CARES Act.

6. Full Deductions for Business Meals

The Act provides for a 100% deduction for business meals, including delivery and carryout meals, provided by a restaurant for amounts paid or incurred between January 1, 2021, and December 31, 2022.

7. Extension of Employee Portion of Certain Deferred Payroll Taxes

– The Act modifies Notice 2020-65, issued in response to the president's August 8, 2020,, Executive Order permitting businesses to defer the employee-portion of payroll taxes incurred on wages paid between September 1, 2020, and December 31, 2020.

- The Act extends the date for remitting postponed taxes from the period beginning January 1, 2021, and ending on April 30, 2021, to the new period beginning on January 1, 2021, and ending on December 31, 2021.
- The employer, however, must still withhold and remit the applicable taxes ratably throughout the repayment period.

8. Increased Deductions for Charitable Contributions

- The Act provides for an extension of the non-itemizer charitable contribution deduction to the 2021 tax year.
- The maximum allowable charitable contribution deduction under this section remains $300, or $600 in the case of married filing joint taxpayers. However, there's a corresponding increase in penalties related to underpayments attributable to overstating the non-itemizer charitable contribution deduction from 20% of the resulting understated tax to 50% of the resulting understated tax.
- Separately, it also extends the increased 100% AGI limitation on charitable deductions from tax year 2020 to tax year 2021.

9. Tax Extensions

- The Act extends or makes permanent numerous expiring provisions. A summary is included below.
- Permanently Extended Provisions
- Reduction in medical expense deduction floor, from 10% to 7.5% of AGI
- Section 179D energy efficient commercial building deduction, with some prospective modifications
- Exclusion of qualified benefits for volunteer firefighters and emergency medical responders
- Repeal of qualified tuition deduction and increased income limitation for lifetime learning credit
- Railroad track maintenance credit, though the credit reduces to 40% for years beginning after 2022
- Reduction of excise taxes and simplified record-keeping requirements for beer, wine, and distilled spirits
- Refunds in lieu of reduced rates for certain alcohol produced outside the United States

10. Temporary Extensions Through 2025

- Look-through rule for related controlled foreign corporations
- New markets tax credit
- Work opportunity tax credit

– Exclusion from gross income for a discharge of qualified principal residence indebtedness, though maximum amount excluded is reduced from $2 million to $750,000
– Seven-year recovery period for motorsports entertainment complexes
– Expensing provisions for certain qualifying film, television, and theatrical productions
– Empowerment zone tax incentives, with some modifications
– Employer tax credit for paid family and medical leave
– Exclusion for certain employer payments of student loans
– Extension of carbon oxide sequestration credit
– Temporary Extensions Through 2021
– Treatment of mortgage insurance premiums as qualified residence interest
– Credit for health insurance costs of eligible individuals
– Indian employment credit
– Mine rescue team training credit
– Classification of certain racehorses as three-year property
– Accelerated depreciation for business property on Indian reservations
– American Samoa economic development credit
– Second generation biofuel producer credit
– Nonbusiness energy property
– Qualified fuel cell motor vehicles
– Alternative fuel refueling property credit
– Two-wheeled plug-in electric vehicle credit
– Energy efficient homes credit
– Extension of excise tax credits relating to alternative fuels
– Black lung disability trust fund excise tax
– Production credit for Indian coal facilities

11. Additional Extensions

– Credit for electricity produced from certain renewable resources (construction must begin by end of 2021)
– Extension and phaseout of energy credit (through 2023)
– Extension of residential energy-efficient property credit and inclusion of biomass fuel property expenditures (through 2023, with credit reduction after 2022)

12. Additional Provisions

The Act also includes the following:

- An allowance for personal protection equipment (PPE) and cleaning supplies used to prevent spread of COVID-19 to be considered qualified educator expenses for purposes of the $250 deduction for teachers
- An election for taxpayers with farming losses to disregard certain net operating loss (NOL) carryback changes made by the CARES Act
- An extension through March 31, 2021, of the paid sick leave and paid family leave credits enacted as part of the Families First Coronavirus Response Act in March 2020, as well as additional modifications to those provisions
- Money purchase pension plans included in favorable CARES Act provisions related to retirement plan distributions for COVID-related expenses
- A one-time election to terminate the transfer period for qualified transfers from pension plan under Section 420
- Minimum 4% low-income housing tax credit rate
- Depreciation of pre-2018 residential rental property over 30-year period for taxpayers that made Section 163(j) real property elections
- Eligibility for waste energy recovery property for energy investment tax credit
- Extension of energy credit for offshore wind facilities
- Minimum rate of interest for certain determinations related to life insurance contracts
- Minimum age for distributions during working retirement
- Temporary rule preventing partial plan termination
- Temporary special rule for the determination of earned income
- Temporary expansions related to flexible spending accounts (FSA)

13. Disaster-Relief Provisions

- Special disaster-related rules for use of retirement funds
- Employee retention credit for employers affected by qualified disasters
- Temporary suspension of limitations on charitable contributions associated with qualified disaster relief
- Special rules for qualified disaster-related personal casualty losses
- Increased low-income housing tax credit in qualified disaster zones

D. The SECURE Act

1. Overview

Another bill in the Omnibus Act is the SECURE Act, an acronym for "Setting Every Community Up for Retirement Enhancement". The core intent of this Act is to update retirement rules for needed improvements and longer life expectancies. Most of these provisions begin in the year 2020.

2. Retirement provisions of the SECURE Act.

– The so-called "Stretch IRA" plan is eliminated for those dying after 2019. Beginning in 2020, IRA beneficiaries must spend the entire account within ten years of the death of the prior owner. Exceptions will remain for certain beneficiaries including spouses, those beneficiaries who are within 10 years of age of the deceased, those beneficiaries who are disabled or chronically ill, and minor children (but only while they are minors – then the 10-year clock will start).

– The Act removes the age 70-1/2 limit on contributing to an IRA. Beginning in 2020, no age limits will apply. All other requirements still apply, such as the requirements to have earned income.

– The Act creates a new exception from the 10% penalty for premature retirement distributions. This new one is for up to $5,000 for a birth or adoption. The distribution will still be subject to income tax – it's just the 10% penalty that is waived.

– The Act increases an employer tax credit for the establishment of a retirement plan to up to $5,000.

– The Act creates a new employer tax credit for adopting an automatic enrollment retirement plan.

– The Act requires that long-term part-time workers be included as eligible employees (those who work at least 500 hours for at least 3 consecutive years).

3. Non-retirement provisions of the SECURE Act.

– Retroactive to 1/1/2019, up to $10,000 annually of 529 plan funds can be used to pay expenses of student loans and apprenticeships.

– Before 2018, children with significant investment income were subject to the so-called "kiddie tax", meaning that the children were taxed at their parents' tax bracket. The Tax Cuts and Jobs Act of 2017 changed this rule effective for 2018, providing that these children will use trust tax rates instead. The Act changes this rule back effective for the tax year 2020. Thus, beginning in 2020, the children are not subject to trust tax rates, but to the incremental rate of their parents.

– Further, taxpayers can elect to apply this new rule to 2019.

– Even further, the taxpayer can elect to apply this new rule to 2018 via an amended return. But it seems that it may be hard to generate sufficient tax savings to justify the expense of this effort.

VII. Estate Tax Update

A. What's New for 2021

1. Estate Tax Exemption

On October 26, 2020, the Internal Revenue Service ("IRS") announced the official estate and gift tax limits for 2021. Currently, the estate and gift tax exemption equivalent is $11.58 million per individual (or $23.16 million for a married couple). For 2021, the exemption equivalent will increase to $11.7 million per individual (or 23.4 million for a married couple). With these exemptions, a married couple can give up to $23.4 million to heirs and pay no federal estate or gift tax.

2. Gift Tax Exclusion

The annual gift exclusion amount for 2021 stays the same at $15,000 per donor, per recipient. Each individual can give away $15,000 to any individual they desire with no federal gift tax consequences. Married couples can combine these amounts and make $30,000 gifts to each individual, doubling the impact. In addition to the $15,000 amount, each individual can make unlimited payments for medical and tuition expenses as long as such payments are made directly to the institution providing the service. It should be noted that these gifts are not limited to children, grandchildren, etc. but can be made to anyone you choose.

3. New Regulations Impacting Fiduciary Income Tax Issued.

Treasury and the IRS issued proposed regulations under Sec. 67(g) clarifying that certain deductions allowed to an estate or nongrantor trust are not and, thus, are not affected by the suspension of the deductibility of miscellaneous itemized deductions contained in the law under the Tax Cuts and Jobs Act.

4. Nelson

In *Nelson, TC Memo 2020-81*, the Tax Court held that the defined-value clause the husband and wife taxpayers used to transfer interests in a family limited partnership (FLP) did not prevent the IRS from imposing gift tax based on the percentage interests stated in the transfer instrument.

5. Estate of Jones

In *Estate of Jones*, *TC Memo 2020 -101*, the Tax Court held that tax-affecting the earnings of an S corporation and limited partnership was appropriate in determining their value under the discounted-cash-flow (DCF) method of valuation.

6. Loans Were Gifts.

In *Estate of Bolles, TC Memo 2020-71*, the Tax Court held that advances the decedent made to one of her sons over many years to support his struggling architecture business were

more properly characterized as gifts and, therefore, were properly included in computing her estate tax liability.

7. Willing Buyer/Willing Seller

In *CCA 201939002*, the IRS determined that a future merger of a corporation whose shares were gifted should be considered for gift tax valuation purposes.

8. Family Limited Partnership Disregarded

In *Estate of Moore*, *TC Memo. 2020-40*, the Tax Court held that the value of a farm a decedent transferred to a family limited partnership (FLP) was includible in the decedent's estate because the decedent retained the possession and enjoyment of the farm until his death; a loan from the FLP to the decedent was not a bona fide loan; and the decedent's transfers to his children within the three-year period preceding his death were gifts rather than loans.

9. Transfers between Grantor Trusts

In *IRS Letter Ruling 202022002*, the IRS ruled that the sale between a trust from which the beneficiary had a general power of appointment and a grantor trust created by that beneficiary is not recognized as a sale for federal income tax purposes because the beneficiary is treated as the owner of both trusts.

10. Valuation of Beneficial Interests

In *Letter Ruling 201932001*, the IRS ruled that the termination of a GST tax-exempt trust and the proposed distribution of the trust assets to beneficiaries will not cause the trust, or any terminating distributions from the trust, to be subject to GST tax or gift tax. The IRS ruled that the proposed transaction, in substance, is a sale of the life tenant's and the life tenant's grandchildren's interests to the life tenant's children, requiring the recognition of gain or loss.

11. Valuation of LLC Interests

In *Estate of Grieve, TC Memo 2020 -71*, the Tax Court upheld the taxpayer's gift tax valuation of 99.8% nonvoting interests in two LLCs that the taxpayer had transferred in 2013 to a grantor retained annuity trust (GRAT) and an irrevocable trust, rejecting a valuation/methodology the IRS offered that assumed that a buyer of a 99.8% interest would start by seeking to purchase the 0.2% controlling interest.

12. Estate Tax Basic Exclusion Amount

The IRS issued final regulations (T.D. 9884, 84 Fed. Reg. 64995) addressing the effect that changes made by the law known as the Tax Cuts and Jobs Act (TCJA)2 have on the basic exclusion amount used in computing federal estate and gift taxes. The final regulations affect donors of gifts made after 2017 and the estates of decedents dying after 2025.

13. Modification – GST

In *Letter Ruling 201947004*, the IRS ruled that the modification of a trust would not cause the trust to lose its grandfathered status as exempt from GST tax, even when the period of trust is extended beyond its original termination date.

14. Trust Reformation

In *Letter Ruling 201941023*, the IRS allowed the reformation of six trusts reforming a beneficiary's withdrawal power from a trust to be applied retroactively because the specific provisions of the trust did not comply with the taxpayer's intent at the time the trusts were created. In addition, it ruled on the consequences of the reformation and certain mistakes made on gift tax returns reflecting the transfers to the trusts.

B. New Regulations Impacting Fiduciary Income Tax

The IRS on September 21, 2020, issued final regulations (T.D. 9918) clarifying that certain expenses incurred by, and certain excess deductions upon the termination of, an estate or nongrantor trust are not affected by the suspension of miscellaneous itemized deductions for tax years 2018 through 2025. The regulations also provide guidance on determining the character, amount, and allocation of excess deductions that are succeeded to by beneficiaries.

The final regulations adopt with few changes proposed regulations issued in May 2020. Sec. 67(g), enacted by the Tax Cuts and Jobs Act (TCJA), P.L. 115-97, disallows miscellaneous itemized deductions for any tax year beginning after Dec. 31, 2017, and before Jan. 1, 2026. Before the TCJA, miscellaneous itemized deductions were allowed to the extent that their aggregate amount exceeded 2% of adjusted gross income (AGI). They are defined as itemized deductions other than those listed under Secs. 67(b)(1) through (12).

Sec. 67(e) directs that the AGI of an estate or trust is computed in the same manner as for an individual, except that deductions are allowed for (1) costs paid or incurred in connection with the administration of the estate or trust that would not have been incurred if the property were not held in an estate or trust, and (2) deductions allowable under Sec. 642(b) (personal exemption amounts for estates and trusts) and Secs. 651 and 661 (distributions by trusts distributing current income and trusts accumulating income, respectively). In Notice 2018-61 issued in July 2018, the IRS announced it would issue regulations to clarify that Sec. 67(e) deductions are not suspended or eliminated by Sec. 67(g).

The proposed regulations amplified this position, along with addressing the treatment of excess deductions upon an estate or trust's termination under Sec. 642(h)(2). That provision allows beneficiaries succeeding to the property of a terminating trust or estate to take a deduction of any excess of certain deductions over gross income of the trust or estate in its last tax year. Prior regulations provided that excess deductions were allowed by beneficiaries in computing taxable income and not AGI; thus, they were treated as a single miscellaneous itemized deduction.

In the proposed regulations, the IRS and Treasury recognized that excess deductions may in fact consist of (1) deductions allowable in arriving at AGI; (2) non-miscellaneous itemized deductions; and (3) miscellaneous itemized deductions. Only the third type is suspended under Sec. 67(g). Consequently, the proposed and final regulations provide rules for trustees to determine for a terminating estate or trust the character and amount of each deduction type and, therefore, their respective allocations to, and applicable limitations upon, the succeeding beneficiaries.

Here's an Example : Assume an estate's income and deductions in its final year are as follows:

Total income of $6,500

– Taxable interest of $500,

– Dividends of $3,000,

– Rental income of $2,000,

– Capital gain of $1,000,

Total Deductions of $17,500

– Probate fees of $1,500

– Estate tax preparation fees of $8,000,

– Legal fees of $2,500

Collectively, IRC §67(e) deductions – (i) personal property taxes of $3,500 (itemized deductions), and (ii) rental real estate expenses of $2,000.

There are two beneficiaries – A (75%) and B (25%).

Pursuant to the regulations under IRC §652, the $2,000 of rental real estate expenses are allocated to the $2,000 of rental income. The executor may, in his discretion allowed under the regulations, allocate the $3,500 of personal property taxes and $1,000 of the IRC §67(e) deductions to the remaining $4,500 of income (thus maximizing the amount of the excess deductions which are considered above-the-line deductions). Therefore, the excess deductions on the termination of the estate are $11,000, consisting entirely of IRC §67(e) deductions which are deductible when computing gross income.

Beneficiary A will be allocated $8,250 of above-the-line deductions, and beneficiary B will be allocated $2,750 of above-the-line deductions.

C. Estate Planning With an Elusive Estate Tax Exemption

1. Taking Advantage of the Current Exemption Amount

a. General Gifting Guidelines

The current federal estate and gift tax exemption for 2021 adjusted for inflation stands at $11,700,000 per individual, or $23,400,000, for a married couple. That exemption will under current law revert to $6,000,000 in 2026. Under President elect Biden’s tax plan, the exemption could revert to $3,500,000 even sooner. Gifts made during your lifetime reduce the exemption amount available to be applied against your estate. One might assume that you could take advantage of the higher exemption amount currently available simply by making gift of the “excess exemption amount”, i.e., the excess of the current exemption amount of $11,700,000 over that which will be available in 2026 projected at $6,000,000 (the “base exemption amount).” That would be the case if the gifts made prior to 2026 reduced that excess exemption amount first, and the base exemption amount only when taxable gifts exceeded that amount. However, the increased exemption is structured in the opposite way so that a gift made in 2021 when the exemption is $11,700,000, will reduce the base exemption amount before it is utilizing the “excess exemption amount”. To illustrate this further consider this example:

Example 1 - A has an estate with a value of $11,700,000. In 2021 he makes a gift of $6,000,000, leaving $5,700,000 of value in his estate. The gift will utilize $6,000,000 of his exemption amount and will incur no gift tax.

If A dies in 2026, when the exemption amount has been reduced under current law to $6,000,000; his estate will have no exemption amount remaining. The $6,000,000, gift in 2021 being deemed to have offset that base exemption amount in full. Because A died in 2026 the excess exemption amount is lost. As a result, A's entire remaining estate of $5,700,000 will be taxable without an exemption and incur a federal estate tax of $2,280,000.

From this we can reach the conclusion that to take advantage of the higher exemption amount of $11,700,000, available in 2021, an individual must either: (1) die before the exemption is reduced either by existing law or by future legislation or (2) make gifts with a value in excess of the base exemption amount. Three more examples will illustrate these concepts:

Example 2 - Assume the much same facts as in Example 1, that is A has an estate with a value of $11,700,000. In 2021 he makes a gift of $6,000,000, leaving $5,700,000 of value in his taxable estate. Again, the gift will be deemed to have utilized the exemption amount to the extent of $6,000,000 of his available $11,700,000 exemption amount, and no gift tax will be incurred.

One change in facts from Example 1: Assume that A dies in 2025, with a remaining estate of $5,700,000 and that the exemption amount remains as it does under current law at $11,700,000.

If this is the case because A died before the exemption amount was reduced in 2026, A's estate will still have $5,700,000 of exemption amount remaining to offset the value of the estate, resulting in no taxable estate and no estate tax.

Two more illustrative examples:

Example 3 - B has an estate with a value of $11,700,000. If B dies in 2026, when the exemption amount has been reduced under current law to $6,000,000. B's entire $11,700,000 estate will be subject to estate tax offset by the reduced exemption of $6,000,000 resulting in a taxable estate of $5,700,000 and a federal estate tax of $2,280,000.

Example 4 – Again assume B has an estate with a value of $11,700,000. However, in this example assume that in 2021 she makes a gift of $9,000,000, leaving $2,700,000 of value in her estate. The gift will utilize $9,000,000 of her exemption amount, but no gift tax will be incurred by the transfer.

If B dies in 2026, when the exemption amount has been reduced under current law to $6,000,000. Her estate will have no exemption amount remaining - the gift in 2021 being deemed to have offset fully that amount. As a result, B's entire remaining estate of $2,700,000 will be taxable without an exemption. However, by reason of the $9,000,000 gift in 2021, her taxable

estate has been reduced to $2,700,000, and the federal estate tax to $1,080,000. This represents a savings of $1,200,000, over what it would have been if she had not made the gift.

As a result, the following conclusion can be reached: To take advantage of the current federal estate tax exemption gifts must be made in excess of the base exemption amount applicable to the estate. Such gifts will effectively reduce the taxable estate, but only in the amount of the excess. The unknown of course is what that base exemption amount will be. The answer depends on when the person dies and whether the new administration with Democrats in control will accelerate the reduction of the exemption amount before 2026.

If law as currently on the books remains unchanged the following guidelines apply to gifts made before 2025:

– If an individual dies before 2025, pre 2026 gifts will effectively remove value from the taxable estate only to the extent they are "leveraged" and to the extent of post gift appreciation.

– If an individual dies before 2025, pre 2026 gifts will not increase or decrease the taxable estate except to the extent they are "leveraged" and to the extent of post gift appreciation.

– If an individual dies after 2025, pre 2026 will reduce the taxable estate, but only to extent they are in excess of the base exemption amount applicable to the estate.

– If an individual dies after 2025, pre 2026 gifts that are less than the base exemption amount will not reduce the taxable estate, i.e., such gifts will reduce the base exemption amount, and reduce the taxable estate by the same amount.

b. Spousal Lifetime Access Trust ("SLAT").

(1) Overview.

One planning option discussed in order take advantage of the higher estate exemption is the so-called Spousal Lifetime Access Trust, or "SLAT."

(2) What is a Spousal Lifetime Access Trust?

The Spousal Lifetime Access Trust ("SLAT") is an irrevocable trust where one spouse makes a gift into a trust to benefit the other spouse (and potentially other family members) while removing the assets from their combined estates.

One spouse may choose to fund a SLAT for the benefit of the other spouse or each spouse may choose to fund SLATs. For married couples, this may offer a way to take advantage of the federal lifetime gift and estate tax exclusion, which is currently $11.7 million per person in 2021, or $23.4 million per married couple, while retaining limited access to the assets, in the event such access is ever needed. Because a SLAT is funded with a gift made during the spouse's lifetime, any post-gift appreciation will take place in the trust and be excluded from the estate of both spouses for federal estate taxation purposes.

(3) How a SLAT works

Married couples may be interested in making large, permanent gifts to reduce the size of their estate. However, concerns can arise because many gifting strategies involve the loss of control of the assets during their lifetime and they may be unsure whether the assets will be needed in the future. A SLAT is an estate planning strategy that can perhaps address these conflicting objectives. This type of trust is created by one spouse (the "donor" spouse) who gifts property to an irrevocable trust for the benefit of the other spouse ("non-donor" spouse). They may also elect to include other family members (typically children and grandchildren) as beneficiaries. The donor spouse uses their federal exclusion when transferring assets to the SLAT.

Although the trust is irrevocable, the donor spouse may indirectly benefit from the property gifted to the trust, as long as the non-donor spouse is living and remains married to the donor. This indirect benefit is achieved because the non-donor spouse is the primary beneficiary of the trust and can request distributions from the trustee of the trust, if needed, during their lifetime. The trustee may approve this request and distribute income or principal to the non-donor spouse, typically to maintain their accustomed standard of living.

Upon the death of the donee spouse the remaining balance of the trust reverts to the heirs other than the donor spouse. Distributions to the non-donor spouse will be reintroduced into their taxable estate unless they are spent. The appropriate amount to gift to a SLAT should be determined through appropriate budgeting and planning, with the ultimate goal of the SLAT to be to let the trust assets grow outside the estate for future generations. Upon the death of the non-donor spouse, the trust assets are transferred to the remaining trust beneficiaries (e.g., children or grandchildren), either outright or in further trust.

(4) Potential benefits of a SLAT

The donor's transfer of assets to the SLAT is considered a taxable gift. If structured properly, the gift permanently removes the assets, as well as future appreciation on the assets, from the donor's taxable estate. Even though the non-donor spouse is a beneficiary of the SLAT, the trust is excluded from the non-donor's taxable estate as well.

SLATs are typically structured as grantor trusts for income tax purposes. This means the donor pays the income tax liability personally on the earnings generated in the trust, rather than the trust itself bearing the burden of income taxes. The grantor trust structure may also further reduce the taxable estate of the donor and allow the assets inside the trust to appreciate outside of the estate of the donor without being encumbered by income taxes.

The current estate tax environment also provides a benefit for those considering SLATs. While the exclusion is currently $11.7 million (in 2021) per person, this is scheduled to "sunset" in 2026 or could be changed sooner, so funding a SLAT prior to the exclusion being lowered enables a donor to effectively utilize the current historically high exclusion amount. Individuals who take advantage of the increased exclusion in effect until December 31, 2025 will not be adversely impacted after 2025 when the exclusion amount sunsets. In other words, there will be no clawback of previously gifted amounts on the individual's estate tax return.3

Like other irrevocable trusts, a SLAT can be an effective tool for multi-generational planning. A SLAT may be designed to benefit the next generation only or be structured as a dynasty trust, which is a long-term trust created to pass wealth from generation to generation without incurring transfer taxes, such as estate and gift taxes or generation skipping transfer tax.

c. Alternative – The Delaware Trust.

An alternative to the SLAT is the Delaware Asset Protection Trust. This is how this would work. You transfer assets to a Delaware Asset Protection Trust. Under the terms of the trust, you do not retain any absolute right to income and principal but do remain eligible to receive distributions in the discretion the trustee or trust advisor that you appoint. Assets transferred to the trust are subject to gift tax but are removed from the taxable estate. The advantage of the Delaware Trust is that it will allow you to take advantage of the higher estate tax exemption and still retain access to the value transferred to the trust. In addition, upon the death of the donor spouse the assets remaining in the trust may be held for the benefit it of the benefit of the surviving spouse before they revert to the benefit of the subsequent heirs.

In most states, the type of trust arrangement would allow your creditors to access the trust and also cause the trust to be included in your estate. However, in Delaware and other states such as Alaska, which provide the trust remain protected from creditors except in certain situations, the creator of the trust can remain eligible to receive distributions from at the trustee's discretion and still have the trust assets remain out of the reach of creditors. This asset protection features of the trust together with the fact that access to trust income and principal is vested with a third party trustee or trust adviser the trust assets will be removed from your estate for tax purposes. As a result, the Delaware Trust allows you to "give" the assets away to the Delaware Trust, remove those assets from your taxable estate, yet be able to get payments from the trust at the trustee's or trust adviser's discretion.

Note: Not everyone agrees with this interpretation of the estate tax law, and the IRS has not ruled on it. In addition, it is not clear that the trusts will protect your assets from creditors. If a court in another state rules that your creditors are entitled to tap the trust, then under the Constitution, the Alaska or Delaware trust probably has to comply with that ruling. That also has not been tested. Using these new trusts for estate planning or asset protection is not a sure thing. The only way to get certainty is to wait for IRS rulings and court decisions. Some asset protection specialists are saying that they will use Alaska trusts in combination with other devices or with an escape valve. For example, the Alaska trust might be automatically moved to a foreign country if a creditor gets a judgment against you. Or the trust might be combined with a family limited partnership. Or the Alaska trust might be created by an offshore trust that you create. But the cost of those strategies will be higher, so a lot of money must be at stake.

Note: One additional caveat in order to establish a Delaware trust you generally to have a Delaware trustee, which means that you must pay trustee's fees. However, even though you must appoint a Delaware trustee, the law allows the discretion to make distributions to you may be vested solely in a "trust adviser" that you appoint

2. *Taking Advantage of "Leverage" Gift Techniques*

a. Overview

As noted, the issue with gifts made to take advantage of the higher exemption amount currently available is that unless such gifts are in excess of the applicable exemption determined at the time of death such gifts will not reduce federal estate tax liability. This is because while such gifts remove value from the taxable estate, they also reduce the exemption amount available to the estate. An alternative is the so-called "leveraged gift." A "leveraged" gift is a gift transfer that is structured in such a way so that the taxable value of the gift is less than the value of the property actually transferred. For example, a leveraged gift can remove say $1,000,000 from the taxable estate at a gift value of $650,000, or even zero (-0-). The following are some of the leveraged gift options.

b. GRATs/GRUTS.

(1) How it Works

Grantor retained annuity trusts ("GRATs") and grantor retained unitrusts ("GRUTs") are often used to minimize the gift tax value of intrafamily transfers. Pursuant to this planning, an individual transfers his or her property to an irrevocable trust, i.e., a GRAT or GRUT, retaining a current income interest in the trust for a specified term (anticipated to be shorter than the grantor's life expectancy). At the end of the term, the remainder interest in the trust property generally passes to beneficiaries named in the trust, either outright or in further trust. If the requirements of IRC §2702 are met, the value of the gift is determined by the "subtraction method," i.e., by subtracting the present value of the retained income right from the fair market value of the property transferred. If the term is long enough and the level of retained income interest is set high enough, the value of the retained right to income can equal the value of the interest transferred. In that case, the value of the gift will be zero.

Under IRC §2702, retained income interests are valued at zero unless they are "qualified interests." IRC § 2702(b) defines three types of qualified interests: (i) an annuity trust interest (i.e., an income interest equal to a fixed amount or fixed percentage of the initial fair market value of the property transferred) (i.e.; a "GRAT"); (ii) a unitrust interest (i.e., an income interest equal to the fair market value of the property transferred determined on an annual basis) (i.e., a "GRUT"); and (iii) any non-contingent remainder interest if all of the other interests in the trust consist of either unitrust or annuity trust interests. For the GRAT or GRUT to realize the tax benefits described, the owner must survive for the period during which he or she has retained the qualified interest. If the owner dies within that period, the value of the interests held by the GRAT or GRUT is included back in his or her taxable estate, effectively reversing the tax benefit created by the GRAT or GRUT.

(2) Illustrative Planning

The transfer of $5,700,000 to a 10 year Grantor Retained Annuity Trust, which provides a 11.13% annual annuity will remove that amount from your taxable estate with a taxable gift value of zero (-0-).

c. Private Annuity/Intentionally Defective Trust.

(1) How it Works

The sale of property to an "intentionally defective grantor trust" ("IDGT") in exchange for a lifetime annuity payment can serve as an alternative to a transfer by gift. Under this plan, an individual first establishes an irrevocable trust – the IDGT. The trust intentionally includes trust provisions which make the trust a "grantor trust" for income tax purposes. As a grantor trust, the trust is essentially ignored for tax purposes, and all of the income, deductions, and credits are taxable to the grantor of the trust, in this case, the individual establishing the trust.

After the IDGT is established and funded, the individual then "sells" a property interest to the IDGT in exchange for an annuity payable for life. Normally a sale would create taxable income to the seller based on the amount of gain realized. In the case of the IDGT, however, because the trust is a "grantor trust," the sale is not considered taxable (the IRS essentially looks at the grantor trust and the trust creator as one taxpayer). As a result, the gain realized on the "sale" is not recognized for tax purposes. To avoid gift tax consequences, the private annuity must be set at a sufficient level that its present value at least equals the value of the property interest transferred. If that is the case, the exchange will be considered made for fair value in money and money's worth, and no gift tax consequences will result from the transaction.

Upon the death of the individual seller, the private annuity terminates leaving nothing to be taxed in his or her estate. From an estate tax point of view, the property interest is removed from the taxable estate without gift or estate tax consequences. This is perhaps overstating the case, since the annuity payments, if retained by the individual seller, will be subject to estate tax.

(2) Illustrative Planning

The transfer of $5,700,000 to an Intentionally Defective Trust in exchange for a private lifetime annuity for an annual life annuity of $380,533 will also remove that amount from your taxable estate with a taxable gift value of zero (-0-).

d. Family Limited Partnership.

(1) How it Works

A "Family Limited Partnership" is a means of transferring property to heirs which attempts to take advantage of the discounts due to "minority" and "lack of marketability," by first transferring assets, sometimes non-business property, to a limited partnership. Under the FLP, a limited partnership is first created. As a next step, the assets are transferred to the FLP by a senior family member, in exchange for a 1% general partnership interest and a 99% limited partnership interest in the FLP. By design, the general partnership interest is entitled to 1% of the cash distributions from the FLP, 1% of the net proceeds in liquidation, and, by law, all of the management control. The limited partnership interest is entitled to 99% of the cash distribution from the partnership, 99% of the net proceeds in liquidation, but by law none of the management control. For the next step, the senior family member transfers the 99% limited partnership interest to chosen heirs, either outright or in trust. This transfer is a taxable gift. The 1% general partnership interest is retained. Like the recapitalization described above, the gift tax value of the transfer of the limited partnership

interest should be subject to a discount for "minority" and "lack of marketability" which will result in a discount of the value of the transferred property by as 35% to 40%.

Particularly when no-business assets, such as marketable securities, are transferred to the FLP, the IRS has sought to challenge the validity of the discounts for estate and gift tax purposes with varying success. Often the challenge is based upon the application of Code Section 2036(a)(1), which provides that the value of the estate includes property transferred by lifetime gift when the transferor retains the right to the possession, enjoyment or income form the property or the right to control the possession, enjoyment or income from the property, until death. The Service has been most successful when the factual background of the contested case includes one or more of the following facts: (i) the transferor transfers most of his or her assets to the FLP, (ii) the transferor continues to use the property transferred as if it is his or her own, (iii) the transferor commingles personal and partnership assets, (iv) the transferor takes disproportionate distributions from the FLP, or (v) uses the entity funds for personal expenses. The IRS has also had some success when the transferor has failed to observe the legal formalities of the FLP, such as maintaining separate bank accounts.

(2) Illustrative Planning

The transfer of $5,700,000 to a Family Limited Partnership followed by the transfer of a 99% limited partnership interest valued at a discounted value of $3,667,950, to a 10-year Grantor Retained Annuity Trust, which provides for an annual annuity of $422,389 will remove $5,700,000 from your taxable estate with a gift tax value of zero (-0-).

The transfer of $5,700,000 to a Family Limited Partnership followed by the transfer of a 99% limited partnership interest valued at a discounted value of $3,667,950, to an Intentionally Defective Trust in exchange for a private lifetime annuity for an annual life annuity of $244,873 will also remove that amount from your taxable estate with a taxable gift value of zero (-0-).

e. Qualified Personal Residence Trust.

(1) How it Works

A qualified personal residence trust ("QPRT") is a trust that is initiated by the transfer of the legal ownership of a primary residence to an irrevocable trust, i.e., the QPRT. The primary advantage of a QPRT lies in its potential for estate and gift tax savings. The QPRT works as a tax savings device by reducing the value of the gift to the value of the remainder interest, as opposed to the value of the entire property interest. Under the terms of the QPRT, the transferor retains the right to live in and manage the residence transferred for the term of the trust. Also, the transferor remains primarily responsible for all costs associated with the property, including the mortgage, insurance, and taxes.

At the end of the trust term, assuming the transferor survives, the residence passes to the beneficiaries named in the trust, either outright or in trust. At that point, the transferor can continue to occupy the residence, but a lease arrangement must be made with the trust or the beneficiaries at a fair market rental.

(2) Illustrative Planning

The transfer of your residence valued $750,000 to a Qualified Personal Residence Trust will also remove that assets from your taxable estate with a taxable gift value of $97,994.