Chapter 5: Wealth Accumulation and Preservation

Tax Planning for Higher-Income Individuals B183
Use of IDGTs and GRATs B201
Charitable Remainder Trusts B211

Please note. Corrections were made to this workbook through January of 2017. No subsequent modifications were made. For clarification about acronyms used throughout this chapter, see the Acronym Glossary at the end of the Index.

For your convenience, in-text website links are also provided as short URLs. Anywhere you see **uofi.tax/xxx**, the link points to the address immediately following in brackets.

TAX PLANNING FOR HIGHER-INCOME INDIVIDUALS

The American Taxpayer Relief Act of 2012[1] increased income tax rates and capital gains tax rates for higher-income taxpayers. These higher income tax rates have resulted in major changes to tax planning strategies for those affected. For 2016, the top income tax bracket of 39.6%[2] applies to the following taxable income amounts.[3]

Filing Status	Taxable Income Threshold for 39.6% Tax Rate
Single	$415,050
Married Filing Jointly (MFJ) and Qualifying Surviving Spouses	466,950
Head of Household (HoH)	441,000

NET INVESTMENT INCOME TAX

The Health Care and Education Reconciliation Act of 2010[4] introduced a 3.8% net investment income tax[5] (NIIT) on certain passive sources of income effective January 1, 2013. As a result, for taxpayers in the 39.6% bracket, the overall rate associated with interest, dividends, short-term capital gains, and other passive sources of income is 43.4%. In addition, for qualified dividends and long-term capital gains, the top rate rose from 15% **to 20%** beginning in 2013, plus the additional 3.8% NIIT. The higher rates make tax planning for higher-income individuals of greater importance compared to years before the tax increases took effect.

The NIIT applies to the lesser of a taxpayer's net investment income (NII) or the amount by which the taxpayer's modified adjusted gross income (MAGI) exceeds $250,000 for MFJ taxpayers (and surviving spouses), $125,000 for married taxpayers filing separately (MFS), and $200,000 for single and HoH.[6] NII includes interest, dividends, annuities, royalties, and rental income not derived in the ordinary course of an active trade or business. Additionally, income from **passive** trade or business activities and income from the business of trading financial instruments or commodities is potentially subject to the NIIT. Income from passive trades and businesses is discussed later in this chapter.

1. PL 112-240.
2. The 39.6% rate is the result of the expiration of tax cuts enacted in 2001 and 2003.
3. Rev. Proc. 2015-53, 2015-44 IRB 615.
4. PL 111-152.
5. IRC §1411.
6. Ibid.

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However, tax-exempt income, distributions from qualified retirement plans, wages, and self-employment (SE) income is exempt from the NIIT.

For individuals with income high enough to trigger the NIIT, income tax planning strategies to minimize the impact of the tax include shifting a portion of investments to tax-exempt bonds and growth stocks rather than dividend-paying stocks. In addition, allowable deductions of expenses allocable to NII should be shown on Form 8960, *Net Investment Income Tax — Individuals, Estates, and Trusts.*

> **Note.** For additional information about the types of income included in NII and allowable deductible expenses that may be used to reduce NII, see the 2013 *University of Illinois Federal Tax Workbook,* Volume A, Chapter 2: Affordable Care Act Update. This can be found at **uofi.tax/arc** [www.taxschool.illinois.edu/taxbookarchive].

Because distributions from qualified retirement plans are not subject to the NIIT, small business owners may want to consider the increased usage of such plans. Similarly, the charitable donation of appreciated securities reduces the impact of the NIIT for a higher-income taxpayer.

TAX PLANNING FOR SELF-EMPLOYED TAXPAYERS

Retirement Plans

For higher-income taxpayers who are self-employed, an effective tax reduction strategy may include the use of certain small business retirement plans. Generally, there are four types of small business retirement plans.

1. A simplified employee pension plan (SEP IRA)
2. A savings incentive match plan for employees (SIMPLE IRA)
3. A self-employed 401(k) plan
4. A 401(k) plan

Following are the key characteristics of the first three types of plans. The 401(k) plan is generally beneficial only for larger businesses due to initial set-up costs and burdens of administration.

- **SEP IRA.** Available for sole proprietorships and partnerships, the employer can contribute up to the lesser of 25**%** of employee compensation or $53,000 (for 2016).[7] Moreover, if the terms of the SEP IRA permit non-SEP contributions, a participant may make regular IRA contributions (including catch-up contributions for participants age 50 or older) in addition to any SEP IRA contributions. The contributed funds for a self-employed individual are not included in the income of the business owner and are deducted on Form 1040, *U.S. Individual Income Tax Return,* (on the line for "self-employed SEP, SIMPLE, and qualified plans") rather than Schedule C.[8] Form 5500, *Annual Return/Report of Employee Benefit Plan,* which is an information return required for certain retirement plans under ERISA, does not need to be filed for a SEP IRA. Employee withdrawals may be made at any time. Amounts withdrawn are subject to income tax, and if the employee/participant is under age 59½ at the time of the withdrawal, an additional 10% penalty under IRC §72(t) applies. There is no initial set-up fee and no annual maintenance fee.

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7. *IRS Announces 2016 Pension Plan Limitations; 401(k) Contribution Limit Remains Unchanged at $18,000 for 2016.* Oct. 21, 2015. IRS. [www.irs.gov/uac/newsroom/irs-announces-2016-pension-plan-limitations-401-k-contribution-limit-remains-unchanged-at-18-000-for-2016] Accessed on Jul. 6, 2016.

8. *Self-Employed Individuals—Calculating Your Own Retirement-Plan Contribution and Deduction.* Feb. 22, 2016. IRS. [www.irs.gov/retirement-plans/self-employed-individuals-calculating-your-own-retirement-plan-contribution-and-deduction] Accessed on Jul. 14, 2016.

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Note. For additional details regarding SEP IRA accounts, see the 2016 *University of Illinois Federal Tax Workbook,* Volume A, Chapter 1: Retirement. Further information is available at **uofi.tax/16b5x1** [www.irs.gov/retirement-plans/retirement-plans-faqs-regarding-seps-contributions].

- **SIMPLE IRA.** These plans are available to C corporations, S corporations, sole proprietorships, and partnerships that have 100 employees or fewer and have no other retirement plan. **Both the employer and the employee can contribute** to the account. The employee can contribute up to $12,500 (for 2016), not to exceed 100% of compensation. The employer either matches the first 3%[9] of employee salary reduction contributions or makes a 2% nonelective contribution for all eligible employees, up to a maximum of $265,000 (for 2016) of compensation. A participant who is age 50 or older may make a catch-up contribution of $3,000 for 2016. The contributions are deducted on the employer's return. It is not necessary to file a Form 5500 for these plans. Withdrawals can be made at any time, but if the employee is under age 59½ at the time of the withdrawal, a 10 % penalty applies.[10]

Note. For additional details regarding SIMPLE IRA accounts, see the 2016 *University of Illinois Federal Tax Workbook,* Volume A, Chapter 1: Retirement. Further information is available at **uofi.tax/16b5x2** [www.irs.gov/retirement-plans/plan-participant-employee/retirement-topics-simple-ira-contribution-limits].

- **Self-Employed 401(k).** These plans are available to self-employed persons or business owners (sole proprietorships, partnerships, C and S corporations) **with no employees** other than the owner and their spouse. This type of retirement plan is also frequently referred to as a "solo 401(k)" or a "one-participant 401(k)."

  Plan contributions can be made in the business owner's capacity as both employer and employee. Employer nonelective contributions can be made up to 25% of compensation. Elective deferrals can also be made up to 100% of compensation, not to exceed the annual contribution limit (in 2016, this is $18,000 or $24,000 if the employee is at least age 50.) The total contributions cannot exceed $53,000 for 2016 (or $59,000 including a $6,000 catch-up contribution if the employee is at least age 50) or 100% of the participant's compensation.

Note. For additional details regarding solo 401(k) accounts, see the 2016 *University of Illinois Federal Tax Workbook,* Volume A, Chapter 1: Retirement. Further information is available at **uofi.tax/16b5x3** [www.irs.gov/retirement-plans/one-participant-401k-plans].

Form 5500 must be filed annually once the plan assets exceed $250,000. Employer contributions are deductible, and withdrawals are included in income subject to an additional 10**%** penalty if the participant is under age 59½ at the time of withdrawal. There is no initial set-up or annual maintenance fee.

Note. For additional information about retirement plans, including the tax treatment of distributions and how to establish such plans, see IRS Pub. 560, *Retirement Plans for Small Business.*

[9] It is possible to elect to reduce the 3% matching contribution for a calendar year if certain conditions are satisfied.

[10] The penalty is 25% if the employee is under age 59½ at the time of the withdrawal and the withdrawal occurred during the first two years after the plan was established.

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Tax-Advantaged Healthcare Accounts

Certain self-employed business owners can also shelter income by optimizing the use of small business healthcare benefits. Establishing healthcare savings accounts, health reimbursement arrangements, and IRC §125 plans converts expenses that would have exceeded applicable deduction limits to expenses that can be paid on a pre-tax basis through the business**.**

Employment of a Child

Another strategy for a self-employed individual may be to include children on the business payroll. Payments to minor children for services rendered to the business are not subject to FICA (social security and Medicare tax) and FUTA (federal unemployment) tax. In addition, the child can contribute to an IRA out of their earned income. The rules associated with a FICA exemption for children provide planning opportunities to split income with children.

Generally, compensation paid for the services of a child under age 18, performed directly for a parent, is exempt from FICA taxation.[11] Moreover, compensation paid to a child under the age of 21 is exempt from FICA if the services performed for a parent constitute domestic service within the parent's residence and not services rendered in connection with a trade or business.[12]

Additionally, compensation paid to a child under the age of 21 employed by a partnership is exempt from FUTA taxation if a parent-child relationship exists with each partner.[13]

> **Note**. Compensation paid to a child employed by a C or S corporation is not exempt from FICA taxation. This is because the corporation is considered to be the child's employer rather than a parent. Therefore, the parent-child prerequisite for a FICA exemption does not exist between employer and employee because the corporation is not considered a parent, even if the parents are shareholders.

If the child is employed by a parent-owned disregarded entity, the parent is considered the employer. In this situation, the requisite parent-child relationship between employer and employee is considered to exist for purposes of a FICA exemption on compensation paid to the child.

> **Observation.** Parents with incorporated businesses that wish to employ a child on a FICA-exempt basis may establish a proprietorship as a management entity to provide bona fide management services to the corporation. Then, the child can be paid directly from the management entity instead of the corporation.

> **Note.** For additional details regarding the relevant rules associated with the employment of children and the applicability of any exemption from payment of FICA tax, see **uofi.tax/16b5x4** [www.irs.gov/businesses/small-businesses-self-employed/family-help].

11. IRC §3121(b)(3)(A).
12. IRC §3121(b)(3)(B).
13. Treas. Reg. §31.3121(b)(3)-1(c).

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Employment of a Spouse

If both spouses participate in the business, it may be beneficial to compensate one spouse substantially higher than the social security wage limit ($118,500 for 2016). The value of the spouse's services must be worth the higher amount. If the compensation can be justified, a social security tax savings can be realized.

Example 1. Ardell and Justice are a married couple and own AJ Enterprises, a small business in which they both materially participate. The total value of services Ardell and Justice provide to AJ Enterprises is $237,000.

At the beginning of 2016, Ardell and Justice's tax advisor informs them that if they are each paid $118,500, their total social security taxes will be $14,694 ($118,500 × 6.2% tax rate × 2 people). However, if one spouse is paid $167,000 and the other spouse is paid $70,000, their combined social security tax will be $11,687 (($118,500 social security wage limit + $70,000) × 6.2%). Giving consideration to the employer FICA match, the total savings is $6,014 (($14,694 – $11,687) × 2).

Note. Only the social security tax has a wage base limit ($118,500 for 2016). There is no wage base limit for Medicare tax. All covered wages are subject to Medicare taxation.[14]

Another reason for compensating a spouse is to fully fund retirement plan contributions for that spouse.

PORTFOLIO INCOME

High-income taxpayers tend to have a relatively high percentage of their income originating from portfolio income — investment income, interest, dividends, royalties, and capital gains. With the exception of capital gains and qualified dividends, portfolio income is taxed at ordinary income rates. When devising a tax planning strategy for portfolio income, it may be wise to include more tax-exempt municipal bonds and capital-appreciating and dividend-generating assets in regular accounts and to move investments that produce ordinary income into retirement accounts to achieve tax-deferred growth. Any conversion of investment income into tax-exempt or deferred income affects the after-tax rate of return.

Note. Under IRC §265, a taxpayer cannot deduct certain expenses or investment interest in connection with an investment in tax-exempt municipal bonds. This factor should be considered in investment portfolio planning strategies.

Note. As previously mentioned, unlike other types of portfolio income, tax-exempt municipal bond interest is not subject to the 3.8% NIIT.

Another strategy involving portfolio income is to lend money to family members. If the loan is for the family member's acquisition of a residence secured by the mortgage, the interest is deductible. The family member-borrower could pay less interest given the low applicable federal interest rates that must be charged.

Commodities and Collectables

Investments such as gold, silver, and collectables that the taxpayer holds directly are taxed at 28% upon sale if they have been held for longer than 12 months. If they have been held for 12 months or less, the gain is taxed at ordinary income rates. If the taxpayer indirectly owns commodities and collectables through a specific investment vehicle for such assets, this could improve the after-tax return on such assets.

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[14] *Topic 751 — Social Security and Medicare Withholding Rates*. Jun. 30, 2016. IRS. [www.irs.gov/taxtopics/tc751.html] Accessed on Jul. 14, 2016.

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Mutual Fund Investments

Dividends and Distributions. Ordinary dividends are the most common type of distribution from a mutual fund. Ordinary dividends are paid out of earnings and profits and constitute ordinary income rather than capital gain. They are shown in box 1a of Form 1099-DIV, *Dividends and Distributions.*

Qualified dividends, however, are taxed at 20% (plus the additional 3.8% NIIT) if the taxpayer is in the 39.6% ordinary income tax bracket. If the taxpayer is in an ordinary income tax bracket between 15% and 39.6%, qualified dividends are taxed at 15%. Qualified dividends are taxed at the 0% rate if the taxpayer is in the 10% or 15% ordinary income tax bracket. Qualified dividends are reported in box 1b of Form 1099-DIV.

Note. A qualified dividend derives from stock that was held for more than 60 days during the 121-day period that begins 60 days before the ex-dividend date (counting the day the stock was disposed of but not the date of acquisition). The ex-dividend date is the first date after the declaration of a dividend on which the buyer of a stock is not entitled to receive the next dividend payment. Instead, the seller gets the dividend.[15]

Note. Capital gain distributions are not qualified dividends, nor are dividends that are paid on deposits with mutual savings banks, cooperative banks, credit unions, savings and loan associations, and similar financial institutions. Likewise, dividends paid by a corporation on employer securities held on the date of record by an employee stock ownership plan maintained by that corporation are not qualified dividends.[16]

Computing Basis. When mutual fund shares are sold, gain or loss is measured by the difference between the amount realized from the sale of the fund shares and the income tax basis of those shares. Income is generally recognized either as ordinary income or capital gain from fund distributions or the redemption of fund shares (resulting in capital gain or loss). Typically, an investor cannot control the income that a fund distributes[17] but can control the timing of the gain or loss recognition when fund shares are sold.

Note. A sale occurs whenever an investor redeems all or a portion of their shares in a mutual fund. A sale also is triggered when the investor directs the fund to redeem a certain amount of shares required for a payout of a specific dollar amount. Likewise, a sale occurs when funds are swapped within a particular "family" of funds — e.g., the surrender of an income fund for the same value of shares in a growth fund. This is treated as a sale of the income fund.

If **all** of the shares in a fund are disposed of in a single transaction, the basis determination is not complex. The basis of all of the shares (acquisition cost or carryover basis plus commissions and sales charges) is added to fund distributions that were reinvested to acquire additional shares. The amount of any distributions representing a return of capital is subtracted from this total.

15. IRS Pub. 17, *Your Federal Income Tax.*

16. Ibid.

17. Mutual funds distribute both ordinary income and capital gains that the fund realizes to shareholders. Under IRC §852(b), short-term capital gains lose their capital gain character when they are distributed. A distributee shareholder treats such amounts as ordinary income.

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The basis computation is more difficult when only a portion of an investor's interest in a fund is disposed of and the shares were acquired at different times and at different prices. In this situation, an investor can use one of several methods to identify the shares sold and determine their basis. The choice of method can impact the tax result upon sale because it can result in a higher basis for the shares sold and/or permit the taxpayer to control the long-term or short-term nature of the gains and losses on sale. The proper choice of method can generate substantial tax savings for high-income clients. The most beneficial method for a particular situation is highly fact-dependent. The available methods are listed below.

- **The first-in, first-out (FIFO) method.** Under this method, the shares sold are deemed to be the first ones owned (the oldest trade lot). Consequently, the gain on sale of shares is calculated by using the income tax basis of the first shares acquired.[18] In a rising market, this approach can cause relatively more gains to be realized. Likewise, more losses are realized in a declining market. Under this approach, gains and losses have a greater likelihood of being long-term.
- **The last-in, first-out (LIFO) method.** Under this method, the shares sold are deemed to be the last ones owned (the newest trade lot). The gain on sale of shares is computed by using the income tax basis of the last shares acquired. The newest shares often have the smallest capital gain but may have been held for less than one year. Accordingly, they may be taxed at ordinary income tax rates rather than long-term capital gain rates.
- **The highest-cost method.** This tax-lot identification approach matches shares beginning with the most expensive trade lot and ending with the least expensive trade lot. The highest-cost method does not take into account the length of time the shares have been held. If several tax lots are involved in a sale that includes shares that have been held both long-term and short-term periods, lower taxable gains may result. However, the tax rate will not be minimized.
- **The lowest-cost method.** This approach matches shares beginning with the least expensive trade lot and ending with the most expensive lot. This method is designed to maximize gain and allows realized losses to offset gains.
- **The beneficial tax approach.** Under this method, the shares are matched in the order that takes into account the highest loss first and the highest gain last. Lots with long-term gains are sold before those with short-term gains. This approach is beneficial when capital gains have previously been realized in the account earlier in the year and the account has unrealized loss positions that can be utilized to offset those prior gains. However, the approach does not factor in the possible application of the wash sale rules that would disallow the loss on the trade.
- **Specific lot method.** This approach allows the taxpayer to select a specific lot from the day after the trade execution or, at the latest, before midnight (eastern time) on the settlement date of the trade. This method allows the investor to determine the precise gain or loss to be recognized on a trade and whether the trade is to be of a tax lot that has been held for a long term or a short term.
- **The average basis (cost) method.** This method is typically the default method used if the account is handled by a custodian or an agent who acquires or redeems shares. It must be elected before the time of the trade.[19] Average basis is calculated by averaging the basis of all of the shares of identical stock in an account regardless of the holding period. The basis of each share of identical stock in the account is the aggregate basis of all shares of that stock in the account divided by the aggregate number of shares.[20] Once this method is used, the taxpayer cannot later change to any other cost method.

Note. For additional details regarding the taxation of mutual fund holdings, see the 2012 *University of Illinois Federal Tax Workbook,* Volume C, Chapter 8: Investment Income. This can be found at **uofi.tax/arc** [www.taxschool.illinois.edu/taxbookarchive].

[18] Because they have been held the longest, the first shares acquired are likely to have the lowest basis. However, they may be more likely to qualify for long-term gain/loss treatment.

[19] Treas. Reg. §1.1012-1(e).

[20] Treas. Reg. §1.1012-1(e)(7).

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With respect to the sale of mutual fund shares, using the specific lot method can provide tax savings. The concept involves the computation of the basis of mutual fund shares that are sold, which can be complicated. Tax lots are recorded every time a new position in a security is purchased. By law, brokerage firms must report cost basis, and many financial services firms keep a detailed record of tax lots. However, it is a good idea for an investor to retain any computation slips and/or activity reports issued by the mutual fund. Such statements show how much was paid for the shares and information about the dividends, capital gains, distributions, and reinvestments that will be needed to compute income tax basis in the fund shares.

Tax loss harvesting is a method advisors use to review accounts throughout the year looking for opportunities to offset any large **realized** capital gains by realizing capital losses. This can result in significant capital gains tax savings and often requires examining specific tax lots in order to generate the most savings.

Example 2. Marcia sold 1,000 shares of Apple in June 2015 and realized a $25,000 gain. In December 2015, Marcia wanted to realize losses to offset that gain. Monsanto is trading at $100 per share and Marcia owns 1,000 shares. Marcia's tax lots are as follows.

Lot	Number of Shares	Purchase Date	Purchase Price per Share	Total Purchase Price
1	250	August 1, 2010	$ 75	$ 18,750
2	250	December 1, 2012	75	18,750
3	250	May 1, 2013	125	31,250
4	250	September 1, 2014	125	31,250
Total	1,000			$100,000

Marcia's total cost for her Monsanto shares is $100,000. At first glance, it looks like she has no gain or loss because the current market value is the same as her cost basis ($100 current market price × 1,000 shares = $100,000). However, Marcia can specify that she wants to sell just the 500 shares in lots #3 and #4, which have a combined loss of $12,500 ((500 shares × $125 purchase price) – (500 shares × $100 current market price)). By doing this, Marcia offsets her $25,000 realized gain from the Apple stock sale by the $12,500 loss from the Monsanto sale.

Note. Many financial services firms have software that allows an investor to identify shares and determine basis when a security is sold.

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Timing the Sale of Mutual Fund Shares. The careful timing of the sale of mutual fund shares can result in the conversion of what would normally be ordinary income to capital gains and thus reduce the tax rate on the sale. This result can be achieved by selling shares **before** the fund makes an income distribution.

Example 3. Reginald's marginal tax rate is 39.6%. He owns 1,000 shares of a mutual fund that he plans to sell before the end of the year. The shares are presently valued at $50 per share and his basis is $30 per share. He owned the shares for more than 12 months.

The fund plans to make a $6 per share distribution to shareholders of record in mid-December. The distribution reduces the per-share value to $44. The distribution is composed of $4 of ordinary income and $2 of long-term capital gain. If Reginald waits until after the distribution date to sell his shares, he will recognize ordinary income of $4,000 and long-term capital gain of $16,000, as shown in the following table.

	Total Income	Ordinary Income	Long-Term Capital Gain
Distribution of ordinary income ($4 per share × 1,000 shares)	$ 4,000	$4,000	
Distribution of capital gain ($2 per share × 1,000 shares)	2,000		$ 2,000
Gain from sale of shares (($44 value per share − $30 basis) × 1,000 shares)	14,000		14,000
Totals	$20,000	$4,000	$16,000

However, if Reginald sells the shares before the fund's income distribution, he avoids recognizing any ordinary income. Instead, his entire gain consists of a long-term capital gain of $20,000 (($50 value per share − $30 basis per share) × 1,000 shares).

Reginald's total income on disposition is the same ($20,000) under both options. However, by selling his shares before the fund makes the income distribution, he converts $4,000 of ordinary income into long-term capital gain. His tax savings is $784 ($4,000 × (39.6% ordinary tax rate – 20% capital gains rate).

Observation. If Reginald decides to donate the mutual fund shares to charity, he should do so **before** the fund makes its distribution so that he avoids the distribution income on the shares he donates to charity.

Deferring Yearend Purchases. Mutual funds must pay out their gains and income to shareholders at least annually to avoid tax at the fund level. This makes timing of the purchase of mutual fund shares an important part of tax planning, particularly with respect to equity funds that make a single distribution annually.

Mutual fund shares that are bought shortly before the record date of the fund's distribution can result in the buyer acquiring a tax liability. If an investor, for example buys **2,000** mutual fund shares at $20 per share (total purchase price $40,000) just before the fund pays a dividend of $4 per share, the per share price will drop to $16. The investor must include $8,000 of dividends in income (irrespective of whether the $8,000 was received in cash or was reinvested in additional fund shares). This is the result even though the investor experienced no increase in the overall value of the investment. However, if the investor does not purchase the shares until after the dividend is paid, the investor can purchase **2,500** shares at $16 per share for the same cash outlay of $40,000, and the "phantom" income can be avoided.

Consequently, investors in mutual funds should pay particular attention to when they invest in a fund. This is especially true for equity funds that make only one distribution each year.

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OTHER TAX-PLANNING STRATEGIES

IRA Contributions

The total amount that can be contributed to a Roth IRA in 2016 is the lesser of the taxpayer's taxable compensation for the year or $5,500 (taxpayers age 50 and over can contribute an additional $1,000).[21] Although a Roth IRA is generally an excellent tax-planning device, a higher-income taxpayer may not be able to take advantage of it due to the taxpayer's high MAGI. A taxpayer can make a contribution to a Roth IRA if their MAGI is lower than the following thresholds.

Filing Status	2016 MAGI Phaseout Range[22]
Single, HoH, or MFS and did not live with spouse during year	$117,000–132,000
MFJ or QW	184,000–194,000
MFS and lived with spouse at any time during year	0– 10,000

However, the taxpayer may want to consider contributing to a nondeductible traditional IRA. Doing so does not generate a deduction at the time of the contribution and does not provide tax-free withdrawals, but the earnings accumulate on a tax-deferred basis.

In addition, individuals who are ineligible to contribute directly to a Roth IRA because of income limitations can make a nondeductible contribution to a traditional IRA and convert it to a Roth IRA. This process is commonly known as a "backdoor" Roth IRA contribution. There are no income limitations on Roth conversions.

Note. For a detailed discussion of traditional and Roth IRAs, including "backdoor" Roth contributions, see the 2016 *University of Illinois Federal Tax Workbook,* Volume A, Chapter 1: Retirement.

Gifting Stock to Children

Higher-income taxpayers with children can gift highly appreciated stock to a child. The child can then sell the stock and at least a portion of the gain on the sale is taxed at the child's lower tax rate. However, a portion of the gain may be subject to the "kiddie tax"; thus, the child's net unearned income is taxed at the parents' highest marginal tax rate.

Note. For further information about the kiddie tax, including rules associated with a child's requirement to file a tax return and acceptable methods to report income received by a child, see the 2013 *University of Illinois Federal Tax Workbook,* Volume C, Chapter 5: Special Taxpayers. This can be found at **uofi.tax/arc** [www.taxschool.illinois.edu/taxbookarchive].

Observation. The gift of stock or other securities to a child may constitute a taxable gift. However, the parent making the gift may allocate an appropriate amount of available lifetime estate exemption to eliminate the gift tax. Such an allocation is shown on a gift tax return for the year in which the gift is made.

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21. *Traditional and Roth IRAs.* Feb. 19, 2016. IRS. [www.irs.gov/retirement-plans/traditional-and-roth-iras] Accessed on Jul. 18, 2016.

22. *Amount of Roth IRA Contributions That You Can Make for 2016.* Dec. 23, 2015. IRS. [www.irs.gov/Retirement-Plans/Plan-Participant,-Employee/Amount-of-Roth-IRA-Contributions-That-You-Can-Make-for-2016] Accessed on Jul. 18, 2016.

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Funding College Expenses

The tax on appreciated wealth can be shifted in a manner that funds the college expenses of a family member via the use of an IRC §529 account. Under IRC §529, a donor can gift up to $70,000 in 2016 (five times the present interest annual exclusion amount for gifts of $14,000) for a child. However, any additional gifts made to the family member during the 5-year period may be subject to gift tax. The taxpayer must file Form 709 to make the 5-year IRC §529 contribution-period election.

Note. For a detailed explanation of §529 accounts, see the 2014 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 2: Individual Taxpayer Issues. This can be found at **uofi.tax/arc** [www.taxschool.illinois.edu/taxbookarchive].

Donate Securities to Nonprofit Organizations

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Higher-income taxpayers who are charitably inclined can donate substantially appreciated securities to nonprofit organizations and claim a deduction for the FMV of the securities. This produces a better tax result than is achieved when the taxpayer sells the assets, pays tax on the gain, and then donates smaller amounts (due to percentage income limitations) in cash.

PASSIVE ACTIVITIES

It is fairly common for a higher-income taxpayer to invest in various activities in which they do not materially participate. This generates passive activity income for the taxpayer. A **passive activity** is defined as any activity that involves the conduct of a trade or business in which the taxpayer does not materially participate.[23] Income from passive activities is generally included in NII and is potentially subject to the additional 3.8**%** NIIT.

Note. A taxpayer is considered to have materially participated in an activity if one of seven tests set forth in Temp. Treas. Reg. §1.469-5T(a) is met. In determining whether any of the seven tests of material participation are satisfied, the participation of the individual's spouse is taken into account.[24]

Under the passive activity rules, a taxpayer can generally deduct losses from a passive activity only to the extent the taxpayer has passive income in that year. The taxpayer can also deduct all deferred losses from that activity in the year of disposition.

Real Estate Professional

A passive activity generally includes any rental activity. Thus, rental real estate losses are generally passive and deductible only to the extent of other passive income, until the activity is sold. However, if a taxpayer qualifies as a **real estate professional,** their rental real estate activities are not automatically considered passive. [25]

23. IRC §469(c)(1).

24. IRC §469(h)(5). Proof of an individual's participation in an activity may be established by any reasonable method. Contemporaneous daily time reports, logs, or similar documents are not required if the extent of participation is established by other reasonable means (e.g., based on appointment books, calendars, or narrative summaries). Temp. Treas. Reg. §1.469-5T(f)(4).

25. IRC §469(c)(7).

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To be a real estate professional, the taxpayer must meet **both** of the following tests.[26]

1. **More than half of the taxpayer's personal services** performed in trades or businesses during the year must be rendered in real property trades or businesses (property development, construction, rental, management, or brokerage activities) in which the taxpayer materially participates.

2. The total hours that the taxpayer materially participates in such businesses **must exceed 750 hours** for the year.

For MFJ taxpayers, both of these tests must be satisfied by the same taxpayer.[27]

Note. The IRS took the position that a trust cannot attain the status of real estate professional because, in the IRS's view, the tests are intended to apply only to individuals.[28] However, the IRS position was rejected by the Tax Court in *Frank Aragona Trust v. Comm'r*.[29] In this case, rental losses of a trust were not disallowed as passive activities under the passive loss rules because trustees, as individuals, can render personal services that meet the material participation test. The trust materially participated in the real estate business via trustees acting in their capacity as trustees and in their capacity as employees of the trust's wholly-owned LLC that managed rental properties. The Tax Court implied that nontrustee employees can also satisfy the material participation test.

A real estate professional may make a grouping election to treat all of the taxpayer's interests in **rental real estate** as a single rental activity in order to facilitate the material participation test.[30] The IRS previously took the position that the 750-hour test applied separately to each activity, which would make it almost impossible for a taxpayer with multiple activities to qualify if they did not make a grouping election. However, in 2014, the IRS clarified that hours in each rental activity, even though those activities may be passive and regardless of whether a grouping election has been made, can be counted toward the tests necessary for eligibility as a real estate professional.[31] This is an important interpretive change for taxpayers with multiple activities.

Example 4. In 2016, Clem is the 100% owner of a real estate development company and two rental properties. He performs more than 750 hours of personal services in these combined businesses. He does not provide personal services to any other trade or businesses.

Clem did not make a grouping election under Treas. Reg. §1.469-9(g) to aggregate his real estate activities. However, he qualifies as a real estate professional in 2016 because more than 50% of his personal services are performed in the combined real property businesses and his total hours in the businesses exceed 750. Even though Clem did not make a grouping election, for purposes of the eligibility tests, all his real estate businesses are combined.

Note. Even though Clem is treated as a real estate professional, he could still fail the test requiring that he materially participate in the activity of each rental property. If he fails this test, he cannot claim the losses from the rental properties as nonpassive. This result may be avoided by making the grouping election under Treas. Reg. §1.469-9(g), which would allow Clem to aggregate all his rental properties for purposes of meeting one of the material participation tests.

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26. IRC §469(c)(7)(B).

27. Treas. Reg. §1.469-9(c)(4).

28. CCA 201244017 (Aug. 3, 2012).

29. *Frank Aragona Trust v. Comm'r,* 142 TC 165 (2014).

30. Treas. Reg. §1.469-9(g).

31. CCA 201427016 (Apr. 28, 2014). The new IRS position agrees with the Tax Court's opinion in *Miller v. Comm'r,* TC Memo 2011-219 (Sep. 8, 2011). See also *Lamas v. Comm'r,* TC Memo 2015-59 (Mar. 25, 2015).

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Although a real estate professional can group all of their interests in rental real estate as a single rental activity,[32] it is not possible for a real estate professional to group a rental real estate activity with another type of real estate activity.[33] For example in *Gragg v. U.S.,*[34] the petitioners, a married couple, consisted of a husband who was a corporate executive and his wife who was a real estate agent. They sustained losses on two rental real estate properties that they owned. The wife's status as a real estate agent meant that she was a real estate professional. Thus, the rental losses were not automatically per se passive (which is the case for non-real estate professionals). The IRS denied the deductibility of the losses on the basis that the petitioners did not materially participate in the rental activities. The petitioners, however, asserted that they did materially participate in the rental activities because they grouped the wife's real estate agent activities with the rental activities.

The trial court agreed with the IRS, citing Treas. Reg. §1.469-9(e)(3) which provides that a qualifying taxpayer cannot group a rental real estate activity with another type of real estate activity. Thus, for real estate professionals, grouping real estate agent activities with real estate rental activities is not allowed for purposes of determining material participation. Consequently, the losses from the petitioner's real estate rental activity were disallowed. The Appellate Court affirmed that the petitioners did not meet a material participation test under IRC §469.

Note. For more information about the *Gragg v U.S.* case, see the 2016 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 6: Rulings and Cases.

Grouping Activities

As previously mentioned, a taxpayer may electively group multiple businesses or multiple rentals as a single activity in order to make it easier to meet one of the material participation tests. Grouping multiple activities is permitted if the activities constitute an "appropriate economic unit."[35]

A taxpayer may use any reasonable method to make the grouping determination. However, the following factors are given the greatest weight in determining whether the activities constitute an appropriate economic unit.[36]

- Similarities and differences in types of business
- The extent of common control
- The extent of common ownership
- Geographical location
- Interdependence between the activities

A rental activity ordinarily cannot be combined with a business activity. However, such a grouping is allowed if either the business or rental activity is insubstantial in relation to the other, **or** each owner of the business activity has the same proportionate ownership interest in the business activity and rental activity.[37]

Note. A failure to properly group activities may result in passive status for an activity. This can be particularly detrimental because a passive loss from a business (lacking material participation by the taxpayer) or a rental activity loss is suspended. In addition, as previously mentioned, the 3.8% NIIT applies to net rental income and other passive business income of higher-income taxpayers.

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32. Treas. Reg. §1.469-9(g).
33. Treas. Reg. §1.469-9(e)(3).
34. *Charles and Delores Gragg v. U.S.,* U.S. Court of Appeals, 9th Circuit; No. 14-16053 (Aug. 4, 2016).
35. Treas. Reg. §1.469-4.
36. Treas. Reg. §1.469-4(c)(2).
37. Treas. Reg. §1.469-4(d)(1).

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2016 Workbook

Grouping Disclosure. In 2010, the IRS issued Rev. Proc. 2010-13, which contained the final guidance on the disclosure reporting requirements for groupings and regroupings.[38] Under the guidance, a written statement must be filed with the taxpayer's original tax return in the following situations.

- New groupings, such as in the first year of grouping two activities
- The addition of a new activity to an existing grouping
- Regroupings, such as for an error or a change in facts

However, no written statement is required for the following.

- Existing groupings prior to the effective date of the guidance, unless there is an addition of an activity
- The disposition of an activity from a grouping
- Partnerships and S corporations (The entity's reporting to each owner on Schedule K-1 of the net result of each activity as separate or as combined serves as the grouping election.)

Caution. If a taxpayer is engaged in two or more business or rental activities and fails to report whether the activities are grouped as a single activity, then each business or rental activity is treated as a separate activity.

A qualifying taxpayer makes a grouping election by filing a statement with the taxpayer's original income tax return for the tax year.[39] The following is a sample statement that may be used for this purpose.

SAMPLE GROUPING STATEMENT

NAME: ____

TAXPAYER ID NUMBER: ______________

YEAR ENDED: ______________________

ELECTION TO GROUP ACTIVITIES PURSUANT TO TREAS. REG. §1.469-4

The taxpayer hereby elects to group the following activities together so that the grouped activities are treated as a single activity for the year ended _____, and all years thereafter. The taxpayer represents that the grouped activities constitute an appropriate economic unit for the measurement of gain or loss for the purposes of IRC §469.

The following activities are to be grouped together and treated as one activity:

Name of Activity	Address and Employer I.D. No.
_________________________	____
_________________________	____
_________________________	____

Note. If the election statement is confirming a prior unwritten grouping position, the first line should be modified to read: "The taxpayer hereby confirms its existing election to group the following activities…"

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38. Rev. Proc. 2010-13, 2010-1 CB 329.

39. Treas. Reg. §1.469-9(g)(3).

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Despite the default rule that treats unreported groupings as separate activities, a taxpayer is deemed to have made a timely disclosure of a grouping if all affected tax returns have been filed consistent with the claimed grouping. The taxpayer must make the required disclosure in the year the failure is first discovered by the taxpayer.[40] However, if the IRS first discovers the failure to disclose, the taxpayer must have reasonable cause for not making the disclosure.

Observation. The practical implication of this relief rule is that if a proper disclosure has not yet occurred, the taxpayer needs to make the disclosure before the IRS discovers the failure to report.

Although prior groupings are grandfathered under the reporting rule, there is a consistency requirement under Treas. Reg. §1.469-4(e). This means that once a taxpayer has grouped activities, they generally may not regroup those activities in subsequent tax years. Accordingly, it is prudent for a practitioner to document a grouping position with a written statement filed with the tax return. This will facilitate the preparation process in subsequent years.

Strategies Involving Disposition of Passive Activities

Generally, under the passive activity loss (PAL) rules, the disallowed (suspended) PAL is carried forward indefinitely and may be used as a deduction against passive activity income received in subsequent tax years.[41] The disallowed PAL must be allocated to those passive activities that generated losses during the year.[42] This allocation determines how much of a PAL may be deductible upon complete disposition of an activity.[43] When a taxpayer **completely disposes** of a passive activity, they can immediately use all previously suspended PALs attributable to the disposed passive activity. Such losses are treated as nonpassive losses.[44] However, there is an ordering rule for the application of such losses. Upon disposition of a passive activity, suspended PALs must be applied in the following order.[45]

- Against any passive income received during the year from the passive activity disposed of
- Against any passive income from other passive activities of the taxpayer
- Against active income of the taxpayer

Grouped activities that meet the appropriate economic unit standard are treated as a single activity for purposes of the PAL rules.[46] In order to use the suspended PAL amounts from the disposition of an activity, all activities in a group must generally be disposed of in a fully taxable transaction.[47]

Note. For a possible exception regarding partial dispositions, see Treas. Reg. §1.469-4(g).

A tax practitioner should give careful consideration to how activities are grouped in order to maximize the taxpayer's ability to use suspended PALs from prior years through strategic dispositions. Such dispositions allow suspended PALs to be used against the taxpayer's nonpassive income.

40. Ibid.
41. IRC §469(b); Treas. Reg. §1.469-1(f)(4).
42. Treas. Reg. §1.469-1(f).
43. IRC §469(g).
44. IRC §469(g)(1)(A).
45. *Uy v. Comm'r,* TC Summ. Op. 2008-36 (Apr. 8, 2008).
46. Treas. Reg. §1.469-4(c)(1).
47. IRC §469(g)(1)(A).

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Grouping Restrictions

An activity conducted through a closely held C corporation may be grouped with another activity of the taxpayer but only for purposes of determining whether the taxpayer materially participates in the other activity. For example, a taxpayer involved in both a closely held C corporation and an S corporation can group those two activities for purposes of meeting the material participation test for the S corporation. However, the closely held C corporation cannot be grouped with a rental activity for purposes of treating the rental activity as an active business.[48]

An activity involving the rental of real property and an activity involving the rental of personal property may not be treated as a single activity, unless the personal property is provided in connection with the real property or the real property is provided in connection with the personal property.[49]

> **Note.** A rental activity owned by one spouse may be grouped with a pass-through business owned by the other spouse.[50]

Other Issues Associated With Grouping Activities

Grouping a Rental and a Business. When a taxpayer has the same proportionate ownership in a rental activity and in a business activity (other than a business organized as a C corporation), the activities may be grouped together into a single trade or business activity if the grouping is otherwise appropriate.[51]

> **Observation.** The rental activity is still reported on Schedule E, *Supplemental Income and Loss.* Although treated as a business activity in which the taxpayer materially participated for purposes of the passive activity rules, any Schedule E income or loss does **not** affect SE income. The Schedule E result flows directly to page 1 of the Form 1040 rather than flowing to Form 8582, *Passive Activity Loss Limitations.*

Example 5. Al and Alena are married and file a joint return. Al is the sole owner of an S corporation conducting a business in which he materially participates. Alena is the sole shareholder of an S corporation that owns a building leased exclusively to Al's S corporation. Because Al and Alena are considered to be one taxpayer under the passive loss rules,[52] the S corporation business and the rental activity have the same proportionate ownership and can be grouped together as a single activity. Because Al elected to group and he meets the material participation requirement, any Schedule E loss from the rental activity will not be treated as a passive loss.

> **Observation.** If the facts of the example were changed such that a portion of the building owned by Alena is rented to Al's business and another portion is rented to an independent third party, the portion not rented to Al's business would remain a passive activity.[53]

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48. Treas. Reg. §1.469-4(d)(5)(ii).
49. Treas. Reg. §1.469-4(d)(2).
50. Treas. Reg. §1.469-4(d)(1)(ii), Example (1).
51. Treas. Reg. §1.469-4(d)(1)(C).
52. Temp. Treas. Reg. §1.469-1T(j)(1) and Treas. Reg. §1.469-4(d)(1)(ii), Example (1).
53. Treas. Reg. §1.469-4(d)(1)(ii), Example (1) and Temp. Treas. Reg. §1.469-2T(c)(2)(i)(D), Example (4).

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If each owner of the business activity does not have the same proportionate ownership interest in the business activity and rental activity, grouping is still allowed if one activity is insubstantial in relation to the other.[54] The regulations do not define the term "insubstantial," but four court cases have addressed the definition. Those cases allow grouping when the rental property is leased to the business activity and when the gross receipts of one activity (usually the rental) are insubstantial (generally under 10% of total gross receipts).[55]

Example 6. Use the same facts as **Example 5,** except 90% of Alena's S corporation is owned by her and 10% is owned by Al and Alena's two children. Therefore, the same proportionate ownership does not exist for the business and the rental activities. However, if the gross rent is less than 10% of the combined gross receipts, the grouping of the rental with the business activity may still be allowed.

Grouping by Pass-through Entities. Partnerships and S corporations are not subject to the written grouping requirements of Rev. Proc. 2010-13. Rather, those entities must comply with the guidance on grouping activities provided in the respective instructions to Form 1065, *U.S. Return of Partnership Income,* and Form 1120S, *U.S. Income Tax Return for an S Corporation.* The instructions for both the partnership and S corporation forms indicate that the entity is to separately report information for each business or rental activity (income, loss, credits, etc.) on a statement attached to the Schedules K-1. Each owner is then to make a determination as to whether the activities are grouped or reported separately for purposes of the §469 PAL rules. The instructions also allow the partnership or S corporation to make a grouping determination. If the activities are grouped at the entity level, they are reported to the owner as an aggregated net income or loss amount on the statement attached to the Schedules K-1. A shareholder or partner may not treat activities grouped together by the entity as separate activities.[56]

S corporations and partnerships reporting rental real estate activity are required to prepare and attach Form 8825, *Rental Real Estate Income and Expenses of a Partnership or an S Corporation,* to the Form 1120S or Form 1065. The instructions to Form 8825 state that each rental property is to be shown separately on the form, even if the activities are combined for purposes of the passive activity rules.

The instructions for Form 8825 state the following.

However, if the partnership or S corporation has more than one rental real estate activity for purposes of the passive activity limitations, attach a statement to Schedule K that reports the net income (loss) for each separate activity. Also, attach a statement to each Schedule K-1 that reports each partner's or shareholder's share of the net income (loss) by separate activity.

Observation. The Form 8825 instructions make it clear that separate reporting on that form is not determinative of whether the entity has grouped or not grouped various rental properties. That determination is made by the entity's disclosure in supplemental Schedule K and Schedule K-1 data.

54. Treas. Reg. §1.469-4(d)(1).

55. *Glick v. U.S.,* 96 F. Supp. 2d 869 (S.D. Ind. 2000); *Schumacher v. Comm'r,* TC Summ. Op. 2003-96 (Jul. 23, 2003); *Candelaria v. U.S.,* 518 F. Supp. 2d 852 (W.D. Tex. 2007); *Stanley v. U.S.,* No. 5:14-CV-05236 (W.D. Ark. Nov. 12, 2015).

56. Treas. Reg. §1.469-4(d)(5)(i); Rev. Proc. 2010-13, 2010-1 CB 329 (sec. 4.05).

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A partner or shareholder is not required to make a separate disclosure of any groupings that are made by a pass-through entity, unless the owner:[57]

- Groups together any of the activities that the entity does not group,
- Groups the entity's activities with other activities conducted directly by the partner or shareholder, or
- Groups the entity's activities with activities conducted through other pass-through entities.

Caution. Tax preparers who receive a Schedule K-1 from a partnership or S corporation along with the individual taxpayer's other tax records should carefully review the supplemental schedules that are provided with the Schedule K-1. If there is separate income or loss information for multiple activities, the pass-through entity has not elected a grouping position with regard to those activities. In this case, the practitioner should consider whether the individual owner would benefit from the grouping election.

Example 7. Joe, an engineer, was a full-time employee of Designco. In early 2016, Joe acquired 10% ownership of Designco and later received a Schedule K-1 reporting $200,000 of business income. Information attached to Joe's Schedule K-1 discloses that Designco has net income of $300,000 and Fabrico (single-member LLC owned by Designco) has a $100,000 loss. Joe explains to his CPA that Fabrico is a manufacturing facility in a distant state and is an activity in which Joe has no personal involvement.

Designco reported two activities to Joe: its engineering net income of $300,000 and Fabrico's manufacturing loss of $100,000. Without a grouping election, Joe's Fabrico loss would be suspended as a passive activity. By attaching a written grouping statement to Joe's Form 1040 that indicates that Designco and Fabrico are treated as a single activity, Joe is entitled to report the Fabrico loss as nonpassive.

Example 8. Leo and Liz are equal partners in a partnership that owns two real estate rental activities. Property 1 shows a $200,000 rental loss and property 2 shows $100,000 of rental income. Liz is the 100% shareholder of an S corporation that operates an active business in which she materially participates. The S corporation occupies all of property 1, with rent paid to the partnership. Schedules K and K-1 attachments do not contain the statement providing the detail for the two properties but rather show an aggregate net loss of $100,000 on line 2 of Schedule K.

The rental real estate loss is a passive loss for both Leo and Liz. Liz is unable to group the property 1 rental activity with her business activity. This is because the grouping of her business with the aggregate rental loss for both properties shown on line 2 of Schedule K does not represent an appropriate economic unit. If the partnership had attached the statement with the details for property 1 and property 2 to the Schedules K and K-1, Liz would have been able to group the property 1 rental results with her S corporation business and avoid the passive loss limitations.

Material Participation by Limited Partners and LLC Members. Limited partners can only establish material participation by meeting one of the following tests.[58]

- The individual participates in the activity for more than 500 hours during the year.
- The individual has materially participated in the activity for any five tax years, whether or not consecutive, during the 10 years immediately preceding the current year.
- The activity is a personal service activity in which the individual materially participated for any three tax years, whether or not consecutive, preceding the current year.

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[57] Rev. Proc. 2010-13, 2010-1 CB 329 (sec. 4.05).

[58] Temp. Treas. Reg. §1.469-5T(e)(2).

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Several courts determined that LLC and LLP members are not treated as limited partners for purposes of determining material participation.[59] The courts found that LLC and LLP members can participate in management, and that differentiates those members from limited partners who cannot participate. However, the IRS then issued regulations that provide a new definition of a limited partnership interest for purposes of the measurement of the partner's material participation.[60] The regulations state that an interest in an entity is treated as an interest in a limited partnership if:

1. The entity is classified as a partnership for federal income tax purposes, and
2. The partner does not have rights to manage the entity at all times during the entity's tax year under the state law in which the entity is organized and under the governing agreement.

An individual holding a limited partner interest is not subject to the more restrictive material participation test if the individual also holds an interest in the partnership that has management authority or other general partner interest.[61]

> **Note.** Under these regulations (which apply only for purposes of IRC §469), an LLC or LLP member can meet any one of the seven tests of material participation (rather than the three that are available for limited partners) if the member has management authority under the agreement or under state law.

Grouping and the NIIT. A taxpayer could make a regrouping election on their 2013 return if they were subject to the NIIT when it became effective for the 2013 tax year. If the election was not made for 2013, the taxpayer could make the election for the first year after 2013 that the taxpayer was subject to the NIIT. This is often called a "fresh start regrouping." Regrouping allows the taxpayer to treat net income from the combined activities as nonpassive business income that is not subject to the NIIT.

> **Caution.** The regrouping can convert passive income that could be offset with passive losses to nonpassive income that cannot be offset by passive losses.

USE OF IDGTs AND GRATs

Business owners and other high-wealth individuals may be able to successfully transfer business interests and/or investment wealth to a successive generation by using an intentionally defective grantor trust (IDGT) and/or a grantor retained annuity trust (GRAT). Both the IDGT and GRAT allow the grantor to "freeze" the value of the transferred assets while simultaneously providing the grantor with a cash-flow stream for a specified period. The freeze derives from the ability to capitalize on the mismatch between interest rates used to value transfers and the actual anticipated performance of the transferred asset.

Generally, an IDGT is based upon interpretations of various Code provisions and regulatory guidance, as well as Tax Court cases and IRS revenue rulings. Unlike a GRAT, an IDGT is not specifically authorized by Code provisions and supporting regulations.

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59. *Garnett v. Comm'r,* 132 TC 368 (2009); *Thompson v. U.S.,* 87 Fed. Cl. 728 (2009), AOD 2010-2 (Apr. 5, 2010); *Newell v. Comm'r,* TC Memo 2010-23 (Feb. 16, 2010).

60. Prop. Treas. Reg. §1.469-5(e).

61. Prop. Treas. Reg. §1.469-5(e)(3)(ii).

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IDGT

An IDGT is a specially designed irrevocable grantor trust that is designed to avoid any retained interests or powers in the grantor that would result in the inclusion of the trust's assets in the grantor's gross estate upon the grantor's death. An IDGT document is deliberately drafted so that the asset transfer from the grantor to the trust is treated as a taxable gift, while, at the same time, ensuring that the trust is a grantor trust for federal income tax purposes. Under the terms of the IDGT, the grantor (or a third party) retains certain powers that cause the trust to be treated as a grantor trust for income tax purposes. However, such retained powers do not cause the trust assets to be included in the grantor's estate. A grantor transferring assets to an IDGT can allocate part of the lifetime exclusion in order to make the gift nontaxable. This asset transfer is considered a completed gift for estate and gift tax purposes (which eliminates the requirement to include the value of the transferred assets in the grantor's estate).

In addition, because the trust is also treated as a grantor trust, any sale of assets from the grantor to the trust is not taxable because the grantor trust is considered a disregarded entity for income tax purposes.[62] Thus, a sale (or other transaction) between the trust and the grantor are not income tax events, and the trust's income, losses, deductions, and credits are reported by the grantor on the grantor's individual income tax return.

Observation. The trust is considered "defective" because the seller (grantor) and the trust are treated as the same taxpayer for income tax purposes. However, an IDGT is defective for income tax purposes only — the trust and transfers to the trust are respected for federal estate and gift tax purposes. The defective nature of the trust means that the grantor has no gain on the sale of the assets to the trust, is not taxed on the interest payments received from the trust, and has no capital gain if the note payments are paid to the grantor in-kind. In addition, the trust is an eligible S corporation shareholder.[63]

The IDGT Transaction

Transferring assets to an IDGT requires strategy and forethought regarding the particular assets transferred in order to maximize the benefits of the IDGT. Such transfers vary depending on the client's objectives and the nature of the assets. Generally, after establishing an IDGT by drafting and signing an appropriate trust document and establishing an operating bank account for the trust, a transaction with the IDGT involves the following steps.

1. The taxpayer provides the IDGT with an initial gift, usually cash, to the trust (called "seed money"). The taxpayer uses the lifetime exemption to eliminate gift tax on the seed money that is transferred to the trust.

Observation. The initial seed money transfer provides the trust with economic substance and is typically 10% or more of the value of the assets the taxpayer wishes to transfer to the IDGT. For additional information about an initial seed money transfer and some potential associated problems, see **uofi.tax/16b5x5** [www.aicpastore.com/Content/media/PRODUCER_CONTENT/Newsletters/Articles_2007/CPA/Dec/Sales.jsp].

2. The taxpayer subsequently transfers the desired assets (e.g., business ownership interests, portfolio investments, or other assets that are anticipated to appreciate over the duration of the IDGT). These are assets that the taxpayer may not want to include in their estate for estate tax purposes because of a limited lifetime exemption amount and the increasing growth in the assets' value.

Note. The grantor may transfer assets to the IDGT by gift, sale, or a combination of gift and sale. If a gift is used, some or all of any remaining lifetime exemption amount may be used to avoid gift tax. If the taxpayer wishes to preserve the lifetime exemption amount (or has no remaining amount to allocate to the IDGT transfer), a sale may be used to transfer assets into the IDGT. For purposes of this discussion, it is assumed that the taxpayer sells assets to the IDGT.

62. IRC §671.

63. Rev. Rul. 85-13, 1985-1 CB 184; IRC §1361(c)(2)(A)(i).

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3. In consideration for the assets sold to the IDGT, the trust provides the grantor with a cash down payment (usually taken from the initial seed money transfer) and a promissory note that calls for payments of interest to the grantor over a term of years. This is the consideration provided to the grantor for the assets purchased by the IDGT. The grantor's transfer of growth assets to the IDGT in exchange for the promissory note is a nontaxable sale of assets to the trust. The sale is nontaxable because the trust is a grantor trust. No gain or loss is recognized, and the annual interest payments are not taxable to the grantor.

Note. The interest rate on the note must be at least the IRC §1274 rate, which is the applicable federal rate (AFR) for the term of the promissory note. These interest rates are established by the IRS and are updated monthly. Current and historical AFRs may be found at **uofi.tax/16b5x6** [apps.irs.gov/app/picklist/list/federalRates.html].

4. At the end of the note's term, the trust assets (which have presumably grown over the term of the note) pass to the beneficiaries. The IDGT reaches the end of its life and is typically dissolved under the terms of the trust document.

Observation. The assets transferred and all of the growth on those assets over the IDGT's term passes to the beneficiaries in a manner that avoids inclusion in the grantor's estate and corresponding estate tax liability.

The IDGT technique involves the grantor selling highly appreciating or high income-producing assets to the IDGT for fair market value (FMV) in exchange for a promissory note.[64] The IDGT transaction is structured so that a completed gift occurs for gift tax purposes with no resulting income tax consequences.[65] As mentioned earlier, the trust language is carefully drafted to provide the grantor with sufficient retained control over the trust to trigger the grantor trust rules for income tax purposes but insufficient control to cause inclusion in the grantor's estate. It is a popular estate planning technique for shifting large amounts of wealth to heirs and creating estate tax benefits because the value of the assets that the grantor transfers to the trust exceeds the value of the assets that are included in the grantor's estate at death. It is generally viewed as an "estate freeze" technique.

Note. Interest on the promissory note is set at the AFR for the month of the transfer that represents the length of the note's term.[66] Because of the current low interest rates, it is reasonable for the grantor to expect to receive a total return on the IDGT assets that exceeds the rate of interest. Indeed, if the income/growth rate on the assets sold to the IDGT is greater than the interest rate on the promissory note received by the grantor, the "excess" growth/income passes to the trust beneficiaries free of any gift, estate, and/or generation-skipping transfer tax (GSTT).

64. The grantor should make an initial "seed" gift of at least 10% of the total transfer value to the trust so that the trust has sufficient capital to make its payments to the grantor.

65. Because the transfer is a completed gift, the trust receives a carryover basis in the gifted assets.

66. The promissory note can call for interest-only payments for a period and a balloon payment at the end, or it may require interest and principal payments.

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The IDGT technique became popular after the IRS issued a favorable letter ruling in 1995[67] that took the position that IRC §2701 did not apply because a debt instrument is not an applicable retained interest.

Note. IRC §2701 applies to transfers of interests in a corporation or a partnership to a family member if the transferor or family member holds an "applicable retained interest" in the entity immediately after the transfer. However, an applicable retained interest is not a creditor interest in bona fide debt.

The IRS, in the same letter ruling also stated that a debt instrument is not a term interest, which meant that IRC §2702 does not apply.

Note. If the seller transfers a remainder interest in assets to a trust and retains a term equity interest in the income, IRC §2702 applies. This results in a taxable gift of the full value of the property sold. For instance, a sale in return for an interest-only note with a balloon payment at the end of the term results in a payment stream that is not a qualified annuity interest because the last payment would represent an increase of more than 120% over the amount of the previous payments.[68]

Example 9. Jayne is 66 years old and is the sole member of Old Town Interior Design, LLC, an established and growing interior design business in Chicago. The value of the business has gradually grown over the past several years, and Jayne is concerned about the large value of the business passing into her estate at death. Her LLC membership interest has a value of $1 million. She would like to pass her LLC membership interest to her daughter, Marcy.

Jayne establishes an IDGT with a 10-year term. After transferring an appropriate amount of seed money, which her attorney determines should be $100,000 ($1 million value of the LLC membership × 10%), she sells her LLC membership interest to the IDGT in exchange for a small cash down payment and a promissory note. The note bears the required IRC §1274 interest rate. Each year, Jayne receives her annual interest payment on the note, which is paid from the income of the business.

At the end of the 10-year IDGT term, Jayne is 76 years old and the membership interest is worth $2.4 million. The IDGT's LLC membership interest passes to Marcy without any tax liability and is not included in Jayne's estate for estate tax purposes. Therefore, Jayne was able to pass on the substantial growth in the value of the LLC membership to Marcy without using any of her lifetime exemption.

Observation. An IDGT provides maximum advantages if the asset growth (which remains in the IDGT to be passed to beneficiaries) has a rate that exceeds the IRC §1274 rate (which establishes the amount paid out of the trust to the grantor and does not remain in the IDGT for further asset growth in favor of the beneficiaries). In order to maximize the length of time the interest payments remain in the IDGT (to provide asset growth to be passed to beneficiaries), the note can be structured so that a balloon payment is made to the grantor at the end of the note's term.

Note. For additional information about the use of IDGTs, see **uofi.tax/16b5x7** [www.vsb.org/site/sections/trustsandestates/sale-to-intentionally-defective-grantor-trust-for-promissory-note].

67. Ltr. Rul. 9535026 (May 31, 1995).

68. See Hatcher and Manigualt. (Mar. 2000). Using Beneficiary Guarantees in Defective Grantor Trusts. 92 *Journal of Taxation* 152.

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2016 Workbook

IDGT Advantages

Some advantages of IDGTs include the following.

- An IDGT has the effect of freezing the value of the assets that are sold to it in the grantor's estate at the low interest rate on the promissory note.
- There are no capital gain taxes due on the promissory note, and the income on the note is not taxable to the grantor.
- Because the grantor pays the income tax on the trust income, this leaves more assets in the IDGT for the remainder beneficiaries.
- Valuation adjustments (discounts) may increase the effectiveness of the sale for estate tax purposes.

IDGT Disadvantages

Disadvantages of IDGTs may include the following.

- If the grantor dies during the term of the promissory note, the note is included in the grantor's estate.
- There is no stepped-up basis in trust-owned assets upon the grantor's death.
- Trust income (such as any interest, dividends, or capital gains earned within the trust during its term) is taxable to the grantor during the grantor's life.
- The grantor could experience a cash-flow problem if the grantor does not earn sufficient income to pay the corresponding tax liability.
- Gift and estate tax exposure may result if insufficient assets are used to fund the trust.

Proper Structuring of Sale to the IDGT

The promissory note must constitute bona fide debt, which is essential to ensure the IDGT withstands IRS scrutiny and accomplishes the taxpayer's income tax and estate planning or business succession objectives. If the debt amounts to an equity interest, then IRC §§2701 and 2702 apply and a large taxable gift could be created, or the transferred assets could end up being included in the grantor's estate.[69]

IRC §2036 causes inclusion in the grantor's estate of property the grantor transfers during their lifetime for less than adequate and full consideration. IRC §2036 applies if the grantor retained for life the possession or enjoyment of the transferred property or the right to the income from the property, or retained the right to designate the persons who will possess or enjoy the property or the income from it. In the context of an IDGT, if the promissory note represents bona fide debt, the grantor does not retain any interest in the property transferred to the IDGT, and the transferred property is not included in the grantor's estate at its date-of-death value.

[69]. In *Karmazin v. Comm'r,* TC Docket No. 2127-03 (2003), the IRS took the position that IRC §§2701 and 2702 applied to the sale of limited partnership interests to the trust, which would cause them to have no value for federal gift tax purposes on the theory that the notes the grantor received were equity instead of debt. The case was settled before trial on terms favorable to the taxpayer with the parties agreeing that neither IRC §§2701 or 2702 applied. However, the IRS resurrected the same arguments in *Estate of Woelbing v. Comm'r,* TC Docket No. 30261-13 (filed Dec. 26, 2013). The parties settled the case before trial with a stipulated decision entered on Mar. 25, 2016, that resulted in no additional gift or estate tax. The total amount of the gift tax, estate tax, and penalties at issue was $152 million.

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All of the tax benefits of an IDGT depend on whether the promissory note is bona fide debt. Thus, it is critical to structure the transaction properly to minimize the risk that the IRS will contend that the note constitutes equity for gift or estate tax purposes. This can be accomplished by observing all formalities of a sale to an unrelated party, including the following.

- Providing sufficient seed money
- Having the beneficiaries personally guarantee a small portion of the amount to be paid under the note
- Not tying the note payments to the return on the IDGT assets
- Following the scheduled note payments in terms of timing and amount
- Making the note payable from the trust corpus
- Not allowing the grantor control over the property sold to the IDGT
- Keeping the term of the note relatively short

These are all indications that the note represents bona fide debt.

Administrative Issues

An IDGT is treated as a separate legal entity. Consequently, a separate bank account is opened for the IDGT in order to receive the "seed" gift and annual cash inflows and outflows.[70] Interest payments to the grantor must be tracked, and annual records of the trust must be maintained, including records showing that the trust was administered in accordance with its trust document.

GRAT

Like the IDGT, a GRAT is an irrevocable trust to which assets likely to appreciate in value are transferred. Similar to an IDGT, assets selected for transfer are generally those expected to grow at a rate exceeding the rate applied to the annual annuity payment the GRAT makes to the grantor. Preferred assets to transfer to a GRAT include marketable securities, real estate, S corporation stock, closely held C corporation stock, and family limited partnership (FLP) interests.

After the desired assets are transferred, the grantor receives the right to a fixed annuity payment for a term of years,[71] with the remainder beneficiaries receiving any remaining assets at the end of the GRAT term.[72] The annuity payment can be structured to remain the same each year or it can increase up to 120% annually. However, once the annuity is established, additional property cannot be added to the GRAT.[73]

Observation. A GRAT can accomplish two important estate planning objectives. The GRAT technique freezes the value of the senior family member's highly appreciated assets at their current value and provides the senior family member with an annuity payment for a term of years. Thus, the GRAT can deliver benefits without potential transfer tax disadvantages. **The present low interest rate environment makes GRATs more attractive.**

70. The grantor's social security number is used for the bank account.

71. The fixed payment is typically a percentage of the asset's initial FMV computed so it does not trigger gift tax.

72. The term of the annuity is fixed in the trust instrument and is either tied to the annuitant's life, a specified term of years, or a term that is the shorter of the two.

73. If an additional contribution is made, the trust no longer qualifies as a GRAT and the grantor is deemed to have made a current gift of the trust assets to the remainder beneficiaries.

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Technical Requirements

A GRAT must make at least one annuity payment to an annuitant every 12 months from either the GRAT's income or principal. Each annual payment must be made within 105 days of the anniversary of the date upon which the GRAT was established.[74] Notes cannot be used to fund annuity payments, and the trustee cannot prepay the annuity amount or make payments to any person other than the annuitant during the qualified interest term.

The annuity amounts paid by a GRAT are subject to a fixed-amount requirement. These payments must be either a fixed dollar amount or a fixed percentage of the initial FMV of the property transferred to the trust.[75] There is also a formula adjustment requirement that is tied to the fixed value of the trust assets as finally determined for gift tax purposes. This provision requires adjustment of the annuity amount.

> **Note.** From a financial accounting standpoint, the GRAT is a separate legal entity. The GRAT's bank account is established using the grantor's social security number as the identification number. Annual accounting is required, including a balance sheet and an income statement.

Tax Consequences

For income tax purposes, the GRAT is treated as a grantor trust because, by definition, the retained interest exceeds 5% of the value of the trust at the time the trust is created.[76] Thus, there is no gain or loss to the grantor on the transfer of property to the GRAT in exchange for the annuity.[77]

Because the trust is a grantor trust, the grantor is taxed on trust income, including interest, dividends, rents, and royalties, as well as pass-through income from business entity ownership.[78] The grantor also can claim the GRAT's deductions. However, the grantor is not taxed on annuity payments, and transactions between the GRAT and the grantor are ignored for income tax purposes. A significant tax benefit of a GRAT is that the sale of the asset between the grantor and the GRAT does not trigger any taxable gain or loss. The transaction is treated as a tax-free installment sale of the asset.

> **Note.** Because a GRAT is treated as a grantor trust, the GRAT assets can grow without the burden of paying income taxes at trust tax rates. Income taxes are paid by the grantor.

For gift tax purposes, the value of the gift equals the value of the property transferred to the GRAT less the value of the grantor's retained annuity interest. In essence, the transferred assets are treated as a gift of the present value of the remainder interest in the property. This allows asset appreciation to be shifted (net of the assumed interest rate that is used to compute present value) from the grantor's generation to the next generation.

> **Note.** If the GRAT underperforms (i.e., the GRAT assets fail to appreciate at a higher rate than the interest rate of the annuity payment), the GRAT can sell its assets back to the grantor with no income tax consequences (if the GRAT is a wholly owned grantor trust).[79] Then, the repurchased property can be placed in a new GRAT with a lower annuity payment. The original GRAT would then pay out its remaining cash and collapse.

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74. Date of creation is largely a state law issue and could be the date the GRAT instrument was signed or the date of funding. If the required annuity amount is not distributed within the 105-day period, the annuity amount is deemed an additional disqualifying contribution to the GRAT.
75. Treas. Reg. §25.2702-3(b)(1)(ii)(A)–(B).
76. IRC §673. Also, under IRC §674, the grantor is treated as the owner of any portion of the trust over which the grantor controls beneficial enjoyment, corpus, or income, exercisable by the grantor or a nonadverse party or both, without the consent of any adverse party. There are exceptions to this general rule, however, under IRC §674(b).
77. There can be issues, however, if there is debt on the property transferred to the GRAT that exceeds the property's basis. Also, there can be an issue with partnership "negative basis" (i.e., the partner's share of partnership liabilities exceeds the partner's share of the tax basis in the partnership assets).
78. The GRAT is permitted to hold S corporation stock.
79. Rev. Rul. 85-13, 1985-1 CB 184.

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It is possible to adjust the gift value to zero so there is no taxable gift. An interest rate formula determined by IRC §7520 is used to calculate the value of the remainder interest. If the income and appreciation of the trust assets exceed the IRC §7520 rate, the assets that remain at the end of the GRAT term pass to the GRAT beneficiaries.

Note. Some practitioners do not adjust the gift value to zero because this may raise the question of whether there is a valid trust (because of the lack of a valid net transfer of value to the trust). Accordingly, for cases in which a minimal gift value is desired, a nominal gift value is used and reported on a gift tax return to ensure that the validity of the trust arrangement is not questioned by the IRS. Such a practice also starts the limitations period with respect to the gift tax by disclosing the nominal gift on the gift tax return.

Note. Given current low interest rates, a GRAT can effectively transfer wealth to the subsequent generation with little or no gift tax consequence.

Example 10. Bob, age 60, transferred $1 million to a GRAT in June 2016 and would like to retain an annuity for seven years. Bob previously made large taxable gifts that utilized his applicable exclusion, so it is important to him that the gift value of the $1 million transfer be zeroed out. Accordingly, based on a June 2016 AFR of 1.8%, Bob needs to receive an annuity payment of $153,327. Assuming that the GRAT assets earn 3% income annually and grow at a rate of 5%, the trust will have assets worth $350,920 at the end of the 7-year term. Those assets will pass to the GRAT beneficiaries.[80] The value of the gift that Bob made to the GRAT will be valued at less than $1.

Observation. Even though the value of the gift was less than $1, Bob should report the gift on a timely filed Form 709, *United States Gift (and Generation-Skipping Transfer) Tax Return,* to trigger the running of the statute of limitations for gift tax assessment purposes.[81] A copy of the trust should be attached along with a description of contributed assets, the value of the assets (including appraisals), and a statement describing how the value of the gift was determined.

The grantor's payment of taxes is not treated as a gift to the trust remainder beneficiaries.[82] Additionally, if the trustee reimburses (or has the power to reimburse) the grantor for the grantor's payment of income tax, the reimbursement (or the discretion to reimburse) does not cause inclusion of the trust assets in the grantor's estate.[83]

For GSTT purposes, appreciation on the GRAT's assets is suspended during the term of the GRAT. This is because the grantor can only allocate the GSTT exemption to the GRAT's assets after the GRAT term expires based on the value of assets at that time.[84] The determination of whether the transfer to the beneficiary is subject to GSTT (i.e., whether the beneficiary of the trust is a skip person) is made based upon the relationship at the time the trust is created, rather than when the trust interest ends.[85]

Note. Under the GSTT rules, a grantor is prohibited from allocating any of their lifetime exemption for GSTT purposes during an estate tax inclusion period (ETIP).[86] An ETIP is the period during which the grantor receives GRAT annuity payments. Accordingly, during the term of a GRAT, the grantor may not make any GSTT allocation. Such an allocation is allowable only after the termination of the grantor's interest in the GRAT.

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80. There is no taxable gift triggered upon the transfer, but the remainder beneficiaries take the donor's basis in the property—a carryover basis rule applies. The IRS also does not challenge the GRAT strategy if the value of the property changes.

81. Treas. Reg. §301.6501(c)-1(f)(4) allows the disclosure of a "non-gift" to start the statute of limitations on any claim by the IRS that a transfer had a gift element.

82. Rev. Rul. 2004-64, 2004-27 IRB 7. If, however, the trust (or local law) requires the trust to reimburse the grantor for income tax the grantor pays that is attributable to trust income, the full value of the trust's assets is includable in the grantor's gross estate under IRC §2036(a)1).

83. The GRAT trustee should be independent from the grantor.

84. IRC §2642(f).

85. Ltr. Rul. 9047028 (Aug. 27, 1990).

86. IRC §2642(f).

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Example 11. Sarah contributed $10 million of assets to a GRAT and retained an annuity payment that essentially zeroed out the gift because it had a present value of $9,999,999. At the end of the GRAT term, the remaining GRAT assets were worth $5 million. Consequently, Sarah transferred $5 million of assets by making a $1 gift.

Sarah established a GRAT remainder trust for the benefit of her grandchildren. At the end of the initial GRAT's term, Sarah must allocate $5 million of GSTT exemption to shelter the remainder trust from the GSTT.

Note. The remainder trust is deemed to be a GSTT trust and Sarah's exemption is automatically allocated to the trust at the end of the initial GRAT's term. That is the case unless Sarah elects otherwise on a timely filed Form 709.

Observation. If Sarah named only her surviving children as the GRAT remainder beneficiaries, she could equalize the treatment of the children of a predeceased child, for example, in her will or revocable trust. Such a transfer would be exempt from GSTT under the predeceased parent rule of IRC §2651(e).

Death of Grantor During GRAT Term

If the grantor dies before the end of the GRAT term, a portion (or all) of the GRAT is included in the grantor's gross estate. The amount included in the grantor's estate is the **lesser** of the FMV of the GRAT's assets as of the grantor's date of death or the amount of principal needed to pay the GRAT annuity into perpetuity (which is determined by dividing the GRAT annuity by the IRC §7520 rate in effect during the month of the grantor's death).[87]

Example 12. Bubba dies in June 2016 with $700,000 of assets held in a 10-year GRAT. The GRAT was created in June 2008 with a contribution of $1.5 million. At that time, the annuity was calculated as $183,099 per year (based on an interest rate of 3.8% and a zeroed-out gift). The amount included in Bubba's gross estate is the lesser of $700,000 (the FMV of the GRAT assets at the time of death) or $10,172,167 (the value of the GRAT annuity paid into perpetuity ($183,099 annuity payment ÷ 0.018 AFR for June 2016)). Therefore, the amount included in Bubba's estate is $700,000.

Note. To minimize the risk of assets being included in the grantor's estate, shorter GRAT terms are generally selected for older individuals.[88]

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87. Rev. Rul. 82-105, 1982-1 CB 133.

88. There is no restriction in the law as to the length of a GRAT term. *Kerr v. Comm'r,* 113 TC 450 (1999), *aff'd.,* 292 F.3d 490 (5th Cir. 2002) involved a GRAT with a term of 366 days, and there is no indication in the court's opinion that the term was challenged. In Ltr. Rul. 9239015 (Jun. 25, 1992), the IRS approved a GRAT with a 2-year term. See also *Walton v. Comm'r,* 115 TC 589 (2000).

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GRAT Advantages

Some advantages of a GRAT are summarized as follows.

- The gift tax cost is reduced compared to a direct gift.
- The GRAT is a grantor trust.
- The grantor can borrow funds from the GRAT, and the GRAT can borrow money from third parties.[89]
- The GRAT term can be as short as two years.
- A properly structured GRAT meets the requirements of IRC §2702. Therefore, many potential IRS challenges to its validity are eliminated because the GRAT conforms to relevant Code provisions (which is not the case with an IDGT).

GRAT Disadvantages

Disadvantages of a GRAT are summarized as follows.

- Upon formation, some of the grantor's applicable exclusion may be utilized.
- The grantor must survive the GRAT term. Otherwise, a portion of the GRAT assets becomes part of the grantor's gross estate.
- No GSTT exemption can be allocated to the GRAT during the GRAT term. This makes the GRAT strategy ineffective for avoiding GSTT if a direct gift to GRAT beneficiaries would be subject to the GSTT.
- Notes or other forms of indebtedness cannot be used to satisfy the required annuity payments.
- The grantor continues to pay income taxes on all of the GRAT's income that is earned during the GRAT term.
- A GRAT must use the IRC §7520 rate (120% of the midterm AFR), which is generally higher than the IDGT rate (which, under IRC §1274, is the AFR based on the term of the note).

Note. Although the higher GRAT rate may not be a large disadvantage in a very low interest rate environment, it may prove to be more disadvantageous if interest rates are higher (because assets transferred to the GRAT need to grow faster than the GRAT rate in order for the GRAT to be worthwhile). The required §7520 rate for GRATs and the §1274 rate for IDGTs is frequently referred to as the "hurdle rate." In a higher-interest rate environment, GRATs may not provide the same advantages as an IDGT because of this difference in hurdle rates.

Note. For additional detailed information about GRATs, including Code requirements for a properly structured GRAT and some special GRAT techniques such as the use of "rolling GRATs," see **uofi.tax/16b5x8** [www.mcguirewoods.com/news-resources/publications/taxation/grats.pdf].

89. When an amount borrowed from third parties is outstanding at the time the GRAT ceases to be a grantor trust, the IRS takes the position that the grantor realizes income of the borrowed amount. TAM 200010010 (Nov. 23, 1999).

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CHARITABLE REMAINDER TRUSTS[90]

Business owners approaching retirement often face a difficult tax dilemma. They may have significant assets to sell but few offsetting deductions. If these asset sales are in the $1 million to $5 million range, spreading the sales over multiple years may not be sufficient to avoid high tax rates. Additionally, self-employment (SE) and net investment income taxes (NIIT) can increase the tax liability.

It may be advantageous for a retiring business owner to create a charitable remainder trust (CRT). This type of trust is a split-interest ownership entity that includes an income interest paid to the donor during the trust term and a remainder interest paid to a charity at the end of the trust term. A CRT can be structured either as a charitable remainder unitrust (CRUT) or a charitable remainder annuity trust (CRAT).

In a properly structured CRT, the retiring business owner transfers the assets to the CRT, the CRT then sells the assets tax-free, and the sales proceeds are invested in income-producing assets. The business owner receives an annuity payment for a specified term to reflect the income interest of the CRT.

The creation of a CRT provides further benefits to the business owner including the following.

- Sales of assets by the CRT are not subject to SE tax.
- Deferred income from the annuity is likely taxed at lower rates because it is received over the life of the annuity.
- Estate tax liability may be reduced because assets were transferred to an irrevocable trust.

A charity benefits at the end of the income term by receiving the remainder interest value of the property in the CRT.

CRT FEATURES

The CRT must be irrevocable, valid under state law, and organized as either a CRAT or CRUT.[91] Both the donor and the income beneficiary may include corporations, partnerships, and individuals (the individual must be living when the trust is created).[92] A CRAT provides for a payment each year to a person or other specified income beneficiary (or a person and a beneficiary) of either a fixed amount or a percentage of the **initial** value of the trust. A CRUT provides for an annual payment to a donor or other specified income beneficiary (or donor and beneficiary or for a term certain) computed as a percentage of the **annual market value** of the trust assets. The remainder interest of a CRT must be transferred to or used by a charitable organization described in IRC §170(c).

> **Note.** The IRS provided sample copies of pre-approved annuity trust instruments in Rev. Procs. 2003-53 through 2003-60 and sample copies of pre-approved unitrust instruments in Rev. Procs. 2005-52 through 2005-59. Use of the pre-approved IRS sample documents eliminates any tax uncertainty and saves legal fees in creating the trust. However, an attorney familiar with state law should still be used to finalize the drafting of the CRT document.

90. Examples in this section are based on content from CliftonLarsonAllen, LLP.

91. IRC §664.

92. IRC §§664(d)(1)(A) and 664(d)(2)(A).

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Both the CRAT and CRUT require minimum percentage distributions to the beneficiary of 5% and not more than 50% of the initial value of the CRAT or of the annual market value of the CRUT.[93] Both types of trusts may have a fixed term that does not exceed 20 years or payments that continue for the life of the beneficiary.[94] The value of the remainder interest must be at least 10% of the initial net FMV of all property contributed to the CRAT or the CRUT.

The CRUT agreement may provide that distributions for any year will not be made in excess of the trust's accounting income.[95] That limitation may further provide for make-up distributions in later years.[96] A CRUT may accept additional contributions in later years; a CRAT may not.

ESTABLISHING THE TRUST

To establish a CRAT or a CRUT, the following steps are necessary in order to derive the desired tax results.

Step 1. The donor creates an irrevocable CRT. The terms of the trust require an annual income stream paid to the donor, but the remainder value passes to a charitable organization after the death of the donor/beneficiary or after a specified term of years.

Step 2. The donor transfers assets to the trust. If the asset is an appreciated long-term capital gain asset,[97] a charitable income tax deduction for the market value of the asset is available, which is reduced by the value of the retained income interest. A contribution of other types of assets yields a charitable deduction equal to the lesser of FMV or basis. No charitable deduction applies if a zero basis ordinary income asset is transferred to the trust.

Step 3. After receipt of the asset, the charitable trust typically sells the asset but reports no taxable gain because the trust is tax-exempt under IRC §664(c)(1).

Step 4. The charitable trust invests the sale proceeds to provide a source of income to allow payment of the specified income interest to the donor.

Step 5. At the death of the donor/income beneficiary, the property remainder interest within the trust passes to the designated charity. The property is not part of the donor's taxable estate and thus escapes any estate taxes.

CHARITABLE DEDUCTIONS

To derive the most benefit from a charitable deduction to a CRT, the asset contributed to the CRT must generally be eligible for long-term capital gain status. Such assets include corporate stock and appreciated real estate. Ordinary income assets, such as inventory or depreciable equipment, produce a charitable deduction for the donor computed as the lesser of FMV or the basis of the asset.

> **Note.** CRT donations are deductible for both regular tax and alternative minimum tax (AMT) purposes.

93. Ibid. See also Rev. Rul. 70-452, 1970-2 CB 199 and Rev. Proc. 2016-42, 2016-34 IRB 269.

94. Ibid.

95. IRC §664(d)(3)(A).

96. IRC §664(d)(3)(B).

97. "Capital gain asset" includes IRC §1231 assets, except to the extent of IRC §§1245 and 1250 ordinary income recapture.

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The charitable income tax deduction of the donor is subject to a 30% of adjusted gross income (AGI) annual limitation.[98] If a charitable contribution exceeds this annual 30%-of-AGI limit, the excess is eligible for a 5-year carryover to the donor's subsequent tax years.[99] This 30% limitation has the advantage of spreading the charitable contribution into several tax years and often allows the contribution to be used against the donor's highest tax-bracket income over several tax years.

Note. Charitable contributions subject to the 50% limit are taken into account on the donor's tax return before contributions subject to the 30% limit. In addition, current year contributions are taken into account before charitable contribution carryovers from prior years. For details about the limitations that apply to certain contributions, see IRS Pub. 526, *Charitable Contributions.*

Because of the percentage limitations and the order in which charitable contributions are taken into account on the donor's tax return, it is important to plan the utilization of the charitable contribution. Such planning helps to ensure that contributions are fully utilized within the six eligible tax return years (the year of contribution plus the five carryforward years). In some cases, it is necessary to fund a CRUT over a number of years to assure utilization of the contribution carryovers.

The amount of the charitable income tax deduction is contingent upon **three primary factors.**

1. The amount or percentage of the retained income interest (the higher the annual income paid to the donor, the smaller the value of the charitable deduction for the remainder portion)

2. The term of years or life expectancy of the retained income interest (the shorter the term of the income interest or the shorter the life expectancies of the beneficiaries, the greater the charitable income tax deduction)

Note. The IRS tables for term and remainder interests and life expectancies are found in three publications. IRS Pub. 1457, *Actuarial Valuations, Version 3A,* is used for income, estate, and gift tax purposes and provides remainder, income, and annuity examples. IRS Pub. 1458, *Actuarial Valuations, Version 3B,* is used for income, estate, and gift tax purposes and provides unitrust remainder examples. IRS Pub. 1458, *Actuarial Valuations, Version 3C,* is used for income tax purposes only and provides examples for computing depreciation adjustment factors.

3. The IRS-published 120% annual mid-term AFR,[100] which must be selected from either the current month or 2-month period prior to the charitable transfer (the greater the interest rate, the larger the charitable deduction)

Observation. A donor may desire to provide a benefit for noncharitable beneficiaries (e.g., their children) by replacing the value of the asset that was given to charity. This can be accomplished by purchasing a life insurance contract naming the donor's heirs as beneficiaries using the income stream and tax savings from the deduction to the charitable trust to fund the purchase. If this life insurance contract is acquired within an irrevocable life insurance trust, the death benefit proceeds are not subject to estate taxes for the donor.

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98. IRC §170(b)(1)(C).

99. IRC §170(b)(1)(D)(ii).

100. See Table 5 of *Index of Applicable Federal Rates (AFR) Rulings*. IRS. [www.irs.gov/pub/irs-drop/rr-16-17.pdf] Accessed on Aug. 10, 2016.

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FUNDING A CHARITABLE TRUST

In late 1993, the IRS issued a private letter ruling that approved a cash-method business owner's transfer of ordinary income business assets to a CRUT.[101]

Key income tax aspects of the ruling include the following.

1. The business owner did not recognize any taxable income or any SE income upon the transfers of the business assets to the CRUT.
2. The expenses that the business owner incurred in producing the business assets prior to transfer to the CRUT were allowable deductions on his tax return.
3. The CRUT would not recognize any income on its subsequent sale of the business assets even if the sale occurred within a short period following the donation by the business owner as long as the sale was not a prearranged transaction and was independently enacted by the CRUT's trustee.
4. The annual distributions from the CRUT to the donor are ordinary income but are not subject to SE tax.[102]

Observation. Because the transfers of assets in this ruling all represented ordinary income property with no basis (as opposed to capital gain property), the donor was not allowed to claim a charitable deduction at the time of the transfer of assets to the CRUT.[103] Rather, the objective of the strategy was to convert business assets into tax-free cash at retirement, defer recognition of income, provide a gift to a designated charity, and avoid the highest income tax rates, SE tax, and NIIT liability.

Example 13. Sale vs. gift of business assets. Jim is a 65-year-old business owner. He has a substantial amount of business inventory and would like to retire soon. The following calculations illustrate tax and cash flow results if Jim sells the inventory. Under the first strategy, Jim invests the sale proceeds to provide retirement income. In the second strategy, he contributes the business assets to a CRUT and retains a lifetime annual income for him and his wife.

Strategy No. 1. Sell business assets and invest proceeds

	Tax Return	Annual Cash Flow
Sale of assets	$200,000	
Less: federal, state, and social security tax costs (50%)	(100,000)	
Excess cash to invest	$100,000	
Multiplied by annual yield	× 5%	
Annual income	$ 5,000	$5,000
Asset to heirs	$100,000	

[101] Ltr. Rul. 9413020 (Dec. 22, 1993).

[102] The facts in the ruling also noted that the business owner intended to contribute machinery and equipment to the CRUT at a later time.

[103] IRC §170(e)(1).

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Strategy No. 2. Contribute business assets to CRT, with 5% retained income

	Tax Return	Annual Cash Flow
Sale of assets by CRT	$200,000	
Less: tax costs	(0)	
Excess cash to invest	$200,000	
Multiplied by annual yield	× 5%	
Annual income	$ 10,000	$10,000
Asset to heirs	$ 0	

5

Observations.

1. If Jim contributes the assets to the CRT, he is not allowed a charitable deduction because the inventory has zero basis.
2. The NII distributed from the CRT may be subject to the 3.8% NIIT. IRS regulations[104] provide that the trust's first distributions are presumed to come from the trust's NII.
3. One risk with the CRT strategy is that Jim's early death would eliminate the extra annual income generated by the CRT. Alternatives to eliminate this risk include the following.
   - Purchase a life insurance policy to replace the asset donated to the charity and that is no longer available to the heirs.
   - Add a second life (such as a spouse) as a successor income beneficiary, to assure that the income stream is available to the family for a longer period of time. (However, the value of the charitable remainder interest must be at least 10% of the initial net FMV of all property contributed to the trust.)
   - Use a fixed-term CRAT that continues to make its payments to Jim's estate or his heirs.

Example 14. Use of a 10-year CRT. Red is a 50-year old business owner. His health problems require him to terminate his sole proprietorship business, which uses the cash method of accounting. Red meets with his tax preparer and learns that selling his business assets, which have an approximate FMV of $400,000, will trigger about $200,000 in federal, state, and SE taxes.

At the suggestion of his attorney and tax preparer, Red forms a CRT. He plans to transfer his business assets to this trust, which has a term of 10 years.

- If structured as a CRUT, the trust can pay 20.6% of the beginning FMV of the trust to Red and his spouse. The beginning FMV of the trust is recalculated annually.
- If structured as a CRAT, the trust can pay a fixed $39,650 per year to Red for the 10-year term.

In both cases, the percentage of the gift benefiting the charity is projected to be slightly in excess of 10%, ensuring that the trust qualifies under IRC §664 as a CRT. Because the trust has a fixed term, distributions would continue to Red's beneficiary if he died before the end of the 10-year term.

104. Treas. Reg. §1.1411-3(C)(2)(i).

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Under either type of trust, Red replaces a present value tax cost of 50% for a present value charitable gift of approximately 10%. However, Red must still pay ordinary income tax on the payments received each year from the charitable trust. The efficiency of this arrangement lies in the elimination of SE tax and the potential to lower federal and state income tax rates if this ordinary income is spread over 10 years.

Caution. The payout optimization varies depending upon the IRC §7520 rate, which is published monthly by the IRS at **uofi.tax/16b5x9** [www.irs.gov/pub/irs-drop/rr-16-17.pdf]. The preceding illustrations are based upon a 1.8% AFR.

Transfer of Appreciated Assets to a CRT

If unmarketable assets are transferred to a CRT, the trust does not qualify for charitable status unless valuation of the property is completed by an independent trustee or determined by a qualified appraisal.[105] In addition, a CRT may have unrelated business taxable income (UBTI), particularly if the CRT attempts to hold an ownership interest in an actively conducted business. A CRT that has UBTI becomes nonexempt and subject to taxation as a complex trust.[106]

Note. Transfers to a CRT of interests in a general partnership, limited partnership, or limited liability company may expose the CRT to UBTI. Additionally, the transfer of debt-financed assets or the existence of debt within the business entity can trigger UBTI.

The 2-tiered "self-dealing" excise tax of IRC §4941 can apply to a CRT that sells property to a disqualified person or otherwise transacts, leases, or deals with the donor or a related party.[107]

ANTI-ABUSE BARRIERS

The value of the charitable remainder in any transfer to a qualified CRAT or a CRUT must be at least 10% of the net FMV of the property as of the date it is contributed to the trust.[108]

IRC §664 measures the necessary charitable remainder amount by reference to net present value at inception of the trust. Ultimately, when the trust reaches its conclusion at either the end of the term certain or the lifetime(s) of the donor and spouse (if applicable), there may be significantly more or less than the 10% target. However, this is immaterial to the entity's eligibility as a qualified CRT.

In view of today's relatively low AFR interest rates, CRTs that are structured for the lifetime of the donor may not qualify under the 10% test, unless a lower payback percentage is selected. This is particularly true for CRATs with a fixed annual payback as compared to CRUTs with a declining annual payback. This is illustrated by the following tables. (The numbers in these tables are generated by specialized software.)

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105. Treas. Reg. §1.664-1(a)(7)(i).

106. Treas. Reg. §1.664-1(c).

107. IRC §4941(a).

108. IRC §§664(d)(1)(D) and (d)(2)(D).

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**Present Value of Charitable Remainder:
CRUT Single Life Unitrust
(Assume 1.8% AFR, Quarterly Income)**

	Unitrust %		
Donor Age	**6%**	**8%**	**10%**
70	46.52%	37.37%	30.53%
60	31.12%	23.52%	17.79%
50	20.91%	13.79%	**9.59%**

**Present Value of Charitable Remainder:
CRAT Single Life Annuity Trust
(Assume 1.8% AFR, Quarterly Income)**

	Fixed %		
Donor Age	**6%**	**8%**	**10%**
70	27.03%	**2.71%**	**0%**
60	**0.00%**	**0.00%**	**0%**
50	**0.00%**	**0.00%**	**0%**

**Present Value of Charitable Remainder:
CRUT Two Life Unitrust
(Assume 1.8% AFR, Quarterly Income)**

	Unitrust %		
Donor and Successor Age	**6%**	**8%**	**10%**
70	34.59%	24.86%	18.08%
60	27.38%	18.31%	12.45%
50	21.37%	13.24%	**8.39%**

Note. With very low interest rates, unless the donor/beneficiary is at least age 66 and receives a fixed percentage of 6% or less, the present value of the amount left to the charity will fail the test for a CRAT. Consequently, in Rev. Proc. 2016-42,[109] effective for trusts created on or after August 8, 2016, the IRS has provided sample language that can be included in a CRAT to protect it from violating the "probability of exhaustion" test of Rev. Rul. 70-452.[110] The sample provision causes the early termination of the CRAT, followed by an immediate distribution of the remaining trust assets to the charitable remainder beneficiary. Specifically, this provision would be triggered the day before the next annuity payment if the payment would result in the value of the trust corpus being less than 10% of the value of the initial trust corpus.

109. Rev. Proc. 2016-42, 2016-34 IRB 269.

110. Rev. Rul. 70-452, 1970-2 CB 199.

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The maximum annual payout percentage may not exceed 50% of the initial net FMV of all property placed in the CRAT and 50% of the net FMV of the assets as annually revalued for a CRUT.[111]

PROBABILITY-OF-EXHAUSTION RULE

In 1977, the IRS indicated that no charitable deduction would be allowable at the time a CRAT is created if there is a greater than 5% actuarial probability that the income beneficiary will survive the exhaustion of the charitable trust corpus.[112] The foundation for this position is the provision in estate and gift tax regulations which states that no deduction is allowable when a charitable transfer is subject to a condition "unless the possibility that the charitable transfer will not become effective is so remote as to be negligible."[113]

> **Note.** Although the 5% probability-of-exhaustion rule is defined in terms of the estate and gift tax charitable deduction, the income tax charitable deduction regulations contain similar language.[114]

This 5% probability rule is not applicable to a CRUT that provides a payback limited to annual income, because under this formula the trust corpus is never invaded.[115] However, the IRS approaches the application of the 5% rule to other unitrust paybacks on a case-by-case basis.[116]

> **Note.** With the enactment of the 10% charitable remainder minimum in 1997, as discussed earlier, this rather vague IRS 5% probability position is now considered by most practitioners to be eliminated in favor of the statutory 10% threshold.

As a practical matter, most practitioners rely on their charitable planning software to test a CRAT's eligibility under the 5% probability-of-exhaustion test. With today's low interest rates, many CRATs based on the donor's life expectancy fail the 5% probability test, even though they pass the 10% charitable remainder threshold. However, fixed term CRATs, particularly those designed to provide only a short-term income tax deferral, face less likelihood of failing the 5% probability-of-exhaustion test. (The numbers in the following table are generated by specialized software.)

CRAT
($100,000 Corpus, 1.8% AFR, Quarterly Income Payback)

Term	Fixed Payout	Charitable Remainder %	5% Probability Test Passed?
5 yr.	$18,858	10.01%	Yes
10 yr.	9,848	10.01%	Yes
15 yr.	6,854	10.01%	Yes
20 yr.	5,362	10.01%	Yes
Lifetime (age 65, 1 life)	5,000	26.55%	No

111. IRC §§664(d)(1)(A) and (d)(2)(A).
112. Rev. Rul. 77-374, 1977-2 CB 329.
113. Treas. Regs. §§20.2055-2(b)(1) and 25.2522(c)-3(b)(1).
114. Treas. Reg. §1.170A-1(e).
115. Ltr. Rul. 7915038 (Jan. 12, 1979).
116. GCM 37770 (Nov. 30, 1978).

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FIXED-TERM CRT

Selecting the AFR

In calculating the charitable remainder (in order to test the required 10% charitable remainder minimum or the 5% probability-of-exhaustion rule), the current AFR is used. The IRC §7520 rate used in computing the remainder interest for CRTs can be found in table 5 of the monthly AFR release.[117] The taxpayer has the flexibility of selecting the AFR for the month in which the valuation date falls or either of the two preceding months.[118]

Selecting the largest AFR available will maximize the quarterly or annual income payout to the donor.

Example 15. Selecting an AFR for a fixed-term CRAT. Wanda is considering the use of a 10-year CRAT, to be funded with an appreciated asset worth $750,000. The trust will pay income annually and will be designed to meet the minimum 10% charitable remainder threshold. Wanda's tax advisor tests the AFR for the current and prior two months and determines that the April rate should be selected.

Month	AFR	Annual Payout to Produce 10% Charitable Minimum
March	1.8%	$74,355
April	2.0%	75,143
May	1.8%	74,355

If the AFR increased to 2.2%, the annual payout would increase to $75,930.

Fixed-Term CRAT vs. CRUT

For a CRAT or CRUT with a fixed term of years, the payments may be continued to the donor's estate or heirs if the donor dies before the expiration of the income payout term.[119]

- A CRAT tends to minimize the income tax consequences of the CRT payout to the donor because the payments are level.
- Under a short-term CRUT, the income payout in the first few years can be substantial. Therefore, the donor has a higher taxable income and tax rate.

Variables must be considered on an individual basis. When a taxpayer considers a short-term CRAT or CRUT in order to provide income tax deferral on a large gain or other high-income event, the tax preparer should carefully analyze other income factors affecting the taxpayer's individual income tax return. For individuals who reach age 70½, required minimum distributions (RMD) of traditional IRAs and qualified retirement plan accounts must begin.[120] In this situation, a short-term CRT might be designed to end prior to the beginning of the RMD payouts.

117. The monthly AFRs can be found at https://apps.irs.gov/app/picklist/list/federalRates.html.

118. Treas. Reg. §1.7520-2(a)(2).

119. Rev. Rul. 74-39, 1974-1 CB 156.

120. IRC §401(a)(9).

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Example 16. CRT ending at RMD inception. Willis, age 61, is a sole proprietor who operates his successful business as a single-member LLC. He is selling his business assets and retiring. His retirement accounts have a total balance of $4 million.

Willis considers the use of a short-term CRT to accommodate the disposition of $2 million of fully depreciated machinery and equipment, which will be sold at an auction. In nine years, Willis will attain age 70½ and be required to begin receiving large RMDs from his retirement plan. Knowing this, his tax preparer designs a CRAT for a 9-year term. Effectively, the $2 million sales proceeds are spread over the next nine years' tax returns. This provides him with sufficient income until he reaches age 70½, when he will start receiving large retirement plan distributions.

CRT Illustrations

The following examples illustrate some of the CRT concepts discussed in this section.

Example 17. CRAT vs. CRUT–fixed term. David intends to fund a 10-year CRT with a $750,000 asset in order to spread the taxable gain from the disposition of that asset over 10 future tax years. The objective is to design a CRAT or a CRUT that leaves the requisite 10% minimum to the charitable remainder entities. The following table illustrates the design parameters, assuming a 1.4% AFR. (The numbers in the following table are generated by specialized software.)

10 Year CRT (Annual Payout, End of Year)

	CRAT	CRUT
Value of gift	$750,000	$750,000
AFR selected	1.4%	1.4%
Term	10 years	10 years
Payout amount	$ 72,800	20.855%
Charitable remainder	10.00%	10.00%

The payout amount ($72,800 in the case of the CRAT or 20.855% in the case of the CRUT) is determined through trial and error. The objective is to achieve a charitable remainder percentage that meets or slightly exceeds 10%.

Observation. If tax deferral is the objective of using the CRT, the CRAT generally performs better than the CRUT because of the CRAT's level payout stream. A short-term CRUT results in very large payouts in the early years and declining payouts in later years.

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Example 18. Outright Sale vs. CRT. Use the same facts as **Example 17.** The following information illustrates David's after-tax cash flow if he sells an appreciated asset outright instead of using a deferred income transaction through a 10-year CRAT or CRUT. Each outright sale alternative involves a different asset category and is subject to different tax rates.

Illustration	Federal Tax Rate
Capital gain property: stock or land	15% or 20% long-term capital gain
Ordinary income: depreciation recapture on machinery and equipment	39.6%
Ordinary income: inventory	39.6% Ordinary income tax + SE tax
Built-in gains (BIG) tax: S corporation (3 years left in recognition period)	35% BIG tax + 39.6% ordinary income tax

The following is a summary of the accumulation fund that David would have available after 10 years. The amounts displayed in the table are generated by off-the-shelf estate-planning software. The results depend upon the term, the IRS interest rate applicable to the month of the gift, the age of the beneficiary of the trust, and other provisions.

Client After-Tax Accumulation Fund

	Outright Sale	10-Year CRAT	10-Year CRUT
15% or 20% long-term capital gain sale	$670,533	$634,747	$634,780
Ordinary depreciation recapture	460,238	504,151	504,190
Ordinary and SE Tax	413,869	504,151	504,190
BIG Tax: S corporation	254,050	433,070	379,000

Observations.

1. The contribution of capital gain property generally produces a charitable deduction to the donor. In this case, the charitable deduction is approximately equal to the 10% remainder value designated to be donated to the charity at the end of the 10-year term of the trust. However, ordinary income property with zero basis produces no charitable deduction.
2. At the lower capital gain rates, incurring the tax on an outright sale leads to a greater after-tax accumulation than deferring under the CRAT or CRUT alternatives. Part of the reason for this outcome is that the capital gain tax rate may be the same (0% for a low AGI or 20% for a high AGI) regardless of whether the capital gain is incurred in a single year or spread over 10 years using a CRT.
3. If the sale of the property increases AGI over the threshold for the imposition of the 3.8% NIIT, the use of a CRAT or CRUT may reduce or eliminate this tax liability. To eliminate the NIIT entirely, the income during all years in which the donor receives a distribution must be under the MAGI threshold levels for the 3.8% NIIT.
4. A large gain may be subject to the 20% capital gains rate.

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5. Using a short-term CRAT or CRUT to defer a capital gain can be a solution to eliminating the AMT that often occurs in a tax year with a very large capital gain. The large capital gain increases AGI, which in turns causes the phase-out of the AMT exemption. As a result, taxpayers may be subject to AMT on their ordinary income (taxed at the 26% or 28% AMT rate rather than the graduated 10%, 15%, or 25% regular tax rates).

6. Under the ordinary income models, the taxpayer is subject to a lower tax rate when the CRT spreads the income over 10 tax years rather than incurring the income in a single tax year for an outright sale. In the illustrations above, it is assumed that a single year sale with $750,000 of ordinary income occurs at a top 39.6% federal rate, whereas deferral over the 10-year term decreases the marginal federal rate considerably.

7. For the sale of inventory, the CRT strategy eliminates the SE tax. This is because the payout from the CRAT or CRUT is an annuity that is not subject to SE tax.

8. A CRT can be utilized when an S corporation is near the end of the built-in gains (BIG) recognition period. If the assets are sold outright, all of the gain is subject to the BIG tax. However, if the assets are placed in a CRAT or CRUT, the BIG tax is incurred only during the remaining recognition period and eliminated thereafter. The CRUT is less desirable because it results in lower accumulation of after-tax funds due to the larger payouts in the early years.

9. A CRT can be utilized by a C corporation to spread income from the sale of fully depreciated equipment, inventory, and appreciated real estate over several years to maximize the benefit of the lower 15% and 25% brackets.

NET INVESTMENT INCOME TAX[121]

A CRT's accumulated NII may be subject to the 3.8% NIIT for tax years beginning after 2012. A CRT's NII is categorized and distributed based on the existing IRC §664 income-tier system.[122] Under this "worst first" system, income is considered distributed in the following order.

1. Ordinary income
2. Capital gains
3. Exempt income

Because NII accumulated in post-2012 years is taxed at a higher rate than investment income from earlier years (due to the 3.8% NIIT), it is considered to be the first income distribution from within each of the first two tiers.

> **Observation.** The gain on the post-2012 sale of assets contributed by a business owner presumably is NII, because the CRT does not meet the material participation test. Under the distribution scheme presented above, the NII is considered distributed first. In the past, the breakdown of the CRT distribution between the interest income portion and the ordinary income portion was moot. However, since 2013, any interest and other investment income that is part of the CRT distribution is subject to the 3.8% NIIT.

[121] IRC §1411.

[122] Treas. Reg. §1.1411-3(d)(2)(i).

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TAXABILITY OF SOCIAL SECURITY BENEFITS

Social security benefits are subject to income tax based on a tiered system. For most high-income taxpayers who receive social security, 85% of such benefits are taxable income.

The following table shows the applicable tiers used to determine the taxable portion of social security income based on the taxpayer's provisional income. Provisional income is the total of one-half of social security benefits plus modified adjusted gross income (MAGI).

		MAGI	
Tier	**Taxable Portion of Social Security Benefits**	**MFJ**	**Single**
1	0%	Under $32,000	Under $25,000
2	Up to 50%	$32,000–44,000	$25,000–34,000
3	Up to 85%	Over $44,000	Over $34,000

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Note. For detailed information about the definition of MAGI and the taxation of social security benefits, see the 2016 *University of Illinois Federal Tax Workbook,* Volume A, Chapter 1: Retirement.

Example 19. In 2015, George and Mary are both over age 65. They receive interest, rent, and other retirement income of $26,000. Their social security benefits are $12,000. At this income level, none of their social security benefits are taxable because their provisional income is just below the second-tier threshold ($26,000 + ($12,000 × 50%) = $32,000). They incur $290 of federal income tax for 2015.

If they add $10,000 of income each year, such as from CRT payouts, part of their social security benefits would be taxable. For taxpayers with provisional income between the second and third tiers, the amount of taxable social security benefits is the lesser of:

- One-half of social security benefits ($12,000 × 50% = $6,000), or
- One-half of provisional income in excess of the second-tier base amount (($36,000 other income + ($12,000 social security benefits × 50%)) − $32,000 base amount) × 50% = $5,000).

Therefore, $5,000 of George and Mary's social security benefits would be taxable. This increases their 2015 tax to $1,790. Their tax is increased by $1,500, as shown in the following table. This represents a 15% increase on the $10,000 of added income, even though their marginal tax rate is 10%.

	Without CRT	With CRT	Additional Tax
Interest, rent income	$26,000	$26,000	
CRT annuity income	0	10,000	
Taxable social security	0	5,000	
Total income	$26,000	$41,000	
Taxable income	$ 2,900	$17,900	
Tax	$ 290	$ 1,790	$1,500

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Example 20. Use the same facts as **Example 19,** except George is single. The increase in George's tax is $2,505, as shown in the following table. This represents a 25% increase on the additional $10,000 of income, even though George's marginal tax rate is 15%.

	Without CRT	With CRT	Additional Tax
Interest, rent income	$26,000	$26,000	
CRT annuity income	0	10,000	
Taxable social security	3,500	10,200	
Total income	$29,500	$46,200	
Taxable income	$17,650	$34,350	
Tax	$ 2,190	$ 4,695	$2,505

FILING REQUIREMENTS

Split-interest trusts,[123] which include CRTs, are required to file an annual Form 5227, *Split-Interest Trust Information Return,* reporting the trust's annual income and balance sheet information. Schedule K-1, *Beneficiary's Share of Income, Deductions, Credits, etc.,* is attached to the Form 5227 to report each beneficiary's share of trust income and distributions. A copy of the charitable trust document must be attached to the Form 5227 for the first year the return is required to be filed, accompanied by a written declaration signed by the trustee indicating that the trust instrument is a true and complete copy.

Form 5227 must be filed for each calendar year and is generally due on April 15. All Forms 5227 are required to be filed with the Internal Revenue Service Center in Ogden, Utah.

[123] See IRC §4947(a)(2).

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