Mary Vandenack provides the transcript from Legal Visionaries podcast on Income Tax Considerations for Estate Planning, Part 1

TRANSCRIPT:

Mary: On today's episode, my guest is Abbie Everist. Abbie is a Senior Manager at RSM in the Washington National Group, and she specializes in estate planning issues. I asked Abbie to participate in today's episode, and we're actually going to do two episodes discussing income tax considerations for estate planning. Thank you for joining me today, Abbie.

Abbie: Mary, thank you so much for inviting me to join your podcast today. I look forward to discussing this great topic on how to incorporate income tax considerations with estate planning.

Mary: We're going to start off just by talking about pass-through business income. Can you just remind our listeners what type of entity we're talking about when we're speaking of pass-through income?

Abbie: Absolutely. Generally, we're talking about partnership interests or maybe a single member LLC.

Mary: The word pass-through simply means what?

Abbie: That the income passes through the business and is actually taxed at the individual level on their individual income tax return.

Mary: Instead of if we had a C corporation as taxed as a separate entity, whereas the S corporation and partnerships flow through to us, and so that has different considerations in the estate planning context. How does the pass-through business income affect estate planning if you have that type of entity?

Abbie: Absolutely. When we're actually looking at comparison of active versus passive treatment, so generally active treatment is more favorable when it looks at characterization and the ability to make certain income tax deductions. When somebody passes away who maybe was the manager or the primary active participant, now we look at the trustee or the other qualified fiduciary who might be in charge of managing the investment to see if we're allowed to continue on that active treatment.

Mary: Can you just briefly explain why the active treatment might or might not be more valuable to the successor or to an owner in general?

Abbie: Absolutely. With active treatment, you're not limited to the deductions and offsets on your individual income tax return, or in the case that may be the fiduciary tax return. For example, if we've heard passive activity losses, that's where you're limited and would have to curate those forward, instead of being able to offset other activities.

Mary: It partly depends on exactly what the business does and if it's passed to a trust upon death of the say an S corporation. S corporation owner dies. Maybe I should use a partnership so we don't have to get into the ESBT. I'll just use a partnership tax. The primary owner of a partnership, because if it's a partnership, we have more than one, but interest passes to a trust at death. What we're concerned about is if the trustee is active, can be deemed to continue the active, then we can offset against ordinary income. If it's passive, you're saying we might have losses that we cannot take.

Abbie: Correct. They would have to be carried forward.

Mary: What would be your key planning point?

Abbie: To appoint someone who is going to be in charge of that investment activity who will be actively managing that activity.

Mary: And that's really important with the trust. I think there's an assumption for some still in talking that you can't do that, but the fact is you can have an active real estate partnership within a trust.

Abbie: Exactly.

Mary: Let's talk about the S corporation status. Let's say that S corporation transfers as part of the estate process. Can you maintain that favorable tax status?

Abbie: With an S corporation, there are more restrictions and limitations on who can be a shareholder. Either a transfer through a gift during their lifetime or when the grantor passes away, now we have a different shareholder. It's either going to be in a state or a trust until it goes out to a final beneficiary who may or may not be an individual. Something to consider with S corporations is number one, the timing that you have to make certain elections and get the elections made.

There are different rules based on a state based on a trust that is a non-grantor trust and based on a trust that starts off as grantor then switches to non-grantor. It also depends on if the grantor shut off the grantor status or if the grantor passed away, and that's what triggered shutting off the grantor status. Making sure that as soon as someone passes away and there's any grantor implications on S corporation shares that you're reviewing the timing that you have to make the election and get that filed.

The two election options are a qualified Subchapter S trust and electing small business trust. The main difference is the flow of income. With what I'll call the QSST, all of the income flows out to the beneficiary. There can only be one income beneficiary, but that can be made through sub-trusts. Now, the actual muddy flow is based on fiduciary accounting income. Essentially usually the minimum is enough for them to pay their taxes, but it could be all the way up to 100% of the income that the Subchapter corporation made that year.

With electing small business trust or an ESBT, all of the income is taxed at the trust level, but all of it's taxed at the top marginal rate. There are no brackets allowed and there's a separate form to file with that in order to calculate that, because you calculate it separately from the other assets in the trust if there are any other ones.

Mary: And just because we mentioned a lot of different type of trusts in that answer, I'm just going to ask for clarification. First, let's talk about what a grantor trust is. Can you just give a brief synopsis of that, what that means?

Abbie: Absolutely. Basically, a grantor trust is the trust where the grantor retained enough power or control over the trust assets for it be includable in their income tax or in the case of a revocable trust would also be included in their estate.

Mary: You could have a revocable grantor trust, which is a common pre-death estate planning strategy, or you could have an irrevocable grantor trust pre-death. And then I want to mention what you said in passing, which was that you can change the status. Let's say I as a grantor create an irrevocable grantor trust, and then I decide I'm paying the taxes on the income, but I don't have the income. Irrevocable grantor trust, I have access to the income. But irrevocable grantor trust, I've given away my rights to the assets, but I'm still paying the tax on the income.

And while we call that the burn for estate tax purposes and it's a great strategy, it's also the strategy that grantors will get tired of, or the facts might change, and it might make sense to change the status. What I believe you said is during the time I'm a grantor and I have created a trust that has grantor trust status that's irrevocable, I can then basically unplug that status and say, "Yeah, I'm tired of paying the taxes. I'm going to change the status of this is going to be a non-grantor trust, but I might still be alive when I do that." Correct?

Abbie: Correct.

Mary: And then how does that affect the S corporation analysis? While it's a grantor trust, it's me that's seen as the S corporation shareholder. Now, the non-grantor trust springs into existence as a separate being. What gets looked at for purposes of the S corporation ownership rules?

Abbie: The trust needs to allow for S corporation holdings. If the grantor wanted it to be the QSST, then those QSST provisions would be in the trust. A lot of trusts just allow for the trustee to decide whether it's going to be the QSST or the ESBT, but it's on them to file the election with the IRS and make sure that all of the applicable information is included in there.

Mary: Anytime a trust owns an S corporation, some consideration should be given to that. What would you say your key planning tip would be?

Abbie: Well, to understand the grantor's intent on how much income he wants the beneficiaries to have at what point in their life and then to make sure that the election is done when the grantor status terminates. It's an easy one to miss, especially after the death of the grantor if it was held in a trust. You're given a significant amount of time, but it's easy to miss things when it gets pushed back. Now, if the grantor just terminates during his lifetime, it's a much shorter time period. Because there are a lot of different rules, just do it as soon as the grantor's status changes.

Mary: Really be aware of the fact that there's an S corporation involved and plan for it.

Abbie: Correct.

Mary: Is that a fair statement?

Abbie: Yes.

Mary: Alright, let's talk about partnerships. If you own an interest in a partnership, should you transfer that during life or at death?

Abbie: A lot of the conversation around income tax planning versus estate tax planning has to do with the amount of assets the grantor has, and kind of which tax outweighs the other. All the assets that the grantor owns at their death gets the basis step up when they pass away.

Mary: Can we give a super simple example of that? If I buy a share of Apple stock for a dollar and it's worth a thousand today, I sell it today while I'm still alive, I have $999 of gain.

Abbie: Correct.

Mary: But tomorrow I die, I still own it, I didn't sell it, the value is a thousand and so the basis of that becomes a thousand?

Abbie: Correct.

Mary: And then my heirs sell it the next day, there's no gain.

Abbie: Right.

Mary: That's the value of the step-up in basis. What happens in the partnership context?

Abbie: In the partnership context, you look through to the assets for the proportionate share of what the grantor owned. If you owned half of the partnership, you look through and you step up the proportionate amount of the assets that the grantor owned to fair market value. For example, if there was a piece of machinery that had been fully depreciated to zero and it was worth $100,000, well, the grantor owned 50%, so now you can step up that basis to $50,000 and essentially restart the depreciation on that.

Mary: You're talking about the inside basis of the partnership.

Abbie: Right.

Mary: Does that require a 754 election be made?

Abbie: Correct.

Mary: So,you could not make a 754 election. Would you then lose the ability to make that step up of the inside basis?

Abbie: Right. That would require a 754. I think it'd be a pretty unusual circumstance where you wouldn't step it up where you had the option to.

Mary: I agree. I was just making the point of there being a difference between inside and outside basis. Again, to your point earlier of awareness of the type of assets that you have being so important, because you need to think about the fact there is a partnership and do you need to make sure as I've seen the 754 get missed.

Abbie: Yes.

Mary: And that, again, is an issue with making the elections regarding the S corporation shares. Your key planning tip on partnerships would be?

Abbie: Would be, again, to reach out to your tax advisor to make sure that all beneficial elections are getting made properly because some of them in the planning perspective have to get balanced against estate tax savings implications. If they had gifted some of that partnership interest during their lifetime, then you don't get that basis step up. But maybe the growth of that asset over the time period at it was gifted outweighs the income tax benefits of that step up.

Mary: The point there is, as part of your advisory team, you want somebody who's familiar with the tax consequences of gifting a partnership interest during life versus holding it at death and looking at the different consequences. It's a numbers game and sometimes it's a little bit of a guess because we don't know when somebody's going to pass away, right?

Abbie: Right. The intent could change about which assets the family plans on retaining versus maybe selling. You do the best that you can.

Mary: Or the tax laws might change at the final hour at the end of the year when we're all trying to take New Year's Day off. Let's talk about inherited retirement accounts. How are beneficiaries taxed on inherited retirement accounts?

Abbie: Traditional IRA accounts or ordinary income to basically whoever is distributed the income when they are distributed the income, there were a lot of changes in the SECURE Act. We used to be able to do these stretch IRAs and now that's really limited to a select few individuals, including a surviving spouse and possibly a disabled child. The basic rule of thumb outside of that is now you have a 10-year period to make those distributions out.

Now, a Roth IRA isn't subject to income tax because it paid tax. The grantor paid tax on income before the contributions were made to the retirement account. One thing that we see people doing with planning for IRA accounts, well, I'll say a couple things, one is if there's charitable intent, they may contribute to a qualified charitable distribution up to $100,000 a year per taxpayer directly to a charity.

If you have professionals where they have significant amount of assets in traditional IRAs, this is nice because you don't have to look through to see if you had to take the income in and then deduct the charitable deduction versus going straight to the charity you know you're going to get top benefit from that.

Mary: Can you just share why that is? Because a lot of people will think, okay, $100,000 of income minus $100,000 deduction, that's not the way it works out. Can you briefly explain that?

Abbie: Right. Well, one thing to look at now is the standard deduction is so large, and so because this is going on the standard deduction form, so just losing some of that is a tremendous savings.

Mary: And also doesn't it affect the adjusted gross income in terms of in one case it's $100,000 higher and to the extent anything is calculated off that?

Abbie: Yeah. That could impact credits or other deductions that are based off of AGI limitations.

Mary: And if I recall correctly, with SECURE Act 2.0 I think is what we're calling last year's last minute act, or maybe it wasn't that last minute, but last year's act was that also the qualified charitable distribution can be made prior to you being subject to RMDs. Can't you do a QCD at 72 even if your RMD age is moved up?

Abbie: You can do the QCD I believe at 70 and a half, and now they've pushed back the RMD ages.

Mary: The QCD is 70 and a half. The RMD got pushed up at one point to 72. Isn't it being phased in over time up to 75, but you can still make the QCD 70 and a half even if you aren't having to make RMDs?

Abbie: Yes.

Mary: Key thing is this area is inherited retirement accounts in general. Retirement accounts are somewhat complicated. What is your thought on here's the key to taxation of retirement accounts and estate planning?

Abbie: The biggest takeaway that I would like people to think about is their charitable intent and focusing on using retirement assets to the extent that they're traditional retirement accounts to pay the charitable intent first, because that saves...as we know, charities don't pay income tax, and so that is more dollar for dollar to beneficiaries versus beneficiaries and taxes.

Mary: To the extent as particularly if they're not subject to estate taxes currently, where there's almost no benefit unless you're paying some state taxes. Looking at getting the benefit of that income tax deduction in your maximum best way.

Abbie: Yes.

Mary: Well, that's all we have time for today. We're going to continue this conversation about income tax and estate planning in a second episode. But do you have any last thoughts on the things that we've discussed today?

Abbie: Just highlighting the importance of the income tax implications versus the state tax implications. Because especially you're talking about adding state tax in as well. Now a lot of places you're over 40% on ordinary income versus the state tax being 40% because only give or take a dozen states have a state tax, but the income tax implications are there all the time.

Mary: If you're in California, for example, I think the rate last time I looked was 13.38%, and they're considering pushing that up further, so that state plus federal ordinary income tax rates add up quite a bit.

Abbie: It does, and they are ironically one of the states without an estate tax.

Mary: Right!? That makes it really interesting play there. Well, thanks very much for sharing the thoughts and I look forward to our next episode. As we reach the end of today's episode, I want to thank our sponsors, Interactive Legal, Foster Group, Veterans Victory Housing, and Carson Private Client. That's all for now. Thanks for listening to today's episode and stay tuned for our weekly releases.