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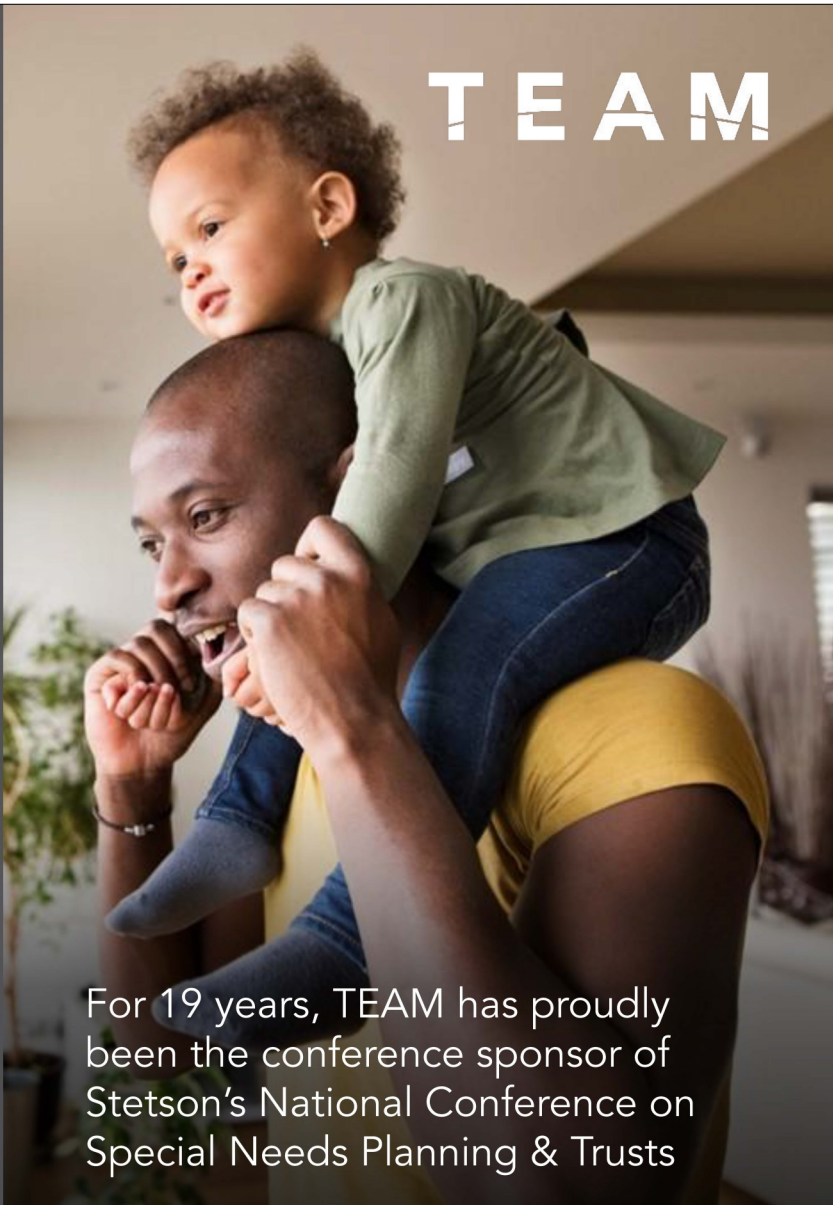
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THE BASICS OF NON-GRANTOR TRUSTS

I. Introduction.

A. Non-Grantor Trusts: Subchapter J of the Internal Revenue Code (“IRC”) (Sections 641-663).

B. Grantor Trusts vs. Non-Grantor Trusts.

1. Grantor Trusts: Grantor taxed on the trust’s income (IRC Sections 671-678)
2. Non-Grantor Trusts: Trust and/or the Beneficiaries of the Trust are taxed on the trust’s income.

C. Types of Non-Grantor Trusts.

1. Simple Trusts (IRC Section 651 and 652). The requirements of a Simple Trust are: (1) the terms of the trust provide all of its income (Fiduciary Accounting Income (“FAI”) be distributed currently; (2) the terms of the trust do not provide for any amounts to be paid to charity; and (3) no distributions in excess of FAI are in fact made to the beneficiaries of the trust.
2. Complex Trusts and Estates (IRC Sections 661-663). Complex trusts fail one or more of the three requirements of a Simple trust.

II. Concepts Applicable to all Non-Grantor Trusts.

A. Fiduciary Accounting Income (“FAI”).

1. IRC Section 643(b) and Regulations thereunder.
2. See Section III. of this Outline.

B. Calculating the Taxable Income of an Estate and Non-Grantor Trust -
The Starting Point.

1. IRC Section 641(b).
2. See Section IV. of this Outline.

C. Distributable Net Income ("DNI").

1. IRC Section 643(a) and Regulations thereunder.
2. See Section V. of this Outline.

D. Estates vs. Non-Grantor Trusts.

1. Summary of the Major Income Tax Differences between them.
2. See Section VI. Of this Outline.

Income Taxation of Trusts & Estates

John P. DeSantis



1

Fiduciary Accounting Income ("FAI")

IRC Section 643(b)- For purposes of subparts A, B, C and D of part J of the IRC, the term "**income**", when not preceded by the words "taxable", "distributable net", "undistributed net" or "gross" means the amount of income of the estate or trust for the taxable year **determined under the terms of the governing instrument and applicable local law.**

Governing Instrument: Most governing instruments do not define what is income and corpus.



2

Fiduciary Accounting Income ("FAI")

Applicable Local Law: Applicable State Law of (1) Estate- the decedent's domicile or (2) Trust (stated in Trust Agreement).

Example : *NYS- EPTL 11-2.1*

NJ- 3B :19B-1 etc. (Handout of NJ Statute reviewed)



3

Fiduciary Accounting Income ("FAI")

Key Concepts:

- **Income** = *FAI* and **Corpus** = Principal

General Rules of what is Income and Corpus:

- **Fiduciary Accounting Income** = Interest, Tax Exempt Interest, Dividends, Rental Income, Cash received from Entities and generally a portion (10% in NJ) of Minimum Required Distributions from Qualified Plans (All such income items are reduced by any expenses related to such income).
- **Corpus** = Capital Gains, IRC Sections 1245 and 1250 Recapture, 1231 Gain, etc.



4

Computation of TI of an Estate or Trust

General Rule and Starting Point: IRC Section 641(b)- *The TI of an estate or trust shall be computed in the same manner as an individual, except as provided in this part (Part J).*

Summary of the major tax differences between computing TI of (1) an individual and (2) a Trust or an Estate. *Most of these differences are set forth in IRC Section 642.*



5

Distributable Net Income ("DNI"). IRC Section 643(a)

A. Role of DNI.

- a. The **DNI** of an Estate/Trust **LIMITS** (I) the amount such entity can **DEDUCT** under IRC Sections 651 (Simple Trusts) and 652 (Complex Trusts/Estates) and (II) the amount on which beneficiaries can be taxed under IRC Sections 652(Simple Trusts) and 662(Complex Trusts and Estates).



6

Distributable Net Income ("DNI"). IRC Section 643(a)

B. Computation of DNI:

- a. **Start with the entity's "Tentative Taxable Income"**- Namely, the TI of the entity before the entity's distribution deduction under IRC Section 651 or 661)
- b. **ADD:**
 - i. Exemption Amount (IRC Sec. 643(a)(1)).
 - ii. Net Capital Loss (IRC Sec. 643(a)(3)).
 - iii. Net Tax-Exempt Income – Gross tax-exempt income less deductions (A) directly attributable to tax exempt income and (B) indirectly attributable to tax exempt income. (IRC Sec. 643(a)(5)).
- c. **LESS:** Net Capital Gain (IRC Sec. 643(a)(3).
- d. **EQUALS:** DNI



7

Basic Concepts- Estate vs. Trust: A Summary of the Major Income Tax Differences

Issue	Estate	Trust
Year-End	Fiscal	Calendar
EIN	Yes	Irrevocable – Yes Revocable – Mostly no
Tax Filing	GI->= \$600 B-Non-Resident Alien	Same & any TI Same
Est. Tax Payments	None for first 2 tax years	Yes if will owe \$1,000 or more
Allocate Est. Tax Payments to Beneficiary	Final Tax Year	Any Tax Year



8

Basic Concepts- Estate vs. Trust: A Summary of the Major Income Tax Differences

Issue	Estate	Trust
Holding Period	Long-Term	Tacking
Basis of Asset Received	Step-up (Not IIRD)	Carry-over
OI Tax Rates	Compressed	Same
Exemption	\$600	Complex: \$100 Simple: \$300 QDT (2025): \$5,100
PALS	If Decedent actively participated, estate will be deemed to Actively Participate for first 2 taxable years	Only if Trustee actively participates



9

Basic Concepts- Estate vs. Trust: A Summary of the Major Income Tax Differences

<u>Issue</u>	<u>Estate</u>	<u>Trust</u>
Commencement Date	Day following date of Decedent's death	First date property transferred to trust
Return Due Date	15 th day of 4 th month, 5.5 month extension	Same

Note: If have a "qualified revocable trust" and both the Executor of the estate and the Trustee of the Revocable Trust make an IRS SECTION 645 ELECTION (Form 8855), the estate will be treated as a trust for income tax purposes.

GRANTOR TRUST OVERVIEW



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I. Introduction

Long a staple of estate tax planning, a grantor trust can be a powerful tool in the elder lawyer's arsenal. All or any portion of a trust drafted to be "defective" for income tax purposes is classified as a "grantor" trust with respect to that portion of the trust. In the context of income taxation, the settlor (or occasionally another individual) is the deemed owner of the portion of the trust that triggers the grantor trust rules and is responsible for income tax liabilities (and perhaps benefits from tax attributes) associated with that portion of the trust.

The courts and Congress throughout the 1940s and 1950s devised the grantor trust rules to impede the ability of individuals to shift tax burdens to lower-bracket taxpayers (*e.g.*, children); the idea was to essentially nullify the transfer to trust (for tax purposes) if the transferor retained too much control. After the adoption of those rules, drafting an "unintentionally defective" trust might have created an undesirable result – perhaps a call to your professional liability insurer. But as the economic and tax climates have changed and asset protection planning has increased, the simultaneous divestiture of legal title by transferring an asset to trust while avoiding the complexities of the "usual" trust taxation rules presents an attractive strategy.

A trust gains "grantor" status by "failing" one of the rules enumerated in IRC §§ 673 through 678. Those sections provide a menu of options for designing an intentionally defective grantor trust. Generally they involve some sort of right or benefit retained by the grantor over the trust assets or beneficiaries. IRC §§ 671 and 672 provide, respectively, general rules and definitions.

The happy result of grantor trust status is that all income tax attributes of some or all of the trust (income, deduction, credit) flow through to the grantor and are reported on her Form 1040.² In this manner an individual can, for example, divest an asset yet retain the income, or transfer a residence but retain the capital gains exclusion on sale of the residence by the trust (all of which will be discussed in greater detail in other segments of the program).

II. IRC §§ 671 and 672: Basic Concepts and Definitions

A. Grantors (and Others) as Tax Owners

A grantor (or another person, for that matter) deemed the "owner" *of any portion* of a trust under the grantor trust rules is required to include in computing his or her taxable income those items of income, deductions, and credits that are attributable *to that portion* of the trust. Remaining items of income, deductions and credits (*i.e.*, those attributable to *other* portions

² Perhaps the clearest summary by the Service is in Rev. Rul. 85-13.

of the trust) are taxed to the trust, or beneficiary, as applicable, under the usual trust taxation rules of subchapter J of the IRC.

A critical definitional issue pertains to who is treated as the “grantor.” Particularly in the context of a D4A Trust established by a parent, grandparent, guardian or court the identity may be somewhat unclear.³

Generally, the regulations under Code section 671 deem any person who creates or funds a trust to be a grantor of the trust.⁴ A grantor, however, may not necessarily be the tax owner. A person may create a trust, but if that person made no gratuitous transfer to the trust or is directly reimbursed for a transfer to the trust, he or she may be the grantor of the trust, but not the owner. As noted above, a D4A Trust established by someone other than the disabled beneficiary is an example..

The converse may apply in certain limited cases. For example, a person who is not the grantor with respect to a trust (*i.e.*, she neither created nor funded any portion of the trust) may nevertheless be the tax owner with respect to any portion of the trust over which she has an unfettered withdrawal power that could benefit herself.⁵ As will be discussed further, this should be of concern only where the grantor has failed to retain (or grant to a nonadverse party) any power that would cause the grantor to be the deemed owner under the grantor trust rules.⁶ This might occur if a nongrantor trust enables a lone trustee to make discretionary distributions to herself. *Take Care!*

There may be more than one grantor and one owner.

It should also be clear, in the context of a self-settled or D4A Trust, that a trust “established” by a parent or grandparent may nevertheless be a grantor trust with respect to the disabled beneficiary to the extent the beneficiary’s assets have been transferred to the trust and the scrivener selects some triggering rule under Code sections 673 through 677 and drafts the appropriate power into the document.⁷

³ See, generally, 42 U.S.C. § 1396p(d)(4)(A).

⁴ Treas. Reg. § 1.671-2(e)(1).

⁵ *Id.* 1.671-2(e)(6) Ex. 4 and I.R.C. § 678(a)(1).

⁶ *Id.*

⁷ If sound benefits and tax planning indicate that grantor trust status with respect to the beneficiary is advisable, there are any number of provisions that can be inserted that should not create difficulties from a Medicaid or SSI standpoint. This outline discusses a number of those provisions further below.

B. Definition of Adverse Party, Nonadverse Party and Independent Trustee

1. “Adverse Party” is a key definition to master. **Know this definition.** The concept is important not because adverse parties are essential, but rather because “nonadverse parties” are so useful.⁸ An “adverse party” is any person having a substantial beneficial interest in the trust which would be adversely affected by the exercise or nonexercise of the power which he possesses respecting the trust. A general power of appointment over trust property constitutes a beneficial interest in the trust, along with countless other possible interests.⁹ It logically follows that any individual who is not an adverse party is a nonadverse party.¹⁰

Example: Anthony has been given an income interest in a trust but Greta Grantor has retained a power to appoint the income interest, Anthony will be adverse with respect to that retained power of appointment because Anthony Adverse will be the loser if Greta exercises her power.

The rules are simply based on an understanding of human nature and the propensity of an individual to act in his or her best interests. An adverse party is less likely to be subject to the influence of the grantor because she might be motivated to take or withhold action to preserve her trust benefits. On the other hand, a nonadverse party is free of those motivations. In fact, if trust design calls for the use of a nonadverse party the grantor will select someone who is not a beneficiary and who will likely do exactly what the grantor wants done.¹¹

2. “Independent Trustees” are really a type of nonadverse party. Think of them as being nonadverse parties “who are really, really nonadverse.” The idea behind many of the adverse/nonadverse distinctions is that an adverse party is going to be affected by the exercise of a power and a nonadverse party will not be (and will likely have been chosen by the grantor to be nonadverse because he was likely to be quite compliant in any event).

⁸ As will be discussed further below, some of the retained grantor trust powers are not “retained” at all, but rather vested in someone other than the grantor who is a nonadverse party. The nonadverse party actually becomes quite an ally if the intent is to create a grantor trust without vesting troublesome powers in the grantor/beneficiary that could create Medicaid/SSI/Veterans benefits issues.

⁹ I.R.C. § 672(a).

¹⁰ *Id.* § 672(b).

¹¹ Mason, 26 NAELA News 18 (Oct./Nov. 2014).

An “independent trustee” on the other hand is a trustee who is a nonadverse party but somewhat more removed from grantor’s sphere of influence. The code defines such a person as someone who is a nonadverse party and also not a “related or subordinate party.”¹² An independent trustee can be given much more leeway to decide whether to apportion or distribute income or principal among various beneficiaries¹³ because, the theory goes, her independence makes it more likely that she will not be acting simply as the grantor’s surrogate. She’ll be . . . well . . . independent.

C. Determining Portions

Much confusion exists with respect to the meaning of “a portion of a trust” and the applicability of that phrase to the grantor trust rules. Many elder law attorneys do not understand that a trust may be a grantor trust as to a portion only, and not a grantor trust with respect to other portions (*i.e.*, subject to the “usual” trust tax rules for non-grantor trusts).

1. A trust portion can appear in one of three ways. Short of being the deemed owner of an entire trust (which is quite common), a grantor could be the deemed owner of the principal or the income, the owner of a pecuniary or fractional share of all trust income, deductions and credits, or the owner of income, deductions and credits attributable to a specific trust asset.

Elder law attorneys are most likely to encounter apportionment in the context of principal and income. To determine what items of income, deduction and credit are apportioned to income and principal, the regulations use the distributable net income (“DNI”) rules under IRC 643(a) applicable to non-grantor trusts.¹⁴ Those rules are discussed in the first part of this outline.

Portions may also be specific assets. For example, a trust owning a residence, cash, and securities could be designed as a grantor trust with respect to the residence, and a nongrantor trust with respect to all other assets.¹⁵

2. The most likely area for an elder law attorney to run afoul of the “any portion of” rules of IRC § 671 is in the area of reserved income interests. For example, the uninitiated may believe that by reserving an income interest they have created a

¹² IRC § 672(c).

¹³ IRC § 674(c).

¹⁴ Treas. Reg. § 1.671-3(c).

¹⁵ Although from a drafting perspective this could be a bit confusing.

grantor trust that will preserve favorable attributes of grantor trust status with respect to corpus – notably a preservation of the capital gains exclusion on sale of a principal residence under Code section 121.¹⁶ But items of capital gain are not included in the “income” portion of a grantor trust because under the usual DNI rules capital gains are allocated to principal. The reservation of a power that will result in grantor trust status with respect to income may not create the desired result with respect to corpus unless some other reserved power triggers grantor trust status with respect to corpus. In such a case, the grantor will be treated as owner of only those items of trust income, deduction, and credit allocated to income and not to principal.¹⁷

III. IRC §§ 673 - 678: The Operational Rules

The grantor trust provisions, while complex, can be conceptualized in a simple fashion. A grantor trust is merely a trust over which the grantor has retained (or often given to certain nonadverse parties) one or more powers that cause the trust (or a portion thereof) to be deemed owned by the grantor.

Think of the various powers as something of a dashboard of switches that may be toggled on or off during trust design to accomplish the strategic goals (Grantor trust with respect to income? Grantor trust with respect to principal? Grantor trust with respect to specific asset?). Once clear on strategy, “pick your switch and flip it on or leave it off.”

Another useful idea: Start drafting with a trust in which the grantor has retained no power whatsoever after trust funding . . . then begin to add back in those powers/benefits you wish for the grantor to retain.

A summary of the basic rules follows. We’ll drill down much more deeply in later program segments. Any of the following may create a grantor trust with respect to a trust or an applicable portion.

SEE THE GRANTOR TRUST CHEAT SHEET ATTACHED

IV. IRC § 673 Reversionary Interests

The grantor is treated as the owner of any portion of a trust in which he has a reversionary interest in either the corpus or the income therefrom, if, as of the inception of that portion of the trust, the value of such interest exceeds five percent (5%) of the value of such portion. In most

¹⁶ See VIII.B beginning p. 19.

¹⁷ Treas. Regs. §§ 1.677(a)-1(g) (example 1); 1.671-3(b). For an interesting case on point *see* *Goldsby v. Comm’r*, T.C. Memo 2006-274 (trust income beneficiary denied pass through of items attributable to corpus).

elder law or special needs contexts a significant reversionary interest in a grantor with asset protection motives is not attractive.

On the other hand, because the section requires the 5% to be calculated on the basis that the trustee will exercise the maximum discretion in favor of the grantor,¹⁸ and because one who funds a trust is considered a “grantor” with respect to the portion she funded,¹⁹ this provision will generally guarantee that a D4A trust will be considered a grantor trust with respect to the beneficiary if it was truly a “self-funded” trust.²⁰

While IRC § 673 is not of much interest outside the D4A context, it does have an interesting interplay with a number of other grantor trust sections and illustrates how a trust power or retained benefit can be caught up by more than one grantor trust provision.²¹

V. IRC § 674 Power to Affect Beneficial Enjoyment – The Grantor Trust Monster

A. Overview

Section 674 is, to my thinking, the most important (and involved) of the grantor trust rules. Master this, and you’re halfway home.

Generally, a grantor is treated as the owner of any portion of a trust in respect of which the beneficial enjoyment of the corpus or the income therefrom is subject to a power of disposition, exercisable by the grantor or a nonadverse party, or both, without the approval or consent of any adverse party.²² If an adverse party’s consent or cooperation is necessary to effect an alternate disposition of assets, the power does not create a grantor trust. In the VA benefits planning context this can be useful when the same power can trigger gross estate inclusion (and stepped-up basis).²³

Example 1: Edith Bunker funds a trust for the benefit of her daughter Gloria and her husband Michael Stivic. Income to Gloria and Michael for the joint lives of Edith and Archie, remainder to Gloria and Michael. Edith retains a right to appoint trust income and

¹⁸ IRC § 673(c)

¹⁹ Treas. Reg. § 1.671-2(e)(1).

²⁰ *I.e.*, the beneficiary’s assets were used to fund the trust, as opposed to some other party’s assets.

²¹ Rather than get ahead of ourselves, this will be discussed under IRC § 677.

²² IRC § 674(a).

²³ See discussion of estate inclusion and basis step-up at X.C.1 and X.C.3.

principal in any manner that does not constitute a general power of appointment. This is a grantor trust under IRC § 674(a).

Example 2: Edith is afraid of creeping periods of forgetfulness, so she gives her dear friend and neighbor Louise Jefferson the power to appoint income and assets among Edith's descendants and their spouses. This is a grantor trust because Louise is a nonadverse party.

Example 3: Edith retains a special power of appointment as provided in Example 1, but her power is exercisable only upon the written approval of Gloria. This is NOT a grantor trust under IRC § 674(a) because Gloria is an adverse party.

There are ten exceptions: Some are powers the grantor or any other person may hold, two are powers an independent trustee may exercise, and one is a power a trustee (other than the grantor or the grantor's spouse) may exercise, without causing the grantor to be taxable as the owner of the trust. Accordingly, if the goal is to create a grantor trust reliance on a simple power to affect the beneficial enjoyment of a trust without verifying whether the power falls within one of the following exceptions is not a good practice. On the other hand, if the goal is to avoid grantor trust status then understanding and using the exceptions to your advantage would be wise. Here we go . . .

B. Exceptions

1. IRC § 674(b)(1).

A grantor is not taxable as the trust's owner merely because any person (including, even, the grantor as long as he is acting in a fiduciary capacity as trustee or co-trustee) may use trust income to discharge a legal support obligation of the grantor.²⁴ However, if trust income is in fact used to discharge the support obligation as described in IRC § 677(b) the income applied will be includible in grantor's ordinary income.²⁵

2. IRC § 674(b)(2).

This power is not a significant power in the elder and special needs law context. A “postponed power” (*i.e.*, a power to affect a trust's beneficial enjoyment that is subject to the occurrence of an event) will create a grantor trust unless the event with respect to which the power could apply is remote enough to have a value less than five percent (5%) of the value of the trust or portion of the trust if it were treated as a reversionary interest.

²⁴ IRC § 674(b)(1); Regs. § 1.674(b)-1(b)(1).

²⁵ Treas. Regs. § 1.677(b)-1.

In other words, if the power was exercised effective as of the future event and it was treated as a reversionary interest a grantor trust would result if the interest is worth more than 5% of the trust (or applicable portion).²⁶ The analysis is the same as one would perform under IRC § 673 with respect to reversionary interests.

Example: Edith establishes a trust for the benefit of Gloria and Michael, but retains the right to appoint income and principal beginning ten years after the trust has been funded. Under relevant valuation principals²⁷ had Edith's power to appoint been a reversionary interest (*i.e.*, in ten years the trust would revert to her or her estate) the interest would be worth 25% of the trust assets. This is a grantor trust under IRC § 674(a) because her postponed power is not excepted by IRC § 674(b)(2).

3. IRC § 674(b)(3).

Contrary to what many believe, unless a bit of care is taken, a testamentary power of appointment alone may not create a grantor trust.²⁸ Anyone other than the grantor may be given a testamentary power of appointment without creating a grantor trust.²⁹ But if the grantor retains a testamentary power of appointment, things become a bit trickier.

Many practitioners believe that simply inserting a testamentary power of appointment in the grantor will create a grantor trust. While this may often be the case, it may not be; and when it is it may be in ways the drafting attorney had not foreseen. With respect to income not allocated to principal (*e.g.*, interest or rental income), if grantor's testamentary power of appointment is not accompanied by an "income accumulation" factor described below, then grantor trust status will not be obtained.

- (a) First, if accumulation of income is mandatory or there is discretionary authority (in either the grantor or a nonadverse party) to accumulate income, *and* the grantor's testamentary power of appointment extends to that accumulated income, the result *will* be a grantor trust.³⁰

Example: Edith establishes a trust that generally requires the distribution of all ordinary or accounting income to Gloria, subject to the power in Louise

²⁶ IRC § 674(b)(2).

²⁷ Call a CPA or valuation consultant; you're a lawyer, for Heaven's sake!

²⁸ *Id.* § 674(b)(3).

²⁹ Treas. Reg. § 1.674(b)-1(b)(3) (first sentence).

³⁰ Treas. Regs. § 1.674(b)-1(b)(3); *see also* Prv. Ltr. Rul. 201326011 for a perfect illustration.

Jefferson to indefinitely suspend the distributions. Edith also retained a testamentary power of appointment over the trust remainder. This is a grantor trust with respect to ordinary income because a nonadverse party (Louise) can elect to accumulate income for later distribution pursuant to Edith's testamentary power of appointment.

- (b) Second, even if there is no mandatory or possible discretionary accumulation of income but grantor does have a right to appoint trust corpus by will, any items of income allocable to trust corpus (*e.g.*, capital gains) under the trust agreement or local law will be attributable to grantor.

Example: Edith establishes a trust that mandates the distribution of all ordinary or accounting income to Gloria. Edith also retained a testamentary power of appointment over the trust remainder. During the year, trust assets generate interest and rental income. The trustee also sells a number of trust assets and generates capital gains income. The interest and rental income will be includible in DNI under IRC § 643(a). On the other hand, if the capital gains income is allocable to principal under the local principal and income act or the trust agreement, the capital gains income will be attributable to the grantor because of his testamentary power.³¹

Example: In the previous example, if the trust agreement requires immediate distribution of all capital gains income to Gloria (together with all other income) the trust will not be a grantor trust with respect to any portion of the trust³² notwithstanding that Edith has retained a testamentary power of appointment.

4. IRC § 674(b)(4).

A grantor is not taxed as a trust's owner if the grantor simply retains a power to allocate the beneficial enjoyment of trust corpus or income among charitable beneficiaries.³³

5. IRC § 674(b)(5).

³¹ Treas. Reg. §§ 1.674(b)-1(b)(3) (last sentence), 1.671-3(b)(3).

³² Recall, a mere testamentary power of appointment, unless coupled with some type of potential income accumulation, does not create a grantor trust. IRC § 674(b)(3).

³³ That's nice. IRC § 674(b)(4); Treas. Reg. § 1.674(b)-1(b)(4).

- (a) A grantor is not taxed as a trust's owner simply because she or a nonadverse person (or both) has a power to distribute corpus among one or more beneficiaries if the power is limited by a “reasonably definite external standard” (*i.e.*, similar to the ascertainable “health, education, maintenance or support” under IRC §§ 2041 and 2514).³⁴

Example: Edith establishes a trust with a mandatory income interest in favor of Gloria, remainder to Gloria and Michael upon Edith’s death. Edith’s sister (Gladys) is trustee, and she has the discretionary authority to make distributions for the health, education, maintenance and support of baby Joey Stivic. Notwithstanding that the power in a nonadverse party (Gladys) to make discretionary distributions of corpus would generally create a grantor trust under IRC § 674(a), this is an excepted power under IRC § 674(b)(5) because it is subject to a reasonably definite standard.

Note *carefully*, if the decision-maker’s authority *seems* to be limited by a reasonably definite external standard, but the trust agreement also says that the decision-maker’s determination is “conclusive,” then the power will not be limited by a reasonably definite external standard.³⁵ Depending upon drafting goals, that should be avoided . . . or could be very useful.

- (b) Further, distributions of corpus may be made to a current income beneficiary as long as the distribution of corpus is chargeable against the beneficiary’s proportionate share (and, in this case, the distribution need not be limited by a reasonably definite standard).³⁶

Example 1: Edith establishes a trust with a mandatory income interest in favor of Gloria and baby Joey for Edith’s life, remainder in baby Joey and Gloria. Pursuant to the trust agreement Edith may make distributions of principal to either baby Joey or Gloria for any reason at all, as long as the principal distributed reduces the proportionate share of the recipient that actually generates that recipient’s income (the easiest way to do this is simply divide the trust into shares and debit the recipient’s share). Edith has named herself as trustee. This is not a grantor trust notwithstanding that the grantor

³⁴ IRC § 674(b)(5)(A); Treas. Reg. § 1.674(b)-1(b)(5)(i).

³⁵ Treas. Reg. § 1.674(b)(5)(i) (penultimate sentence).

³⁶ IRC § 674(b)(5)(B); Treas. Reg. § 1.674(b)-1(b)(ii).

has discretionary power to alter the timing of the enjoyment of the corpus, she really isn't altering who ultimately receives those benefits.

Example 2: Edith establishes a trust with a mandatory income interest in favor of Gloria, remainder in Gloria. Edith may make distributions of principal to Gloria for any reason at all. This is not a grantor trust.

A couple of noteworthy points in the elder law context:

- First grantor trust status *will* result if the power in the grantor or a nonadverse person to distribute corpus to or among beneficiaries is *not* limited by a reasonably definite standard and the corpus so distributed is not charged proportionately to the distributee's share.
- Second, pursuant to flush language at the end of IRC § 674(b)(5), if the grantor or a nonadverse party retain the right to add a beneficiary or to a class of beneficiaries, the result will be grantor trust status.

Both of these could be extremely useful powers if the intent is to create a grantor trust with respect to principal without retaining additional powers that could create Medicaid "asset retention" issues, particularly if a nonadverse party is the powerholder.

Example: Edith establishes a trust with a mandatory income interest in favor of Gloria and baby Joey, remainder in baby Joey and Gloria. Edith names her sister Gladys as trustee. Gladys may make distributions of principal to either baby Joey or Gloria as she may deem to be in either of their best interests. This is not excepted under IRC § 674(b)(5) and this is a grantor trust with respect to Edith.

6. IRC § 674(b)(6)

Think of this as a little like the "flip side" of IRC § 674(b)(5) exception with respect to distributions of *corpus*. There are actually two subtly different exceptions here. Under subparagraph (A) a grantor is not taxed as a trust's owner if she or a nonadverse person (or both) has a power to distribute or apply *income* to or for any current income beneficiary or to accumulate the income for that beneficiary, provided that any accumulated income must ultimately be payable to *that* beneficiary, his estate, or to his appointees.³⁷

³⁷ IRC § 674(b)(6)(A).

Example: Edith establishes a trust with equal income interest in favor of Gloria and baby Joey for Edith's life, remainder in baby Joey and Gloria. Pursuant to the trust agreement Edith may make or withhold distributions of income to either baby Joey or Gloria for any reason at all, as long as the withheld income is added to the affected beneficiary's remainder share. Edith has named herself as trustee. This is not a grantor trust notwithstanding that the grantor has discretionary power to alter the timing of the enjoyment of the income because she really isn't altering who ultimately receives those benefits.

Under subparagraph (B) a grantor is not taxed as a trust's owner if she or a nonadverse person (or both) has a power to distribute or apply *income* to or for any current income beneficiary or to accumulate the income and add it to corpus, provided that any accumulated income that has augmented the corpus must, upon trust termination, ultimately be distributable to the current income beneficiaries in shares that are irrevocably specified in the trust agreement.³⁸ This is so even if it allows the grantor to shift income (ultimately) among the remainder beneficiaries.

Example: Edith establishes a trust with a discretionary income interest in favor of Gloria and baby Joey for Edith's life, and upon Edith's death remainder to baby Joey (2/3rd) and Gloria (1/3rd). Pursuant to the trust agreement Edith may make or withhold distributions of income to either baby Joey or Gloria for any reason at all, as long as the withheld income is added to the general corpus. Edith has named herself as trustee. This is not a grantor trust notwithstanding that the grantor has discretionary power to alter the timing of the enjoyment of the income because she really isn't altering the class of beneficiaries who will receive those benefits.

In my opinion, care should be taken if relying on one of these exceptions that a grantor not be able to alter the ultimate distribution of corpus through a testamentary power of appointment.

As with the (b)(5) exception relating to corpus, this exception does not apply if any person has the power to add a beneficiary or to the class of beneficiaries (other than after born or after adopted children).

7. IRC § 674(b)(7).

³⁸ IRC § 674(b)(6)(B).

A grantor is not taxed as a trust's owner simply because she or a nonadverse person (or both) reserves a power to withhold income from a current income beneficiary during any legal disability of the beneficiary or until such beneficiary attains age 21.³⁹ Again, this exception does not apply if the grantor has the right to add to the class of beneficiaries ultimately to receive the trust income or corpus (other than after born or after adopted children).

Example: Edith establishes a third party special needs trust for Gloria (who recently went on Medicaid) with a life income benefit, baby Joey is the remainder beneficiary upon Gloria's death. Edith is the trustee. The trust gives the trustee the power to withhold income distributions to Gloria if Gloria has been determined to be disabled. This is not a grantor trust.

8. IRC § 674(b)(8)

A power held by the grantor or a nonadverse person (or both) to allocate receipts and disbursements as between corpus and income, even though expressed in broad language, does not constitute a power to dispose of the beneficial enjoyment of the trust corpus or income that would cause the grantor to be taxed as the trust owner.⁴⁰ The regulations provide no further guidance, but it seems logical that this would apply to authority under a trust agreement to make fiduciary determinations of income and principal. For example, in the context of classifying receipt as between income and principal, regulations provide that “[t]rust provisions that depart fundamentally from traditional principles of income and principal will generally not be recognized.”⁴¹

9. The “C” and “D” Exceptions Under IRC § 674.

Take a deep breath: These two exceptions apply only to powers exercisable by certain trustees (who, presumably, will be acting under a fiduciary standard). If there is no trustee power involved, don't waste your time on these exceptions.

(a) IRC § 674(c) -- Independent Trustee Exception

While the general rule is that a nonadverse trustee with certain powers to control beneficial enjoyment (including the right to apportion or accumulate principal or

³⁹ IRC § 674(b)(7).

⁴⁰ *Id.* § 674(b)(8).

⁴¹ Treas. Reg. § 1.643(b)-1 (the regulation then describes various adjustments that would be recognized if permitted under local law and the trust agreement . . . which is a topic totally beyond the scope of this summit).

income among beneficiaries) will trigger grantor trust status under IRC § 674(a), IRC § 674(c) provides an exception.

A grantor is *not* taxed as a trust's owner if an *independent trustee* has the power to distribute, apportion, or accumulate income or corpus to or for a beneficiary or a class of beneficiaries, as long as *no one* is able to add to or enlarge the class (after born children excepted).

An independent trustee is not the grantor, nor a related or subordinate party.⁴² A “related or subordinate party” in relation to the grantor includes the spouse, parents, descendants, siblings, employees, corporation or entity in which his holdings are “significant” (or an employee of such an entity) or a subordinate employee of an entity in which the grantor is an executive.⁴³

The idea is that an independent trustee is far enough removed from the grantor’s influence (that might be something of a legal fiction!) that this type of trustee should have more discretion without having that discretion attributed back to the grantor. Perhaps another way to think of this exception is the “Bank Exception.”

Caution: If the grantor retains the right to terminate the trustee and replace the trustee with another trustee who would not satisfy the conditions for this exception to apply (in this case, naming a successor who is not independent) this exception will not be available.⁴⁴

Example: Edith establishes a trust for the benefit of Gloria, Michael, baby Joey and any other later born descendants. Aleesta Mill Bank & Trust has been named as Trustee. Edith retains the right to terminate the trustee and name any other independent trustee of her choice as successor. This is not a grantor trust.

(b) IRC § 674(d) - The “Anybody But The Grantor or Live-in Spouse” Trustee Exception

A grantor is not taxed as a trust's owner if any trustee other than grantor or grantor’s cohabiting spouse (*no need for independent trustee*) holds the power to distribute, apportion or accumulate income (note: does not apply to principal) to or for a beneficiary or a class of beneficiaries, if the power is limited by a reasonably definite

⁴² *Id.* § 674(c)

⁴³ *Id.* § 672(c).

⁴⁴ Treas. Reg. § 1.674(d)-2.

external standard, and if *no one* can add to or expand the class of beneficiaries to receive either income or corpus (other than after born children).⁴⁵ It seems a testamentary power of appointment (or any other power of appointment) in anyone would knock this exception out because someone could expand the class of beneficiaries. Also, recall that if the determination of the trustee as to whether the “reasonably definite external” conditions have been met is “conclusive,” then the power is not subject to such a standard.

Unlike the IRC § 674(c) exception, above, any of the trustees may be related or subordinate to the grantor. The IRC § 674(c) power and the IRC 674(d) power are very similar other than the fact that the independent trustee has complete leeway of decision making and the ‘merely’ nonadverse (but potentially related or subordinate to the grantor) trustee is bound somewhat by the “reasonably definite external standard.”

Take care with the manner in which successor trustees are named. If a grantor has power to remove, substitute, or add trustees (other than a power exercisable only upon certain limited conditions such as the death or resignation of, or breach of fiduciary duty by, an existing trustee) in a manner that could result in a successor trustee not necessarily being independent or nonadverse, a trust may not qualify under section IRC § 674(c) or (d). For example, if a grantor has an unrestricted power to remove an independent trustee and substitute any person including himself as trustee, the trust will not qualify under section IRC § 674(c) or (d), above. Conversely, if the grantor's power to remove, substitute, or add trustees is limited so that its exercise could not alter the trust in a manner that would disqualify it under section IRC § 674(c) or (d) the power does not cause grantor trust treatment. To further clarify, a power in the grantor to remove or discharge a nonadverse trustee on the condition that she substitute another nonadverse trustee will not prevent a trust from qualifying under section 674(d).⁴⁶

VI. IRC § 675 Retained Administrative Powers

A. Overview

Certain administrative powers exercisable by the grantor *or a nonadverse person*, or both, for the benefit of the grantor rather than for the trust beneficiaries will cause the trust to be taxable to the grantor as owner of the trust. The first three categories are of no use in the

⁴⁵ *Id.* § 674(d); Treas. Reg. § 1.674(d)-1.

⁴⁶ Treas. Regs. § 1.674(d)-2(a).

elder law context because they will render trust assets as available resources for Medicaid purposes; the fourth category contains a provision that is much more interesting. They are:

B. Specific Powers

1. Dealing at a Bargain – IRC § 675(1)

The existence of a power exercisable by the grantor or any nonadverse party to enable the “grantor or any person” to deal with trust assets for less than adequate and full consideration.

2. Loans at Great Terms – IRC § 675(2)

The existence of a power exercisable by the grantor or any nonadverse party to borrow trust assets without adequate interest and security.

(a) If you insist, use a nonadverse party!

In the elder law context, if you insist on using this power to create a grantor trust, *use a nonadverse party!* Keep in mind that any powers retained by the grantor could have adverse Medicaid availability issues.

(b) The Unfortunate Ms. Edholm

Mary Edholm established an irrevocable trust for asset protection purposes. In order to create a grantor trust, the scrivener inserted a provision that the grantor retained the right to “borrow” assets from the trust without interest and adequate security. Years later, the grantor applied for Medicaid and the trust assets were deemed available due to the provision. In court⁴⁷ the grantor argued that the provision was inserted merely for tax reasons so the trust would be deemed available *for tax purposes*.

Unimpressed, the court held that because there were circumstances under which payment could be made from trust (*i.e.*, interest-free loan on demand) the assets were deemed available.⁴⁸ In an interesting twist, the decision said that because the trust was deemed the grantor’s for tax purposes, it supported the welfare commissioner’s contention that the assets were available for Medicaid purposes.⁴⁹

⁴⁷ Edholm v. Minn. Dep’t of Human Servs. (Hennepin County Dist. Ct. 27-CV-11-23237) (June 17, 2013). This is an unpublished opinion; I have a copy available upon request.

⁴⁸ Recall the Medicaid rule that assets in a trust funded the beneficiary will be deemed available if they can be distributed to the beneficiary “under any circumstances.” 42 USC § 1396p(d)(3)(B).

⁴⁹ A bit like mixing Medicaid apples with tax oranges, in my opinion, but the opinion does underscore the fact that words in a trust agreement mean something; they are not “just there.”

3. Actually Borrowing – IRC § 675(3)

Unless the trustee is independent, if a grantor borrows trust assets (even with adequate security and interest) and fails to repay the loan before the end of the taxable year the trust will be treated as a grantor trust for the year.⁵⁰ Another handy use for independent trustees if you wish to avoid grantor trust status and the grantor insists on borrowing (but even then, it must be with adequate interest and security).⁵¹

4. Home of the Swap Power – IRC § 675(4)

This paragraph details three additional triggers. Two are fairly insignificant in the elder law context. One is highly significant.

- (a) Elder Law Boring. A power to vote or direct the voting of stock or other securities of a corporation *in which the holdings of the grantor and the trust are significant* from the viewpoint of voting control;
- (b) Elder Law Boring. A power to control the investment of the trust funds either by directing investments or reinvestments, or by vetoing proposed investments or reinvestments, to the extent that the trust funds consist of stocks or securities of corporations *in which the holdings of the grantor and the trust are significant* from the viewpoint of voting control;

(c) Home of the Swap/Power of Substitution!

A grantor trust in both income and principal will result if the grantor or a nonadverse person *acting in a nonfiduciary capacity* (no trustees!) has the power to reacquire the trust corpus by substituting other property of an equivalent value. This particular power could be important to the elder law attorney.

COUNTER TO BAD ADVICE: Apparently some presenters at CLE seminars have recommended that the “swap” power be given to a nonfiduciary *adverse* party (perhaps a remainder beneficiary).⁵² This is NOT good advice. Admittedly IRC § 675(4) says the power can be exercised in a nonfiduciary capacity by *any* party, which could include an adverse party. On the other hand, the regulations are to the contrary, and they actually make sense. The regulations say the power must be

⁵⁰ This doesn’t apply if a loan with adequate interest and security is made by a trustee who is not the grantor or a related or subordinate party.

⁵¹ Risky, in my opinion, in the elder law context.

⁵² Thanks to TrustChimp Trust Summit alum and Pennsylvania elder law attorney Henry Levandowski for the heads up. I didn’t ask who this person was and Henry didn’t offer. I do not want to unnecessarily embarrass anyone.

exercised by any *nonadverse* party.⁵³ The “any party” approach runs counter to every other provision of the grantor trust rules, and I cannot help but wonder if the statutory discrepancy was an ancient legislative drafting oversight.⁵⁴

CAUTION: One potential line of attack that could be used by a regulator attempting to assert that trust assets are available for Medicaid purposes due to the retention of a power of substitution has surfaced in Colorado. Colorado Medicaid regulations provide that “If there are any circumstances under which payments from the trust could be made to or for the benefit of the individual . . . the portion of the corpus of the trust . . . from which payment to the individual could be made shall be considered as resources available to the individual.”⁵⁵ Apparently the Colorado Medicaid office interprets the provision to provide that if a trust contains either a power of substitution or a right to borrow assets without adequate security the assets will be deemed available. Further, if the trust is amended to remove the power, the “fix” date will be treated as “the date on which payment to the individual from the trust was foreclosed” with respect to assessing a transfer sanction.⁵⁶ Given that this is a power of “equal substitution” it is difficult to see how such a retained power is anything but the ability to enter into a fair market exchange (nonsanctionable).

Nevertheless, concerns over a “Colorado-like attack” could be avoided by simply vesting a power of substitution in some nonadverse party willing to lend her name to the cause.

Admittedly the section refers to “*reacquired*” and a grantor is the only person capable of “*reacquiring*” an asset, but the section also refers (applying generally to all “administrative powers”) to the power existing in the grantor or any nonadverse party (there is no limitation with respect to this power). In a closely analogous setting, the IRS published model charitable lead trust language in 2007.⁵⁷ Section 7 of the ruling provides model language for a grantor lead trust, and in model trust section 11 the IRS chose to structure the trust by giving a nonadverse party the power of substitution

⁵³ Treas. Reg. § 1.675-1(b)(4).

⁵⁴ See, also, Jonathan G. Blattmachr, *Income Taxation of Estates and Trusts*, § 4:5.3F at 4-87 (2011). Blattmachr notes that the regulation, in this case, would likely be enforced over the statute under the “broad deference” standard annunciated in *Chevron U.S.A., Inc. v. Natural Res. Def. Council, Inc.*, 467 U.S. 837 (1984).

⁵⁵ 10 Colo. Code Regs. § 2505-8.110.52.B.4.

⁵⁶ *Id.* § B.4.a.4.

⁵⁷ Rev. Proc. 2007-45.

under IRC § 675(4). The annotations to the model explain the use and specify that the exercise must be in a nonfiduciary capacity.⁵⁸ The following paragraph even explains that the drafter is free to choose some other power under the grantor trust rules if the power of substitution does not fit client needs.⁵⁹

VII. IRC § 676 Power to Revoke

If a grantor (or grantor's spouse) or any other nonadverse person retains the power to revest the title to the trust assets in the grantor, then the grantor shall be treated as the owner of such portion, even though no other provisions of IRC §§ 671-678 apply. Obviously, in the context of Medicaid and SSI this is not an attractive option.

VIII. IRC § 677 Retained Income Rights

A. Current Payment or Current Accumulation

A grantor is taxable as the owner of any trust or trust portion as to which she, or any nonadverse person (or both), has the ability to distribute, or accumulate for distribution, the trust income to the grantor or the grantor's spouse without the consent or approval of an adverse person.

The regulations clarify that a grantor who retains an income interest only is treated as owner of only ordinary income items, and not owner of any trust property properly allocable to principal.⁶⁰

B. Care With Portions

IMPORTANT: Do not reserve a simple income interest and expect grantor trust treatment with respect to both income and principal. For example, as noted above at II.C.2, a grantor who retains an income interest (and no other interest under the grantor trust rules that would treat him as owner of principal) and transfers a principal residence to the trust will not be able to obtain an exclusion from capital gains upon sale of the residence under IRC § 121.

A trust may trigger grantor trust status with respect to income if the grantor or a nonadverse party (without the approval of an adverse party) directs, or may direct, any of the following to occur:

⁵⁸ *Id.* § 8.09(1).

⁵⁹ *Id.* § 8.09(2).

⁶⁰ Treas. Reg. § 1.677(a)-1(g) (ex. 1).

1. Actual or constructive distribution of income to the grantor or the grantor's spouse (THIS IS THE CLASSIC INCOME ONLY TRUST!);
2. Accumulation of income for future distribution to the grantor or the grantor's spouse;
3. Application of income to payment of premiums on policies of insurance on the life of the grantor or the grantor's spouse (other than certain policies payable to charitable beneficiaries) (*this could be interesting in certain circumstances*).

Careful: There must be life insurance policies in existence and with respect to which it is possible for the trustee to pay the premiums. The power will not suffice if it is the mere statement of a power in the trust agreement and there are no such policies.⁶¹

4. Notwithstanding (1) or (2), above, a grantor will not be taxed on trust income simply because income *could* be used to discharge the grantor's or her spouse's legal obligation of support actual application or distribution of income to discharge the grantor's or her spouse's legal obligation of support; however, when income *is so applied*, the grantor will be taxable.

IX. IRC § 678 Person Other Than Grantor Treated As Owner

A. Overview

This section is the only grantor trust provision under which a person other than the grantor or a transferor to the trust could be the deemed owner of all or a portion of the trust for tax purposes. Note that each of IRC §§ 673 through 677 begin “The grantor shall be treated . . .” and IRC § 678(a) commences with “[a] person other than the grantor shall . . .”).

IRC § 678 is poorly drafted and is the source of confusion. From the face of the statute, it appears that a person with “power exercisable solely by himself to vest the corpus or the income therefrom in himself” will be the deemed tax owner.⁶²

B. An Ambiguous Exception

However, IRC § 678(b) applies an exception:

Subsection (a) shall not apply with respect to a power over income, as originally granted or thereafter modified, if the grantor of the trust or a transferor (to whom section 679 applies) is otherwise treated as the owner under the provisions of this subpart other than this section.

⁶¹ With respect to any tax year the policies must be in existence and the trust must be capable of applying funds toward the payment of premiums. Iverson, Lorenz, 3 TC 756, 774 (1944); Weil, Joseph, 3 TC 579, 584 (1944).

⁶² IRC § 678(a)(1).

In other words, is this statute to be read that if the grantor and the other person are both treated as the owner of trust *income*, the rules of IRC §§ 674 through 677 trump application of IRC § 678(a) to the third party? For example, if grantor has retained an income interest IRC § 678(a) might not apply . . . or so it seems. On the other hand, a third person with power of corpus would, in fact, be treated as tax owner notwithstanding that grantor also has powers over corpus because IRC 678(b) would not apply . . . or so it seems. The statute actually is “something else.”⁶³

C. If It’s A Grantor Trust For Grantor . . . Move On.

The apparently correct reading of the section should be that if the grantor has retained any power over corpus *or* income under IRC §§ 674 through 677, the power will trump application of IRC § 678(a) to the third party. The key to answering the riddle is in the definition of “income.”

In the context of IRC § 678, “income” likely refers to “taxable income” as opposed to “trust accounting income.” The former includes both income allocable to corpus (*i.e.*, gains on sale or exchange of capital assets) and to trust accounting income (*i.e.*, ordinary income); the latter includes ordinary income.

1. Treas. Reg. § 1.671-2(b) specifies that for purposes of the grantor trust rules the term “income” refers to income for tax purposes and not trust accounting purposes and that if trust accounting income is being referenced the term “ordinary income” would be used. IRC § 678(b) uses the unmodified term “income” which refers to taxable income pursuant to the regulation. Accordingly, if a grantor and a third person are both deemed the owner of income allocable to either corpus or accounting income, then under IC § 678(b) the grantor would be treated as the owner (*i.e.*, IRC §§ 674 through 677 trump IRC § 678(a)).
2. IRC § 643(b) specifies that the term “income” refers to “income of the estate or trust for the taxable year determined under the terms of the governing instrument and applicable local law” (*i.e.*, trust accounting income) for the purposes of Subparts B, C, and D of Part I of Subchapter J. The grantor trust rules are in Subpart E, clearly omitted from the IRC § 643(b) reference. Combined with the reference under Treas.

⁶³ IRC § 678 reminds me of the motto of the State of North Carolina: *Esse quam videri* (“To be, rather than to seem”). The motto is a literal translation of a phrase from a sentence in Cicero's *On Friendship* (De Amicitia, chapter 26). The complete sentence in Latin is: *Virtute enim ipsa non tam multi praediti esse quam videri volunt*, which means something along the lines of “Fewer persons actually possess virtue than those who would seem to possess it.” I still believe it could apply to IRC § 678, but I digress.

Reg. § 1.671-2(b) discussed above, the meaning of “income” under IRC § 678(b) takes on some clarity.

Particularly in the context of veterans’ benefits planning, designing a trust to avoid application of the grantor trust rules to the grantor may be a sound strategy if a goal is to avoid trust tax attributes appearing on the grantor’s tax return. In connection with that strategy many may want to provide access to trust assets by allowing the trustee or some other person to make distributions to one or more individuals in a class of individuals.⁶⁴

Care should be taken to avoid application of IRC § 678(a) to an individual with the sole authority to order distributions to a class that includes herself. For example, a trust granting a trustee the authority to make distributions to descendants of the grantor “within the sole discretion of the trustee” will trigger application of the grantor trust rules to the trustee if the trustee is a descendant of the grantor. There are two ways to address the issue.

1. Perhaps the easiest method is to subject the decision-maker’s authority to the approval of another person, perhaps a sibling or some other trust beneficiary.⁶⁵ This approach not only avoids IRC § 678(a) issues, but may provide an added layer of security to trust assets by fettering an otherwise broad power residing in a single individual.
2. A second approach is to subject the decision-maker’s authority to an ascertainable or “health, education, maintenance and support” standard.

Crummey powers and inter vivos powers of appointment could also trigger this section with respect to a trust if the grantor has not retained powers under IRC §§ 673-677 that would cause grantor trust status with respect to the grantor (even if the beneficiary is unable to exercise the Crummey power due to minority or disability).⁶⁶

⁶⁴ As an aside (and a bit of drafting advice), if you wish to give a trustee who is also a beneficiary the power to make distributions that could involve distributions to the trustee/beneficiary you should check your state’s trust code to determine whether it includes a provision similar to Uniform Trust Code § 814(b). That section provides that a trustee/beneficiary (who is not the settlor) may not make a distribution to herself unless the trust agreement expressly opts out of the rule with a specific reference to the rule.

⁶⁵ Example: “The Trustee may elect within her sole discretion to make distributions of principal or income to any of grantor’s descendants subject to the advance written approval of a proposed distribution or distributions by one of grantor’s descendants not then serving as Trustee.”

⁶⁶ See, e.g., Rev. Rul. 81-6, 1981-1 C.B. 385. If you enjoy self-testing, go through the ruling and determine why the trust in question was *not* a grantor trust with respect to parent. The Service does not tell the reader that (which would have made the ruling much clearer). Or you can take my word for it.

X. Estate Inclusion for Stepped-up Basis

A. Overview

Most elder and special needs clients do not have issues with the federal estate tax inasmuch as they rarely have estates in excess of the estate and gift tax credit amount of \$15 million (2026 individual) or \$30 million (2026 couple).⁶⁷ Nevertheless, estate tax issues are important because the law in that area ties directly to the treatment of basis in the hands of various beneficiaries upon the death of the client.

As will be discussed in detail below, if stepped-up basis in various trust assets is an important planning goal, it is essential that the trust assets be includible in the grantor's gross estate as determined for estate tax purposes under the estate tax rules of the Internal Revenue Code (never mind that there may likely not be any issue with respect to whether any estate tax will be due). In a much-ballyhooed 2023 revenue ruling, the Service confirmed this position (which did not cause me much angst as it reiterated what I have always believed to be the case).⁶⁸

B. Basis Issues

1. Transferred Basis

Generally, transfers by gift result in Donee's basis being the same as the basis "in the hands of the donor."⁶⁹ Similarly, basis in property acquired by a transfer in trust (whether held by the trustee or later by a beneficiary) is "as it would be in the hands of the grantor . . ."⁷⁰

2. Stepped-up Basis

Notwithstanding IRC § 1015, however, IRC § 1014(a)(1) provides that "basis in the hands of a person acquiring the property from a decedent" shall be "the fair market value of the property at the date of the decedent's death." These are the so-called "stepped up basis" rules. If a grantor makes a gratuitous transfer to trust, upon the death of the grantor basis will be determined under either Code section 1015 (a transfer basis) or Code section 1014 (a stepped up basis).

⁶⁷ One Big Beautiful Bill Act of 2017, § 70106, Pub. L. No. 119-21, amending IRC § 2010(c)(3).

⁶⁸ Rev. Rul. 2023-2

⁶⁹ IRC § 1015(a).

⁷⁰ *Id.* § 1015(b).

Obviously, if stepped up basis is an important goal, compliance with Code section 1014 is necessary. In fact, as will be seen, the retention by the grantor of all the trust's income will result in gross estate inclusion under Code section 2036(a)(1) and, pursuant to Code section 1014(b)(9), result in stepped-up basis upon the grantor's death. That would be the end of the basis question. **The question becomes a bit more complex, however, if an income interest is not retained.**

Why? The estate tax inclusion rules of IRC §§ 2031 through 2046 and the grantor trust rules of IRC §§ 671 through 678 have considerable, **but not complete**, overlap. A grantor trust could very well be includible in a gross estate because one of the grantor trust "triggers" included in the trust agreement also triggers estate inclusion.⁷¹ But it isn't guaranteed.

C. Estate Inclusion

The gross estate rules are codified as Part III of Subchapter A of Chapter 11 of Subtitle B of the Internal revenue Code. In Plain English that refers to IRC §§ 2031 through 2046. Rather than provide a complete tutorial on estate inclusion rules, this outline touches on the most relevant and likely provisions affecting grantor trusts in the elder law or special needs law context.

As a preliminary matter, be aware that the following sections overlap in many cases; assets may be brought in to an estate under more than one section.⁷²

Also, unlike the grantor trust rules, if the grantor/decedent has not *retained* a power (which may or may not be exercised alone or in conjunction with others), the estate inclusion rules are not implicated. This is different from the grantor trust rules in which grantor may completely and irrevocably delegate a power to a nonadverse party.

1. IRC § 2036

IRC § 2036(a)(1) includes in an estate the value of property with respect to which the decedent "made a transfer" and retained an income interest or a life time right of possession or enjoyment. Note carefully that IRC § 2036(a)(2) also includes property with respect to which the decedent retained a right "*either alone or in conjunction with*

⁷¹ Or vice versa. *See, e.g.*, the denial of estate inclusion simply because a grantor trust contained a power of substitution under IRC § 675 (which does not trigger estate inclusion). CCA 200937028 (Nov. 18, 2008, released Sep. 11, 2009).

⁷² Think "and" . . . not "either-or."

any other person, to designate the persons who shall possess or enjoy the property or income therefrom.”

IRC § 2036 is analogous, to a great degree, with a number of grantor trust provisions. For example, IRC § 677 applies to an income interest retained by the grantor. IRC § 674 applies, in part, to the grantor’s right to designate who will receive the benefits of trust income. As with most grantor trust provisions, however, the grantor’s power must be exercised by the grantor or a nonadverse party and without the approval or consent of an adverse party.

IRC § 2036, and its interplay with the grantor trust provisions, offers an interesting planning opportunity: the power may be subject to the cooperation of “any person.” The regulations clarify that the other person may be an adverse party and that the capacity of the other person is immaterial (*e.g.*, the person could be the trustee).⁷³ If the other person is an adverse party, it should be possible to guarantee gross estate inclusion for basis purposes and avoid grantor trust status if that is a desirable objective (*e.g.*, perhaps for VA benefits planning purposes).

2. IRC § 2037

IRC § 2037 includes property transferred to trust over which the grantor retained a reversionary right the value of which exceeds 5% of the value of the property determined as of the date of death. The provision probably should not merit serious consideration in the elder and special needs law context because such a reversionary interest would raise significant Medicaid issues regarding the countability of trust assets.

3. IRC § 2038

IRC § 2038 is important and somewhat similar to IRC § 2036 (there is much overlap between the two sections). That provision includes in a grantor’s estate the value of property transferred to trust by the grantor if the property remains subject to a retained right “to alter, amend, revoke, or terminate” the ultimate enjoyment thereof. As with IRC § 2036(a)(1), this right may be in the grantor alone, or exercised “*in conjunction with any other person.*”

IRC § 2038 is analogous to IRC § 674. As discussed above, however, under IRC § 674 the grantor’s power must be exercised by the grantor or a nonadverse party and without the approval or consent of an adverse party.

⁷³ Treas. Reg. § 20.2036-1(b)(3).

Under IRC § 2038, estate inclusion will extend to powers retained during the decedent's life as well as to powers exercisable only upon death. A testamentary power of appointment will cause estate inclusion under IRC § 2038;⁷⁴ and it may or may not create a grantor trust under IRC § 674 (depending upon whether accumulated income is subject to testamentary disposition).

One miscellaneous note with respect to swap powers: A swap power or power of substitution (creating a grantor trust under IRC § 675) generally will not cause the inclusion of assets in an estate. After years of back and forth argumentation from commentators and Service general counsel memoranda, the Service recently clarified that a trust will not be includible in the grantor's taxable estate simply by virtue of being a grantor trust.⁷⁵ If stepped-up basis is the goal, be absolutely sure that the trust is includible in the grantor's gross estate under the inclusion rules. There is a large overlap between the grantor trust rules and the estate inclusion rules, but it is not a complete overlap.

4. IRC § 2041

IRC § 2041(a)(2) includes in an estate property transferred to trust which remains subject to a general power of appointment in the decedent. The decedent's right to exercise the power can be subject to exercise in conjunction with another person as long as that other person is a nonadverse party with respect to the property.⁷⁶

This power is a bit different from, say, IRC §§ 2036 and 2038 (which apply to property with respect to which the grantor had "at any time made a transfer") in that there is no requirement that the grantor has *retained* any power; a IRC § 2041 power can be conferred (in other words, there is no requirement that the grantor must have once owned the property in trust and conveyed it to the trust). **On the other hand, be very careful of general powers of appointment.** Pursuant to Section 501 of the Uniform Powers of Appointment Act, property subject to a general power created by the power holder would likely subject the property to the claims of the powerholder's creditors. Under Section 502, a general power given to another could subject property to that powerholder's creditors if the powerholder actually exercises the power.

⁷⁴ Marshall v. United States, 338 F. Supp. 1321 (D. Md. 1971); Priv. Ltr. Rul. 9437034.

⁷⁵ Rev. Rul. 2023-2.

⁷⁶ IRC § 2041(b)(1)(C)(ii).

GRANTOR TRUST CHEAT SHEET

673	Reversionary interest = 5% or more; Maximum trustee discretion assumed
674	
(b)(1)	Provision allowing income to legal support obligation OK; Actually do it – grantor trust
(b)(2)	Postponed power as long as less than 5%
(b)(3)	Testamentary power unless income accumulation
(b)(4)	Allocate among charitable beneficiaries
(b)(5)(A)*	Distribute <u>corpus</u> among beneficiaries if subject to reasonably definite standard
(b)(5)(B)*	Distribute <u>corpus</u> to income beneficiaries as long as chargeable to donee share
(b)(6)*	Power to distribute or accumulate <u>income</u> to any income beneficiary as long as: • Ultimately payable to THAT beneficiary or his assignees or estate, OR • Added to corpus and distributed to current income beneficiaries in irrevocably specified shares on termination
(b)(7)*	Withhold income during incapacity
(b)(8)	Reasonable allocations between principal and income
(c)*	Independent trustees can accumulate, distribute corpus or income among beneficiaries or class of beneficiaries
(d)*	Trustee (other than grantor or spouse) can accumulate/distribute income among beneficiaries if subject to reasonably definite standard
675	Admin Powers: Bargain dealing, great loans for grantor or nonadverse; grantor borrows and fails to repay before years end (unless trustee Independent); Power of Substitution
676	Power of revocation in grantor or nonadverse party
677	Income distributed or accumulated for grantor or grantor's spouse
678	Someone other than grantor

* No one may have the power to add to a beneficiary or class unless for after-born/after-adopted



GRANTOR TRUSTS OVERVIEW

BOB MASON, CELA, CAP,
ACTEC Fellow

www.masonlawpc.com

1

RELAX!

You're here for
an overview.

2

Grantor Trusts

- An exception to the rule
- Treated as the grantor's tax alter ego, in whole or in part

3

Results of Grantor Trust Status . . .

It's All Yours, Man . . .

Or at least part . . .

4

Why That MIGHT Be Good!

- Grantor (Mom? Dad?) Might Well Be at Lower Tax Bracket
- Preservation of IRC § 121 Exclusion
- Transfers of Nonqualified Annuities

5

How To Make a Grantor Trust

In a Nutshell . . .

Grantor (or Often a "Nonadverse Party") without an Adverse Party-Crasher

Retains Some Benefit or Control

Over ALL or SOME of the Trust Assets

6

Who Is The Grantor?

7

Who is ADVERSE?
Who is NONadverse?

Look at Attachment A

8

**IRC § 672 –
ADVERSE PARTY**



9

IRC § 672 - NONADVERSE



Well . . . I don't really
have any skin in that
game . . . But I DO
owe Grandma
Grantor, and my
cousins are slackers . .

10

IRC § 672 – NONADVERSE . . . AND INDEPENDENT



I'd do anything for
Aunt Greta
Grantor.

I'm a banker.
As long as the
Trust pays, I'm
OK.



Neither a parent, issue, sibling,
or corporate employee of grantor

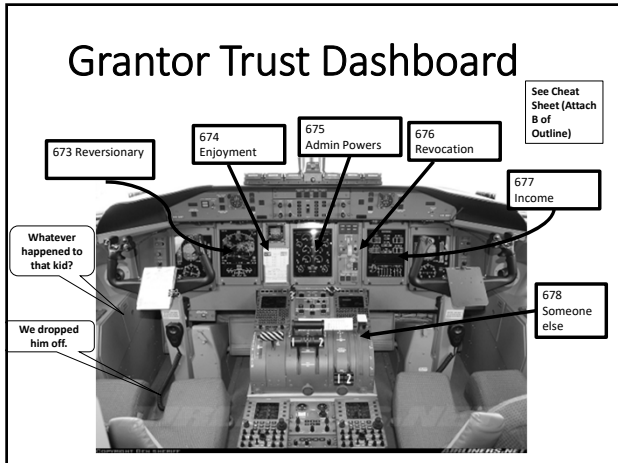
11

IRC § 671

"PORTION"
CONTROL



12



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The Grantor Trust Dashboard:

- **IRC § 673 Reversionary Interest**
 - Assume Trustee Will Exercise Max Discretion
 - D4A Trusts
- **IRC § 674 Affect Beneficial Enjoyment**
 - The Monster
 - Riddled with Exceptions

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The Grantor Trust Dashboard:

- **IRC § 675 Administrative Powers**
 - Home of the Power of Substitution
- **IRC § 676 Power to Revoke**
- **IRC § 677 Income Rights**
 - Distributed to or Accumulated for Later Distribution to

15

The Grantor Trust Dashboard:

- **IRC § 678 Person Other Than Grantor**
 - Watch Out!
 - A Power Exercisable Solely in any Person to Vest Corpus or Income in Self WILL Create Grantor Trust Status in That Person UNLESS
 - It is Already a Grantor Trust
 - So Who Cares?
How About the Trustee/Beneficiary of a Nongrantor Trust?

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The Grantor Trust Dashboard:

- **IRC § 678 Person Other Than Grantor**
 - **UTC § 814(b): A**
nonsettlor/beneficiary/trustee subject to
HEMS only; Cotrustee may act, though
 - Pa. Cons. Stat. § § 7504, 7505: Similar

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ESTATE
INCLUSION

STEPPED-UP
BASIS

18

Insuring Stepped Up Basis

- Stepped Up Basis Rules
- Grantor Trust Automatically Steps Up? (NOPE!)
- Inclusion in Gross Estate (Rev. Rul. 2023-2) (YEP!)

19

Gross Estate Inclusion – Two Main Rules

- IRC § 2036(a)(1)
 - Retained an Interest
 - A Retained Income Interest Will Trigger
- IRC § 2036(a)(2)
 - Retained Right, Alone or With ANY Other Person
 - To Designate Possession, Enjoyment, Income

20

Gross Estate Inclusion – Two Main Rules

- IRC § 2038
 - Retained Right to “Alter, amend, revoke, or terminate”
 - Alone or With ANY Other Person
 - A Testamentary Power of Appointment Will Trigger

21

And So . . . ?

Trying to Avoid Grantor Trust Status BUT . . .

Trying to Trigger estate Inclusion, NOTE and COMPARE

Grantor Trust Rules: Adverse Party Crashers
Estate Inclusion Rules: ANY Party

22

You MUST know these rules

- Knowing the tax rules will enable you to counsel your clients as to an existing trust
- You cannot properly design a trust without knowing these rules
- If not, keep your malpractice carrier telephone number handy

23



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October 22, 2025

Unexpected Implications of Trust Modifications and Decanting: What You Need to Know



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Unexpected Implications of Trust Modifications and Decanting: What You Need to Know

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Unexpected Implications of Trust Modifications and Decanting: What You Need to Know

By

Jeffrey M. Gad, Esq and O. Larkin Skinner, Esq.

When asked to explain the difference between a Revocable Trust Agreement and an Irrevocable Trust Agreement, the typical answer is to explain that a Revocable Trust Agreement can be modified or terminated by the Grantor, while an Irrevocable Trust Agreement generally cannot. To further back this up, it is common practice for Irrevocable Trust Agreements to contain provisions enforcing this concept by providing something close to: “The Grantor shall have no right to alter or amend the Trust Agreement in any way...”

Despite this, Florida law provides methods of modifying Irrevocable Trusts in certain circumstances. These materials and the accompanying presentation can be divided into three parts. The first part will summarize the base requirements and use cases for the four primary methods of irrevocable trust modification under Florida law. The second part will highlight and summarize caselaw demonstrating the potential consequences when the modification of any form of irrevocable trust is done improperly. The third part will highlight specific considerations when performing trust modifications to a Supplemental Needs Trust.

I. Uniform Trust Code.

A total of 36 states including Florida, adopted the Uniform Trust Code (UTC) as a model law for trust administration created by the Uniform Law Commission to unify and codify trust laws across the United States.¹ The UTC was designed in part to help standardize rules for trusts and

¹ <https://www.uniformlaws.org/committees/community-home?CommunityKey=193ff839-7955-4846-8f3c-ce74ac23938d>

has been considered a major success, with a majority of states having adopted it in some form.² The UTC generally encompasses a broad range of trust-related matters, including trust modifications, reformations, non-judicial settlements and termination of trusts as part of a consistent model framework. The UTC has also been supplemented by other uniform acts, such as the Uniform Trust Decanting Act and the Uniform Directed Trust Act.

II. The Toolbelt: Methods of Trust Modification Under Florida Law

Florida law generally provides four distinct methods of modifying an irrevocable trust: Judicial Modification, Non-Judicial Modification, Non-Judicial Settlement Agreements, Reformation, and Trust Decanting. In turn, each of these methods has its own distinct challenges and best use cases.

A. Judicial Modification

Judicial Modification of a trust is accomplished by petitioning a court of competent jurisdiction to make the necessary modifications detailed in the petition. If the modification falls within the court's authority at common law or under one of two statutory frameworks, the court generally has the authority to (i) amend specific terms of the trust, including terms governing distributions to beneficiaries or administrative provisions; (ii) terminate the trust in whole or in part; (iii) authorize trustee actions that are either not explicitly authorized or are prohibited under the terms of the trust; or (iv) prohibit the trustee from taking actions that are permitted or required under the terms of the trust.³

In addition to the common law right for courts to modify, amend, terminate, or revoke trusts, Florida law provides two primary statutory mechanisms for judicial modification of a trust.

² *Id.*

³ Fla. Stat. § 736.04113(2)(a)-(d)

First, Fla. Stat. § 736.04113 authorizes courts to modify irrevocable trusts when any one of the following conditions are met: (i) the purposes of the trust have been fulfilled or have become illegal, impossible, wasteful, or impracticable to fulfill; (ii) because of circumstances not anticipated by the grantor, compliance with the terms of the trust would defeat or substantially impair the accomplishment of a material purpose of the trust; or (iii) a material purpose of the trust no longer exists.⁴

Due to its requirements, judicial modifications under 736.04113 focus on circumstances where modification is necessary to better align the trust's administration with the Grantor's original intentions or to adapt to unforeseen circumstances that may significantly trust's original purpose. Courts may consider situations where the objectives of the trust have already been substantially achieved, rendering ongoing administration wasteful or impractical, or where compliance with the strict terms of the trust has become impracticable due to changes in circumstances. These changes could include economic developments, legal shifts, altered family dynamics, or other unforeseen factors that make strict adherence to the trust terms detrimental to the trust or its beneficiaries. In such scenarios, modification may rectify inefficiencies, such as reducing administrative costs or eliminating redundancies associated with fulfilling terms that no longer serve the trust's material purpose. Additionally, the court may evaluate whether trust assets are being utilized to their full potential or if the trust's provisions inadvertently result in excessive expenditures or depletion of resources over time. By exercising this authority, the court seeks to ensure that the trust operates in a manner that honors the grantor's objectives while responding to practical realities faced by beneficiaries.

⁴ Fla. Stat. § 736.04113(1)(a)-(c)

By contrast, Fla. Stat. § 736.04115 provides a broader authority by authorizing courts to modify a trust if the terms of the trust are no longer in the best interests of the beneficiaries.⁵ This method is particularly suited for cases where the continuation of a trust’s original terms no longer adequately serve the financial, personal, or developmental needs of its beneficiaries or where changes in circumstances create imbalances in its application. Courts applying this statute aim to ensure that the trust functions effectively in light of present realities, placing the welfare of the beneficiaries at the forefront of their analysis.

It should be noted that Florida law on this topic is somewhat more detailed than some other states. Many states have adopted statutes that are significantly closer to the Uniform Trust Code, providing that “[t]he court may modify the administrative or dispositive terms of a trust or terminate the trust if, because of circumstances not anticipated by the settlor, modification or termination will further the purposes of the trust.”⁶ Similar to Florida law, these statutes also include an instruction that any such modification must be made in accordance with the Grantor’s testamentary purposes in creating the trust.⁷

While this statutory authority is broad, the court must still examine the underlying purposes of the trust and seek to align any modifications with those purposes. This process may include adjusting terms related to the timing or amount of distributions, administration guidelines, or other provisions that affect how the trust operates in practice. In doing so, the court aims to adapt the trust to better achieve its intended objectives while eliminating inefficiencies or inequities that have emerged over time.

⁵ Fla. Stat. § 736.04115(1)

⁶ S.C. Code § 62-7-412(a); *see also*, N.C. Gen. Stat. § 36C-4-412(a); UNIF. TRUST CODE § 412 (UNIF. LAW COMM’N 2023)

⁷ *Id.*

Petitions under this section can be an important tool for addressing situations where the trust's terms create preventable hardships or fail to adapt to evolving conditions, such as economic changes, family dynamics, or the specific needs of individual beneficiaries. By focusing on the best interests of the beneficiaries, this statute ensures that the trust remains relevant, efficient, and equitable, reflecting both the original goals of the grantor and the present-day realities faced by those the trust is designed to benefit.

It is additionally important to note that Florida law additionally preserves the court's authority under common law to modify trusts.⁸ Under Florida common law, courts must allow modifications when the Grantor and all beneficiaries under the trust consent to the modification, regardless of whether the trust is irrevocable or if the trust's purposes are still relevant and active.⁹ As this indicates, common law trust modifications require the grantor to be alive and requires that the Grantor and the beneficiaries of the trust to not be incapacitated, such that they can consent to a modification.¹⁰

This mechanism provides a flexible solution for such cases. By emphasizing consensus and mutual agreement among all interested parties to the trust, this common law rule serves as a valuable alternative in cases where statutory conditions for modification or termination cannot be satisfied.

Despite the flexibility and authority of judicial modifications, this method also has drawbacks, including the costs and hassle associated with opening a court proceeding in order to request modification, and the possibility that a probate judge will not agree with the requested

⁸ Fla. Stat. § 736.04113(4); Fla. Stat. 736.04115(5)

⁹ Peck v. Peck, 133 So. 3d 587 (Fla. 2d DCA 2014)

¹⁰ Randall v. Randall, 60 F. Supp. 308 (S.D. Fla. 1944)

modifications even if the necessary statutory requirements are met. In such circumstances one should consider one of the alternative methods that do not require court involvement.

B. Non-Judicial Modification

The next option afforded by Florida law is Non-Judicial Modification under Fla. Stat. § 736.0412. This section allows for irrevocable trusts to be modified by unanimous agreement of the trustee of the trust and all of the qualified beneficiaries of the trust.¹¹ For reference, under the Florida Trust Code, a “qualified beneficiary” means any living beneficiary who is eligible to receive distributions from a trust, would be eligible if the interests of a current beneficiary terminated, or would be eligible to receive distributions if the trust terminated.¹² This definition essentially extends to all current beneficiaries and all living remainder beneficiaries of a trust.

The binding nature of a Non-Judicial Modification extends to beneficiaries whose interests are adequately represented under Fla. Stat. §§736.0301-736.0306 by another person who has consented to the modification. This includes situations where beneficiaries are either minors, incapacitated, unborn or unascertainable, and their interests are adequately represented by someone who has no conflict of interest regarding the trust modification.¹³

While the 736.0412 does not contain limitations on modification authority related to the purposes of the trust, as is the case for Judicial Modification, there are several timing and administrative limitations imposed by the statute. First, Non-Judicial Modification cannot occur while the Grantor of the trust is still alive.¹⁴ Additionally, the statute does not apply to any trust created prior to January 1, 2001, or to certain trusts created after December 31, 2000, that must

¹¹ Fla. Stat. § 736.0412(1); *see also*, UNIF. TRUST CODE § 411 (UNIF. LAW COMM’N 2023)

¹² Fla. Stat. § 736.0103(19)

¹³ *See* Fla. Stat. § 736.0304

¹⁴ Fla. Stat. § 736.0412(1) (Stating that such modifications must occur “[A]fter the settlor’s death...”)

vest or terminate within the period prescribed by the rule against perpetuities, unless the terms of the trust expressly authorize Non-Judicial Modification.¹⁵ Finally, the statute does not apply to any trust for which a charitable deduction is allowed under the Internal Revenue Code until the termination of all charitable interests in the trust.¹⁶

It is important to note that the authorization of Non-Judicial Modifications under Florida law may represent a deviation from the Uniform Trust Code, and it does not have a close equivalent in the Uniform Trust Code.

C. Non-Judicial Settlement Agreements

The third option afforded under Florida law is for the interested persons of an irrevocable trust (typically consisting of the Trustee(s) and/or qualified beneficiaries) to enter into a binding non-judicial settlement agreement under Fla. Stat. § 736.0111. Generally, interested persons may enter into these agreements with respect to any matter involving the trust. However, such agreements are subject to important limitations. A nonjudicial settlement agreement is valid only to the extent the terms and conditions could be properly approved by the court.¹⁷ Additionally, a nonjudicial settlement agreement may not produce a result not authorized by other provisions of the Florida Trust Code, including terminating or modifying a trust in an impermissible manner.¹⁸ Examples of matters that can be resolved through a nonjudicial settlement agreement include interpreting or construing trust terms, appointing or resigning trustees, and determining trustee compensation.¹⁹

¹⁵ Fla. Stat. § 736.0412(4)

¹⁶ Fla. Stat. § 736.0412(4)(c)

¹⁷ Fla. Stat. § 736.0111(3); *see*, S.C. Code § 62-7-111(c); N.C. Gen. Stat. § 36C-1-111(c); *see also* UNIF. TRUST CODE § 111(c) (UNIF. LAW COMM'N 2023)

¹⁸ *Id.*

¹⁹ Fla. Stat. § 736.0111(4); *see also* UNIF. TRUST CODE § 111(d) (UNIF. LAW COMM'N 2023)

Unlike Non-Judicial *Modifications*, Non-Judicial *Settlement Agreements* can address a much broader scope of trust-related matters beyond mere amendments to trust terms. Additionally, Sec. 736.0111 does not include limitations contained in Sec. 736.0412 related to trusts created before 2001. Moreover, Non-Judicial Settlement Agreements can be entered into regardless of whether the Grantor is still living.

Despite their broader scope, Non-Judicial Settlement Agreements typically cannot change actual terms of a trust. While some flexibility can be found in the authorization to interpret and construe the terms of a trust, it is important to keep in mind that this does not entail actually rewriting the terms of the trust. Instead, the interested persons can utilize these agreements to construe or clarify terms of a trust that may be ambiguous.

D. Reformation

Fla. Stat. § 736.0415 permits courts to reform trust to cure mistakes within the terms of the trust. Like a Judicial Modification, the process of reformation begins with a petition to the court, which may be filed by the Grantor or by any interested person. The petitioner must present evidence showing by clear and convincing evidence that both the settlor's intent and the trust's written terms were negatively affected by a mistake.²⁰ Such mistakes can arise from misunderstandings, incorrect assumptions, or clerical errors that result in provisions contrary to the Grantor's wishes. Importantly, the statute recognizes mistakes in both expression - such as drafting or typographical errors – and inducement, where factual or legal misjudgments underpinned the creation of the trust terms, and reformation may be employed to cure scrivener's

²⁰ Fla. Stat. § 736.0415; *see also*, UNIF. TRUST CODE § 415 (UNIF. LAW COMM'N 2023)

errors within the trust agreement.²¹ One additional potential use of Judicial Reformation of a trust is as a curative measure when a trust has been modified improperly.²²

It is important to note that Florida law permits reformation of trusts even after the Grantor's death under certain circumstances. For example, a trust with testamentary aspects may be reformed after the death of the Grantor for a unilateral drafting mistake so long as the reformation is not contrary to the interest of the Grantor.²³

While this approach can work for fixing clear errors in the drafting of the trust agreement. It cannot be used as a justification for the modification of trust terms to account for changes in circumstance such as significant changes in the financial circumstances of the Grantor between the time when the trust was executed and the time of the Grantor's death.²⁴ For such circumstances, a different method, such as Judicial Modification would be necessary.

E. Trust Decanting

Finally, Fla. Stat. § 736.04117 authorizes an authorized Trustee to decant the trust by appointing all or part of the principal to the trustee of a new trust.²⁵ Under the statute, the authorized trustee who has the authority to decant the trust must not be the Grantor or a beneficiary under the original trust, and must have the power to invade the principal of the original trust.²⁶

²¹ Reid v. Temple of Judea, 994 So. 2d 1146, at 1150 (Fla. 3d DCA 2008) (quoting Fla. S. Comm. On Banking & Ins., CS for SB 1170 (2006) Staff Analysis 20 (March 21, 2006))

²² See Berger v. United States, 487 F. Supp. 49 (W.D. Pa. 1980)

²³ See Megiel-Rollo v. Megiel, 162 So. 3d 1088 (Fla. 2d DCA 2015)

²⁴ Morey v. Everbank, 93 So. 3d 482, at 491 (Fla. 1st DCA 2012)

²⁵ Fla. Stat. § 736.04117(2)(a); see also, UNIF. TRUST DECANTING ACT § 11 (UNIF. LAW COMM'N 2015)

²⁶ *Id.*

Another important restriction on decanting is that the beneficiaries of the new trust must include only beneficiaries of the original trust.²⁷ Additionally, the new trust cannot reduce any beneficiaries vested interest in the trust property from the original trust.²⁸

Procedurally, the Florida statutes mandate strict requirements when decanting a trust. Trustees must provide written notice to all qualified beneficiaries, the Grantor in certain situations, any other Trustees, and any individual with the power to remove or replace the authorized Trustee of the original trust at least 60 days before exercising to power to decant.²⁹ The Trustee must also provide copies both of the original trust instrument, as well as the proposed instrument for the replacement trust.³⁰ The beneficiaries have the opportunity to waive the notice period.³¹ Otherwise, the beneficiaries have the opportunity to object to the decanting during the 60 day notice period. If no objections are made, and the authorized Trustee complies with the other statutory requirements, the decanting process may proceed.

While Florida law provides significant flexibility, it also allows the terms of the trust agreement to expressly prohibit decanting.³² If the original trust document explicitly states that decanting is forbidden, the trustee must abide by this provision and cannot exercise powers to transfer assets to the new trust. Such prohibitions serve as Grantor-imposed limits on trustee authority and must be strictly observed. Where no such prohibition exists, trustees may proceed with decanting provided that the decanting meets the statutory requirements outlined above.

²⁷ *Id.*

²⁸ *Id.*

²⁹ Fla. Stat § 736.04117(8)(a); *see also* UNIF. TRUST DECANTING ACT § 11(c) (UNIF. LAW COMM'N 2015)

³⁰ Fla. Stat § 736.04117(8)(b); *see also* UNIF. TRUST DECANTING ACT § 11(e) (UNIF. LAW COMM'N 2015)

³¹ Fla. Stat § 736.04117(8)(c)

³² Fla. Stat. § 736.04117(2)(a)

III. Consequences of Improper Modification of Trusts

When utilizing any of the forms of trust modification outlined above, one must always start by determining the Grantor's purposes and intent when the trust was formed. Additionally, an attorney modifying a trust must determine (i) that the modification will not violate any of the statutory requirements associated with the type of modification that will be utilized; and (ii) that the subsequent actions of the interested parties will not result in adverse tax consequences. The most basic consequence of an improper trust modification would be the invalidation of the modification.

A. Harrell v. Badger, and Special Considerations for Special Needs Trusts

The Case of *Harrell v. Badger* is instructive on two fronts: first, as an example of an invalidating trust decanting, and second for its relation to Special Needs Trusts. The story of this case begins when Rita Wilson established a trust under her Last Will and Testament for the sole benefit of her adopted son, David Wilson.³³ Under the terms of the Trust, the Trustee was instructed to pay all of the trust income to David on a monthly basis, and the Trustee was given discretion to make additional payments of the trust principal to David under an ascertainable standard.³⁴ Upon David's death, the remaining trust assets were to be distributed to Rita's daughters.³⁵

At a time after Rita's death, the Trustee of David's Trust attempted to decant the trust into a Special Needs Trust to qualify David for government benefits.³⁶ To accomplish this the Trustee joined David's Trust as a subtrust under a pooled special needs trust entitled the Florida Foundation for Special Needs Trust.³⁷ In accomplishing this change, the Trustee made two errors. First, the Trustee did not provide notice to Rita's daughters, as the remainder beneficiaries, of his intent to

³³ *Harrell v. Badger*, 171 So. 3d 764, at 766 (Fla. Dist. Ct. App. 2015)

³⁴ *Id.*

³⁵ *Id.*

³⁶ *Id.* at 767

³⁷ *Id.*

invade the principal of the trust under Fla. Stat. § 736.04117.³⁸ The second error came from the terms of the decanted trust. Under the decanted trust, provided that, upon David's death, his trust would be dissolved and any remaining assets would be absorbed into the Florida Foundation for Special Needs Trust.³⁹

The court determined that this fact pattern first presented a violation of Fla. Stat. § 736.04117(2)(a), requiring the beneficiaries of the successor trust to include only beneficiaries under the original trust, and a violation of Fla. Stat. § 736.04117(8), requiring notice to be provided to all qualified beneficiaries of the original trust.⁴⁰ As a result of these statutory violations, the Court ordered that the decanting be reversed, and that all remaining assets be returned to the original trust.⁴¹

The *Harrell* case demonstrates the most basic concept that one must actually follow the statutory requirements for a given modification as provided under Florida law. Additionally, it presents a particular warning for practitioners who intend to either decant a non-qualifying trust into a Special Needs Trust or to decant a Special Needs Trust into a non-Special Needs Trust. At its base, this case demonstrates basic consequences stemming from failure to meet the statutory requirements for modification. However, recent federal caselaw further demonstrates that unintended consequences can result, even when a modification is successful and the statutory requirements are met.

IV. Anenberg and McDougall: Tax Considerations Post Modification

³⁸ Harrell, 171 So. 3d at 769

³⁹ *Id.*

⁴⁰ *Id.*

⁴¹ *Id.*

Last year, the United States Tax Court released two opinions involving the termination of marital trusts holding certain terminable interests and the subsequent sale of assets held under marital trusts prior to termination. The two relevant cases, *Estate of Sally J. Anenberg v. Commissioner* and *McDougall v. Commissioner*, have extremely similar fact patterns, but resulted in seemingly different rulings. Consequently, they should be analyzed together to better understand the potential consequences and implications moving forward.

A. QTIP Elections and Gifts Under § 2519

As a preliminary matter, to better understand the results of the *Anenberg* and *McDougal* cases, we must first provide a foundation regarding the laws surrounding Qualified Terminable Interest Property (“QTIP”) trusts and the corresponding tax laws. In general, when the first spouse of a married couple dies, the Internal Revenue Service provides an unlimited marital deduction on gift and estate tax for transfers to the surviving spouse.⁴² It does not necessarily eliminate estate tax liability, but it does operate to defer the potential payment of estate tax until the death of the surviving spouse if estate taxes are owed for that estate. In general, transfers to the surviving spouse must grant the surviving spouse an absolute ownership interest in the assets transferred. This means that so-called “terminable interests,” such as life estates, typically will not qualify for QTIP status.⁴³

However, gifts of terminable interests can still qualify for the marital deduction if they are gifts of “qualified terminable interest property” (“QTIP property”).⁴⁴ In order for such terminable interests to be recognized as QTIP property, they must first be transferred to the spouse in such a

⁴² See IRC § 2523(a) (for the marital deduction from gift tax); and IRC § 2056(a) (for the marital deduction from estate tax)

⁴³ IRC § 2523(b); IRC § 2056(b)(1)

⁴⁴ IRC § 2523(f)(1); IRC § 2056(b)(7)(A)

way that the surviving spouse retains a qualifying income interest for life. Additionally, the decedent spouse's personal representative must make an election on the decedent spouse's estate tax return for the property to be treated as marital QTIP property under Schedule M.⁴⁵

In practice, transfers of QTIP property are typically accomplished by forming a marital trust for the sole benefit of the surviving spouse upon the decedent spouse's death. In order to ensure qualification, the marital trust's terms must provide for mandatory distributions of all trust income to the surviving spouse at least annually. At the surviving spouse's death, the remaining assets of the marital trust will be distributed to the beneficiaries selected by the decedent spouse.

Potential issues arise if the surviving spouse attempts to gift all or part of his or her qualifying income interest to a different beneficiary. In that instance, the tax laws generally provide that any such disposition will not be treated as a disposition of the income interest; but will instead be characterized as a disposition of 100% of the remainder interests in the QTIP property.⁴⁶ With these general rules in mind, we can now revisit the *Anenberg* and *McDougall* cases.

B. Estate of Anenberg v. Commissioner

The essence of this case begins with Alvin and Sally Annenberg, a married couple who owned an oil company, and Alvin's two children from a prior marriage, Steven and Neil.⁴⁷

In 1987 Alvin and Sally formed a revocable trust and funded it with 100% of the shares of the oil company.⁴⁸ Their trust provided for the creation of two marital trusts upon first death, and the terms of the trust gave the Trustee discretion to make a QTIP election with regard to the property held in the marital trusts. The marital trusts provided the surviving spouse with the requisite

⁴⁵ IRC § 2523(f)(2); IRC § 2056(b)(7)(B)(i)

⁴⁶ IRC § 2519

⁴⁷ *Est. of Anenberg v. Commissioner*, 162 T.C. 199, at 202 (2024)

⁴⁸ *Id.* at 203

qualifying income interest for life, and provided that the marital trust property would pass to trusts for the benefit of Alvin's children and descendants.

In 2008, Alvin died, and roughly half of the shares in the oil company passed to the marital trusts for Sally's benefit.⁴⁹ On Alvin's estate tax return, the personal representative of his estate made the requisite QTIP elections, and the marital deduction was applied.⁵⁰

In 2011, Steven, the Trustee of the marital trusts, filed a petition to terminate the marital trusts, and to distribute all of the remaining property to Sally outright. The trust beneficiaries all signed consents to the petition, as required under state law, and the court granted the petition in 2012.⁵¹

Subsequent to the termination of the marital trusts, Sally gifted a portion of the oil company stock that had previously been held under the marital trusts to new trusts established for Alvin's children.⁵² A month later, she sold the remainder of the shares to various trusts established for Alvin's descendants in exchange for promissory notes bearing annual interest at the applicable federal rate.⁵³ Additionally, Sally reported the gifted stock on a timely filed gift tax return, but excluded the sold shares under the position that the promissory notes represented adequate consideration for their sale.⁵⁴ In 2016, Sally died, and the IRS determined that her estate was liable for a gift tax deficiency of over \$9 million resulting from the termination of the marital trusts and the subsequent disposition of the oil company shares, along with an accuracy-related penalty of over \$1.8 million.⁵⁵

⁴⁹ *Id.*

⁵⁰ *Id.*

⁵¹ *Id.* at 204

⁵² *Est. of Annenberg*, 162 T.C. at 204

⁵³ *Id.* at 205

⁵⁴ *Id.*

⁵⁵ *Id.*

In assessing these penalties, the IRS took the position that IRC § 2519 applied either when the marital trusts were terminated or when the subsequent installment sales took place.⁵⁶ However, the Tax Court rejected the IRS's position due to the structure of the transactions. The Court reasoned that, in order for IRC § 2519 to apply and trigger gift tax, the relinquishment of the QTIP property would have to be in favor of someone other than Sally. Thus, because Sally was the beneficiary of the marital trusts, and because all of the property was distributed to Sally when the marital trusts were terminated, no gift tax was triggered.⁵⁷

Next, the Court concluded that IRC § 2519 did not apply to the subsequent installment sales and gifts of the (formerly) marital trust assets. The Court reasoned that, after the termination of the marital trusts, the marital trust property ceased to be QTIP property and Sally became the absolute owner of the property.⁵⁸ In essence, this means that the Court interpreted 2519 to require Sally to transfer the marital trust property to Alvin's children immediately upon the termination of the trust in order to apply. Notably, because the IRS did not make the argument in the *Anenberg* case, the Court did not consider an alternate possibility of whether Alvin's children could be deemed to make a gift to Sally by consenting to the termination of the marital trusts. Instead, this issue would be left for a subsequent case described in further detail below.

C. McDougall v. Commissioner

The facts of the McDougall case are very similar to those discussed in the *Estate of Anenberg*. Cotide McDougall died in 2011, and under her Last Will and Testament, her residuary estate

⁵⁶ *Id.*

⁵⁷ *Est. of Anenberg*, 162 T.C. at 216

⁵⁸ *Id.* at 217-218

passed to a trust for the benefit of her husband, Bruce.⁵⁹ The terms of the residuary trust provided that all income was to be distributed to Bruce annually, and provided for discretionary distributions of principal to Bruce under an ascertainable standard.⁶⁰ Upon the termination of a trust, Cotilde's Will provided that any remaining trust assets were to be distributed to the beneficiary entitled to receive distributions.⁶¹ As was the case in *Estate of Anenberg*, a QTIP election was made on Cotilde's estate tax return.⁶²

By 2016, the trust assets had appreciated significantly, and Bruce and Cotilde's children agreed that the assets would be better utilized outside of the trust.⁶³ To accomplish this, they entered into a non-judicial settlement agreement, providing that the residuary trust would terminate and all remaining trust assets would be distributed to Bruce outright.⁶⁴ On the date of the non-judicial settlement agreement, Bruce sold the assets to trusts for the benefit of the children in exchange for promissory notes.⁶⁵

Interestingly, the parties in *McDougall* took a different approach when filing gift tax returns. Each of Bruce and the children filed gift tax returns, where they each took the position that the termination of the residuary trust did result in a deemed gift by Bruce under 2519. However, they argued that because the children joined in the non-judicial settlement agreement, the children made offsetting gifts of their remainder interests to Bruce.⁶⁶ Because of this, they argued that no taxable gifts resulted from the termination. As was the case in *Estate of Annenberg*, the IRS disputed this

⁵⁹ *McDougall v. Commissioner*, 163 T.C. No.5, at 2-3 (2024)

⁶⁰ *Id.*

⁶¹ *Id.* at 3-4

⁶² *Id.* at 4

⁶³ *Id.*

⁶⁴ *Id.*

⁶⁵ *McDougall*, 163 T.C. No.5, at 5

⁶⁶ *Id.* at 5-6

position and issued notices of deficiency to Bruce and the children.⁶⁷ However, unlike Estate of Annenberg, in this case the Tax Court did find that gift tax liability was triggered.

The difference in these rulings can be boiled down to the fact that the issue was raised in Bruce and the children's gift tax returns as to whether the children made gifts of their remainder interests when they agreed to the termination of the residuary trust. The Court actually maintained its ruling from Estate of Annenberg, concluding that Bruce did not make a gift to the children when the trust was terminated.⁶⁸ This was because Bruce received all of the trust property upon termination. However, the Court then then determined that the children had made taxable gifts by consenting to the termination of the residuary trust in exchange for no consideration.⁶⁹ Because of this, the Court concluded that the children were subject to gift tax under IRC §§ 2501 and 2511.

V. Modification of Supplemental Needs Trusts

Utilization of any of the five trust modification methods outlined above in the context of special needs trusts requires careful consideration of the potential effects such changes could have on the trust's ability to continue to qualify as a special needs trust.

Special Needs Trusts must satisfy specific federal requirements under 42 U.S.C.S. § 1396p(d)(4)(A). These trusts are required: “(1) to benefit a disabled individual who is under 65 years of age; (2) to contain this beneficiary's assets; (3) to have been established for the beneficiary by a parent, grandparent, guardian, or court; and (4) to give the state the amount left in the trust when the beneficiary dies, up to the amount of total medical assistance paid by the state.”⁷⁰

⁶⁷ *Id.* at 8

⁶⁸ *Id.* at 22

⁶⁹ *Id.*

⁷⁰ *Sai Kwan Wong v. Daines*, 582 F. Supp. 2d 475, at 481 (S.D.N.Y. 2008); *see also* 42 U.S.C § 1396p(d)(4)

To this end, special care must be exercised in making modifications to ensure that the trust's qualification as a Special Needs Trust will not be jeopardized. Additionally, one must also ensure that the statutory requirements for the given form of trust modification are strictly followed.

VI. Conclusion

The conclusion one can reach from the statutory rules and case law regarding modifications to irrevocable trusts is that nothing is set in stone... except for stone. When employing any of the statutory tools provided to modify a trust, the practitioner must always keep a firm grounding in the Grantor's purposes in creating the trust. To the extent that a modification is needed to better effectuate that intent, the statutes provide options to accomplish this. However, all of these tools must adhere to appropriate procedural requirements and limitations as set forth in the statutes authorizing their use. Additionally, trust modifications should only be employed after rigorous consideration of the potential tax consequences resulting therefrom.

Unexpected Implications of Trust Modifications and Decanting: What You Need to Know

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Modifying and Revoking the Irrevocable: Nothing is Set in Stone... Except for Stone

ARTICLE XIV Irrevocability

This Trust Agreement shall be irrevocable. The Settlor shall have no right to alter it or amend it in any way and, notwithstanding any other provision hereof, none of the principal and none of the income therefrom shall ever be payable to the Settlor, to the Settlor's estate, or to the creditors of the Settlor's estate, or to discharge any obligation of the Settlor to the Settlor's creditors, to the Settlor's estate or to the creditors of the Settlor's estate. The authorization to distribute income or principal for a beneficiary's support does not include authority to make distributions that would discharge or substitute for any obligation of the Settlor to support the beneficiary. The Settlor intends that no distribution from a trust hereunder shall be deemed to discharge or substitute for the Settlor's obligation to support a beneficiary of a trust hereunder, and the Settlor directs that no distribution shall be made that would have that effect.

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A Brief Note on Different States and the Uniform Trust Code

- The Uniform Law Commission produces a number of proposed Statutes in an effort to standardize laws between states, including the Uniform Trust Code and the Uniform Trust Decanting Act
- As of 2024, 36 states have adopted some portion of these uniform trust laws, including Florida

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Florida's Statutory Toolbelt for Trust Modification

- Judicial Modification



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Florida's Statutory Toolbelt for Trust Modification

- Judicial Modification
- Non-Judicial Modification*



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Florida's Statutory Toolbelt for Trust Modification

- Judicial Modification
- Non-Judicial Modification*
- Non-Judicial Settlement Agreements



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Florida's Statutory Toolbelt for Trust Modification

- Judicial Modification
- Non-Judicial Modification*
- Non-Judicial Settlement Agreements
- Judicial Reformation



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Florida's Statutory Toolbelt for Trust Modification

- Judicial Modification
- Non-Judicial Modification*
- Non-Judicial Settlement Agreements
- Judicial Reformation
- Trust Decanting



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Florida Law: Purposes for Judicial Modification

- Judicial Modification can be Pursued in 2 baseline situations:
 - Modification not inconsistent with Settlor's purpose (Fla. Stat. § 736.04113)



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Florida Law: Purposes for Judicial Modification

- Judicial Modification can be Pursued in 2 baseline situations:
 - Modification not inconsistent with Settlor's purpose (Fla. Stat. § 736.04113)
 - Modification in the best interests of the Beneficiaries (Fla. Stat. § 736.04115)



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736.04113: When It Can be Used

- The purposes of the trust have been fulfilled or have become illegal, impossible, wasteful, or impracticable to fulfill;



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736.04113: When It Can be Used

- The purposes of the trust have been fulfilled or have become illegal, impossible, wasteful, or impracticable to fulfill;
- Because of circumstances not anticipated by the settlor, compliance with the terms of the trust would defeat or substantially impair a material purpose of the trust



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736.04113(1): When It Can be Used

- The purposes of the trust have been fulfilled or have become illegal, impossible, wasteful, or impracticable to fulfill;
- Because of circumstances not anticipated by the settlor, compliance with the terms of the trust would defeat or substantially impair a material purpose of the trust; or
- A material Purpose of the trust no longer exists



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736.04113(2): What can a Judge Do?

- Amend or change the terms of the trust, including terms governing distribution of the trust income or principal or terms governing administration of the trust;



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736.04113(2): What can a Judge Do?

- Amend or change the terms of the trust, including terms governing distribution of the trust income or principal or terms governing administration of the trust;
- Terminate the trust in whole or in part;



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736.04113(2): What can a Judge Do?

- Amend or change the terms of the trust, including terms governing distribution of the trust income or principal or terms governing administration of the trust;
- Terminate the trust in whole or in part;
- Direct or permit the trustee to perform actions (even if those actions are not covered in the agreement or are explicitly prohibited);



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736.04113(2): What can a Judge Do?

- Amend or change the terms of the trust, including terms governing distribution of the trust income or principal or terms governing administration of the trust;
- Terminate the trust in whole or in part;
- Direct or permit the trustee to perform actions (even if those actions are not covered in the agreement or are explicitly prohibited);
- Prohibit the trustee from performing actions that are authorized under the trust agreement



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Interstate Law Interlude

Fla. Stat. § 736.04113(2)

(2) In modifying a trust under this section, a court may:

- (a) Amend or change the terms of the trust, including terms governing distribution of the trust income or principal or terms governing administration of the trust;
- (b) Terminate the trust in whole or in part;
- (c) Direct or permit the trustee to do acts that are not authorized or that are prohibited by the terms of the trust; or
- (d) Prohibit the trustee from performing acts that are permitted or required by the terms of the trust.



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Interstate Law Interlude

Fla. Stat. § 736.04113(2)

(2) In modifying a trust under this section, a court may:

- (a) Amend or change the terms of the trust, including terms governing distribution of the trust income or principal or terms governing administration of the trust;
- (b) Terminate the trust in whole or in part;
- (c) Direct or permit the trustee to do acts that are not authorized or that are prohibited by the terms of the trust; or
- (d) Prohibit the trustee from performing acts that are permitted or required by the terms of the trust.

S.C. Code § 62-7-412

- (a) The court may modify the administrative or dispositive terms of a trust or terminate the trust if, because of circumstances not anticipated by the settlor, modification or termination will further the purposes of the trust. To the extent practicable, the modification must be made in accordance with the settlor's probable intention.



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Fla. Stat. § 736.04115: Beneficiaries' Best Interests

- Less limited ability to modify trusts in situations where circumstances have changed and trust terms are no longer ideal to provide for trust beneficiaries



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Fla. Stat. § 736.04115: Beneficiaries' Best Interests

(2) In exercising discretion to modify a trust under this section:

- (a) The court shall exercise discretion in a manner that conforms to the extent possible with the intent of the settlor, taking into account the current circumstances and best interests of the beneficiaries.
- (b) The court shall consider the terms and purposes of the trust, the facts and circumstances surrounding the creation of the trust, and extrinsic evidence relevant to the proposed modification.
- (c) The court shall consider spendthrift provisions as a factor in making a decision, but the court is not precluded from modifying a trust because the trust contains spendthrift provisions.



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Interstate Law Interlude 2: The Revenge

Fla. Stat. § 736.04115

(1) Without regard to the reasons for modification provided in §. 736.04113, if compliance with the terms of a trust is not in the best interests of the beneficiaries, upon the application of a trustee or any qualified beneficiary, a court may at any time modify a trust that is not then revocable as provided in §. 736.04113(2).



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Interstate Law Interlude 2: The Revenge

Fla. Stat. § 736.04115

(1) Without regard to the reasons for modification provided in §. 736.04113, if compliance with the terms of a trust is not in the best interests of the beneficiaries, upon the application of a trustee or any qualified beneficiary, a court may at any time modify a trust that is not then revocable as provided in §. 736.04113(2).

S.C. Code § 62-7-411

(a) A noncharitable irrevocable trust may be modified or terminated with court approval upon consent of the settlor and all beneficiaries, even if the modification or termination is inconsistent with a material purpose of the trust. A settlor's power to consent to a trust's modification or termination may be exercised by an agent under a power of attorney only to the extent expressly authorized by the power of attorney or the terms of the trust; by the settlor's conservator with the approval of the court supervising the conservator if an agent is not so authorized; or by the settlor's guardian with the approval of the court supervising the guardianship if an agent is not so authorized and a conservator has not been appointed.



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Fla. Stat. § 736.0412: Non-Judicial Modification

- Broad authorization to modify trust terms with the consent of the Trustee and all "Qualified Beneficiaries"



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What is a Qualified Beneficiary

Fla. Stat. § 736.0103(19): "Qualified beneficiary" means a living beneficiary who, on the date the beneficiary's qualification is determined:

- (a) Is a distributee or permissible distributee of trust income or principal;
- (b) Would be a distributee or permissible distributee of trust income or principal if the interests of the distributees described in paragraph (a) terminated on that date without causing the trust to terminate; or
- (c) Would be a distributee or permissible distributee of trust income or principal if the trust terminated in accordance with its terms on that date.



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Fla. Stat. § 736.0412: Non-Judicial Modification

- Requirements:
 - The Settlor must be dead



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Fla. Stat. § 736.0412: Non-Judicial Modification

- Requirements:
 - The Settlor must be dead
 - Cannot extend the administration period under the Rule Against Perpetuities



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Fla. Stat. § 736.0412: Non-Judicial Modification

- Requirements:
 - The Settlor must be dead
 - Cannot extend the administration period under the Rule Against Perpetuities
 - Cannot be used for Trust established prior to January 1, 2001
 - Any Trust with provisions requiring the Trust to vest or terminate prior to the end of the perpetuities period

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Non-Judicial Settlement Agreements

- What are they?

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Non-Judicial Settlement Agreements

- What are they?
 - An agreement between the “Interested Persons” to take certain actions with regard to a trust

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Non-Judicial Settlement Agreements

- What are they?
 - An agreement between the “Interested Persons” to take certain actions with regard to a trust
- “Interested Persons”
 - Can include the Qualified Beneficiaries, the Trustee, and the Settlor/Grantor (in some cases)



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Non-Judicial Settlement Agreements

- What can an NJSA do (typically)?



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Non-Judicial Settlement Agreements

- What can an NJSA do (typically)?
 - Approve Trustee reports and accountings



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Non-Judicial Settlement Agreements

- What can an NJSA do (typically)?
 - Approve Trustee reports and accountings
 - Direct the Trustee to perform or refrain from performing particular administrative acts or grant the Trustee authority to perform administrative acts

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Non-Judicial Settlement Agreements

- What can an NJSA do (typically)?
 - Approve Trustee reports and accountings
 - Direct the Trustee to perform or refrain from performing particular administrative acts or grant the Trustee authority to perform administrative acts
 - Handle resignation or appointment of trustees and determination of trustee compensation

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Non-Judicial Settlement Agreements

- What can an NJSA do (typically)?
 - Approve Trustee reports and accountings
 - Direct the Trustee to perform or refrain from performing particular administrative acts or grant the Trustee authority to perform administrative acts
 - Handle resignation or appointment of trustees and determination of trustee compensation
 - Transfer a trust's principal place of administration

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Non-Judicial Settlement Agreements

- What can an NJSA do (typically)?
 - Approve Trustee reports and accountings
 - Direct the Trustee to perform or refrain from performing particular administrative acts or grant the Trustee authority to perform administrative acts
 - Handle resignation or appointment of trustees and determination of trustee compensation
 - Transfer a trust's principal place of administration
 - Determine trustee liability



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Non-Judicial Settlement Agreements

- What can NJSA's not do
 - Generally, cannot make any modification or take any action that could not be approved by a court



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Judicial Reformation

- Method of petitioning a court to cure errors in the trust document



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Judicial Reformation

- Requirement: Petitioner must present clear and convincing evidence that both the settlor's intent and the trust's written terms were negatively affected by a mistake



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Judicial Reformation

- Requirement: Petitioner must present clear and convincing evidence that both the settlor's intent and the trust's written terms were negatively affected by a mistake
- Mistakes can include misunderstandings, incorrect assumptions, or clerical/scrivener's errors



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Judicial Reformation

- In general a mistake has to relate to a condition that was present when the trust was created



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Judicial Reformation

- In general a mistake has to relate to a condition that was present when the trust was created
 - Courts will not grant reformation in cases where circumstances such a financial situations change subsequent to the execution of the trust



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Trust Decanting

- What Is it?



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Trust Decanting

- What Is it?
 - The act of the Trustee to invade the principal of the trust (the trust's assets) and to appoint the assets to a new trust



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Trust Decanting

- Requirements for the Replacement Trust



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Trust Decanting

- Requirements for the Replacement Trust
 - The beneficiaries must only include beneficiaries of the original trust



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Trust Decanting

- Requirements for the Replacement Trust
 - The beneficiaries must only include beneficiaries of the original trust
 - The replacement trust cannot reduce the vested interest of any beneficiary



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Trust Decanting

- What can the Replacement Trust change?

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Trust Decanting

- What can the Replacement Trust change? Fla. Stat. § 736.04117(2)(b):
 1. Retain a power of appointment granted in the first trust;
 2. Omit a power of appointment granted in the first trust, other than a presently exercisable general power of appointment;
 3. Create or modify a power of appointment if the power holder is a current beneficiary of the first trust;
 4. Create or modify a power of appointment if the power holder is a beneficiary of the first trust who is not a current beneficiary, but the exercise of the power of appointment may take effect only after the power holder becomes, or would have become if then living, a current beneficiary of the first trust; and
 5. Extend the term of the second trust beyond the term of the first trust.

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Trust Decanting

- Notice Requirements

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Trust Decanting

- Notice Requirements
 - Must be provided to all beneficiaries, other Trustees, and any individual with the power to remove Trustees at least 60 days prior to exercise of power to decant

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Trust Decanting

- Notice Requirements
 - Must be provided to all beneficiaries, other Trustees, and any individual with the power to remove Trustees at least 60 days prior to exercise of power to decant
 - Notice must include an explanation of the decanting, and provide copies of both the original trust and the proposed replacement trust

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Trust Decanting

- Notice Requirements
 - Must be provided to all beneficiaries, other Trustees, and any individual with the power to remove Trustees at least 60 days prior to exercise of power to decant
 - Notice must include an explanation of the decanting, and provide copies of both the original trust and the proposed replacement trust
 - A beneficiary can waive his/her right to receive notice

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Illustration: Harell v. Badger, 171 So. 3d 764



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Tax Consequences: When Trust's Shouldn't be Modified

- Est. of Anenberg v. Commissioner, 162 T.C. 199 (2024)
- McDougall v. Commissioner, 163 T.C. No.5 (2024)



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Important Considerations for Trust Modification

- What was the testamentary intent of the settlor?



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Important Considerations for Trust Modification

- What was the testamentary intent of the settlor?
- Once a Tool is chosen from the Toolbelt, what are the statutory requirements for its proper use?



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Important Considerations for Trust Modification

- What was the testamentary intent of the settlor?
- Once a Tool is chosen from the Toolbelt, what are the statutory requirements for its proper use?
 - Procedural Requirements?



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Important Considerations for Trust Modification

- What was the testamentary intent of the settlor?
- Once a Tool is chosen from the Toolbelt, what are the statutory requirements for its proper use?
 - Procedural Requirements?
 - Limitations?



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Important Considerations for Trust Modification

- What was the testamentary intent of the settlor?
- Once a Tool is chosen from the Toolbelt, what are the statutory requirements for its proper use?
 - Procedural Requirements?
 - Limitations?
- If everything is done properly, what consequences will result post-modification



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- Questions?



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Thank You!



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Attachment A -- A Pre-TEFRA Annuity in 2025!

TRANSFERRING TAX DEFERRED ASSETS (OFTEN TO TRUSTS)

I. INTRODUCTION

Some of the trickiest Medicaid planning issues involve tax deferred assets. By “tax deferred” I am referring to annuities and individual retirement accounts. The problem is that in many (if not most) cases a transfer of the asset will trigger taxation, which presents an obstacle if a desirable transfer would be to some sort of asset protection trust. But there are exceptions. Understanding those exceptions can provide you with very useful tools to serve your clients.

Many good estate planning and elder law attorneys approach the topics of annuities and IRAs with the deepest of dread. Further, many (too many) attorneys have only a rudimentary understanding of the practical and tax aspects of annuities, and as a result, are missing out on some significant planning opportunities. A good grasp of the rules is also useful for surmounting the inevitable pushback from financial institutions and advisors who will insist that “you can’t do that.” Hopefully, this outline will dispel some of the mystery and instill some thought. To paraphrase Albert Einstein, if you want to play better than anyone else, you must first learn the rules.¹

The first section of this outline examines rules applicable to nonqualified annuities (as opposed to annuities held in individual retirement accounts). As you will see, a nonqualified annuity is nevertheless a tax deferral mechanism. Knowing how to transfer an annuity to a trust without triggering taxation can be useful.

The second section will examine transferring an inherited IRA to a trust under 42 U.S.C. § 1396p(d)(4)(A). The rest of this outline will refer to a self-settled trust under that section as a “D4A Trust.”

The last two sections stray off from funding a trust, but because annuities and trusts share some common characteristics, an annuity can provide “trust-like” benefits. Accordingly, the third section will look at Medicaid treatment of annuities so that the last section will make some sense. Finally, the last section will discuss annuities held in individual retirement accounts (or annuitized individual retirement accounts). Each section will offer some (I hope) useful, perhaps even intriguing, planning tips.

II. NONQUALIFIED ANNUITIES

A. Background

Elder law attorneys involved in Medicaid and asset protection planning must routinely deal with annuities. In that context, understanding the tax rules applicable to “cashing in” or transferring (including to a trust) an annuity is important.

¹ Most sources have the quote, “You have to learn the rules of the game. And then you have to play better than anyone else.” Whatever.

First, a bit of background (or nothing else will make sense).

1. Annuities generally

An annuity contract binds an insurance company to provide a payment or stream of payments in exchange for a single premium or perhaps a series of premiums. As I tell my clients, an annuity is nothing more than a loan to the insurance company in which it is promising to pay you back with interest in some form or fashion.² In fact, an annuity stream is likely to be taxed in a manner similar to that of a loan: A portion will represent a tax-free return of loan principal and a portion will be a taxable payment of interest.

The rules of Section 72 of the Internal Revenue Code of 1986 (“I.R.C.”) and regulations thereunder generally govern annuities. Over the years Congress designed the rules to encourage retirement savings and discourage the use of annuities for various nefarious tax-shifting purposes. Because the rules have many of the same policy goals as qualified retirement plans under the Employee Retirement Income Security Act of 1974 (“ERISA”), they can bear a striking resemblance to each other, particularly the distribution rules of I.R.C. § 401(a)(9). Someone familiar with the ERISA rules should have an easy time understanding the rather opaque annuity rules of I.R.C. § 72.³

2. The Parties

a. *Holder*. The owner of the contract is the individual who purchased the annuity, makes decisions about various design elements, and can often make other changes (such as ownership, the identity of the annuitant, and so forth). I.R.C. § 72 refers to this individual (who need not be a human being) as the “holder” without defining the term.

b. *Annuitant*. Strictly speaking, the annuitant is the human being whose life is the measuring component of an annuitized annuity (whether the annuitized stream is for a life, or life with a period certain, or some other variation). Often (if not usually) the holder and the annuitant are the same person. Because of this, many use the terms interchangeably, which doesn’t do much when clarity is needed.⁴ Because this Outline deals with trusts, I will take a strict approach to using the terms. A trust might be a holder or a beneficiary, but it will never be an annuitant (trusts don’t die, they terminate).

² Yes, you may borrow that description.

³ I started practice decades ago 30 floors up from Atlanta’s Five Points (downtown) as an ERISA lawyer for a large law firm. While the experience scarred me for life, and I eventually fled for the gentler climes of Savannah, and later to the Old North State, the knowledge has come in handy over the years.

⁴ See, e.g., I.R.C. § 72(b)(3)(A) (referring to an annuitant as an individual allowed a deduction for year of death if all of investment in contract not recovered) or 42 U.S.C. § 1396p(c)(1)(G) (in Medicaid annuity context, the person who bought the annuity).

c. *Beneficiary*. The individual who has a right to any death benefit under the contract upon the death of either the holder or the annuitant. As we will see further below, the death of the holder is what will trigger the payment of whatever annuity benefit is offered under the contract unless the holder is a trust, in which case the death of the primary annuitant triggers the benefit flow.

A useful analogy (not perfect, but close) is a life insurance contract. An owner (holder) can own a policy on the life of another person (annuitant) that will pay on the death of that person to another individual (beneficiary).

3. Classification

a. Annuities may be classified in a few ways. As mentioned above, an annuity may be qualified or nonqualified depending upon the manner of acquisition. If it was purchased as part of a qualified retirement plan or an individual retirement account, it is “qualified” and the tax rules of ERISA apply. If it was purchased with “after tax” money the annuity is “nonqualified” and the rules of I.R.C. § 72 apply. Qualified annuities are discussed in Sections IV and V.

b. An annuity may be immediate or deferred, depending upon the timing of benefits. An immediate annuity begins paying the annuity stream shortly after purchase; a deferred annuity will begin payments at some future date. If the annuity is a deferred annuity, then there are two phases that may have differing tax rules.

(1) The accumulation phase of a deferred annuity is simply the time that premium payments are held by the issuer (and perhaps experience investment returns).⁵

(2) The distribution phase is when the benefits under a deferred annuity begin to payout to the beneficiary (the “Annuity Start Date” or “ASD”). Any number of design features may trigger the ASD: The death of a holder, making an election, the occurrence of an event, or perhaps the conclusion of a period of time stated in the contract.

B. Tax Rules During Holder’s Life

1. Tax deferral

During both the Owner’s life and the accumulation phase the growth within the annuity is tax deferred, which is the probably the biggest advantage of an annuity.

2. Annuity held by a trust

⁵ Believe me, the insurers are using the premiums held to make much more money than they’ll have to payout over the life of the annuity. Which is why they almost always have early surrender charges.

Congress added I.R.C. § 72(u) in 1986 to prohibit tax deferral for owners who are not “natural persons.”⁶ Fortunately, there is an exception for trusts “acting as an agent for a natural person.”⁷

Certainly, a revocable trust with human beneficiaries would satisfy this provision. The bigger question is the applicability to irrevocable trusts (both grantor and nongrantor). In a string of letter rulings, the Service has approved grantor and nongrantor irrevocable trusts as ‘agents for natural persons.’⁸ We all learned in Income Tax 1L not to rely on letter rulings, but they are certainly indicative of Service thinking and we pay lots of money to keep up with the latest.

Finally, the rules do not apply to non-natural owners if the annuity is an immediate annuity.⁹

3. Income received as an annuity

At the conclusion of the accumulation phase the annuity start date (ASD)¹⁰ (whatever the design trigger may be) will commence the distribution phase.

The taxation of amounts received as an annuity is generally covered by I.R.C. § 72(a), (b), and (c). For the sake of brevity, I will not tease these sections apart, but will attempt to give an overview for those not familiar with annuities (this is my ‘client version’).

Not all amounts received as an annuity are taxable. The first step is to calculate an “exclusion ratio” as of the ASD which will yield a fraction. That fraction of any amount received as an annuity will represent a tax-free return of the “investment in the contract.”¹¹ For our purposes, think of this as total premiums or other consideration paid as of the ASD. That number will represent the numerator of the fraction.

The denominator is the “expected return”¹² on the contract. If you are into actuarial calculations as a hobby, great. If not, call the insurance company.

Example 1: Ann invested \$100,000 for a single premium deferred annuity with an ASD 10 years from the purchase date. It will pay \$1,500 monthly for 120 months. Her

⁶ Real, bleeding people.

⁷ I.R.C. § 72(u)(1) (Flush language).

⁸ See, e.g., Priv. Ltr. Ruls. 9752035 (12/24/1997) (testamentary trust; focused on beneficial ownership), 199905015 (2/5/1999) (irrevocable, nongrantor trust), 199933033 (8/20/1999) (irrevocable, nongrantor trust; trustee with complete settlement/termination authority), 200449016 (12/3/2004) (irrevocable, nongrantor trust), 202031008 (7/31/2020) (life insurance company requested ruling for issuing contracts to both grantor trust and nongrantor trust vehicles f/b/o of sole primary beneficiaries), and 202118002 (5/7/2021) (irrevocable nongrantor trust f/b/o grandchildren).

⁹ I.R.C. § 72(u)(3)(E).

¹⁰ Defined at I.R.C. § 72(c)(4) as the “first day of the first period for which an amount is received as an annuity.”

¹¹ *Id.* § 72(c)(1).

¹² *Id.* § 72(c)(3).

investment in the contract is \$100,000. Her expected return is \$180,000 (\$1,500 x 120). Her exclusion ratio is 5/9. Thus, of every \$1,500 received, \$833.33 will be tax-free and \$666.67 will be ordinary income.

Of course, Ann will simply report the ordinary income on her Form 1040. If a trust is receiving amounts as an annuity, the trust tax rules will apply, depending upon trust status as a grantor or nongrantor trust.

4. Income other than as an annuity – I.R.C. § 72(e)

Different rules apply to amounts received under a contract that are other than part of an annuity stream. I.R.C. § 72(e) sets out the different rules and defines “amounts not received as annuities” as amounts received under a contract that are not subject to other tax provisions of the section (basically subsections I.R.C. § 72(a) through (c)).

Amounts drawn out of an annuity contract before the ASD are “income other than as an annuity.” Special allocations rules apply to force a “last in, first out” or LIFO allocation.¹³ If the cash value of the contract exceeds the investment in the contract, any withdrawal will be classified as ordinary income to the extent it is less than or equal to the difference between cash value and the investment in the contract.¹⁴ To add insult to injury, “cash value” is calculated “without regard to any surrender charges.”

Example 2: Ann paid a single premium of \$100,000 for a single premium deferred annuity with an ASD 10 years from the purchase date as discussed in Example 1, above. However, in year 5 she decided to “dip in” to the annuity to the tune of \$40,000 at a time when the annuity had a cash value of \$130,000 and for that year carried a 4% cash surrender charge. The issuer will distribute \$38,400 (minus the 4% surrender charge) and she will report \$30,000 on her Form 1040 as ordinary income. That was an expensive dip.

Observation: As an elder law attorney I come across these situations quite often in the Medicaid planning context (when it might be necessary to liquidate an annuity prior to the ASD).

5. Gratuitous transfer rules – More I.R.C. § 72(e)

I.R.C. § 72(e)(4)(C)¹⁵ provides, with an exception, that gratuitous transfers of an annuity will result in immediate recognition of any tax deferred gain.¹⁶

¹³ Prior to August 13, 1982 it was “FIFO.” Rules added by Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248 § 265(c)(1), effective for annuities issued on or after August 13, 1982. A client gave me the attached last year. It had been twenty years or more since I had seen a Pre-TEFRA Annuity. See Attachment A (Catch the purchase date: August 1, 1982!).

¹⁴ *Id.* § 72(e)(3).

¹⁵ Added by Tax Reform Act of 1986, Pub. L. No. 99-514 § 1826(b)(3) (“TRA 1986”).

¹⁶ *Id.* § 72(e)(4)(C).

The purpose of the section is to prevent an individual from shifting built-in gains on an annuity contract to another (perhaps more lightly taxed) individual and perhaps stretching the tax deferral of those gains. Think: Shifting and delaying gains.¹⁷

a. Exception: To a spouse

I.R.C. § 72(e)(4)(C)(ii) exempts transfers to a spouse from the gain recognition rule.

b. Exception: To a grantor trust wholly includible in gross estate

A gratuitous transfer to a grantor trust¹⁸ should not trigger recognition, particularly so if the trust would be includible in the transferor's gross estate. Such a transfer simply does not trigger the "gains shifting and delaying" that the subsection polices.

C. Tax Rules at Holder's Death (Force-out Rules)

1. Beneficiary's IRD on annuity gain

The beneficiary of an annuity will continue to be taxed similarly to Holder receiving amounts as an annuity as described above. While I.R.C. § 1014(b)(9) provides that assets included in a decedent's estate will generally receive a step-up in basis; subparagraph (b)(9)(A) specifically removes section 72 annuities from stepped up basis. Rather, the beneficiary is taxed under the income in respect of decedents (IRD) rules.¹⁹ In other words, amounts received by the beneficiary will be treated as ordinary income to the extent such amounts received exceed the deceased Holder's investment in the contract.²⁰ A lump sum received by a beneficiary will be treated in the same fashion as a Holder cashing in an annuity; a beneficiary receiving an annuity stream will be taxed in the same fashion as a Holder. According to the Service, the annuity rules of I.R.C. § 72 simply apply to the beneficiary.²¹

The foregoing pertains to HOW a beneficiary is taxed; the following pertains to the time period over which the beneficiary must receive the benefits. I refer to these as the

¹⁷ The legislative history so provides:

Without these clarifications relating to gratuitous transfers of annuity contracts and changes in primary annuitants, the required distribution rules adopted in the 1984 Act could be avoided easily because they would allow taxpayers to continue tax deferral beyond the life of an individual taxpayer.

Description of the Technical Corrections Act of 1987, Joint Committee on Taxation, 112 (6/15/1987) (commenting on TRA 1986 § 1826(b)(1) and (3).

¹⁸ See Rev. Rul. 85-13, 1985-1 C.B. 184 (Grantor is treated as owner of grantor trust for all income tax purposes). This ruling will be discussed in more detail at section III.C, *infra*.

¹⁹ I.R.C. § 691(a).

²⁰ See Rev. Rul. 2005-30

²¹ *Id.*

annuity “force out” rules. If the annuity was issued after January 18, 1985,²² it must satisfy the “force out” rules discussed below.

2. Holder dies before ASD

- a. General: The annuity must be distributed WITHIN five years after the death of the Holder.²³

3. Holder dies after ASD

- a. General: The annuity must be distributed at least as rapidly as under the method used as of the Holder’s death.²⁴

4. Exceptions (of course!)

- a. Exception: If the spouse of the Holder is the primary beneficiary, then she has a couple of choices.

- (1) If the Holder died before the ASD, she could simply elect to continue the contract (the annuity contract should be carefully reviewed to see what impacts, if any, it would have on guaranteed benefits under the contract).²⁵

- (2) Alternatively, she could elect a lump sum (assuming the contract allows it). She could also elect the “at least as rapidly” rule if the annuity was in payout status.

- (3) And finally, she could elect payout over her life expectancy (discussed immediately below for annuities in payout status).

- b. Exception: If the contract names a “designated beneficiary” then the beneficiary may elect to take distributions over his life expectancy, as long as distributions begin within one year of the Holder’s death.²⁶

BEWARE: I.R.C. § 72(h) provides that if an annuity provides for payment in lump sum, but provides for an annuity payout option, then the annuity payout option must be elected within 60 days after the day the lump sum became payable. Read together, the most conservative reading is that if a beneficiary wishes to elect a life (or shorter) annuity in lieu of a lump sum (a) an election should be made within 60 days of the Holder’s death (b) to receive an annuity stream commencing within one year of the Holder’s death.

²² Deficit Reduction Act of 1984, Pub. L. No. 98-369 § 222(b), added the I.R.C. 72(s) “force out” rules effective for annuities issued on or after January 18, 1985.

²³ I.R.C. § 72(s)(1)(B).

²⁴ *Id.* § 72(s)(1)(A).

²⁵ *Id.* § 72(s)(3).

²⁶ *Id.* § 72(s)(2). The one year rule is strictly construed – no excuses. See Priv. Ltr. Rul. 201532026 (April 23, 2015).

c. Trusts

(1) Trusts don't qualify as a designated beneficiary for purposes of these rules.²⁷ Thus, a trust will necessarily be saddled with the "at least as rapidly" rule or the "five year" rule, depending upon when the Holder died in relation to the ASD. Trusts are often named as beneficiaries in the asset protection and elder law contexts, and a planner will need to explore this loss of deferral versus asset protection concerns with the client.

(2) If a trust is Holder, the primary annuitant is treated as Holder "for purposes of this subsection" (s) of section 72. As should be clear at this point I.R.C. § 72(s) provides the force-out rules "where the holder dies before entire interest is distributed."²⁸ Thus, the death of the primary annuitant of a trust-owned annuity will trigger the force-out rules discussed above in this subsection II.C.

(3) In view of the above, any change of primary annuitant will be treated as death of Holder.²⁹ Recall the general objective of Section 1826 of TRA 1986 to avoid extending tax deferral times and shifting taxation to lower taxed individuals.³⁰

D. Trust Annuity Rules Recap

1. A trust may hold a deferred annuity if acting "as an agent for a natural person." It matters not whether the trust is a revocable, irrevocable, grantor or nongrantor trust if human beings are the beneficiaries.³¹
2. Generally gratuitous transfers of an annuity trigger immediate recognition of income to the transferor. This should not be the case if the transfer is to a grantor trust that would be includible in the transferor's gross estate.³²
3. If a trust is the beneficiary of an annuity, it will receive the annuity benefits under either the "five year" rule (if the Holder died before the ASD) or the "at least as rapidly" rule (if the Holder died after the ASD).³³

²⁷ I.R.C. § 72(s)(2) exceptions apply only to designated beneficiaries with "life expectancies" who are individuals. *See, also, Id.* § 72(s)(4) (definition of "designated beneficiary").

²⁸ Old trusts don't die, they just terminate.

²⁹ I.R.C. § 72(s)(7), added by TRA 1986 § 1826(b)(1).

³⁰ *See* n.15 and n.17.

³¹ *See* n.6 through n.9.

³² Because I said so. *See* n.18.

³³ *See* n.27 and accompanying text at II.C.4.c(1).

4. If a trust is the owner/holder of an annuity, the primary annuitant is treated as the Holder, and the death of the annuitant will trigger the force out rules of I.R.C. § 72(s).³⁴³⁵
5. If a trust owns an annuity, any change in the primary annuitant will trigger immediate taxation.

III. TRANSFERRING AN INHERITED IRA

Occasionally, due to poor or no planning, a disabled individual will inherit assets that jeopardize continued qualification for Medicaid or SSI. In that situation, Congress provided an exemption from the general rule that self-settled trusts will be countable to the beneficiary if there are any circumstances in which a distribution could be made to the beneficiary. That relief, of course, are the exemptions provided under 42 U.S.C. § 1396p(d)(4)(A)-(C). Of interest to this outline is the self-settled/payback trust provided under paragraph (A) (the D4A Trust exemption).

A. D4A Trust Recap

As long as one of the correct parties established the trust, the trust is solely for the benefit of the beneficiary during the beneficiary's life, and the trust contains a provision to "pay back" Medicaid from any assets remaining upon the beneficiary's death, funding the D4A Trust will not be a sanctionable transfer³⁶ and the assets will not be treated as countable assets for continued benefit eligibility.³⁷ The distribution standard for a D4A Trust will grant the trustee discretionary authority to make a wide array of distributions to or for the benefit of the beneficiary as long as the distributions do not supplant, but rather supplement, public benefits.

B. D4A Trust Tax Status

A D4A Trust will be a grantor trust for income tax purposes. I.R.C. § 671 says that where it is specified (in later sections) that a grantor is treated as an owner of a portion of the trust, all items of income, deductions, and credit attributable to that portion will be included in computing the grantor's taxable income.³⁸

I.R.C. § 673(a) provides that a grantor will be treated as owner of any portion of the trust over which the grantor has a reversionary interest exceeding five percent of the trust value at its inception. I.R.C. § 673(c) says to assume the trustee will exercise maximum discretion in making distributions. Although I am not a math whiz, given that a D4A Trust trustee has full discretion in making distributions, subject only to not disqualifying the beneficiary from

³⁴ See II.C.4.c(2).

³⁵ See n.29 and accompanying text.

³⁶ 42 U.S.C. § 1396p(c)(2)(B)(iv).

³⁷ *Id.* § (d)(4)(A).

³⁸ Treas. Reg. § 1.671-3(a)(1) clarifies that if the grantor is treated as the owner of the entire trust, all such items (including capital gains and losses) will be taken into account by the grantor in the same manner "had the trust not been in existence during the period he is treated as the owner."

Medicaid or SSI, it seems that 100% of the trust will be considered owned by the grantor/beneficiary.

I.R.C. § 677(a) further provides that the grantor will be treated as the owner of the trust if income of the trust could be distributed to the beneficiary within the discretion of the beneficiary or a nonadverse party (and without the consent of an adverse party). If the trustee is not an adverse party (namely, not a remainder beneficiary with respect to anything left after the state has subjected the trust to its tender ministrations), the trust will be a grantor trust.

C. Revenue Ruling 85-13

Taking pity on those who had a difficult time understanding I.R.C. § 671 and Treas. Reg. § 1.671-3(a)(1), as well as the fact that they vehemently disagreed with the Second Circuit Court of Appeals in *Rothstein v. United States*³⁹, the Service issued Revenue Ruling 85-13.⁴⁰

With respect to *Rothstein*, for reasons that are irrelevant here, both the Service and the court agreed that the tax attributes of the trust in question should be included in determining the grantor's tax liabilities. The court, however, determined that while the grantor in the case at hand was to include the tax attributes of the trust in his tax calculations the trust would continue to exist as a separate taxpayer. The court reasoned, that there could be times when the results could be different between the taxpayer and the trust.

In the revenue ruling, the Service ruled that under I.R.C. § 671 and Treas. Reg. § 1.671-3(a)(1), the trust would be treated as if it simply did not exist. This is an important point I will return to.

D. The Inherited IRA

IRAs are inherited routinely. And just as routinely, the minimum required distributions of the IRA can be calculated as a function of the beneficiary's age. Trusts benefitting solely a designated beneficiary or an eligible designated beneficiary are also routinely named as beneficiaries of an IRA by the owner of the IRA to take effect on the owner's death. Further, those trusts may also calculate minimum distributions using the beneficiary's age, and may even accumulate those distributions within the trust for certain classes of eligible designated beneficiaries (*e.g.*, minors and disabled beneficiaries). This Outline will NOT be a recap of the SECURE Act and SECURE 2.0 Act rules which are treated exhaustively elsewhere.

But what of the disabled or minor beneficiary who directly inherits an IRA from a now deceased individual, perhaps due to poor (or no) planning? Generally, I.R.C. § 691(a)(1)

³⁹ 735 F.2d. 704 (2d. Cir. 1985).

⁴⁰ 1985-1 C.B. 184, 1985 I.R.B. 28.

classifies an inherited IRA as income in respect of a decedent and thus taxed as ordinary income in the year the distributions are received. I.R.C. § 691(a)(2), however, subjects the entire value of the IRA to immediate taxation to the beneficiary if the beneficiary transfers the IRA.

This creates a dilemma, particularly for the disabled beneficiary receiving Medicaid or SSI benefits. If she retains the IRA, she will likely lose public benefits until the IRA has been spent down. If she cashes in the IRA to fund a D4A Trust, the cash-in will be subject to immediate taxation. The tax uncertainty is that if she does transfer the IRA to a D4A Trust, will it trigger taxation under I.R.C. § 691(a)(2)?

1. *The letter rulings.* As noted above,⁴¹ the only individual who may rely on a private letter ruling from the Service is the taxpayer who requested the ruling after paying a small fortune in attorneys' fees and fees to the Service. If that is so, why do we subscribe to myriad services to stay informed as to the latest letter rulings? Because they give us some insight into how the Service will view certain tax issues and guidance with regard to structuring transactions (or evaluating the risks of following a certain course of action).

The Service has issued three letter rulings pertaining to the transfer of inherited IRAs to grantor trusts. Two involved disabled beneficiaries and one a minor beneficiary.

PLR 2006-20025 and PLR 2011-16005 both involved IRAs inherited by disabled beneficiaries and the proposed transfers of the IRAs to D4A Trusts. PLR 2006-20025 reasoned that under I.R.C. § 677(a) the D4A Trust was a grantor trust with respect to the beneficiary. There then follows a discussion of Revenue Ruling 85-13, and I.R.C. § 691(a)(1)-(2). The ruling concludes that because the transfer was to a grantor trust, the transfer was not a "sale or disposition" within the meaning of I.R.C. § 691(a)(2). Five years later PLR 2011-16005 made the same ruling with language that tracked the earlier ruling.

PLR 2008-26008 is interesting because the beneficiary was not disabled. Simply a minor. The trust was an irrevocable discretionary trust solely for the benefit of the minor, with mandatory distributions upon the attainment of certain ages. The Service applied the same reasoning it used in PLR 2006-20025.

2. *So What?* I have used this strategy and saved the day for my clients (and by accident the remainder beneficiaries of the D4A Trust).

I'll call him "Dave." Dave was a fellow in his late 40s who had been drawing Medicaid for many years and had been in and out of facilities over the years (mostly due to drug and alcohol problems). Dave was an only child and his much older parents had large IRAs (around \$1 million in each). He had no other family and very few friends except two old friends from high school (one an attorney and one a CPA) who looked after him and tried to

⁴¹ See subsection II.B.2

keep him out of trouble.

Mom and Dad died within months of each other, and, of course, Dave inherited the IRAs. Recalling the rulings discussed above, I reasoned that there was not much to lose if the transfer to a D4A Trust did not work out and the Service decided to reverse its earlier rulings. The attorney and the CPA agreed. I met with Dave on multiple occasions (alone) and he insisted on naming his friends the remainder beneficiaries.⁴² We set-up a D4A Trust. An employee of the custodian of the IRA (an individual employed by a large entity we have all heard of) refused to participate (On the telephone, I could not tell if the representative was choking or guffawing). I embarked on what seemed a futile quest. Then a thoughtful colleague suggested: Peak Trust!

Peak Trust Company has offices in Anchorage and Las Vegas. They have a great and helpful staff (including a number named “Blattmachr” who I suspect are related). We worked it out successfully. They are a great resource, particularly if you have trouble finding anyone who will think creatively.

The Rest of the Story: Dave died after a little more than a year, having spent the last six months in a facility. I asked estate recovery for an itemized statement as he had been on Medicaid most of his adult life. The estate recovery people could only account for about two years of benefits. Needless to say, I was shocked (as were they and the beneficiaries). For some reason, the attorney and CPA have become good referral sources.

IV. MEDICAID, AN INDIVIDUAL’S IRA, AND ANNUITIES

A. The Individual’s IRA

I know, I know . . . the Conference billed this session as pertaining to funding TRUSTS with tax deferred assets. I am going off script.

The discussion above focused on transferring an inherited IRA to trust, because there is some support for that. There is NO support for an IRA owner transferring to a D4A Trust. I believe, theoretically, it could be done, especially given that Revenue Ruling 85-13 says, “Because A is treated as the owner of the entire trust, A is considered to be the owner of the trust assets for federal income tax purposes.” If that is not clear enough, it goes on to say, “section 671 requires that the grantor includes in computing the grantor’s tax liability all items of income, deduction, and credit of the trust as though the trust were not in existence” (emphasis added).

I puzzled over that for some time until it occurred to me that perhaps a D4A Trust would be an inferior approach, particularly if there is a community spouse. A D4A Trust has a mandatory payback feature. The annuity rules are much friendlier to a spouse (as will be discussed), and if there is no spouse, one can accomplish much the same with an annuity

⁴² Tearfully, he said, “They’re all I got!”

that could be accomplished with a D4A Trust.⁴³

Further, the Medicaid rules tend to conflate annuities and trusts. “The term ‘trust’ includes any legal instrument or device that is similar to a trust but includes an annuity only to such extent and in such manner as the Secretary specifies.”⁴⁴ Transmittal 64 fleshes this out.⁴⁵

By annuitizing an IRA for an institutionalized spouse or an individual with a disabled child, I have obtained excellent results. As will be discussed, you will have to “run the numbers.”

B. Countability Rules

To state the obvious, an annuity is an asset. In the Medicaid context, an asset is either countable or noncountable for purposes of meeting the resource limits. If it is noncountable, the next step is to determine whether actions were taken in the process of creating the noncountable asset that warrant the imposition of a transfer sanction.

Generally, the asset rules applicable in Medicaid can be no more restrictive than those applicable under the Supplemental Security Income (“SSI”) program.⁴⁶ SSI considers an asset as a resource for means-tested eligibility purposes if the applicant or spouse owns the asset, has the ability to convert it to cash, and is not restricted from using it for support or maintenance (unless, of course, the asset is specifically exempted under the rules).⁴⁷ There is no detailed exemption for an annuity under the SSI rules; it is either available because it can be cashed-in or sold or it is not because the owner is “stuck with it.” Under the Medicaid rules this translates into an examination of whether an annuity is irrevocable and nonassignable.⁴⁸ Or, as I explain to my clients, “You can’t change it, sell it, or give it away.” Of course, the resulting income stream is countable income to the annuitant.

The rules are much more detailed, however, with respect to whether purchasing or altering an annuity that is noncountable should be subject to a transfer sanction.

C. Transfer Rules Applicable to Annuities

1. The Deficit Reduction Act of 2005 imposed the current annuity rules under 42 U.S.C. § 1396p(c)(1)(F) and (G). Subsection (c) of the section is the federal statutory source of

⁴³ Other than generating an income stream, which could present issues that a D4A Trust would avoid by accumulating income.

⁴⁴ 42 U.S.C. § 1396p(d)(6).

⁴⁵ The Health Care Financing Administration (“HCFA”) was the predecessor to the current Centers for Medicare and Medicaid Services (“CMS”). Transmittal 64 added §§ 3257-3259 of Chap. 3 of the CMS State Medicaid Manual. The State Medicaid Manual (hereinafter “SMM”) is available online at <http://www.cms.gov/Regulations-and-Guidance/Guidance/Manuals/Paper-Based-Manuals-Items/CMS021927.html>. Better yet, simply search online using “CMS State Medicaid Manual.” Transmittal 64 was (and remains) HCFA’s explanation to State Medicaid officials of the trust provisions of OBRA ’93.

⁴⁶ 42 U.S.C. § 1396a(a)(10).

⁴⁷ See Program Operations Manual System (POMS) SI 01110.100 B.

⁴⁸ See, e.g., North Carolina Adult Medicaid Manual (MA) 2230 XII. E.2.

the Medicaid transfer rules. Paragraph (1) of subsection (c) gives us the transfer of assets rules we have all come to love. Paragraph (2) gives us the exceptions.

Subparagraph (F) of paragraph (c)(1) specifies that the state must be named as the primary remainder beneficiary of the annuity to the extent of Medicaid benefits paid. Importantly, the state may be moved behind a spouse, a minor child, or a disabled child.

TIP: When structuring an annuity in a planning context for a widowed or divorced applicant, do not overlook a disabled child of any age when naming a remainder beneficiary. This will be discussed much more below.

Paragraph (G) provides that the purchase of an annuity will be treated as a transfer of assets unless

- a. The annuity is an individual retirement annuity (translation: an annuity that is structured to meet the general requirements applicable to individual retirement accounts under I.R.C. § 408).

OR

- b. The annuity was purchased with the proceeds of either a Roth or traditional IRA (a subtle difference from a. above – the IRA has invested in an annuity).

OR

- c. The annuity is irrevocable and nonassignable, the annuity is actuarially sound, and the annuity provides for equal periodic payments.

North Carolina (where I practice) follows the federal statute precisely at MA-2240 IX A.2.b.⁴⁹ In fact, the North Carolina manual follows my formatting in emphasizing “OR” (which is often overlooked). Your state likely has something similar.

2. Most practitioners focus on using an annuity to shelter excess cash for the benefit of a community spouse by purchasing a short-term annuity or implementing so-called “half-a-loaf” planning to shelter a portion of a single Medicaid applicants cash. In doing so, the focus is on the annuity rules outlined above at section IV.C.1.c. Both the federal statute and the MA section impose the actuarial standard by requiring the annuity to completely pay-out within the annuitant’s actuarial life expectancy as determined under Social Security Administration tables. Often that is meaningless because the term of the annuity purchased from a Medicaid compliant annuity vendor is going to be very short term and well within the annuitant’s Social Security life expectancy.

Most attorneys do not appreciate the word “OR”! The Social Security actuarial standards apply ONLY to annuities described in paragraph IV.C.1.c., above. The other two

⁴⁹ This is what a citation to the North Carolina Adult Medicaid Manual looks like.

overlooked exceptions (paragraphs a. and b., above) assume that in the qualified plan (*i.e.*, IRA) context the individual will have to comply with the various tax rules, including maximum payout periods.⁵⁰

As will be discussed further below, planning opportunities open because the life expectancy tables used in the qualified plan context are much more generous than the Social Security tables. Before implementing those strategies, you will need to have a basic understanding of the applicable tax rules.

V. ANNUITIZED IRAs

Background for those who do not speak ERISA: There are two broad categories of qualified retirement plans. One of those consists of various sorts of individual account plans such as 401(k) plans, profit sharing plans, and individual retirement plans. These are referred to as defined contribution (DC) plans. Another feature of DC plans is that the investment risk with respect to the funds in the plan rests squarely with the participant.⁵¹ Likely every one of the hundreds of SECURE Act lectures you have listened to over the past couple of years have focused on defined contribution plans.⁵² Set all of that aside, because we are going to the land of defined benefit plans.

Defined benefit (DB) plans are those plans that generally do not consist of individual accounts, but rather commence a benefit stream upon some event (likely retirement) and will be calculated by factors such as years of service, income levels, and so forth. These are also commonly called pension plans. A feature of DB plans is that once the benefit level and payout period are set, the investment risk rests entirely on the employer, employer sponsored qualified trust fund, or the insurance company. Sounds like an annuity?

DB plans have a different set of distribution rules than DC plans. When an individual retirement account invests in an annuity or is converted to an individual retirement annuity the common DC rules no longer apply, and the DB rules take over.

A. DB Rules Applicable to Annuities

Understanding both the DB rules applicable to an annuitized IRA and the Medicaid rules applicable to annuities can open some very interesting planning opportunities. Notably, annuitizing and rendering a Medicaid applicant's otherwise countable IRA a noncountable asset might be an attractive alternative to simply cashing it in and taking the tax hit, particularly if the applicant has a shortened life expectancy and has a spouse or a disabled child (of any age). The cost to this approach is that the resulting annuity stream will be income and could very well become part of the applicant's patient monthly liability payable

⁵⁰ In effect, 42 § U.S.C. 1396p(c)(1)(G) is saying, "If it's OK with the IRS, it's OK with us."

⁵¹ The terms "participant," "employee," "owner" are used interchangeably. Because the focus here will be on IRAs, I will use the term "owner."

⁵² Ten year payout, eligible designated beneficiaries, multi-beneficiary trusts. Sound familiar?

to the SNF under the Medicaid rules. On the other hand, if the community spouse is much younger and has years before a required beginning date and can roll the applicant's IRA as a lump sum into his or her IRA, the years that the inherited amount can grow on a tax-deferred basis might more than make up for the amount that had been paid to the nursing home while the applicant was alive. The attorney's job (perhaps with assistance from a financial advisor) is to weigh the costs and benefits.

This outline covers DB distribution rules on a basic level and only those rules that apply to annuitized IRAs in a Medicaid context.

1. Required Beginning Date (RBD). For owners born on or after January 1, 1951 (*i.e.*, attained age 72 on or after January 1, 2023) the RBD is April 1 following attainment of age 73.⁵³ For owners born on or after January 1, 1959 (*i.e.*, attained age 74 on or after January 1, 2033) the RBD is April 1 following attainment of age 75.
2. Annuity Start Date (ASD). The date annuity payments commence (which must be no later than the RBD).
3. Permissible forms of annuity.⁵⁴
 - a. Straight annuity on the owner's life. Maximizes payments and no beneficiary. Not attractive in the Medicaid context.
 - b. An annuity calculated on the joint lives of the owner and a spouse. The joint life calculation will yield a longer payout, and thus lower monthly payments. When combined with a lump sum distribution to spouse option on death of owner, this option can be attractive. Recall, under the Medicaid rules, a spouse can be listed as a remainder beneficiary ahead of the state.
 - c. An annuity for the joint lives of the owner and a nonspouse beneficiary. Recall also, that under the Medicaid rules, a disabled child of any age can be slotted in ahead of the state as a remainder beneficiary.

If the survivor is more than 10 years younger than the owner, the survivor's annuity must not exceed a percentage of the owner's annuity, as determined in a chart provided in the regulations. For example, if the owner is 74 on the ASD and the survivor beneficiary is a child aged 45, then the age difference is 29 years. Looking in column 1 of the chart (see citation below) for "29" the number "61" appears. That means that at the owner's death, the survivor's annuity could be no more than 61%

⁵³ I.R.C. § 401(a)(9)(C)(v). Consolidated Appropriations Act, 2023, Division T SECURE 2.0 Act of 2022

⁵⁴ See Treas. Reg. § 1.401(a)(9)-6 A-1, A-2; these have been carried forward into the proposed regulations at Prop. Reg. § 1.401(a)(9)-6(b).

of what the owner was receiving.⁵⁵ For example, if the owner was receiving \$1,100 monthly, the survivor could receive no more than \$671 monthly.

d. A period certain annuity. I will not discuss that here because it is not particularly useful in the Medicaid context.

4. Calculating the annuity payments.

When calculating an annuity stream based on a single life or joint lives, the life tables issued for such purposes by the Service are used, NOT the Social Security Administration life expectancy tables. Annuity payout periods may not exceed the “period certain annuity” limitations.⁵⁶ The limitation (in years) cannot exceed the denominator that would be used if the plan was a DC plan. In other words, the DB rules “borrow” the life tables used for calculating MRDs for traditional (non-annuitized) IRAs.⁵⁷

For example, the appropriate table for use if the owner and spouse are within 10 years of each other in age, or the spouse is not the sole beneficiary, or the owner is unmarried is the Uniform Lifetime Table. For a 72 year-old, the table assigns a distribution period of 27.4 years. That would be the maximum term of the owner’s annuity. On the other hand, if the spouse is more than 10 years younger and is the sole beneficiary, then Joint Life and Last Survivor Expectancy table may be used. If spouse is, say, 60 years old, the distribution period extends to 28.8 years. Compare this to the current SSA Period Life Table that assigns a life expectancy of 12.3 years to a 72 year-old male and 14.36 years to a 72 year-old female.

5. Death benefit options.

a. Nonspouse beneficiary. Leave the annuity as structured and continue receiving the annuity stream, or take a lump sum cashout (which would be taxable) as long as the cashout does not exceed the amount initially annuitized.⁵⁸

b. Spouse beneficiary. Same as above for nonspouse beneficiary. However, the spouse also has the option of rolling the lump sum cashout amount into her own IRA.⁵⁹

B. The Institutional Spouse’s Annuity

Dealing with the IRA of an institutionalized spouse (“IS”) presents thorny planning issues. Most states count an IRA owned by the IS. There are just three options for addressing the IS IRA.

⁵⁵ Treas. Reg. § 1.401(a)(9)-6 A-2(c); Prop. Reg. § 1.401(a)(9)-6(b)(2)(iii).

⁵⁶ Treas. Reg. § 1.401(a)(9)-6 A-3(a); Prop. Reg. § 1.401(a)(9)-6(c)(1).

⁵⁷ *Id.*

⁵⁸ Treas. Reg. § 1.401(a)(9)-6, A-14(a)(5); Prop. Reg. § 1.401(a)(9)(o)(1)(v).

⁵⁹ I.R.C. § 402(c)(9); Treas. Reg. § 1.402(c)-2 A-12; Prop. Reg. § 1.402(c)-2(j).

One is to cash it in and take the tax hit. The costs of a skilled nursing facility at \$12,000 a month will often quickly exceed the pain of writing a check to the IRS.

Another option is to annuitize the IS IRA using the Uniform Life Tables under Treasury Regulations and taking a much longer stretch than that afforded under the Social Security Administration actuarial tables. As will be discussed, the income stream will be the IS's income and either be awarded as the community spouse ("CS") MMMNA⁶⁰ or go to the nursing home as the IS monthly payment liability. While the value of that annuity stream will be lost during the IS's lifetime to the extent it is not awarded as MMMNA, the CS will have the option to take a lump sum spousal rollover. Further, the annuity stream will spread the tax pain out and at lower marginal rates; in fact, the payments may generate a tax deduction. This is the planning option I will first explore before considering a cashout.

The final option is using the so-called "Name on the Check" technique. The following section discusses my concerns regarding this technique.

1. Name on the Check Technique

A popular technique to avoid the tax burden of cashing in the institutionalized spouse's IRA and to maximize Medicaid benefits by maintaining a lower income level is the so-called "Name on the Check" strategy ("NOC"). The approach is to annuitize the IS's IRA under 42 U.S.C. § 1396p(c)(1)(F)-(G) to render it noncountable, but to irrevocably assign the annuity stream to the community spouse.

While widely used and creative, I believe the strategy poses some significant risks. I have never used it for the reasons below. For an interesting back and forth on the topic see the *NAELA Journal* issues of Spring and Fall 2020.⁶¹ I generally agree with the Landsman-English approach, but take a slightly different approach by adding a couple of additional considerations.

The fact that many have successfully used the NOC strategy does not necessarily mean no one will ever be caught. Your clients will be furious if they are caught with full taxation of the IRA (plus penalties and interest) while that same vehicle is tied up in an irrevocable (and very illiquid) annuity. At the very least, advise them of the risks.⁶²

2. Medicaid Concerns

The treatment of a married couple's income for Medicaid planning can present planning challenges. Very briefly, the rules provide that the starting point is to treat the income

⁶⁰ *Id.* § 1395r-(b)-5(d)(3). The "minimum monthly maintenance needs allowance" or "MMMNA."

⁶¹ Dale M. Krause & Scott M. Engstrom, Fixing the Leak: Avoiding IRA Liquidation in Crisis Medicaid Planning, 16 *NAELA J.* 35 (2020) ("Fixing the Leak") (Pro) and Ron M. Landsman & David English, Commentary on Fixing the Leak, 16 *NAELA J.* 131 (Con).

⁶² A technique commonly referred to by the acronym "CYA."

of each spouse separately.⁶³ From this point, if the community spouse has income below certain thresholds, an allowance may be made out of the institutionalized spouse's income to raise the community spouse's income to a higher maintenance level.

The community spouse may have an unlimited amount of income, and the only negative to such a development is ineligibility for the MMMNA. The institutionalized spouse will have an income cap that varies from state to state, but it is usually pegged to the particular facility's Medicaid reimbursement rate.

While determining which spouse to attribute income to is often a straightforward proposition, rules exist for assigning income in less than clear situations. Subsection (d)(2)(A) provides rules for income generated by "Non-trust property." 42 U.S.C. § 1395r-5(d)(2)(A)(i) is the source of the "name on the check rule" and says that "if payment of income is made solely in the name of the institutionalized spouse or the community spouse, the income shall be considered available only to that respective spouse." Other rules under the subsection parse through situations involving multiple payees (irrelevant here). Note: This subsection, by its very title, applies to non-trust property.

Subsection (d)(2)(B), on the other hand, pertains to income generated by "Trust property." Individual retirement annuities will be considered "trust property" by Medicaid⁶⁴ within the meaning of the statute. Subsection (d)(2)(B)(ii) says (emphasis mine):

[I]ncome shall be considered available to each spouse as provided in the trust, or, in the absence of a specific provision in the trust—

(I) if payment of income is made solely to the institutionalized spouse or the community spouse, the income shall be considered available only to that respective spouse[.]

The "trust" (*i.e.*, the IRA) is not silent. All attributes of the IRA belong to the individual owner (the IS) during his or her life. My biggest concern, from a Medicaid standpoint, is that the NOC technique is attempting to apply the name on the check rule of 42 U.S.C. § 1395r-5(b)(A) (non-trust property) to 42 U.S.C. § 1395r-5(b)(B) (trust property, *i.e.*, annuities).

3. Tax Considerations

Simple. An individual retirement annuity must be nontransferable.⁶⁵ Further, the annuity must be "for the exclusive benefit of the individual in whose name it is

⁶³ See 42 U.S.C. § 1395r-5(b).

⁶⁴ See, *e.g.*, *Id.* § 1395p(d)(6)

⁶⁵ I.R.C. § 408(b)(1).

purchased or for his beneficiaries.”⁶⁶ In the context of ERISA and IRAs “beneficiaries” refers to remainder beneficiaries upon the death of the individual owner or participant.⁶⁷

C. Putting It All Together: Planning Scenarios

a. *Scenario 1:* Harry, 72, is headed to Shadey Grove Health and Rehab for a permanent stay. Sally, 60 and very healthy, is Harry’s wife. Harry owns a \$350,000 IRA and has monthly SS retirement benefits of \$2,000. Sally continues to work in accounting and earns \$75,000 annually. Harry’s IRA is the only obstacle to obtaining what would otherwise be a routine Medicaid plan for a married couple.

If Harry cashes in his IRA, Sally estimates tax due (based on her income and Harry’s IRA) at about \$153,000.⁶⁸ The inclusion of the IRA in gross income added about \$135,000 in tax liability, and leaves about \$215,000 in cash to apply to some standard Medicaid planning for a married couple.

If they decide to annuitize the IRA, Sally may be named primary beneficiary ahead of the state. Because Sally is more than 10 years younger than Harry, they can use the Joint Life and Last Survivor Expectancy table and use a denominator of 28.8 to calculate the annuity stream. They plan also to find an annuity provider that will allow a lump sum distribution option at Harry’s death.⁶⁹ Sally plans to roll the eventual final distribution as a lump sum to a traditional DC-type IRA.

Sally estimates that the annuity stream to Harry will be about \$1,000 monthly,⁷⁰ which will be considered income and will be applied to Harry’s PML. But it also may be tax deductible medical expense.⁷¹

Harry dies after 4 years. The present value of the annuity is about \$300,000, which the provider calculates to be the amount available to roll to a new IRA if Sally wishes to avail herself of that option. She does.

Sally is now 64, and is 11 years from her RBD. If her IRA grows at 7% for the next 11 years, the IRA should stand at about \$630,000 on her RBD.

⁶⁶ *Id.* §§ 408(a) & (b)(4).

⁶⁷ *See, e.g.*, Tres. Regs. § 1.408-2(b)(7).

⁶⁸ Please understand these are rough calculations; a financial professional with access to better forecasting tools would probably be more accurate. The scenarios are meant to illustrate the planning idea.

⁶⁹ Many financial advisors may balk at this scenario. Shameless plug: Gerald Applefield, at Barry, Evans, Josephs & Snipes in Charlotte can help you. BEJ&S is an advisory firm catering to the affluent, and Gerald knows more about the insurance industry than anyone else that I know. And, yes, he is Nicki Applefield Engel’s father.

⁷⁰ $\$350,000/28.8 = \$12,153$.

⁷¹ I.R.C. § 213 allows deduction of medical expenses in excess of 7.5% of AGI.

b. *Scenario 2:* Harry and Sally are both 74. Sally's monthly SS retirement benefit is \$1,100.

If they cash in Harry's IRA, it will add about \$95,000 tax liability, leaving \$255,000 cash to apply to some standard Medicaid planning for a married couple.

You then decide to see what the numbers look like if they decide to annuitize the IRA. The denominator in the Uniform Lifetime Table (used when a spouse is beneficiary and there is a less than 10-year age gap in the couple) is 25.5. That will yield a monthly annuity stream of about \$1,100 to Harry. However, you astutely observe that the July 1, 2024 minimum maintenance needs allowance is \$2,555. Because Sally's monthly income is just \$1,100, she will be entitled to an allowance out of Harry's income of \$1,455. The math may be illusory. If they had cashed in the IRA, Harry's PML would have been around \$265.⁷² You are still out the monthly annuity amount of \$1,100.

Harry dies 2 years later at age 76. The cash distribution amount available to Sally is about \$320,000. She rolls it into an IRA. Because she is past her RBD, she will immediately begin MRDs. Upon her death she can leave it to her children, and because you have been to at least 38 SECURE Act seminars addressing standard DC-type IRAs, you will know just what to do.

c. *Scenario 3:* Sally was recently hit by a school bus while checking her mail box. She did not make it. Harry is 74 and still has a \$350,000 IRA. His only child, Sandy, is 45, and drawing Social Security Disability Income (SSDI).

Harry's attorney-in-fact, Sandy, wants to know the options. If the IRA is cashed in the tax liability will be around \$122,000, leaving about \$228,000. This amount could then be gifted to Sandy free from sanctions.⁷³

You could annuitize the IRA and name Sandy as the remainder beneficiary. As in Scenario 2, this will yield an about \$1,100 monthly annuity stream to Harry.⁷⁴ Sandy's survivor benefit, however, would be limited to \$671 for her life due to the 29 year age gap.⁷⁵ Harry dies 3 years later, and the cash out amount is about \$310,000. The tax liability for Sandy would be around \$105,000, leaving about \$205,000 net of taxes.

So, what do you want Sandy? \$228,000 when qualifying Harry for Medicaid? \$205,000 (net of taxes) cash-out at Harry's death? \$671 monthly for the rest of your life. My advice would be to cash in the IRA.

⁷² \$2,000 – \$300 – \$70 – \$1,365 = \$265. \$300? I decided to throw in a Medicare Supplement premium of that amount. The \$70 is the newly established personal needs allowance (MA-2270 V.C.3.).

⁷³ *Id.* (c)(2)(B)(iii); MA-2240 VII.C.

⁷⁴ The Uniform Life Table denominator for a 74 year old is 25.5.

⁷⁵ See my explanation at V.A.3.c on p. 13, above.

ATTACHMENT A –A Pre-TEFRA ANNUITY IN 2025

Contract Details

SINGLE PREMIUM DEFERRED ANNUITY
00009 [REDACTED]

Value As of Date: 10/07/2024

Contract Details	Historical Values
Annuitant: [REDACTED] Product Name: <u>Single Premium Deferred Annuity</u> Annuity Type: Nonqualified Contract Status: In Force Issue Date: 08/01/1982 Current Statement: – Maturity / Income Date : 08/01/2038 Note: For Maturity/Income Date the contract owner may choose to begin distributions before the indicated date or extend the date to the latest available date in the future. Please contact the Jackson Service Center for additional details regarding how Jackson determines the Maturity/Income Date.	Value As of Date: 10/07/2024 → Values
My Representative	
DANNY [REDACTED] Tel: [REDACTED] Email: [REDACTED]@aol.com	

Additional Details	
Total Deposits: \$5,000.00 Free Withdrawal Amount¹: \$85,302.07 Cash Surrender Value³: \$86,302.07 Average Interest Rate: 5.50%	Accumulated Value: \$86,302.07 Cash Surrender Charge \$0.00 Amount²: Market Value Adjustment: \$0.00 Minimum Guaranteed 5.50% Interest Rate:
1. Free withdrawal amount applies to surrender charge calculations only. 2. Please review your contract for specific details regarding the applicable Surrender Charge and minimum balance requirement to remain active. 3. Free Look Endorsement may apply, please refer to your contract for details.	

Beneficiaries (As of 10/04/2024)

Primary Beneficiaries			Contingent Beneficiaries		
Name	Relationship	Percentage	Name	Relationship	Percentage
[REDACTED]	Spouse	100%	[REDACTED]	Child	50%
			[REDACTED]	Child	50%

Names and Addresses	
Contract Owner	Annuitant
[REDACTED] DR [REDACTED], NC [REDACTED]	[REDACTED] [REDACTED] NC 28673

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Jackson National Life Insurance Company
1 Corporate Way
Lansing, MI 48951



**FUNDING AN SNT
WITH
TAX DEFERRED ASSETS**

2025 NATIONAL CONFERENCE
ON SPECIAL NEEDS PLANNING
AND SPECIAL NEEDS TRUSTS

STETSON UNIVERSITY COLLEGE OF LAW

1

Sorry, but

**Annuities
and
IRAs**

2

OUR AGENDA

- **Nonqualified Annuities**
- **Inherited IRAs**
- **Trust-like Features of Annuities**
- **Medicaid and Annuities**
- **Annuitized IRAs**

3

ANNUITIES

- You **MUST** understand annuities in a Medicaid practice
- Trust ownership can be useful
- Qualified vs Nonqualified
- What they are – a bit like a loan

4

ANNUITIES

- IRC § 72
- Encourage retirement savings
- Police against nefarious tax schemes
- Many similarities to IRC § 401(a)(9)

5

ANNUITIES

The Parties

- Holder – The Owner
- Annuitant – Technically, the measuring life
- Beneficiary – The person who will benefit

6

ANNUITIES

Classification

- **Qualified v. Nonqualified**
- **Immediate v. Deferred**
- **Other features**

7

ANNUITIES

If Deferred

- **Accumulation Phase**
- **Distribution Phase**
- **Annuity Start Date ("ASD")**
- **Different tax rules pre/post ASD**

8

ANNUITIES

Rules During Holder's Life

- **Tax Deferral during accumulation/life**
- **Annuity held by trust – Agent for natural person – look at beneficiaries**
- **Income received as an annuity**
- **Income NOT received as an annuity**

9

ANNUITIES
Rules During Holder's Life

- Income received as an annuity –
1/18/1985 Force Out Rules
- After ASD
- Exclusion ratio
- Investment in the K ÷ Expected return

10

ANNUITIES
Rules During Holder's Life

- Income received as an annuity
 - The exclusion ratio: Tax-free return
 - The rest: Ordinary income
 - If a trust apply usual tax rules

11

ANNUITIES
Rules During Holder's Life

- Income NOT received as an annuity
 - Amounts drawn out before ASD
 - Last In/First Out (LIFO) (TEFRA '82)
(Effective 8/18/192 . . . Look at the 8/1/1982 outline attachment!)
 - If a trust apply usual tax rules

12

ANNUITIES
Rules During Holder's Life

- Income NOT received as an annuity
- Example:
 - \$100,000 investment
 - ASD 10 years out
 - In 5 years dip in when worth \$130,000
 - Take out \$40,000/4% surrender chg
 - Receives \$38,400
 - \$30,000 ordinary income

13

ANNUITIES
Rules During Holder's Life

- Gratuitous Transfers
- Except: To spouse
- Except: Grantor trust/estate includible
 - Because I said so
 - Underlying policy

14

ANNUITIES
Rules At Holder's Death

- Force-out Rules
- Beneficiary Taxation

15

ANNUITIES

Rules At Holder's Death

- **How fast?**
- **Holder dies before ASD**
 - **Five year rule**
- **Holder dies after ASD**
 - **At least as rapidly as**

- ## **ANNUITIES**
- Rules At Holder's Death**
- **How fast?**
 - **Holder dies before ASD**
 - **Five year rule**
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ANNUITIES

Rules At Holder's Death

- **How fast?**
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ANNUITIES

Rules At Holder's Death

EXCEPTIONS!

- **Spouse is primary beneficiary**
 - **Death before ASD – continue**
 - **Lump sum (if allowed in K)**
 - **Death after ASD – At least as**
Death after ASD – Spouse LE

ANNUITIES

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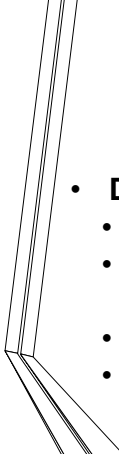
- # ANNUITIES
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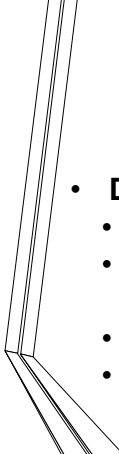


ANNUITIES

Rules At Holder's Death

EXCEPTIONS!

- **Designated beneficiary**
 - **May elect DB's life**
 - **Must receive first install w/in one year**
 - **Must elect within 60 days**
 - **Election counters constructive receipt**

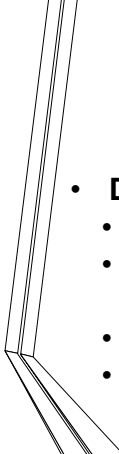


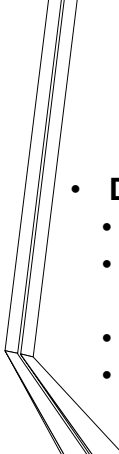
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ANNUITIES

Rules At Holder's Death

EXCEPTIONS!

- **Trust are not humans! NOT DBs**
 - **Either 5 year rule or “at least as rapidly as”**
 - **If Trust is Holder, then death of Primary Annuitant triggers**
 - **If Trust changes Primary Annuitant: Immediate tax**



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ANNUITIES AND TRUST RECAP

- **Trust can hold as “agent” – type of trust irrelevant**
- **Exception to gratuitous transfer rule**

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ANNUITIES AND TRUST RECAP

- **If Trust is beneficiary – either 5 year or at least as rapidly as**
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- **If trust is Holder – Don't change PA**

TRANSFERRING AN INHERITED IRA

- **Poor/No Planning by Parent**
- **Any Circumstances Rule**
- **D4A Exception**

22

D4A Trusts

- **Recap**
- **Tax Status as Grantor Trust**
- **IRC § § 673 and 677**

23

Treas. Reg. § 1.671-3(a)(1)

- **If Grantor treated as owner of whole trust --**

All tax attributes taxed to Grantor in same manner “Had the trust not existed”

24

Revenue Ruling 85-13

- **Reiterates Treas. Reg. § 1.671-3**
- **For tax purposes, treat the trust as if it simply did not exist**

25

The Inherited IRA

- **Trusts are routinely named as beneficiaries**
- **Extensive SECURE Act (and 2.0) rules**
- **This is NOT a rehash**

26

The Inherited IRA

- **But what about an inherited IRA (woops)?**
- **Generally, IRC § 691(a) IRD when received; totally when transferred**
- **Disabled bennie in a tough spot**

27

The Letter Rulings

- **PLRs 2006-20025 & 2011-16005**
- **IRAs inherited by disabled beneficiaries**
- **D4As were grantor trusts due to IRC § 677 (income accumulation)**

28

The Letter Rulings

- **PLRs 2006-20025 & 2011-16005**
- **Discussed 691(a)(2) (Transfers trigger total tax)**
- **Discussed Rev. Rul. 85-13**

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The Letter Rulings

- **PLRs 2006-20025 & 2011-16005**
- **Conclusion: Not a transfer under IRC § 691(a)(2) because to a grantor trust**
- **Under Rev. Rul. 85-13 not a “sale or disposition”**

30

The Letter Rulings

- **PLR 2008-26008**
- **Beneficiary a minor (not disabled)**
- **Irrev Trust with mandatory distributions at certain ages**
- **Same reasoning used**

31

The Inherited IRA

- **Dave's story**
- **The Trust – Yay Peak Trust!**
- **Estate Recovery**
- **The remainder beneficiaries**

32

SWITCHING GEARS GOING OFF SCRIPT!

- **We've talked about inherited IRAs – We have support for transferring to trust**
- **What about owned IRAs to D4A or other grantor trust?**

33

SWITCHING GEARS
TRANSFERRING AN OWNED IRA
TO TRUST

- No support; even though 85-13 says to “treat as if trust doesn’t exist”
- Irrev Grantor Trust: 5 year lookback and tie up IRA

34

SWITCHING GEARS
TRANSFERRING AN OWNED IRA TO
TRUST

- D4A: Payback; Not good if CS
- What about annuitized IRAs?
 - Friendly inheritance rules for spouse
 - If no spouse, annuity can STILL mimic D4A

35

SWITCHING GEARS
Besides

- Rules tend to conflate annuities and trusts
- What about annuitized IRAs?
 - Great for a CS or a disabled child

36

SWITCHING GEARS

So

- Let's discuss Medicaid and Annuities (I may have a surprise)
- Then let's look at annuitized IRAs

37

SWITCHING GEARS

MEDICAID AND ANNUITIES

- Countable Assets?
- Transfer Rules

38

Countable?

- Irrevocable
- Nonassignable

See POMS SI 01110.100B &
42 USC § 1396p(c)(1)(G)(i)(II)(ii)(I)
("irrevocable and nonassignable")

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42 USC § 1396p(c) – The Transfer Rules

(c)(1)(A) through (J) -- The general
transfer prohibitions

(c)(2)(A) and (B) – The Exceptions
to (1)

40

Transfer?

- **DRA 2005 added
1396p(c)(1)(F) & (G)**

- **Subparagraph (F)**

- **Remainder Beneficiaries: State, Spouse,
Disabled Child (More to follow)**

41

Transfer - Subparagraph (G)

- **Individual Retirement Annuity (Qualified)**

OR

- **Purchased with IRA proceeds (Qualified)**

OR

- **Nonqualified Proceeds**

- Irrevocable/nonassignable
 - Actuarially sound
 - Equal Periodic Payments

42

Subparagraph (G) and Qualified Assets

- Most of us focus on the THIRD category
- But think about the FIRST and SECOND (Qualified assets)
- The qualified assets do not need to comply with “actuarially sound” – Simply the more generous IRA life table rules

43

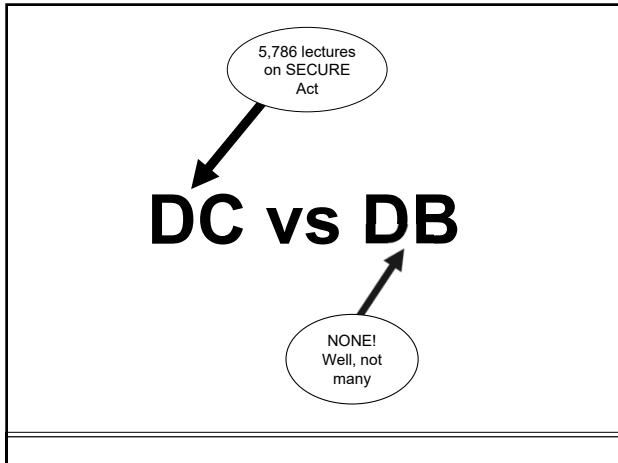
ANNUITIZING AN IRA

44

DC = DEFINED CONTRIBUTION

DB = DEFINED BENEFIT

45



46

SNEAK PEEK AT OUR DISCUSSION OF A FEW MINUTES FROM NOW:

Does it make sense to annuitize the I/S IRA ?

- Make noncountable
- Avoid cash-out (defer taxes)
- Annuity payments either to SNF or to Spouse (MMMNA)
- Upon death of I/S, spouse rolls to own IRA

Hold that thought. First some rules

47

THE DB RULES SYNOPSIS

- SECURE Act made few changes to DB rules
- RBD:
 - If 72 on or after 1/1/2023 – age 73
 - 75 if born on or after 1/1/1959
- ASD: Date annuity payments begin (no later than RBD)

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PERMISSIBLE FORMS OF ANNUITY UNDER DB RULES

- Straight Life – Maximizes payout; no beneficiaries; not Medicaid attractive
- Joint life of owner and spouse – Lowers payout; spouse can have lump sum payout at death of owner; spouse named ahead of state
- Joint life of owner and another – Recall a disabled child can be remainder ahead of state
- Period certain: Yuck!

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CALCULATING THE ANNUITY STREAM

- DITCH THE SSA ACTUARIAL TABLES!
- “Period certainty” limitation -- “Borrow” the denominator from the appropriate IRS DC Life Table

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THE IRS LIFE TABLES

- Uniform Lifetime Table
 - Owner + Spouse within 10 years of age of owner
 - Owner + Spouse not sole remainder beneficiary
 - Owner not married
 - E.g., owner is 72 – ULT assigns 27.4 years
- Compare to “stingy” SSA Period Life Table:
12.3 (Male) 14.36 (Female)

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THE IRS LIFE TABLES

(Continued)

- **Joint Life and Last Survivor Expectancy Table**
 - Owner is 10 or more years older than beneficiary spouse
 - Think: Michael Douglas (79) and Catherine Zeta Jones (54) OR Heidi Klum (47) and Tom Kaulitz (31)
 - E.g., Owner (72) and Spouse (60) – ULT assigns 28.8 years

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Death Benefit Options

- **Nonspouse Beneficiary**
 - Leave annuity stream as is, or
 - Cashout (and pay tax!) (an exception to nonincreasing payments rule)
- **Spouse Beneficiary**
 - Same as above OR
 - Rollover PV into own IRA (spousal rollover)

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ANNUITIZING AN IRA

A COST – BENEFIT ANALYSIS

54

INSTITUTIONAL SPOUSE IRA

- **MOST COMMON APPROACH:** Cash it in and tax the tax hit!
- Annuitize it under (c)(1)(G)
- Name on the Check Technique

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A CRITIQUE OF THE NOC TECHNIQUE

MEDICAID ISSUES

- Look at Spring/Fall 2020 NAELA Journal

56

A CRITIQUE OF THE NOC TECHNIQUE

MEDICAID ISSUES

- 1395r-5(d)(2)(A) NONtrust Property
Name on check rule: What is his is his, and what is hers is hers

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A CRITIQUE OF THE NOC TECHNIQUE

MEDICAID ISSUES

- 1395r-5(d)(2)(B) Trust Property
 - Income as provided under the trust
 - Otherwise “Name on Check”

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A CRITIQUE OF THE NOC TECHNIQUE

TAX ISSUES

- IRC § 408(b)(1): IR Annuity must be nontransferable
- Treas. Reg. § 1.408-2(b)(7): Must be for exclusive benefit of individual (and later on) beneficiaries

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ANNUITIZING UNDER (c)(1)(G)

60

**ANNUITIZE INSTITUTIONAL SPOUSE ANNUITY
AND . . .**

CONS

- Annuity payments become income for MA purposes
- May end up going to SNF

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**ANNUITIZE INSTITUTIONAL SPOUSE
ANNUITY AND . . .**

PROS

- Different life tables apply (much longer stretch)
- Much younger spouse
- Tax deductible to extent NH expenses paid exceed 7.5% of AGI

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**ANNUITIZING THE
INSTITUTIONAL SPOUSE IRA:
THE COST-BENEFIT ANALYSIS**

- How long is I/S expected to live? Using that guesstimate, how much will go to SNF as PML?
- What is tax savings by not cashing in?

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SCENARIO 1

Harry, 72, and headed to Shady Grove Health & Rehab.

Sally (Harry's wife), 60, and very healthy.

Harry owns \$350,000 IRA. SS Retirement \$2,000/mo.

Sally works. \$75,000/yr. Is an accountant.

IRA is only obstacle to what should have been routine married couple Medicaid planning matter.

64

OPTIONS

1. Cash in the IRA. Tax liability: \$135,000. Net IRA proceeds: \$215,000.

2. Annuitize the IRA.

A. Use Joint & Last Survivor Table: 28.8.

Annuity stream of about \$1,000/mo to Harry.

B. 4 Years later, Harry dies. PV of annuity is \$300,000. Sally now 64, 11 years from her RBD. Sally estimates FV in 11 years to be \$630,000.

65

SCENARIO 2

Same facts, except both Harry and Sally are 74. Sally's monthly SSRB is \$1,100.

66

OPTIONS

1. **Cash in the IRA.** Added tax liability: \$95,000. Net \$255,000 to use in standard planning.
2. **Annuitize.** Using Uniform Life Table divisor is 25.5, yielding a stream of about \$1,100/mo.
Harry dies 2 years later at 76. PV of annuity is about \$320,000. Sally rolls to her DC-type IRA.
When Sally dies, the kids can inherit, and you'll know what to do because of all the DC-type seminars you have been to.

67

SCENARIO 3

Sally was recently hit by a school bus and killed. Their child Sandy, aged 45, is on SSDB. Harry's IRA is worth \$350,000. UL Table denominator: 25.5

If annuitized, Harry's IRA would yield about \$1,100/mo (based on 25.5 divisor).

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OPTIONS

1. **Cash in the IRA.** The net after taxes would be about \$228,000. This could be gifted to Sandy sanction-free.
2. **Annuitize the IRA and name Sandy Beneficiary.** Yield to Harry, about \$1,100 monthly. Sandy's life benefit would be limited to \$671.

69

NEWS FLASH!

3 years later . . . Harry has taken his light into another room . . .

There is about \$310,000 available for cash-out that net of taxes will yield about \$205,000 to Sandy . . . Unless she wants the \$671 monthly for the rest of her life.

I'm thinking she's sorry she didn't take \$228,000 back when we qualified Harry for Medicaid.

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DONE!

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QUESTIONS?

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STETSON LAW

Tax Intensive

October 22, 2025

The Intersection of Medicaid Planning Trusts and Taxation



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## **I. Introduction**

- A. Course Objectives
- B. Course Structure

**II. Global Example.** Jack is 78 years old and incapacitated. Jack owns a house (FMV \$400,000, AB \$150,000), an IRA (\$250,000) and cash (\$125,000). Jack's social security income is \$30,000 per year and his annual expenses (including property taxes, income taxes and an in-house aid) are \$90,000. Jack is widowed and has one child, Jill. Jill is named in Jack's Power of Attorney as his attorney-in-fact. Jill visits you to discuss planning for her father.

## **III. Threshold Issues**

- A. Determine Jack's capacity
- B. Review Jack's documents
  - 1. Power of Attorney (Gifting/Successor Agents)
  - 2. Health Care Directive (HIPAA/Successor Agents)
  - 3. Will
- C. Verify Jack's Assets and Liabilities
- D. Verify Jack's Income and Expenses (look at prior year's Form 1040)
- E. Verify no one is leaving Jack any money.

## **IV. Jack's Principal Residence**

- A. Options
  - 1. Do Nothing
  - 2. Gift Principal Residence (Outright/Trust)
  - 3. Sell Principal Residence
  - 4. Rent Principal Residence

## **V. Section 121: Exclusion of Gain Realized on Sale of Principal Residence**

- A. General Rule-IRC Section 121(a) - Gross Income shall not include gain realized from the sale or exchange of property if, during the five-year period ending on the date of sale or exchange, such property was owned and used by the taxpayer as its principal residence for periods aggregating two or more years. The amount of gain that can be excluded is generally limited to \$250,000 (single individuals) and \$500,000 (married couples and certain surviving spouses).
- B. Principal Residence – a residence includes a houseboat, mobile home, Coop and Condo. Furniture and other personal property will not qualify under IRC Section 121.
- C. Ownership and Use:
  - 1. In General-Reg. Section 1.121-1(c)(7) – The ownership and use requirements may be satisfied during noncurrent periods so long as both the ownership and use requirements are met (24 months or 730 days) during the 5-year period ending on the date of sale or exchange.
  - 2. Use:
    - a. Reg. Section 1.121-1(c)(2) - Occupancy is required for the use test to be met. Short-

term absences such as vacations or other seasonal absences, even if accompanied by rental of the residence, are counted as periods of use.

- b. A special rule applies to any taxpayer who becomes physically or mentally incapable of self-care and who owns property and uses it as the principal residence for periods aggregating at least one year during the 5-year period ending on the date of the sale or exchange (Section 121(d)(7); 1.121-1(c)(2)(ii)). Under this rule, the taxpayer is treated as using the property as the principal residence for any time during that five-year period in which the taxpayer owns the property but resides in any nursing home or other facility that is licensed by a state or political subdivision to care for an individual in the taxpayer's condition.
3. **Ownership:** If a residence is owned by a trust, the taxpayer is treated as owning the residence for any period for which the taxpayer is treated under the grantor trust rules (IRC Sections 671-679; See VI. below) as the owner of the trust or the portion of the trust that includes the residence, and the sale or exchange by the trust will be treated as if made by the taxpayer (Reg. Sec. 1.121-1(c)(3)(i)). If a residence is owned by an eligible entity that has a single owner and is disregarded for federal tax purposes as an entity separate from its owner, the owner of the entity is treated as owning the residence, and the sale or exchange by the entity will be treated as if made by the owner (Reg. Sec. 1.121-1(c)(3)(ii)).
4. **Partial Use (1.121-1(e)):** If a portion of any property is used as a principal residence and another portion, separate from the dwelling unit, is used for non-residential purposes, only the gain allocable to the residential portion is eligible for the Section 121 exclusion. No allocation is required if both the residential and non-residential portions of the property are within the same dwelling unit, but Section 121 does not apply to the portion of the gain attributable to depreciation deductions allowed for periods after May 6, 1997. To determine the amount of gain allocable to the residential and non-residential portions of the property, the taxpayer must allocate the basis and the amount realized between the residential and the non-residential portions of the property using the same method of allocation that the taxpayer used to determine depreciation.
5. **Spousal Ownership:**
- a. **\$500,000 exclusion for certain joint filers (121(b)(2)).** In the case of a taxpayer who files a joint return for the tax year of the sale or exchange of the property, the \$250,000 limitation that applies to the exclusion of gain from the sale or exchange of a principal residence becomes \$500,000 if:
    - i. either spouse meets the ownership requirements with respect to the property;
    - ii. both spouses meet the use requirements with respect to the property;
    - iii. neither spouse is ineligible for the benefits of the exclusion with respect to the property by reason of the one sale every two years rule (Reg. Section 121(b)(3)).
  - b. There is a special rule (121(b)(4)) applicable to certain sales or exchanges after December 31, 2007 by surviving spouses. The \$500,000 exclusion amount for joint returns applies to a sale or exchange by an unmarried individual whose spouse is deceased as of the date of sale provided:
    - i. the sale occurs not later than two years after the date of death of the spouse; and
    - ii. the requirements set forth in V.C.5.a. above were met immediately before the date of death.

- c. An unmarried widower/widow is treated as owning and using the property for any period that the deceased spouse of such individual owned and used the property.

**Example 1:** SS has solely owned the residence that SS and her spouse (DS) have used as their principal residence since January 1, Year 1. On January 1, Year 10, DS dies. SS and DS had not sold another residence within the two years before DS's death. SS sells the residence on January 2, Year 11. SS would be entitled to a maximum gain exclusion of up to \$500,000 because:

- the sale occurred not later than two years after DS's date of death (i.e., before January 1, Year 12);
- SS met the two-year ownership requirements with respect to the residence immediately before DS died;
- both DS and SS met the two-year use requirements with respect to the residence immediately before DS died; and
- neither DS nor SS was ineligible for the benefits of the exclusion with respect to the residence by reason of the one sale every two years rules.

**Example 2:** The facts are the same as in Example 1, except that DS and SS had owned their residence as tenants in common since January 1, Year 1. Under the terms of DS's will, DS's interest in the residence is left to a trust for the benefit of SS and DS's descendants (for example, a qualified terminable interest property trust or QTIP trust). SS and the trustee of the trust sell the residence on January 2, Year 11. Will SS be entitled to a maximum gain exclusion of up to \$500,000?

6. Exclusion allowed on one sale every two (2) years: Assuming the eligibility requirements are met, the exclusion of gain from the sale or exchange of a principal residence does not apply to any sale or exchange by the taxpayer if, during the two-year period ending on the date of the sale or exchange, there was any other sale or exchange by the taxpayer to which the exclusion applied. If a single taxpayer who is otherwise eligible for an exclusion marries someone who has used the exclusion within the two years before the marriage, the newly married taxpayer is allowed a maximum exclusion of \$250,000. Once both spouses satisfy the eligibility rules and two years have passed since the last exclusion was allowed to either of them, the taxpayers may exclude \$500,000 of gain on their joint return.
7. Disposition of Principal Residence Caused by Employment, Health or Unforeseen Circumstances
- a. A Taxpayer who fails to meet the requirements of Section 121 due to a change in place of employment, health or unforeseen circumstances may exclude the fraction of the \$250,000 (\$500,000) amount equal to the shorter of (1) the aggregate periods during which the ownership and use requirements were met during the five year period ending on the date of sale bears to two years or (2) the period after the date of the most recent sale to which Section 121 applied bears to two years.
- i. Change in Employment – Safe Harbor: New place of employment is at least 50 miles further from the residence sold than was the former place of employment.
- ii. Change in Health – Move needed to obtain, provide or facilitate the diagnosis, cure, mitigation or treatment of a disease, illness or injury (Safe Harbor:

Physician's recommendation).

- iii. Unforeseen Circumstances – the occurrence of an event that the taxpayer could not reasonably have anticipated (i.e. Natural disaster, divorce, unemployment that results in an inability to pay housing costs and reasonable basic living expenses).

## VI. Grantor Trust Rules

### A. Synopsis of Grantor Trust Rules

1. **Section 673** – Under Section 673, the grantor is the owner of any portion of a trust in which he or she holds a reversionary interest that on the date of the transfer to the trust has a value in excess of 5 percent of the trust fund.
2. **Section 674** – Under Section 674, the grantor is the owner of any portion of a trust over which he or she or any nonadverse party holds a power to control the trust beneficial enjoyment, even if that power cannot be exercised for the grantor's personal benefit, subject, however, to numerous important exceptions. These rules are of critical importance in drafting inter vivos trusts, because they dictate what powers a selected trustee may hold and, when certain powers are essential, who may serve as the trustee without causing the grantor to be taxed as the owner of the trust.
3. **Section 675** – Under Section 675, the grantor is the owner of any portion of a trust as to which the grantor or any other nonadverse party holds certain administrative powers. Section 675 includes important limitations on the ability to avoid grantor trust status while providing the grantor with benefits from the trust in the form of loans, and on the exercise by any person of fiduciary powers (such as the right to vote closely held stock) in a nonfiduciary capacity.
4. **Section 676** – Under Section 676, the grantor is the owner of any portion of a trust as to which he or she holds a power to revoke the trust and reacquire its assets.
5. **Section 677** – Section 677 taxes the grantor as the owner of any portion of a trust the income from which is or may be paid to, accumulated for, or used to pay premiums on policies of insurance on the lives of the grantor or the grantor's spouse. These rules also tax the grantor as the owner of any portion of trust income actually used to discharge the grantor's legal obligation of support, making this set of rules an important consideration in trust administration.
6. **Section 678** – Section 678 taxes a person other than the grantor as the owner of any portion of a trust over which such third person (virtually always a beneficiary) holds a substantially unrestricted power to invade the trust assets. This rule also applies when trust income is used to discharge the support obligation of a third person, and when the holder of a broad power partially releases that power and retains a more limited power resembling a grantor trust power under Sections 673 through 677.
7. **Section 679** – Section 679 contains rules that tax a U.S. grantor as the owner of any portion of a foreign trust that has or may have a U.S. beneficiary.

### B. Right to Substitute Assets – Section 675(4)

1. The retention of the right, exercisable in a nonfiduciary capacity, to reacquire assets by substituting assets of equivalent value, will create a grantor trust.\
2. *Jordahl v. Commissioner* (65 TC 92 (1975)) and PLRs 200606006 and 200603040 – the 674(4) power does not constitute a power to alter, amend or revoke a trust within Section 2038(a)(2). However, in *Jordahl*, the power to substitute was possessed in a

fiduciary capacity. Also Rev. Rul. 2008-22 and PLR 200944002 – retained power by a trust grantor, acting in a non fiduciary capacity, to substitute trust assets with other assets having an equivalent value does not cause the trust to be included in the Grantor's estate under Code Sections 2036 and 2038. This result will apply provided the trustee has a fiduciary obligation, either under local law or pursuant to the terms of the trust document, to ensure that the properties substituted by the grantor are in fact equivalent value and the power of substitution cannot be exercised in a manner that can shift interests among the beneficiaries of the trust.

3. Rev. Rul. 2011-28 – the power to reacquire life insurance policy in a non-fiduciary capacity, so long as trustee can require appropriate value, will not cause inclusion under IRC Sec. 2042.

## **VII. Transfer Tax Ramifications of Gifting Residence**

### **A. Gift**

1. General Rule – When is a gift complete?
  - a. Under IRC Section 2511(a), a gift tax applies whether a transfer is made in trust or not; whether a gift is direct or indirect; and whether property is real, personal, tangible or intangible. When a donor parts with dominion and control of a gift so as to leave him no power to change its disposition, a gift is complete (Treasury Regulation Section 25.2511-2(b)). But, if a donor retains any power over the disposition of property, depending on the facts of the transfer, a gift may be wholly incomplete or may be partially complete and partially incomplete. Thus, in every case of a transfer of property subject to a reserved power, the terms of the power must be examined and its scope determined.
2. Incomplete Gift – Under Treasury Regulation Section 25.2511-2(b) and (c), a transfer is incomplete when a donor transfers property to a trust and retains the power to change the beneficial interests in the trust (Example: Testamentary Limited Power of Appointment makes gift incomplete).
  - a. However, IRS Chief Counsel Office issued Internal Legal Memorandum CCA 201208026 which stated a testamentary limited power of appointment is not sufficient to make entire gift incomplete (only remainder interest).
  - b. As a result, it would be prudent to also insert a provision in the IDIT allowing the Grantor to add charitable beneficiaries to the trust.
3. Basis of Gift
  - a. Completed Gift
  - b. Incomplete Gift (See Estate Rules Below)

### **B. Estate IRC Section 2036 – Retained Income/Right to Designate**

1. 2036(a)(1). If the decedent retained, by express or implied agreement, possession, enjoyment, or the right to income, then the transferred property should be included in the decedent's estate. The decedent is considered as having retained the income from property transferred that is applied towards the discharge of a legal obligation of the decedent. The existence or nonexistence of an express or implied agreement is determined from the facts and circumstances surrounding both the transfer of the property and the subsequent use of the property.
2. 2036(a)(2). If the decedent, either alone or in conjunction with any person, retains the right to designate the persons who shall possess or enjoy the property transferred or the

income therefrom, then the property transferred should be included in the decedent's estate. This subsection **does not** include the retention of a right to exercise managerial powers over the transferred property nor does it apply if such a retained power is held solely by a person other than the decedent.

## **VII. Jack's IRA/Cash**

### **A. Jack's IRA (\$250,000)**

1. Gift IRA: Jack will pay approximately \$60,000 (24%) in income taxes and will be able to gift the balance of \$190,000.
2. Keep IRA: Use for Jack's living expenses for next 5 years.
3. Part Gift/Keep Balance.

### **B. Jack's Cash (\$125,000)**

1. Gift: \$25,000 (see plan below VIII.A.).
2. Keep: \$100,000 (see plan below VIII.A.).

## **VIII. Analysis**

### **A. Plan**

1. Determine Living Expense Deficiency.
  - a. \$60,000: Annual deficiency between Social Security Income (\$30,000) and living expenses (\$90,000).
  - b. Five Year Deficiency: \$300,000 (\$60,000 X 5). Jack will need approximately \$300,000 to "live on" over next 5 years.
2. Keep Enough Assets for Jack to live on.
  - a. IRA: \$250,000 (Approximately \$210,000 after income taxes)
  - b. Cash: \$100,000
3. Jack makes an incomplete gift of the Remaining Assets (House: \$400,000 and cash \$50,000) to an IDIT.

### **B. Result**

1. No need to file Gift Tax Return (Form 709) as gift is incomplete.
2. Step-up in basis of assets in IDIT at Jack's demise as IDIT will be includable in Jack's estate (IRC §2036 and 2038).
3. Get §121 Exclusion if sell house while Jack's alive as IDIT is a Grantor Trust.
4. Start 5 year clock running for Medicaid.

## **IX. Conclusion**



LII > U.S. Code > Title 26 > Subtitle A > CHAPTER 1 > Subchapter B  
> PART III > **§ 121**

Quick search by citation:

**Title**

**Section**

# 26 U.S. Code § 121 - Exclusion of gain from sale of principal residence

U.S. Code   Notes   Authorities (CFR)

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## **(a) EXCLUSION**

Gross income shall not include gain from the sale or exchange of property if, during the 5-year period ending on the date of the sale or exchange, such property has been owned and used by the taxpayer as the taxpayer's principal residence for periods aggregating 2 years or more.

## **(b) LIMITATIONS**

### **(1) IN GENERAL**

The amount of gain excluded from gross income under subsection (a) with respect to any sale or exchange shall not exceed \$250,000.

## **(2) SPECIAL RULES FOR JOINT RETURNS**

In the case of a husband and wife who make a joint return for the taxable year of the sale or exchange of the property—

### **(A) \$500,000 Limitation for certain joint returns**

Paragraph (1) shall be applied by substituting “\$500,000” for “\$250,000” if—

- (i)** either spouse meets the ownership requirements of subsection (a) with respect to such property;
- (ii)** both spouses meet the use requirements of subsection (a) with respect to such property; and
- (iii)** neither spouse is ineligible for the benefits of subsection (a) with respect to such property by reason of paragraph (3).

### **(B) Other joint returns**

If such spouses do not meet the requirements of subparagraph (A), the limitation under paragraph (1) shall be the sum of the limitations under paragraph (1) to which each spouse would be entitled if such spouses had not been married. For purposes of the preceding sentence, each spouse shall be treated as owning the property during the period that either spouse owned the property.

## **(3) APPLICATION TO ONLY 1 SALE OR EXCHANGE EVERY 2 YEARS**

Subsection (a) shall not apply to any sale or exchange by the taxpayer if, during the 2-year period ending on the date of such sale or exchange, there was any other sale or exchange by the taxpayer to which subsection (a) applied.

## **(4) SPECIAL RULE FOR CERTAIN SALES BY SURVIVING SPOUSES**

In the case of a sale or exchange of property by an unmarried individual whose spouse is deceased on the date of such sale, paragraph (1) shall be applied by substituting “\$500,000” for “\$250,000” if such sale occurs not later than 2 years after the date of death of such spouse and the requirements of paragraph (2) (A) were met immediately before such date of death.

## **(5) EXCLUSION OF GAIN ALLOCATED TO NONQUALIFIED USE**

**(A) In general**

Subsection (a) shall not apply to so much of the gain from the sale or exchange of property as is allocated to periods of nonqualified use.

**(B) Gain allocated to periods of nonqualified use**

For purposes of subparagraph (A), gain shall be allocated to periods of nonqualified use based on the ratio which—

(i) the aggregate periods of nonqualified use during the period such property was owned by the taxpayer, bears to

(ii) the period such property was owned by the taxpayer.

**(C) Period of nonqualified use**

For purposes of this paragraph—

**(i) In general**

The term “period of nonqualified use” means any period (other than the portion of any period preceding January 1, 2009) during which the property is not used as the principal residence of the taxpayer or the taxpayer’s spouse or former spouse.

**(ii) Exceptions**

The term “period of nonqualified use” does not include—

(I) any portion of the 5-year period described in subsection (a) which is after the last date that such property is used as the principal residence of the taxpayer or the taxpayer’s spouse,

(II) any period (not to exceed an aggregate period of 10 years) during which the taxpayer or the taxpayer’s spouse is serving on qualified official extended duty (as defined in subsection (d)(9)(C)) described in clause (i), (ii), or (iii) of subsection (d)(9)(A), and

(III) any other period of temporary absence (not to exceed an aggregate period of 2 years) due to change of employment, health conditions, or such other unforeseen circumstances as may be specified by the Secretary.

**(D) Coordination with recognition of gain attributable to depreciation**

For purposes of this paragraph—



**(i)** subparagraph (A) shall be applied after the application of subsection (d)(6), and

**(ii)** subparagraph (B) shall be applied without regard to any gain to which subsection (d)(6) applies.

**(c) EXCLUSION FOR TAXPAYERS FAILING TO MEET CERTAIN REQUIREMENTS**

**(1) IN GENERAL**

In the case of a sale or exchange to which this subsection applies, the ownership and use requirements of subsection (a), and subsection (b)(3), shall not apply; but the dollar limitation under paragraph (1) or (2) of subsection (b), whichever is applicable, shall be equal to—

**(A)** the amount which bears the same ratio to such limitation (determined without regard to this paragraph) as

**(B)**

**(i)** the shorter of—

**(I)** the aggregate periods, during the 5-year period ending on the date of such sale or exchange, such property has been owned and used by the taxpayer as the taxpayer's principal residence; or

**(II)** the period after the date of the most recent prior sale or exchange by the taxpayer to which subsection (a) applied and before the date of such sale or exchange, bears to

**(ii)** 2 years.

**(2) SALES AND EXCHANGES TO WHICH SUBSECTION APPLIES**

This subsection shall apply to any sale or exchange if—

**(A)** subsection (a) would not (but for this subsection) apply to such sale or exchange by reason of—

**(i)** a failure to meet the ownership and use requirements of subsection (a), or

**(ii)** subsection (b)(3), and

**(B)** such sale or exchange is by reason of a change in place of employment, health, or, to the extent provided in regulations, unforeseen circumstances.

**(d) SPECIAL RULES**

**(1) JOINT RETURNS**

If a husband and wife make a joint return for the taxable year of the sale or exchange of the property, subsections (a) and (c) shall apply if either spouse meets the ownership and use requirements of subsection (a) with respect to such property.

**(2) PROPERTY OF DECEASED SPOUSE**

For purposes of this section, in the case of an unmarried individual whose spouse is deceased on the date of the sale or exchange of property, the period such unmarried individual owned and used such property shall include the period such deceased spouse owned and used such property before death.

**(3) PROPERTY OWNED BY SPOUSE OR FORMER SPOUSE**

For purposes of this section—

**(A) Property transferred to individual from spouse or former spouse**

In the case of an individual holding property transferred to such individual in a transaction described in section 1041(a), the period such individual owns such property shall include the period the transferor owned the property.

**(B) Property used by former spouse pursuant to divorce decree, etc.**

Solely for purposes of this section, an individual shall be treated as using property as such individual's principal residence during any period of ownership while such individual's spouse or former spouse is granted use of the property under a divorce or separation instrument.

**(C) Divorce or separation instrument**

For purposes of this paragraph, the term "divorce or separation instrument" means—

**(i)** a decree of divorce or separate maintenance or a written instrument incident to such a decree,

**(ii)** a written separation agreement, or

(iii) a decree (not described in clause (i)) requiring a spouse to make payments for the support or maintenance of the other spouse.

#### **(4) TENANT-STOCKHOLDER IN COOPERATIVE HOUSING CORPORATION**

For purposes of this section, if the taxpayer holds stock as a tenant-stockholder (as defined in section 216) in a cooperative housing corporation (as defined in such section), then—

(A) the holding requirements of subsection (a) shall be applied to the holding of such stock, and

(B) the use requirements of subsection (a) shall be applied to the house or apartment which the taxpayer was entitled to occupy as such stockholder.

#### **(5) INVOLUNTARY CONVERSIONS**

##### **(A) In general**

For purposes of this section, the destruction, theft, seizure, requisition, or condemnation of property shall be treated as the sale of such property.

##### **(B) Application of section 1033**

In applying section 1033 (relating to involuntary conversions), the amount realized from the sale or exchange of property shall be treated as being the amount determined without regard to this section, reduced by the amount of gain not included in gross income pursuant to this section.

##### **(C) Property acquired after involuntary conversion**

If the basis of the property sold or exchanged is determined (in whole or in part) under section 1033(b) (relating to basis of property acquired through involuntary conversion), then the holding and use by the taxpayer of the converted property shall be treated as holding and use by the taxpayer of the property sold or exchanged.

#### **(6) RECOGNITION OF GAIN ATTRIBUTABLE TO DEPRECIATION**

Subsection (a) shall not apply to so much of the gain from the sale of any property as does not exceed the portion of the depreciation adjustments (as defined in section 1250(b)(3)) attributable to periods after May 6, 1997, in respect of such property.

#### **(7) DETERMINATION OF USE DURING PERIODS OF OUT-OF-RESIDENCE CARE**



In the case of a taxpayer who—

**(A)** becomes physically or mentally incapable of self-care, and

**(B)** owns property and uses such property as the taxpayer's principal residence during the 5-year period described in subsection (a) for periods aggregating at least 1 year,

then the taxpayer shall be treated as using such property as the taxpayer's principal residence during any time during such 5-year period in which the taxpayer owns the property and resides in any facility (including a nursing home) licensed by a State or political subdivision to care for an individual in the taxpayer's condition.

## **(8) SALES OF REMAINDER INTERESTS**

For purposes of this section—

### **(A) In general**

At the election of the taxpayer, this section shall not fail to apply to the sale or exchange of an interest in a principal residence by reason of such interest being a remainder interest in such residence, but this section shall not apply to any other interest in such residence which is sold or exchanged separately.

### **(B) Exception for sales to related parties**

Subparagraph (A) shall not apply to any sale to, or exchange with, any person who bears a relationship to the taxpayer which is described in section 267(b) or 707(b).

## **(9) UNIFORMED SERVICES, FOREIGN SERVICE, AND INTELLIGENCE COMMUNITY**

### **(A) In general**

At the election of an individual with respect to a property, the running of the 5-year period described in subsections (a) and (c)(1)(B) and paragraph (7) of this subsection with respect to such property shall be suspended during any period that such individual or such individual's spouse is serving on qualified official extended duty—

**(i)** as a member of the uniformed services,

**(ii)** as a member of the Foreign Service of the United States, or

**(iii)** as an employee of the intelligence community.

**(B) Maximum period of suspension**

The 5-year period described in subsection (a) shall not be extended more than 10 years by reason of subparagraph (A).

**(C) Qualified official extended duty**

For purposes of this paragraph—

**(i) In general**

The term “qualified official extended duty” means any extended duty while serving at a duty station which is at least 50 miles from such property or while residing under Government orders in Government quarters.

**(ii) Uniformed services**

The term “uniformed services” has the meaning given such term by section 101(a)(5) of title 10, United States Code, as in effect on the date of the enactment of this paragraph.

**(iii) Foreign Service of the United States**

The term “member of the Foreign Service of the United States” has the meaning given the term “member of the Service” by paragraph (1), (2), (3), (4), or (5) of section 103 of the Foreign Service Act of 1980, as in effect on the date of the enactment of this paragraph.

**(iv) Employee of intelligence community**

The term “employee of the intelligence community” means an employee (as defined by section 2105 of title 5, United States Code) of—

**(I)** the Office of the Director of National Intelligence,

**(II)** the Central Intelligence Agency,

**(III)** the National Security Agency,

**(IV)** the Defense Intelligence Agency,

**(V)** the National Geospatial-Intelligence Agency,

**(VI)** the National Reconnaissance Office,



**(VII)** any other office within the Department of Defense for the collection of specialized national intelligence through reconnaissance programs,

**(VIII)** any of the intelligence elements of the Army, the Navy, the Air Force, the Marine Corps, the Federal Bureau of Investigation, the Department of Treasury, the Department of Energy, and the Coast Guard,

**(IX)** the Bureau of Intelligence and Research of the Department of State, or

**(X)** any of the elements of the Department of Homeland Security concerned with the analyses of foreign intelligence information.

**(v) Extended duty**

The term "extended duty" means any period of active duty pursuant to a call or order to such duty for a period in excess of 90 days or for an indefinite period.

**(D) Special rules relating to election**

**(i) Election limited to 1 property at a time**

An election under subparagraph (A) with respect to any property may not be made if such an election is in effect with respect to any other property.

**(ii) Revocation of election**

An election under subparagraph (A) may be revoked at any time.

**(10) PROPERTY ACQUIRED IN LIKE-KIND EXCHANGE**

If a taxpayer acquires property in an exchange with respect to which gain is not recognized (in whole or in part) to the taxpayer under subsection (a) or (b) of section 1031, subsection (a) shall not apply to the sale or exchange of such property by such taxpayer (or by any person whose basis in such property is determined, in whole or in part, by reference to the basis in the hands of such taxpayer) during the 5-year period beginning with the date of such acquisition.

**[(11) REPEALED. PUB. L. 111-312, TITLE III, §301(A), DEC. 17, 2010, 124 STAT. 3300]**

**(12) PEACE CORPS**

**(A) In general**

At the election of an individual with respect to a property, the running of the 5-year period described in subsections (a) and (c)(1)(B) and paragraph (7) of this subsection with respect to such property shall be suspended during any period that such individual or such individual's spouse is serving outside the United States—

**(i)** on qualified official extended duty (as defined in paragraph (9)(C)) as an employee of the Peace Corps, or

**(ii)** as an enrolled volunteer or volunteer leader under section 5 or 6 (as the case may be) of the Peace Corps Act (22 U.S.C. 2504, 2505).

**(B) Applicable rules**

For purposes of subparagraph (A), rules similar to the rules of subparagraphs (B) and (D) of paragraph (9) shall apply.

**(e) DENIAL OF EXCLUSION FOR EXPATRIATES**

This section shall not apply to any sale or exchange by an individual if the treatment provided by section 877(a)(1) applies to such individual.

**(f) ELECTION TO HAVE SECTION NOT APPLY**

This section shall not apply to any sale or exchange with respect to which the taxpayer elects not to have this section apply.

**(g) RESIDENCES ACQUIRED IN ROLLOVERS UNDER SECTION 1034**

For purposes of this section, in the case of property the acquisition of which by the taxpayer resulted under section 1034 <sup>[1]</sup> (as in effect on the day before the date of the enactment of this section) in the nonrecognition of any part of the gain realized on the sale or exchange of another residence, in determining the period for which the taxpayer has owned and used such property as the taxpayer's principal residence, there shall be included the aggregate periods for which such other residence (and each prior residence taken into account under section 1223(6) <sup>[1]</sup> in determining the holding period of such property) had been so owned and used.

(Added Pub. L. 88-272, title II, § 206(a), Feb. 26, 1964, 78 Stat. 38; amended Pub. L. 94-455, title XIV, § 1404(a), title XIX, § 1906(b)(13)(A), Oct. 4, 1976, 90 Stat. 1733, 1834; Pub. L. 95-600, title IV, § 404(a)-(c)(2), Nov. 6, 1978, 92 Stat. 2869, 2870; Pub. L. 97-34, title I, § 123(a), Aug. 13, 1981, 95 Stat. 197; Pub. L. 100-647, title VI, § 6011(a), Nov. 10, 1988,

LII > Electronic Code of Federal Regulations (e-CFR)

> Title 26—Internal Revenue

> CHAPTER I—INTERNAL REVENUE SERVICE, DEPARTMENT OF THE TREASURY

> SUBCHAPTER A—INCOME TAX > PART 1—INCOME TAXES

> Credits Against Tax

> **§ 1.121-1 Exclusion of gain from sale or exchange of a principal residence.**

# 26 CFR § 1.121-1 - Exclusion of gain from sale or exchange of a principal residence.

CFR

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## **§ 1.121-1 Exclusion of gain from sale or exchange of a principal residence.**

**(a) *In general.*** Section 121 provides that, under certain circumstances, gross income does not include gain realized on the sale or exchange of property that was owned and used by a taxpayer as the taxpayer's principal residence. Subject to the other provisions of section 121, a taxpayer may exclude gain only if, during the 5-year period ending on the date of the sale or exchange, the taxpayer owned and used the property as the taxpayer's principal residence for periods aggregating 2 years or more.



**(b) Residence**—(1) *In general.* Whether property is used by the taxpayer as the taxpayer's residence depends upon all the facts and circumstances. A property used by the taxpayer as the taxpayer's residence may include a houseboat, a house trailer, or the house or apartment that the taxpayer is entitled to occupy as a tenant-stockholder in a cooperative housing corporation (as those terms are defined in section 216(b)(1) and (2)). Property used by the taxpayer as the taxpayer's residence does not include personal property that is not a fixture under local law.

**(2) Principal residence.** In the case of a taxpayer using more than one property as a residence, whether property is used by the taxpayer as the taxpayer's principal residence depends upon all the facts and circumstances. If a taxpayer alternates between 2 properties, using each as a residence for successive periods of time, the property that the taxpayer uses a majority of the time during the year ordinarily will be considered the taxpayer's principal residence. In addition to the taxpayer's use of the property, relevant factors in determining a taxpayer's principal residence, include, but are not limited to—

- (i) The taxpayer's place of employment;
- (ii) The principal place of abode of the taxpayer's family members;
- (iii) The address listed on the taxpayer's federal and state tax returns, driver's license, automobile registration, and voter registration card;
- (iv) The taxpayer's mailing address for bills and correspondence;
- (v) The location of the taxpayer's banks; and
- (vi) The location of religious organizations and recreational clubs with which the taxpayer is affiliated.

**(3) Vacant land**—(i) *In general.* The sale or exchange of vacant land is not a sale or exchange of the taxpayer's principal residence unless—

- (A) The vacant land is adjacent to land containing the dwelling unit of the taxpayer's principal residence;
- (B) The taxpayer owned and used the vacant land as part of the taxpayer's principal residence;
- (C) The taxpayer sells or exchanges the dwelling unit in a sale or exchange that meets the requirements of section 121 within 2 years before or 2 years after the date of the sale or exchange of the vacant land; and
- (D) The requirements of section 121 have otherwise been met with respect to the vacant land.

**(ii) *Limitations***—(A) *Maximum limitation amount.* For purposes of section 121(b)(1) and (2) (relating to the maximum limitation amount of the section 121 exclusion), the sale or exchange of the dwelling unit and the vacant land are treated as one sale or exchange. Therefore, only one maximum limitation amount of \$250,000 (\$500,000 for certain joint returns) applies to the combined sales or exchanges of vacant land and the dwelling unit. In applying the maximum limitation amount to sales or exchanges that occur in different taxable years, gain from the sale or exchange of the dwelling unit, up to the maximum limitation amount under section 121(b)(1) or (2), is excluded first and each spouse is treated as excluding one-half of the gain from a sale or exchange to which section 121(b)(2)(A) and § 1.121-2(a)(3)(i) (relating to the limitation for certain joint returns) apply.

**(B) *Sale or exchange of more than one principal residence in 2-year period.*** If a dwelling unit and vacant land are sold or exchanged in separate transactions that qualify for the section 121 exclusion under this paragraph (b)(3), each of the transactions is disregarded in applying section 121(b)(3) (restricting the application of section 121 to only 1 sale or exchange every 2 years) to the other transactions but is taken into account as a sale or exchange of a principal residence on the date of the transaction in applying section 121(b)(3) to that transaction and the sale or exchange of any other principal residence.

**(C) *Sale or exchange of vacant land before dwelling unit.*** If the sale or exchange of the dwelling unit occurs in a later taxable year than the sale or exchange of the vacant land and after the date prescribed by law (including extensions) for the filing of the return for the taxable year of the sale or exchange of the vacant land, any gain from the sale or exchange of the vacant land must be treated as taxable on the taxpayer's return for the taxable year of the sale or exchange of the vacant land. If the taxpayer has reported gain from the sale or exchange of the vacant land as taxable, after satisfying the requirements of this paragraph (b)(3) the taxpayer may claim the section 121 exclusion with regard to the sale or exchange of the vacant land (for any period for which the period of limitation under section 6511 has not expired) by filing an amended return.

**(4) *Examples.*** The provisions of this paragraph (b) are illustrated by the following examples:

**EXAMPLE 1.**

Taxpayer A owns 2 residences, one in New York and one in Florida. From 1999 through 2004, he lives in the New York residence for 7 months and the Florida



residence for 5 months of each year. In the absence of facts and circumstances indicating otherwise, the New York residence is A's principal residence. A would be eligible for the section 121 exclusion of gain from the sale or exchange of the New York residence, but not the Florida residence.

**EXAMPLE 2.**

Taxpayer B owns 2 residences, one in Virginia and one in Maine. During 1999 and 2000, she lives in the Virginia residence. During 2001 and 2002, she lives in the Maine residence. During 2003, she lives in the Virginia residence. B's principal residence during 1999, 2000, and 2003 is the Virginia residence. B's principal residence during 2001 and 2002 is the Maine residence. B would be eligible for the 121 exclusion of gain from the sale or exchange of either residence (but not both) during 2003.

**EXAMPLE 3.**

In 1991 Taxpayer C buys property consisting of a house and 10 acres that she uses as her principal residence. In May 2005 C sells 8 acres of the land and realizes a gain of \$110,000. C does not sell the dwelling unit before the due date for filing C's 2005 return, therefore C is not eligible to exclude the \$110,000 of gain. In March 2007 C sells the house and remaining 2 acres realizing a gain of \$180,000 from the sale of the house. C may exclude the \$180,000 of gain. Because the sale of the 8 acres occurred within 2 years from the date of the sale of the dwelling unit, the sale of the 8 acres is treated as a sale of the taxpayer's principal residence under paragraph (b)(3) of this section. C may file an amended return for 2005 to claim an exclusion for \$70,000 (\$250,000-\$180,000 gain previously excluded) of the \$110,000 gain from the sale of the 8 acres.

**EXAMPLE 4.**

In 1998 Taxpayer D buys a house and 1 acre that he uses as his principal residence. In 1999 D buys 29 acres adjacent to his house and uses the vacant land as part of his principal residence. In 2003 D sells the house and 1 acre and the 29 acres in 2 separate transactions. D sells the house and 1 acre at a loss of \$25,000. D realizes \$270,000 of gain from the sale of the 29 acres. D may exclude the \$245,000 gain from the 2 sales.

**(c) *Ownership and use requirements***—(1) *In general.* The requirements of ownership and use for periods aggregating 2 years or more may be satisfied by establishing ownership and use for 24 full months or for 730 days (365 × 2). The

requirements of ownership and use may be satisfied during nonconcurrent periods if both the ownership and use tests are met during the 5-year period ending on the date of the sale or exchange.

## **(2) Use.**

**(i)** In establishing whether a taxpayer has satisfied the 2-year use requirement, occupancy of the residence is required. However, short temporary absences, such as for vacation or other seasonal absence (although accompanied with rental of the residence), are counted as periods of use.

**(ii) *Determination of use during periods of out-of-residence care.*** If a taxpayer has become physically or mentally incapable of self-care and the taxpayer sells or exchanges property that the taxpayer owned and used as the taxpayer's principal residence for periods aggregating at least 1 year during the 5-year period preceding the sale or exchange, the taxpayer is treated as using the property as the taxpayer's principal residence for any period of time during the 5-year period in which the taxpayer owns the property and resides in any facility (including a nursing home) licensed by a State or political subdivision to care for an individual in the taxpayer's condition.

**(3) *Ownership*—(i) *Trusts.*** If a residence is owned by a trust, for the period that a taxpayer is treated under sections 671 through 679 (relating to the treatment of grantors and others as substantial owners) as the owner of the trust or the portion of the trust that includes the residence, the taxpayer will be treated as owning the residence for purposes of satisfying the 2-year ownership requirement of section 121, and the sale or exchange by the trust will be treated as if made by the taxpayer.

**(ii) *Certain single owner entities.*** If a residence is owned by an eligible entity (within the meaning of § 301.7701-3(a) of this chapter) that has a single owner and is disregarded for federal tax purposes as an entity separate from its owner under § 301.7701-3 of this chapter, the owner will be treated as owning the residence for purposes of satisfying the 2-year ownership requirement of section 121, and the sale or exchange by the entity will be treated as if made by the owner.

**(4) *Examples.*** The provisions of this paragraph (c) are illustrated by the following examples. The examples assume that § 1.121-3 (relating to the reduced maximum exclusion) does not apply to the sale of the property. The examples are as follows:

### **EXAMPLE 1.**

Taxpayer A has owned and used his house as his principal residence since 1986. On January 31, 1998, A moves to another state. A rents his house to tenants from that date until April 18, 2000, when he sells it. A is eligible for the section



121 exclusion because he has owned and used the house as his principal residence for at least 2 of the 5 years preceding the sale.

**EXAMPLE 2.**

Taxpayer B owns and uses a house as her principal residence from 1986 to the end of 1997. On January 4, 1998, B moves to another state and ceases to use the house. B's son moves into the house in March 1999 and uses the residence until it is sold on July 1, 2001. B may not exclude gain from the sale under section 121 because she did not use the property as her principal residence for at least 2 years out of the 5 years preceding the sale.

**EXAMPLE 3.**

Taxpayer C lives in a townhouse that he rents from 1993 through 1996. On January 18, 1997, he purchases the townhouse. On February 1, 1998, C moves into his daughter's home. On May 25, 2000, while still living in his daughter's home, C sells his townhouse. The section 121 exclusion will apply to gain from the sale because C owned the townhouse for at least 2 years out of the 5 years preceding the sale (from January 19, 1997 until May 25, 2000) and he used the townhouse as his principal residence for at least 2 years during the 5-year period preceding the sale (from May 25, 1995 until February 1, 1998).

**EXAMPLE 4.**

Taxpayer D, a college professor, purchases and moves into a house on May 1, 1997. He uses the house as his principal residence continuously until September 1, 1998, when he goes abroad for a 1-year sabbatical leave. On October 1, 1999, 1 month after returning from the leave, D sells the house. Because his leave is not considered to be a short temporary absence under paragraph (c)(2) of this section, the period of the sabbatical leave may not be included in determining whether D used the house for periods aggregating 2 years during the 5-year period ending on the date of the sale. Consequently, D is not entitled to exclude gain under section 121 because he did not use the residence for the requisite period.

**EXAMPLE 5.**

Taxpayer E purchases a house on February 1, 1998, that he uses as his principal residence. During 1998 and 1999, E leaves his residence for a 2-month summer vacation. E sells the house on March 1, 2000. Although, in the 5-year period preceding the date of sale, the total time E used his residence is less than 2 years (21 months), the section 121 exclusion will apply to gain from the sale of



the residence because, under paragraph (c)(2) of this section, the 2-month vacations are short temporary absences and are counted as periods of use in determining whether E used the residence for the requisite period.

**(d) Depreciation taken after May 6, 1997**—(1) *In general.* The section 121 exclusion does not apply to so much of the gain from the sale or exchange of property as does not exceed the portion of the depreciation adjustments (as defined in section 1250(b)(3)) attributable to the property for periods after May 6, 1997. Depreciation adjustments allocable to any portion of the property to which the section 121 exclusion does not apply under paragraph (e) of this section are not taken into account for this purpose.

**(2) Example.** The provisions of this paragraph (d) are illustrated by the following example:

**EXAMPLE.**

On July 1, 1999, Taxpayer A moves into a house that he owns and had rented to tenants since July 1, 1997. A took depreciation deductions totaling \$14,000 for the period that he rented the property. After using the residence as his principal residence for 2 full years, A sells the property on August 1, 2001. A's gain realized from the sale is \$40,000. A has no other section 1231 or capital gains or losses for 2001. Only \$26,000 (\$40,000 gain realized—\$14,000 depreciation deductions) may be excluded under section 121. Under section 121(d)(6) and paragraph (d)(1) of this section, A must recognize \$14,000 of the gain as unrecaptured section 1250 gain within the meaning of section 1(h).

**(e) Property used in part as a principal residence**—(1) *Allocation required.* Section 121 will not apply to the gain allocable to any portion (separate from the dwelling unit) of property sold or exchanged with respect to which a taxpayer does not satisfy the use requirement. Thus, if a portion of the property was used for residential purposes and a portion of the property (separate from the dwelling unit) was used for non-residential purposes, only the gain allocable to the residential portion is excludable under section 121. No allocation is required if both the residential and non-residential portions of the property are within the same dwelling unit. However, section 121 does not apply to the gain allocable to the residential portion of the property to the extent provided by paragraph (d) of this section.

**(2) Dwelling unit.** For purposes of this paragraph (e), the term *dwelling unit* has the same meaning as in section 280A(f)(1), but does not include appurtenant structures or other property.

**(3) Method of allocation.** For purposes of determining the amount of gain allocable to the residential and non-residential portions of the property, the taxpayer must allocate the basis and the amount realized between the residential and the non-residential portions of the property using the same method of allocation that the taxpayer used to determine depreciation adjustments (as defined in section 1250(b)(3)), if applicable.

**(4) Examples.** The provisions of this paragraph (e) are illustrated by the following examples:

**EXAMPLE 1 NON-RESIDENTIAL USE OF PROPERTY NOT WITHIN THE DWELLING UNIT.**

**(i)** Taxpayer A owns a property that consists of a house, a stable and 35 acres. A uses the stable and 28 acres for non-residential purposes for more than 3 years during the 5-year period preceding the sale. A uses the entire house and the remaining 7 acres as his principal residence for at least 2 years during the 5-year period preceding the sale. For periods after May 6, 1997, A claims depreciation deductions of \$9,000 for the non-residential use of the stable. A sells the entire property in 2004, realizing a gain of \$24,000. A has no other section 1231 or capital gains or losses for 2004.

**(ii)** Because the stable and the 28 acres used in the business are separate from the dwelling unit, the allocation rules under this paragraph (e) apply and A must allocate the basis and amount realized between the portion of the property that he used as his principal residence and the portion of the property that he used for non-residential purposes. A determines that \$14,000 of the gain is allocable to the non-residential-use portion of the property and that \$10,000 of the gain is allocable to the portion of the property used as his residence. A must recognize the \$14,000 of gain allocable to the non-residential-use portion of the property (\$9,000 of which is unrecaptured section 1250 gain within the meaning of section 1(h), and \$5,000 of which is adjusted net capital gain). A may exclude \$10,000 of the gain from the sale of the property.

**EXAMPLE 2 NON-RESIDENTIAL USE OF PROPERTY NOT WITHIN THE DWELLING UNIT AND RENTAL OF THE ENTIRE PROPERTY.**

**(i)** In 1998 Taxpayer B buys a property that includes a house, a barn, and 2 acres. B uses the house and 2 acres as her principal residence and the barn for an antiques business. In 2002, B moves out of the house and rents it to tenants. B sells the property in 2004, realizing a gain of \$21,000. Between 1998 and 2004 B claims depreciation deductions of \$4,800 attributable to the antiques business. Between 2002 and 2004 B claims depreciation deductions of \$3,000



attributable to the house. B has no other section 1231 or capital gains or losses for 2004.

**(ii)** Because the portion of the property used in the antiques business is separate from the dwelling unit, the allocation rules under this paragraph (e) apply. B must allocate basis and amount realized between the portion of the property that she used as her principal residence and the portion of the property that she used for non-residential purposes. B determines that \$4,000 of the gain is allocable to the non-residential portion of the property and that \$17,000 of the gain is allocable to the portion of the property that she used as her principal residence.

**(iii)** B must recognize the \$4,000 of gain allocable to the non-residential portion of the property (all of which is unrecaptured section 1250 gain within the meaning of section 1(h)). In addition, the section 121 exclusion does not apply to the gain allocable to the residential portion of the property to the extent of the depreciation adjustments attributable to the residential portion of the property for periods after May 6, 1997 (\$3,000). Therefore, B may exclude \$14,000 of the gain from the sale of the property.

### **EXAMPLE 3 NON-RESIDENTIAL USE OF A SEPARATE DWELLING UNIT.**

**(i)** In 2002 Taxpayer C buys a 3-story townhouse and converts the basement level, which has a separate entrance, into a separate apartment by installing a kitchen and bathroom and removing the interior stairway that leads from the basement to the upper floors. After the conversion, the property constitutes 2 dwelling units within the meaning of paragraph (e)(2) of this section. C uses the first and second floors of the townhouse as his principal residence and rents the basement level to tenants from 2003 to 2007. C claims depreciation deductions of \$2,000 for that period with respect to the basement apartment. C sells the entire property in 2007, realizing gain of \$18,000. C has no other section 1231 or capital gains or losses for 2007.

**(ii)** Because the basement apartment and the upper floors of the townhouse are separate dwelling units, C must allocate the gain between the portion of the property that he used as his principal residence and the portion of the property that he used for non-residential purposes under paragraph (e) of this section. After allocating the basis and the amount realized between the residential and non-residential portions of the property, C determines that \$6,000 of the gain is allocable to the non-residential portion of the property and that \$12,000 of the gain is allocable to the portion of the property used as his residence. C must recognize the \$6,000 of gain allocable to the non-residential portion of the property

(\$2,000 of which is unrecaptured section 1250 gain within the meaning of section 1(h), and \$4,000 of which is adjusted net capital gain). C may exclude \$12,000 of the gain from the sale of the property.

**EXAMPLE 4 SEPARATE DWELLING UNIT CONVERTED TO RESIDENTIAL USE.**

The facts are the same as in *Example 3* except that in 2007 C incorporates the basement of the townhouse into his principal residence by eliminating the kitchen and building a new interior stairway to the upper floors. C uses all 3 floors of the townhouse as his principal residence for 2 full years and sells the townhouse in 2010, realizing a gain of \$20,000. Under section 121(d)(6) and paragraph (d) of this section, C must recognize \$2,000 of the gain as unrecaptured section 1250 gain within the meaning of section 1(h). Because C used the entire 3 floors of the townhouse as his principal residence for 2 of the 5 years preceding the sale of the property, C may exclude the remaining \$18,000 of the gain from the sale of the house.

**EXAMPLE 5 NON-RESIDENTIAL USE WITHIN THE DWELLING UNIT, PROPERTY DEPRECIATED.**

Taxpayer D, an attorney, buys a house in 2003. The house constitutes a single dwelling unit but D uses a portion of the house as a law office. D claims depreciation deductions of \$2,000 during the period that she owns the house. D sells the house in 2006, realizing a gain of \$13,000. D has no other section 1231 or capital gains or losses for 2006. Under section 121(d)(6) and paragraph (d) of this section, D must recognize \$2,000 of the gain as unrecaptured section 1250 gain within the meaning of section 1(h). D may exclude the remaining \$11,000 of the gain from the sale of her house because, under paragraph (e)(1) of this section, she is not required to allocate gain to the business use within the dwelling unit.

**EXAMPLE 6 NON-RESIDENTIAL USE WITHIN THE DWELLING UNIT, PROPERTY NOT DEPRECIATED.**

The facts are the same as in Example 5, except that D is not entitled to claim any depreciation deductions with respect to her business use of the house. D may exclude \$13,000 of the gain from the sale of her house because, under paragraph (e)(1) of this section, she is not required to allocate gain to the business use within the dwelling unit.

**(f) Effective date.** This section is applicable for sales and exchanges on or after December 24, 2002. For rules on electing to apply the provisions of this section retroactively, see § 1.121-4(j).

[T.D. 9030, 67 FR 78361, Dec. 24, 2002]



# 26 U.S. Code Subtitle A Chapter 1 Subchapter J Part I Subpart E - Grantors and Others Treated as Substantial Owners

U.S. Code      Notes

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§ 671. Trust income, deductions, and credits attributable to grantors and others as substantial owners

§ 672. Definitions and rules

§ 673. Reversionary interests

§ 674. Power to control beneficial enjoyment

§ 675. Administrative powers

§ 676. Power to revoke

§ 677. Income for benefit of grantor

§ 678. Person other than grantor treated as substantial owner

§ 679. Foreign trusts having one or more United States beneficiaries

# 26 U.S. Code § 675 - Administrative powers

U.S. Code      Notes

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The grantor shall be treated as the owner of any portion of a trust in respect of which—

**(1) POWER TO DEAL FOR LESS THAN ADEQUATE AND FULL CONSIDERATION**

A power exercisable by the grantor or a nonadverse party, or both, without the approval or consent of any adverse party enables the grantor or any person to purchase, exchange, or otherwise deal with or dispose of the corpus or the income therefrom for less than an adequate consideration in money or money's worth.

**(2) POWER TO BORROW WITHOUT ADEQUATE INTEREST OR SECURITY**

A power exercisable by the grantor or a nonadverse party, or both, enables the grantor to borrow the corpus or income, directly or indirectly, without adequate interest or without adequate security except where a trustee (other than the grantor) is authorized under a general lending power to make loans to any person without regard to interest or security.

**(3) BORROWING OF THE TRUST FUNDS**

The grantor has directly or indirectly borrowed the corpus or income and has not completely repaid the loan, including any interest, before the beginning of the taxable year. The preceding sentence shall not apply to a loan which provides for adequate interest and adequate security, if such loan is made by a trustee other than the grantor and other than a related or subordinate trustee subservient to the grantor. For periods during which an individual is the spouse of the grantor (within the meaning of section 672(e)(2)), any reference in this paragraph to the grantor shall be treated as including a reference to such individual.

**(4) GENERAL POWERS OF ADMINISTRATION**

A power of administration is exercisable in a nonfiduciary capacity by any person without the approval or consent of any person in a fiduciary capacity. For purposes of this paragraph, the term "power of administration" means any one or more of the following powers: (A) a power to vote or direct the voting of stock or other securities of a corporation in which the holdings of the grantor and the trust are significant from the viewpoint of voting control; (B) a power to control the investment of the trust funds either by directing investments or reinvestments, or by vetoing proposed investments or reinvestments, to the extent that the trust funds consist of stocks or securities of corporations in which the holdings of the grantor and the trust are significant from the viewpoint of voting control; or (C) a power to reacquire the trust corpus by substituting other property of an equivalent value.

# 26 U.S. Code § 2511 - Transfers in general

U.S. Code      Notes

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## **(a) SCOPE**

Subject to the limitations contained in this chapter, the tax imposed by section 2501 shall apply whether the transfer is in trust or otherwise, whether the gift is direct or indirect, and whether the property is real or personal, tangible or intangible; but in the case of a nonresident not a citizen of the United States, shall apply to a transfer only if the property is situated within the United States.

## **(b) INTANGIBLE PROPERTY**

For purposes of this chapter, in the case of a nonresident not a citizen of the United States who is excepted from the application of section 2501(a)(2)—

**(1)** shares of stock issued by a domestic corporation, and

**(2)** debt obligations of—

**(A)** a United States person, or

**(B)** the United States, a State or any political subdivision thereof, or the District of Columbia,

which are owned and held by such nonresident shall be deemed to be property situated within the United States.

(Aug. 16, 1954, ch. 736, 68A Stat. 406; Pub. L. 89-809, title I, § 109(b), Nov. 13, 1966, 80 Stat. 1575; Pub. L. 107-16, title V, § 511(e), June 7, 2001, 115 Stat. 71; Pub. L. 107-147, title IV, § 411(g)(1), Mar. 9, 2002, 116 Stat. 46; Pub. L. 111-312, title III, § 302(e), Dec. 17, 2010, 124 Stat. 3302.)



LII > Electronic Code of Federal Regulations (e-CFR)

> Title 26—Internal Revenue

> CHAPTER I—INTERNAL REVENUE SERVICE, DEPARTMENT OF THE TREASURY

> SUBCHAPTER B—ESTATE AND GIFT TAXES

> PART 25—GIFT TAX; GIFTS MADE AFTER DECEMBER 31, 1954 > Transfers

> **§ 25.2511-2 Cessation of donor's dominion and control.**

## 26 CFR § 25.2511-2 - Cessation of donor's dominion and control.

CFR

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### **§ 25.2511-2 Cessation of donor's dominion and control.**

**(a)** The gift tax is not imposed upon the receipt of the property by the donee, nor is it necessarily determined by the measure of enrichment resulting to the donee from the transfer, nor is it conditioned upon ability to identify the donee at the time of the transfer. On the contrary, the tax is a primary and personal liability of the donor, is an excise upon his act of making the transfer, is measured by the value of the property passing from the donor, and attaches regardless of the fact that the identity of the donee may not then be known or ascertainable. For gift tax rules related to an ABLE account established under section 529A, see § 1.529A-4 of this chapter.

**(b)** As to any property, or part thereof or interest therein, of which the donor has so parted with dominion and control as to leave in him no power to change its disposition, whether for his own benefit or for the benefit of another, the gift is complete. But if upon a transfer of property (whether in trust or otherwise) the donor



reserves any power over its disposition, the gift may be wholly incomplete, or may be partially complete and partially incomplete, depending upon all the facts in the particular case. Accordingly, in every case of a transfer of property subject to a reserved power, the terms of the power must be examined and its scope determined. For example, if a donor transfers property to another in trust to pay the income to the donor or accumulate it in the discretion of the trustee, and the donor retains a testamentary power to appoint the remainder among his descendants, no portion of the transfer is a completed gift. On the other hand, if the donor had not retained the testamentary power of appointment, but instead provided that the remainder should go to X or his heirs, the entire transfer would be a completed gift. However, if the exercise of the trustee's power in favor of the grantor is limited by a fixed or ascertainable standard (see paragraph (g)(2) of § 25.2511-1), enforceable by or on behalf of the grantor, then the gift is incomplete to the extent of the ascertainable value of any rights thus retained by the grantor.

**(c)** A gift is incomplete in every instance in which a donor reserves the power to revest the beneficial title to the property in himself. A gift is also incomplete if and to the extent that a reserved power gives the donor the power to name new beneficiaries or to change the interests of the beneficiaries as between themselves unless the power is a fiduciary power limited by a fixed or ascertainable standard. Thus, if an estate for life is transferred but, by an exercise of a power, the estate may be terminated or cut down by the donor to one of less value, and without restriction upon the extent to which the estate may be so cut down, the transfer constitutes an incomplete gift. If in this example the power was confined to the right to cut down the estate for life to one for a term of five years, the certainty of an estate for not less than that term results in a gift to that extent complete.

**(d)** A gift is not considered incomplete, however, merely because the donor reserves the power to change the manner or time of enjoyment. Thus, the creation of a trust the income of which is to be paid annually to the donee for a period of years, the corpus being distributable to him at the end of the period, and the power reserved by the donor being limited to a right to require that, instead of the income being so payable, it should be accumulated and distributed with the corpus to the donee at the termination of the period, constitutes a completed gift.

**(e)** A donor is considered as himself having a power if it is exercisable by him in conjunction with any person not having a substantial adverse interest in the disposition of the transferred property or the income therefrom. A trustee, as such, is not a person having an adverse interest in the disposition of the trust property or its income.

**(f)** The relinquishment or termination of a power to change the beneficiaries of transferred property, occurring otherwise than by the death of the donor (the statute being confined to transfers by living donors), is regarded as the event that completes the gift and causes the tax to apply. For example, if A transfers property in trust for the benefit of B and C but reserves the power as trustee to change the proportionate interests of B and C, and if A thereafter has another person appointed trustee in place of himself, such later relinquishment of the power by A to the new trustee completes the gift of the transferred property, whether or not the new trustee has a substantial adverse interest. The receipt of income or of other enjoyment of the transferred property by the transferee or by the beneficiary (other than by the donor himself) during the interim between the making of the initial transfer and the relinquishment or termination of the power operates to free such income or other enjoyment from the power, and constitutes a gift of such income or of such other enjoyment taxable as of the "calendar period" (as defined in § 25.2502-1(c)(1)) of its receipt. If property is transferred in trust to pay the income to A for life with remainder to B, powers to distribute corpus to A, and to withhold income from A for future distribution to B, are powers to change the beneficiaries of the transferred property.

**(g)** If a donor transfers property to himself as trustee (or to himself and some other person, not possessing a substantial adverse interest, as trustees), and retains no beneficial interest in the trust property and no power over it except fiduciary powers, the exercise or nonexercise of which is limited by a fixed or ascertainable standard, to change the beneficiaries of the transferred property, the donor has made a completed gift and the entire value of the transferred property is subject to the gift tax.

**(h)** If a donor delivers a properly indorsed stock certificate to the donee or the donee's agent, the gift is completed for gift tax purposes on the date of delivery. If the donor delivers the certificate to his bank or broker as his agent, or to the issuing corporation or its transfer agent, for transfer into the name of the donee, the gift is completed on the date the stock is transferred on the books of the corporation.

**(i)** [Reserved]

**(j)** If the donor contends that a power is of such nature as to render the gift incomplete, and hence not subject to the tax as of the calendar period (as defined in § 25.2502-1(c)(1)) of the initial transfer, see § 301.6501(c)-1(f)(5) of this chapter.

[T.D. 6334, 23 FR 8904, Nov. 15, 1958, as amended by T.D. 7238, 37 FR 28728, Dec. 29, 1972; T.D. 7910, 48 FR 40374, Sept. 7, 1983; T.D. 8845, 64 FR 67771, Dec. 3, 1999; T.D. 9923, 85 FR 74047, Nov. 19, 2020]



# IOWA STATE UNIVERSITY

Center for Agricultural Law and Taxation

## Chief Counsel Memo. 201208026 (Sept. 28, 2011)

(transfers to irrevocable trust under terms of which trustee had full discretion to administer trust for beneficiaries of charity constituted completed gifts of beneficial term interests because donors' retained testamentary limited powers of appointment relate only to trust remainder; gift tax incurred on transfer and transfer not incomplete gift covered by Treas. Reg. Sec. 25.2522-2(b); IRS analyzed income and remainder interests separately and concluded that POA impacted only remainder interest and did not impact what beneficiaries would receive during term interest - donors had no retained interest in term interest; gifts not of minority interests equal in value to donors' respective withdrawal rights (*Crummey* Powers) which would reduce the taxable gifts to zero because withdrawal rights not legally enforceable; beneficiary could not enforce withdrawal right in state court; no annual exclusion allowable for any of the withdrawal rights).

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# 26 U.S. Code § 2036 - Transfers with retained life estate

U.S. Code      Notes

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## **(a) GENERAL RULE**

The value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, under which he has retained for his life or for any period not ascertainable without reference to his death or for any period which does not in fact end before his death—

**(1)** the possession or enjoyment of, or the right to the income from, the property, or

**(2)** the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom.

## **(b) VOTING RIGHTS**

### **(1) IN GENERAL**

For purposes of subsection (a)(1), the retention of the right to vote (directly or indirectly) shares of stock of a controlled corporation shall be considered to be a retention of the enjoyment of transferred property.

### **(2) CONTROLLED CORPORATION**

For purposes of paragraph (1), a corporation shall be treated as a controlled corporation if, at any time after the transfer of the property and during the 3-year period ending on the date of the decedent's death, the decedent owned (with the application of section 318), or had the right (either alone or in conjunction with any person) to vote, stock possessing at least 20 percent of the total combined voting power of all classes of stock.

### **(3) COORDINATION WITH SECTION 2035**

For purposes of applying section 2035 with respect to paragraph (1), the relinquishment or cessation of voting rights shall be treated as a transfer of property made by the decedent.



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**October 22, 2025**

### **Trading Up Without Paying Up: Using 1031 Exchanges to Preserve Wealth for Families with Special Needs**



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# **Trading Up Without Paying Up: Using 1031 Exchanges to Preserve Wealth for Families with Special Needs**

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## **I. Introduction**

Section 1031 of the Internal Revenue Code allows taxpayers to defer the recognition of gain when real property held for investment or productive use in a trade or business is exchanged for like-kind property of equal or greater value.<sup>1</sup> This powerful nonrecognition provision is rooted in the principle of continuity of investment: if the taxpayer has not cashed out but has merely changed the form of the investment, there should be no taxable event.<sup>2</sup>

Although Section 1031 is most often associated with sophisticated real estate investors or large-scale commercial transactions, its value in the estate planning context—particularly in planning for families with special needs—has received less attention. Families with disabled beneficiaries often hold appreciated real estate as a core investment. A sale of such property can trigger substantial capital gains tax and, if not carefully managed, disrupt eligibility for means-tested public benefits such as Medicaid and Supplemental Security Income (SSI).<sup>3</sup> Through Section 1031 exchanges, families can defer tax liability and better align assets with long-term planning objectives.

## **II. Statutory and Regulatory Framework**

The statutory foundation of like-kind exchanges is found in IRC Section 1031(a)(1), which provides that no gain or loss shall be recognized on the exchange of real property held for productive use in a trade or business or for investment, if such real property is exchanged solely for real property of like kind to be held either for productive use in a trade or business or for investment.<sup>4</sup> This broad nonrecognition rule has long been justified by the continuity-of-investment rationale: the taxpayer who exchanges one qualifying property for another has not liquidated wealth, but has merely shifted its form.<sup>5</sup>

The Tax Cuts and Jobs Act of 2017 (TCJA) amended Section 1031 to narrow its scope exclusively to real property held for investment or for use in a trade of business.<sup>6</sup> Prior to the TCJA personal property exchanges were also eligible including artwork, collectibles, and equipment. The elimination of personal property from Section 1031 narrowed the tool's utility but left intact its central role in real estate planning.

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<sup>1</sup> IRC §1031(a)(1)

<sup>2</sup> See Bittker & Lokken, *Federal Taxation of Income, Estates and Gifts* ¶ 103.1 (explaining policy rationale).

<sup>3</sup> 42 U.S.C. §1382b (SSI resource rules).

<sup>4</sup> IRC §1031(a)(1).

<sup>5</sup> See Bittker & Lokken, *Federal Taxation of Income, Estates and Gifts* ¶ 103.1.

<sup>6</sup> Pub. L. No. 115-97, §13303 (2017) (TCJA).

Treasury Regulations provide essential detail. Treas. Reg. Section 1.1031(a)-1(b) defines like-kind property broadly to include most U.S. real property, regardless of grade or quality. For example, an apartment building may be exchanged for raw land, or farmland may be exchanged for a warehouse. Treas. Reg. Section 1.1031(k)-1 governs deferred exchanges, establishing the familiar 45-day identification period and 180-day exchange period.<sup>7</sup> IRC Section 1031(h) prohibits the exchange of U.S. property for foreign property. Additionally, related-party rules under Section 1031(f) impose a two-year holding period to prevent taxpayers from circumventing recognition through family-controlled entities. These strict deadlines are non-negotiable and must be closely monitored by advisors.

Together these statutory and regulatory rules outline the use of like-kind exchanges. On its face Section 1031 is simple; however, the technical requirements can be rigid and failure to comply with timing or qualification rules results in full gain recognition.<sup>8</sup> Failing to meet the technical requirements has significant implications for families engaging in special needs planning. Specifically, missing deadlines or improper structuring could result in both unexpected tax liability and adverse effects on public benefits.

### **III. Judicial Development of Exchanges**

Although Section 1031 has existed in the tax code for nearly a hundred years, the current version has been shaped significantly by judicial interpretation. In the seminal case of *Starker v. United States* the Ninth Circuit held that a taxpayer could execute a deferred, non-simultaneous exchange and still qualify for nonrecognition treatment.<sup>9</sup> Prior to *Starker*, the IRS insisted that like-kind exchanges be simultaneous. The decision opened the door to the use of qualified intermediaries and the widespread adoption of deferred exchange structures. Congress responded by amending the Code to impose the strict 45-day identification and 180-day exchange deadlines that govern deferred exchanges today.<sup>10</sup>

Later cases helped to define the parameters of Section 1031. In *Magneson v. Commissioner*, the Ninth Circuit ruled that a simultaneous transfer to a partnership was acceptable only if the taxpayer promptly transferred replacement property into the partnership and his transaction did not lose its “investment character.”<sup>11</sup> By contrast, in *Bolker v. Commissioner* the Court ruled that a taxpayer may exchange property even if it is the taxpayer’s intent to sell it shortly thereafter if held for productive use or investment.<sup>12</sup> These cases illustrate that not the holding period, but rather personal predisposition of the taxpayer is crucial to qualification.

Exchange litigation also has seen widespread use of the step transaction doctrine. The Tenth Circuit in *True v. United States* collapsed three steps into one, making the transaction a taxable event, and cautioned that transactions with lack of economic substance undertaken principally to avoid taxes may be disregarded.<sup>13</sup> The holding underscores the importance of structuring exchanges with genuine business purposes.

Practical variants of the exchange transaction, such as multi-party and related-party transactions have also been recognized by courts. In *Alderson v. Commissioner*, the Ninth Circuit had allowed

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<sup>7</sup> Treas. Reg. §1.1031(k)-1(b), (c).

<sup>8</sup> See Mertens, Law of Federal Income Taxation §44:28 (strict application of deadlines).

<sup>9</sup> *Starker v. United States*, 602 F.2d 1341 (9th Cir. 1979).

<sup>10</sup> IRC §1031(a)(3); Treas. Reg. §1.1031(k)-1(b), (c).

<sup>11</sup> *Magneson v. Commissioner*, 753 F.2d 1490 (9th Cir. 1985).

<sup>12</sup> *Bolker v. Commissioner*, 760 F.2d 1039 (9th Cir. 1985).

<sup>13</sup> *True v. United States*, 190 F.3d 1165 (10th Cir. 1999).

an exchange where a taxpayer exchanged property with another person through a third-party intermediary — an anticipation of today's qualified intermediaries.<sup>14</sup> Together, *True* and *Alderson* illustrate that Section 1031 remains heavily fact-dependent, requiring advisors to pay close attention to both form and substance.

#### **IV. Mechanics of a 1031 Exchange**

The successful execution of a like-kind exchange requires adherence to two core components: the relinquished property and the replacement property. Both must be held for investment or productive use in a trade or business.<sup>15</sup> Property held primarily for resale, such as inventory, does not qualify for Section 1031 treatment.<sup>16</sup>

The concept of 'like-kind' is defined broadly for real property. Treas. Reg. Section 1.1031(a)-1(b) provides that differences in grade or quality do not matter so long as the properties are both real property held for investment or business use. Thus, an apartment building may be exchanged for farmland, or an office building may be exchanged for a warehouse. However, U.S. real property is not like-kind to foreign real property under IRC Section 1031(h).<sup>17</sup>

Timing rules are particularly important. Under IRC Section 1031(a)(3) and Treas. Reg. Section 1.1031(k)-1(b), the taxpayer must identify potential replacement property within 45 days of transferring the relinquished property. Identification must be in writing and unambiguously describe the property. The taxpayer then has 180 days from the transfer—or until the due date of their tax return, if earlier—to acquire the replacement property.<sup>18</sup> Failure to comply with either the 45-day or 180-day deadlines results in immediate recognition of built-in-gain.

The use of a qualified intermediary (QI) is essential in deferred exchanges. The QI holds proceeds from the sale of the relinquished property, ensuring that the taxpayer does not have actual or constructive receipt of the funds.<sup>19</sup> Revenue Procedure 2000-37 created a safe harbor for 'reverse exchanges,' where the replacement property is acquired before the relinquished property is sold.<sup>20</sup>

This guidance was later refined by Revenue Procedure 2004-51, which curtailed certain abusive arrangements but preserved the general utility of reverse exchanges.

Specialized structures such as improvement or 'build-to-suit' exchanges are also permitted, allowing taxpayers to use exchange proceeds to construct improvements on replacement property. However, even these transactions must satisfy the identification and 180-day requirements. This can be tough given actual construction schedules.

The operation of the mechanical rules creates both opportunities and pitfalls. In the case of families engaged in special needs planning, the strictness of these deadlines means careful involvement of advisors is essential to creating an undesired outcome.

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<sup>14</sup> *Alderson v. Commissioner*, 317 F.2d 790 (9th Cir. 1963).

<sup>15</sup> IRC §1031(a)(1).

<sup>16</sup> Treas. Reg. §1.1031(a)-1(a)(2).

<sup>17</sup> IRC §1031(h).

<sup>18</sup> IRC §1031(a)(3); Treas. Reg. §1.1031(k)-1(b), (c).

<sup>19</sup> Treas. Reg. §1.1031(k)-1(g)(4).

<sup>20</sup> Rev. Proc. 2000-37, 2000-2 C.B. 308; modified by Rev. Proc. 2004-51, 2004-2 C.B. 294.



## **V. Intersection with Special Needs Planning**

Families with beneficiaries who have special needs face unique planning challenges when managing appreciated real estate. Liquidating property through a sale can create significant capital gains tax liability while also generating cash that may jeopardize eligibility for means-tested programs such as Medicaid and Supplemental Security Income (SSI).<sup>21</sup> For example, SSI imposes a strict \$2,000 limit on countable resources.<sup>22</sup> A lump-sum cash distribution resulting from the sale of appreciated property could easily disqualify a beneficiary.

Section 1031 exchanges provide a means of deferring tax liability while preserving real estate wealth in a form that may be more manageable within the context of long-term planning. Families can exchange highly appreciated, actively managed properties—such as duplexes or small rental units—for triple-net-leased commercial properties or other investment real estate that generates stable income and requires minimal oversight. This repositioning can make it easier to combine real property interests with a supplemental needs trust (SNT).

The interaction between Section 1031 and SNTs requires careful attention. An SNT may serve as the owner of replacement property, provided that the trust meets statutory requirements and is drafted to preserve Medicaid and SSI eligibility.<sup>23</sup> Boot, or non-like-kind property received in an exchange, must be avoided or directed away from the disabled beneficiary, as cash distributions could be deemed countable resources.<sup>24</sup> Advisors must also consider state-level rules governing trusts and benefits, which may impose additional constraints.

The ability to defer tax on appreciated real estate while aligning the resulting assets with trust planning objectives can preserve capital for years. Combined with the basis step-up at death under IRC Section 1014, exchanges can allow families to defer gain during life and ultimately eliminate it at death, maximizing the value available for the care of a disabled beneficiary.<sup>25</sup>

Section 1031 and special needs planning intersect around two key issues, tax deferral and benefits preservation. By aligning the real estate sales alongside trust structures advisors can assist families in preserving financial security and continued public benefit availability for those with special needs.

## **VI. Hypotheticals**

### **Hypothetical 1: Converting Active Rental Real Estate into Passive Income Property**

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Husband and wife purchased a duplex 30 years ago for \$100,000. Today it is worth \$1.2 million and generates some rental income but requires substantial ongoing management. Their adult daughter is disabled and relies on SSI and Medicaid for her daily needs. If husband and wife sell the duplex outright, they would realize approximately \$1.1 million in gain, triggering hundreds of thousands of dollars in capital gains tax. Instead, they structure a Section 1031 exchange into a triple-net-leased commercial property. The exchange defers recognition of gain, preserves the full \$1.2 million of value, and produces stable income with minimal management. Because the

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<sup>21</sup> See IRC §61(a)(3) (gross income includes gains from property sales).

<sup>22</sup> 42 U.S.C. §1382b (SSI resource rules).

<sup>23</sup> See 42 U.S.C. §1396p(d)(4)(A) (statutory basis for special needs trusts).

<sup>24</sup> IRC §1031(b) (boot rule).

<sup>25</sup> IRC §1014 (basis step-up at death).

replacement property is easier to administer, husband and wife can later contribute it to a supplemental needs trust, ensuring long-term financial support for their daughter.

#### Hypothetical 2: Using an Exchange to Fund a Future Supplemental Needs Trust

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Husband and wife own raw land with very low basis and have held the property for over twenty years. Their estate plan includes funding a third-party supplemental needs trust for the benefit of their daughter upon their deaths. However, husband and wife are concerned that the land is unproductive and difficult to manage. As such, they execute a Section 1031 exchange into a multi-family residential property. The exchange defers gain, while the new asset generates predictable rental income. Upon their deaths, the property receives a step-up in basis under IRC Section 1014, eliminating the deferred gain. The property then funds the supplemental needs trust, providing income to their disabled child without jeopardizing public benefits.

#### Hypothetical 3: Failed Exchange and Public Benefits Consequences

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A family attempts to complete a Section 1031 exchange but fails to identify replacement property within the 45-day period. As a result, the qualified intermediary returns \$900,000 in cash proceeds. Under IRC Section 1031(b), the entire gain is recognized. Worse still, the family deposits part of the proceeds into a bank account titled in the name of their disabled child. The deposit exceeds the \$2,000 SSI resource limit resulting in immediate disqualification from Medicaid and SSI.<sup>26</sup> This scenario illustrates the dual risks of technical noncompliance with Section 1031 and the collateral consequences to the taxpayer's public benefits.

These hypotheticals illustrate the inflexibility of Section 1031 exchanges. When done correctly, they can protect wealth, change the form of assets and be consistent with special needs trust planning. But missing statutory deadlines or misusing the money could result in severe tax and benefit risks.

### **VII. Planning Pitfalls and Ethical Considerations**

Despite the benefits, advisors must take care to avoid frequently occurring mistakes and maintain adherence with ethical rules. There is little room for error in practice with respect to statutory language that imposes inflexible rules on family planning since private letter rulings cannot be obtained to hold open the statute and regulations.

One of the most common is pitfalls is among related parties. IRC Section 1031(f) creates a two-year holding period requirement where property is exchanged between related parties (a term that has been read broadly to cover family members and entities with common ownership).<sup>27</sup> Transactions designed to move basis or avoid gain recognition among family members are heavily scrutinized by the IRS. Advisors will need to consider whether related party rules would be triggered where you are dealing with parents, children or family trusts.

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<sup>26</sup> 42 U.S.C. §1382b (SSI resource rules).

<sup>27</sup> IRC §1031(f).

The step transaction doctrine also presents significant risk. Courts have consistently applied this doctrine to re-cast multi-step transactions that are without economic reality.<sup>28</sup> For example, a 'drop-and-swap' strategy, in which a partnership distributes property to a partner shortly before an exchange, may be recast as a taxable sale. Advisors should ensure that transactions have an independent business purpose.

Ethical implications go beyond those related to complying with tax laws. Attorneys of families with special needs dependents need to be aware of fiduciary obligations, conflicts of interest and the greater-than-normal susceptibility of disabled clients.<sup>29</sup> The Model Rules of Professional Conduct require attorneys to maintain loyalty, competence, and diligence, while avoiding actions that could harm a client's eligibility for essential public benefits.<sup>30</sup>

Moreover, advisors must be able to effectively discuss complex transaction structures with their clients, who are sometimes not financially sophisticated and often have very little tax knowledge. It is ethically incumbent upon us to explain, simply and clearly, the hazards associated with blowing time limits, structuring improperly or on the wrong end of boot. Investment professionals take this idea into account when financial suitability standards and fiduciary duties are balanced with considerations of client welfare and investment objectives.

Simply put, when it comes to 1031 exchanges in the special needs context not only is a high degree of technical mastery necessary, but also an appreciation for the ethical and fiduciary duties owed vulnerable clients. Advisors must combine stringent compliance with transparent communication and a client-centric focus.

## **VIII. Legislative and Policy Outlook**

Section 1031 has been a frequent target of policy and legislative discussions. Many policymakers see like-kind exchanges as a deferral vehicle that disproportionately favors high-net-worth individuals and real estate holders. Efforts to repeal or restrict Section 1031 have appeared in Treasury's Greenbook over the years during both the Obama and Biden administrations.<sup>31</sup> Their specific proposals have tended to limit the amount of gain that would be eligible for deferral to \$500,000 per taxpayer per year.

Nevertheless, in the past Congress has maintained Section 1031 appreciating its value in increasing transactional liquidity and fostering economic growth. The Tax Cuts and Jobs Act of 2017 limited Section 1031 to real property but did not repeal it.<sup>32</sup> The ongoing existence of Section 1031 illustrates the tension between revenue concerns and macroeconomic stimulus.

For advisors dealing with families who have special needs considerations, awareness of legislative risk is critical. Although Section 1031 remains available, the repeated inclusion of limitation proposals in Treasury's Greenbook signals that it is a perennial target. Families who are considering exchanges as part of long-term planning should be advised that the availability of deferral is not guaranteed indefinitely.

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<sup>28</sup> See *True v. United States*, 190 F.3d 1165 (10th Cir. 1999).

<sup>29</sup> See Restatement (Third) of the Law Governing Lawyers §16 (duty of loyalty and care).

<sup>30</sup> ABA Model Rules of Professional Conduct, Rules 1.1, 1.4, 1.7.

<sup>31</sup> U.S. Department of the Treasury, General Explanations of the Administration's Fiscal Year 2024 Revenue Proposals (the "Greenbook").

<sup>32</sup> Pub. L. No. 115-97, §13303 (2017) (TCJA).

Looking ahead, advisors should be vigilant about legislation going forward. Even without a repeal statutory changes could vary identity timing, the types of permitted property or the importance of related-party rules. These sorts of changes could potentially interfere with families' abilities to efficiently reallocate assets for the purpose of special needs planning.

## **IX. The “One Big Beautiful Bill” Act and Section 1031 Exchanges**

The OBBBA, signed into law in July 2025, was Congress's most significant tax legislation since the TCJA in 2017. Though the sweeping bill covered numerous topics including individual income tax rates, retirement savings changes, and corporate international taxation, many advisors focused in on whether Section 1031 would see a major change or be eliminated.

Earlier versions of the OBBBA would have restricted like-kind exchanges, in line with Treasury Greenbook estimates to cap deferral at \$500,000 per year for each taxpayer. But those recommendations did not make it through the Legislature. In its final form, OBBBA left Section 1031 intact. Like-kind exchanges remain available for real property, subject to the post-TCJA limitation that excludes personal property.

The lesson from OBBBA is twofold. First, Section 1031 continues to provide reliable deferral opportunities for real estate investors and families engaging in special needs planning. Second, frequent return to the issue of repealing or curtailing it in legislative bargaining points to its fragility.

All put together, OBBBA reiterated the persistence of Section 1031 yet affirmed it remains a perennial target for policy change. Families who are applying the planning strategy of using Section 1031 in their special needs plans should continue to monitor the evolving legislature that may limit this deferral tactic.

## **X. Qualified Opportunity Zones and Comparison to Section 1031**

Qualified Opportunity Zones (QOZs) were created by the TCJA to encourage investment in economically distressed communities.<sup>33</sup> Codified at IRC Section 1400Z-1 and 1400Z-2, the program incentivizes taxpayers to reinvest capital gains into Qualified Opportunity Funds (QOFs), which in turn invest in designated zones certified by the Treasury Department.

Under the statute, taxpayers may elect to defer recognition of eligible capital gains if those gains are invested in a QOF within 180 days of the sale or exchange that generated them.<sup>34</sup> Under the OBBBA, the deferred gain must be recognized no later than five years after the initial investment or upon disposition of the QOF investment, whichever occurs earlier. Qualified Opportunity Zones also offer partial basis adjustments historically 10% for five-year holdings.<sup>35</sup> Finally, if the QOF investment is held for at least ten years then all of the post-investment appreciation is excluded from gross income.<sup>36</sup>

Both QOZs with Section 1031 exchanges allow taxpayers to defer capital gains but their mechanics differ substantially. Section 1031 requires reinvestment in like-kind real property and offers potentially indefinite deferral, with the possibility of permanent elimination of gain at death through

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<sup>33</sup> IRC §§1400Z-1, 1400Z-2; Pub. L. No. 115-97, §13823 (2017) (TCJA).

<sup>34</sup> IRC §1400Z-2(a)(1).

<sup>35</sup> IRC §1400Z-2(b)(2)(B).

<sup>36</sup> IRC §1400Z-2(c); Treas. Reg. §1.1400Z2(a)-1 through -3; IRS Notice 2018-48, 2018-28 I.R.B. 9; IRS Notice 2020-39, 2020-26 I.R.B. 984.

the basis step-up under IRC Section 1014. By contrast, QOZs apply to a broader range of gains and provides for a basis step-up after five years and elimination of post-investment appreciation after ten years.

From a planning perspective, Section 1031 is often more compatible with special needs strategies, particularly where families hold real estate intended for eventual transfer into a supplemental needs trust. QOZ investments require hyper-technical compliance requirements that may be inappropriate for a trustee. However, in instances in which liquidity from a sale cannot be reinvested into like-kind property exchange QOZs may provide another tax-efficient alternative.

## **XI. Section 1035 Exchanges of Insurance and Annuities**

While Section 1031 governs exchanges of real property, Section 1035 provides a parallel deferral mechanism for insurance and annuity contracts. IRC Section 1035(a) allows nonrecognition of gain on certain exchanges of life insurance policies, endowment contracts, and annuities, provided that the insured remains the same and the exchange does not involve cash or other non-qualifying property.<sup>37</sup> Like Section 1031, Section 1035 reflects the principle of continuity of investment: taxpayers who simply exchange one qualifying contract for another should not face immediate taxation.

In *Conway v. Commissioner*, the First Circuit upheld nonrecognition treatment for an exchange of life insurance contracts, reinforcing the continuity rationale.<sup>38</sup> More recently, the IRS has addressed modern variations such as annuity-to-annuity exchanges (Rev. Rul. 2003-76) and partial annuity exchanges (Rev. Rul. 2007-24).<sup>39</sup> With these rulings, it is clear that Section 1035 protects a high degree of flexibility, but it also must follow strict statutory rules.

Parallels to Section 1031 are striking. Both provisions require continuity of investment, and both impose limitations on qualifying property. Just as boot in a Section 1031 exchange triggers gain, receipt of cash or other property in a Section 1035 transaction causes recognition.<sup>40</sup> Similarly, Section 1035 disallows cross-exchanges as does Section 1031 (for different reasons). For example, swapping an annuity for a life insurance policy. This is similar, although different, to Section 1031 which disallows exchanges of U.S. property for foreign property.

Section 1035 exchanges can provide a useful tool for special needs planning. Life insurance and annuities are often used to fund supplemental needs trusts or provide stable income streams for individuals with disabilities. Through the benefit of not having to figure out income tax at the time of an exchange, families can rework contract terms and long-term planning objectives to match better. One example would be for a family exchanging their old life insurance policy into a contemporary contract with superior long-term care riders, thereby increasing the amount available to support a child who has become disabled.

## **XII. Conclusion**

The 1031 exchange is one of the most potent and least used tools in special needs and estate planning. Through the deferral of gain and maintaining families' ability to horizontally diversify into higher-yield property, Section 1031 helps families preserve capital for the long term, make

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<sup>37</sup> IRC §1035(a); Treas. Reg. §1.1035-1.

<sup>38</sup> *Conway v. Commissioner*, 111 F.2d 611 (1st Cir. 1940).

<sup>39</sup> Rev. Rul. 2003-76, 2003-1 C.B. 355; Rev. Rul. 2007-24, 2007-1 C.B. 1282.

<sup>40</sup> IRC §1035(d)(1).

investments in supplemental needs trusts, and maintain public benefits eligibility. Paired with deathbed basis step-up to the extent allowed by law, Section 1031 provides families a way to eliminate most, if not all, built-in-gain.

For advisors to families with special needs Section 1031 exchanges can provide a cornerstone strategy in wealth preservation, but it must be integrated carefully in trust and ethical planning while considering eligibility benefits. With an understanding of not only the technical needs, but also the larger policy background, advisors can assist families in providing stability, security and peace of mind for family members at their most vulnerable.

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### What is a 1031 Exchange?

- A 1031 exchange allows investors to sell a property and reinvest the proceeds in "like-kind" real estate while deferring recognition of any taxable gain and the payment of taxes from the original sale

- Requirements:
  - Qualifying property
    - Like-kind property
    - Investment or business property only
  - Timing
  - Greater or equal value
  - No boot
  - Arm's length transaction



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### Qualifying Property

1031 exchange property must be like-kind property and held for investment or use in a trade or business.

Treas. Reg. 1.1031(a)-1(b) – Definition of "like-kind."

- Focus on the nature or character of property and not its grade or quality.
- Improvements are not material.

- Examples:

- Apartment building for farmland = ok
- Improved land for raw land = ok
- Industrial land for fractional land held in a DST = ok
- US property for foreign property = not ok

What are some examples of property not held for investment or use in a trade or business under Section 1031?

- Stocks, bonds, notes, and securities of any kind.
- Interests in a partnership.
- Property held primarily for sale.

Source: IRC and AB

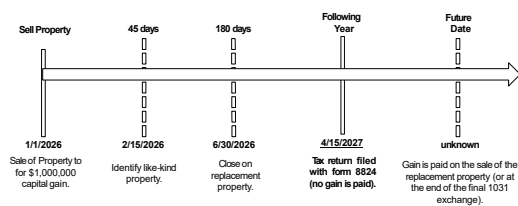
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### Timing of a 1031 Exchange





Additional Requirements – Debt in a 1031 exchange

To defer all gains in a 1031 exchange:

- 1. 100% of the equity proceeds from the sale of the relinquished property must be reinvested into replacement property; and
- 2. Debt repaid in conjunction with the sale of the relinquished property must be replaced upon purchase of the replacement property with either new or assumed debt or an additional cash contribution.

| Relinquished Property Sale                 |             | Replacement Property Purchase      |             |                                    |             |
|--------------------------------------------|-------------|------------------------------------|-------------|------------------------------------|-------------|
|                                            |             | Example #1 - Cash Contribution     |             | Example #2 - Debt Assumption       |             |
| Asset Sale Proceeds                        | \$2,000,000 | Equity from Qualified Intermediary | \$1,750,000 | Equity from Qualified Intermediary | \$1,750,000 |
| Less: Debt Repaid at Closing               | (\$250,000) | Additional Cash Contributed        | \$250,000   | Debt Assumed at Purchase           | \$750,000   |
| Remaining Equity to Qualified Intermediary | \$1,750,000 | Property Purchased                 | \$2,000,000 | Property Purchased                 | \$2,500,000 |

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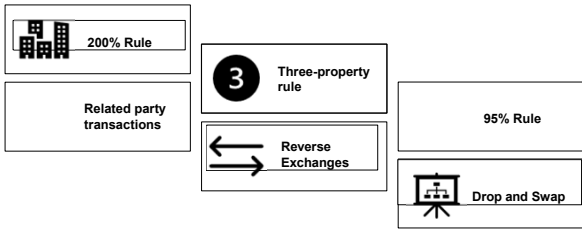


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Nuisances and Variations of 1031 Exchanges



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Additional Requirements – Arm's Length Transactions

- **Example 1:** X and Y are related parties (within the meaning of Sec. 267). X owns a high-value/low-basis warehouse with a fair market value of \$1,000 and an adjusted basis of \$200. Y owns a high-value/high-basis apartment building with a fair market value of \$1,000 and an adjusted basis of \$1,000. The related group (X and Y) wants to sell the warehouse (low-basis property) for \$1,000 but wants to avoid the recognition of an \$800 gain (\$1,000 sale price less \$200 adjusted basis).
- Can X and Y enter into a Section 1031 exchange with each other?
- Maybe, but they must meet three related-party exceptions.
  - (1) the two-year/second disposition rule (Sec. 1031(f)(1));
  - (2) the rule against transactions structured to avoid the purpose of Sec. 1031(f)(1) (Sec. 1031(f)(4)); and
  - (3) the principal purpose to avoid tax rule (Sec. 1031(f)(2)(C)).

Source: The Tax Advisor  
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### Recap of 1031 Exchanges

| Advantages of 1031 Exchanges                                                                                                                                                                                                                                                                                                                                                                                                  | Disadvantages of 1031 Exchanges                                                                                                                                                                                                                                                                                                     |
|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| <ul style="list-style-type: none"><li>• Significant depreciation taken 10+ year ownership.</li><li>• Debt Above Basis – have refinanced out equity.</li><li>• Access liquidity by refinancing out equity.</li><li>• Building wealth through compounding.</li><li>• Want control, hands on - make your own buy sell decisions.</li><li>• Potentially pay no tax.</li><li>• Step-up in basis on death (estate taxes).</li></ul> | <ul style="list-style-type: none"><li>• Taxed on "boot."</li><li>• Finding replacement property can be difficult.</li><li>• Multiple procedures, rules and regulations to follow.</li><li>• Reduced basis on property acquired.</li><li>• Losses cannot be recognized.</li><li>• Potential future increased in tax rates.</li></ul> |

Source: AB  
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### Why Does This Matter In Special Needs Planning?



- Preserving real estate value without triggering capital gains.
- Aligning assets with the trust's income needs.
- Coordinating with estate and gift tax objectives.
- Integrating with pooled or third-party special needs trusts.

Source: AB  
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Are QOZs an alternative to Section 1031 exchanges?

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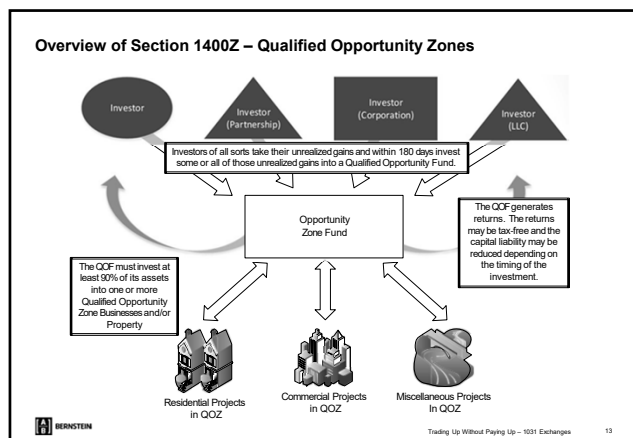
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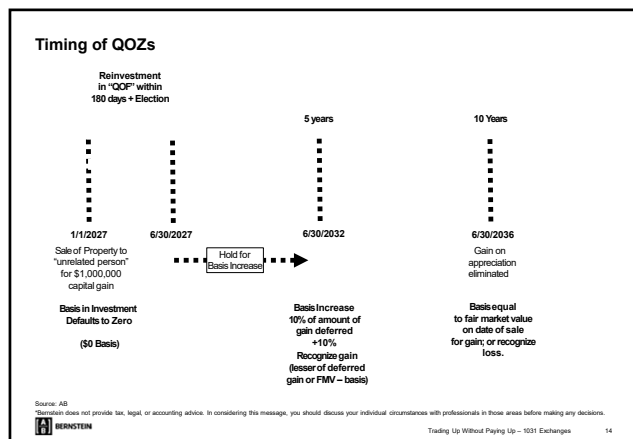
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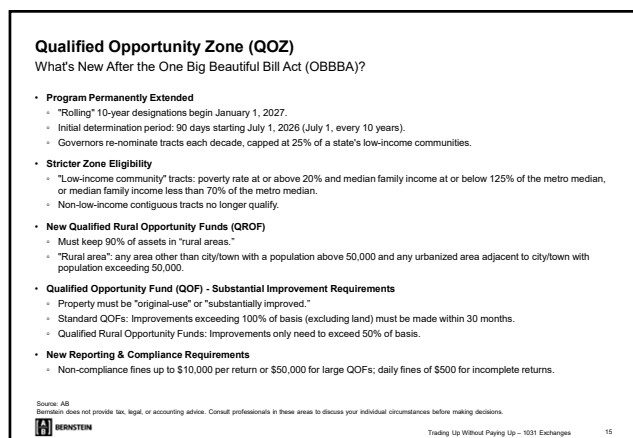
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### Qualified Opportunity Funds (QOFs)

### Key Planning Insights

- **Bridge 2026 Sales – The Pass-Through Entity Solution**

- Consider utilizing pass-through entities to extend the 180-day investment period into 2027.
- Partners may have expanded for when the 180-day investment period begins [Reg. §1.1400Z2(a)-1(c)(8)(iii)]

- **Option 1:** The partnership's 180-day period.
- **Option 2:** The last day of the partnership's taxable year.
- **Option 3:** The due date for the partnership's tax return, without extensions, for year in which the gain is realized.

**January 1, 2026 - Partnership sells capital gain property.**  
**March 15, 2027 - The 180-day investment period for each partner begins.**  
**September 11, 2027 - Latest date for Each partner to make a QOF investment.**

- **Leverage Bonus Depreciation**

- In partnership QOF, each investor's outside & at-risk basis is increased by his/her share of recourse or "qualified non-recourse" real-estate debt (IRC §§752 & 465).
- After a 10-year hold, investor is able to step up basis to fair market value (§1400Z-2(c)).
  - Ordinary (§1245) & unrecaptured §1250 recapture are wiped out.
  - The bonus-depreciation deduction becomes a permanent tax saving.

Source: AB  
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## Comparing 1031 Exchanges and Qualified Opportunity Zones

|                                 | 1031 Exchanges | 1400Z QOZs |
|---------------------------------|----------------|------------|
| 45 day requirement?             | Yes            | No         |
| 180 day requirement?            | Yes            | Yes        |
| Like-kind requirement?          | Yes            | No         |
| Step-up in basis?               | No             | Yes        |
| Personal property?              | No             | Yes        |
| Infinite deferral of gain?      | Yes            | No         |
| Depreciation deferral?          | Yes            | No         |
| Hands on management?            | Yes            | Not likely |
| Cash out refinance?             | Yes            | No         |
| Gain due in 5 years?            | No             | Yes        |
| Tax-free appreciation possible? | No             | Maybe      |
| Related party sales?            | Maybe          | No         |

Source: AB  
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STETSON LAW

## **Tax Intensive**

October 22, 2025

### **Post-Mortem Planning Checklist: Tax Priorities After Death**



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# POST-MORTEM PLANNING: TAX PRIORITIES AFTER DEATH

*Debra L. Boje  
Gunster, Yoakley & Stewart, P.A.  
Tampa  
October 22, 2025*

## I. INTRODUCTION

Death is not the end of the planning process. The administration of an estate or trust is much more than just marshaling assets, paying debts and distributing assets to beneficiaries. In some cases, a decedent may die without an estate plan, or the decedent's estate plan may not maximize tax benefits. Post-mortem planning is a vital part of the administration process. Proper post-mortem planning may offer opportunities for tax savings and prevent unintended tax results. This outline reviews the basic post-mortem tax planning opportunities that should be considered following the death of a decedent. It is not intended to address all the potential income and estate tax issues that may arise in any given estate or trust.

## II. ABBREVIATIONS & REFERENCES

A. "Executor" means a person defined as an executor under I.R.C. § 2203 and includes an executor or administrator of a decedent's estate, any person in possession of any of the decedent's property if no executor or administrator has been appointed, qualified, and acting in the United States.

B. "Form" refers to an official Internal Revenue Service form to be used for a tax filing.

C. "I.R.C." refers to the Internal Revenue Code of 1986 as amended. Sections of the Internal Revenue Code of 1986 are referred to by citing I.R.C. followed by the corresponding section number. For example: § I.R.C. 2031.

D. "IRS" refers to the Internal Revenue Service.

E. "OBBA" refers to the One Big Beautiful Bill Act signed into law on July 4, 2025.

F. "Reg." refers to the Treasury Regulations promulgated by the Internal Revenue Service and the United States Department of Treasury. Sections of the Treasury Regulations are referred to by citing Reg. followed by the corresponding regulation number. For example: Reg. 20.2031-1.

G. "U.S.C." refers to Title 31 of the United States Code. Sections of Title 31 of the United States Code are referred to by citing U.S.C. followed by the corresponding section number. For example, § U.S.C. 3713.

## III. NOTICES AND INFORMATIONAL REQUESTS

A. Form 56, Notice Concerning Fiduciary Relationship

1. Who is a Fiduciary for Tax Purposes

a. A fiduciary for tax purposes is defined as “any person in a position of confidence acting on behalf of any other person. A fiduciary assumes the powers, rights, duties, and privileges of the person or entity on whose behalf the fiduciary is acting.”<sup>1</sup>

b. A fiduciary includes, but is not limited to, administrators, conservators, executors, trustees of a trust, personal representatives, and persons in possession of property of a decedent’s estate.<sup>2</sup>

2. Purpose of Form 56: The Form 56 puts the IRS on notice of the creation or termination of a fiduciary relationship under I.R.C. § 6903 and notice of qualification under I.R.C. § 6036. Until the IRS is notified of the fiduciary relationship, tax notices will be sent to the last known address of the decedent. Relying on mail forwarding by the post office is an option but not recommended as it is not always dependable. Once filed the IRS must communicate directly with the fiduciary.

3. Failure to File: There is no penalty for not filing a Form 56. However, if you do not file a Form 56 you may miss important tax notices. Absent the filing a Form 56 if a tax notice is issued and sent to the decedent’s last known address and the fiduciary does not receive it, the fiduciary may become personally liable for the decedent’s tax burden.

4. Termination of Relationship: A Form 56 should also be filed when the fiduciary relationship ends in order to put the IRS on notice of the termination.

#### B. Form 2848, Power of Attorney and Declaration of Representative

A Form 2848 is used to authorize an individual to represent a taxpayer before the IRS. The representative named must be eligible to practice before the IRS. Generally, the executor will name the attorney or accountant as the individual to discuss and resolve tax matters and receive information from the IRS.

#### C. Form 4506, Request for Copy of Tax Return

A Form 4506 can be used to request a copy of the decedent’s past tax returns. Unless the executor has copies of the decedent’s past tax returns or is familiar with the decedent’s assets and obligations it is recommended the executor obtain tax returns for the past seven years. The tax returns may help find unknown assets or obligations.

#### D. Form 4506-T, Request for Transcript of Tax Return

A Form 4506-T can be used to request an online transcript for the decedent. The transcript will provide most of the line items for a tax return as filed by the decedent with the IRS. If requested, the transcript will also provide income information from Forms W-2, 1099, or 1098 for the year or years requested. A Form 4506-T can also be used to provide verification for whether a return was filed for one or more years by the decedent.

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<sup>1</sup> IRS, Instructions to Form 56: Notice Concerning Fiduciary Relationship (Rev. December 2024).

<sup>2</sup> Id.

E. (Form SS-4) Application of Employee Identification Number

A Form SS-4 is used to apply for an Employer Identification Number (“EIN”) for the estate. An EIN will be needed to open accounts for the estate as well as for filing tax returns for the estate. If this form is completed online an EIN will be received immediately upon completing the application. If you apply by mail, it will generally take 4 weeks to get an EIN.

F. Form 8822, Change of Address

A Form 8822 is used to notify the IRS if there is a change of official mailing address for the estate. The Form 8822 should be filed in addition to the Form 56, *Notice Concerning Fiduciary Relationship*.

IV. DECEDENT’S FINAL INCOME TAX RETURN (FORM 1040)

A. Who Must File

The executor has the responsibility for filing the decedent’s final Form 1040.<sup>3</sup> The term executor is broadly defined and if there is no court appointed executor it includes any person in possession of any of the decedent’s property.<sup>4</sup>

B. Short Year

For the year of the decedent’s death, a final personal income tax return must be filed for the period beginning with the first day of the decedent’s tax year (January 1<sup>st</sup>) and ending on the day of the decedent’s death.<sup>5</sup> Thus, unless the decedent died on December 31<sup>st</sup> the decedent’s tax year for the year of death will be a “short year.”

C. WARNING

It may be necessary for the executor to also file the tax return for the year prior to the year of the decedent’s death. For example, if the decedent dies on April 1, 2025, and the decedent did not file their return for the tax year 2024 the executor will need to file both the 2024 return (which return must be filed by April 15, 2025, unless an extension is filed) and the decedent’s final return for the period from January 1, 2025 – April 1, 2025 (which return will be due on April 15, 2026, unless an extension is filed). NOTE: The executor will also be responsible for filing any other income tax returns for the decedent for which the executor knows or should know need to be filed.

D. Joint Return Analysis

1. If the decedent is survived by a spouse, a decision will need to be made whether the decedent and the surviving spouse should file a joint return.

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<sup>3</sup> I.R.C. § 6012(b)(1).

<sup>4</sup> I.R.C. § 2203.

<sup>5</sup> I.R.C. § 443(a)(2) and Reg. 1.6072-1(b).



2. For the year of death, the decedent and his or her surviving spouse may file a joint return provided the surviving spouse does not remarry before the end of year.<sup>6</sup>

3. If a joint return is filed, it will include the decedent's income from the beginning of the tax year through the date of the decedent's death and the surviving spouse's income for the entire taxable year.

4. The same tax rate and personal exemption will apply even though the final year is a short year (no proration is required).

5. If the executor is appointed prior to the due date of the final return both the executor and the surviving spouse must consent to the filing of a joint return. If an executor has not been appointed the surviving spouse may file a joint return on their own. If an executor is subsequently appointed, the executor may disaffirm the joint return within one year of the last day for filing the surviving spouse's return.<sup>7</sup>

6. The responsibility for the payment of the tax is divided proportionately between the estate and the surviving spouse based upon the income attributable to each.<sup>8</sup>

7. A primary disadvantage of filing a joint return is the joint and several tax liability of both the decedent's estate and the surviving spouse for the taxes, interest and penalties related to the return.<sup>9</sup>

8. **PLANNING OPPORTUNITY:** A joint return should be filed if the income tax liability of the estate for the joint return will be lower than if separate returns are filed. This determination will depend on how the tax liability is apportioned between the estate and the surviving spouse. If an estate tax return is required to be filed, the decedent's share of the tax liability for the year of death is deductible on the Form 706.

9. **PLANNING OPPORTUNITY:** If the surviving spouse is claiming a child, stepchild, or adopted child as a tax dependent and otherwise meets the requirements, the surviving spouse will be able to claim "qualifying surviving spouse" filing status for two years *following* the year of the decedent's death.<sup>10</sup> This status allows the surviving spouse to use the joint return tax rates and the married filing jointly standard deduction amount if they do not itemized deductions.

#### E. Deduction Considerations

1. As soon as possible following the decedent's death an analysis should be made as to whether there are any unused deductions that may be available to the decedent (i.e. medical expense, passive activity losses, charitable deductions and other itemized deductions). If there are unused deductions available, the decedent's accountant (or tax advisor) should be consulted to provide a complete income tax analysis. NOTE: After 2017, miscellaneous itemized deductions are no longer allowed. OBBBA made permanent the disallowance of miscellaneous itemized deductions. Miscellaneous itemized deductions would include investment advice, safe deposit box rental fees,

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<sup>6</sup> I.R.C. § 6013(a)(2).

<sup>7</sup> I.R.C. § 6013(a)(3).

<sup>8</sup> Reg. § 20.2053-6(f).

<sup>9</sup> I.R.C. § 6013(d)(3).

<sup>10</sup> Qualifying spouse status cannot be claimed for the year of death.

service charges on dividend reinvestment plans, travel expenses, and appraisal fees not related to determining the fair market value of assets as of for estate tax purposes or for determining value for purposes of distributions.

2. PLANNING OPPORTUNITY: Some deductions that are not used to offset the decedent's income in the year of death are lost. For example, if the decedent has net capital losses in the year of death these losses will not carry over to the estate.<sup>11</sup> If, however, the surviving spouse has net capital gains in the year of death and a joint return is filed the decedent's losses can offset the surviving spouses gain. If the surviving spouse does not have enough capital gain, consider having the surviving spouse accelerate capital gain (i.e. sell appreciated stock) in the year of the decedent's death.

3. PLANNING OPPORTUNITY: If the decedent has excess deductions in the year of death and the surviving spouse does not have enough income to utilize the excess deductions, consider having the estate make a distribution to the surviving spouse. The distribution will carry out the estate's distributable net income (DNI) thereby increasing the surviving spouse's income. This planning opportunity will only work if the estate has a calendar year end, DNI to carry out, and the surviving spouse is a beneficiary of the estate.

4. Medical Expenses -- PLANNING OPPORTUNITY:

a. Unreimbursed medical expenses that are ***paid*** by the decedent's estate within 12 months after the decedent's death may be deducted on either (i) the decedent's income tax return for the year the expenses are incurred<sup>12</sup> or (ii) the estate tax return (Form 706) as a liability of the decedent. Medical expenses deductions cannot be taken on the estate's *income* tax return (Form 1041).

b. The executor will need to make an election to claim the deduction on the decedent's final income tax return. An election is not necessary for medical expenses paid prior to death.

c. To claim a medical expenses deduction on the decedent's income tax return, the decedent must itemize deductions, and the amount must be 7.5% above the decedent's adjusted gross income.

d. A surviving spouse who pays the decedent's medical expenses, either before or after the decedent's death, can claim a deduction on their own return for the year the expenses are paid.

e. PLANNING OPPORTUNITY: The executor's decision whether to make an election to take the deduction on the decedent's income tax return as opposed to the estate tax return (Form 706) will depend upon whether the estate is subject to estate tax and, if it is, a comparison of the decedent's personal income tax bracket and the estate tax bracket. In making this comparison remember that the decedent's income tax obligation is deductible on the estate tax return

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<sup>11</sup> Rev. Rul. 74-175, 1974-1C.B. 52.

<sup>12</sup> An amended income tax return can be filed if the expense was incurred in a prior year.

(Form 706) as a debt.<sup>13</sup> As a rule of thumb, the deduction will be more valuable on the estate tax return if the estate will owe estate taxes.

#### F. Savings Bonds -- PLANNING OPPORTUNITY

1. If the decedent owned series EE or series I<sup>14</sup> savings bonds at death and the decedent did not choose to report interest each year, the executor can elect to report all the accrued interest as income on the decedent's final tax return or on the estate's income tax return.<sup>15</sup> If an election is made the transferee (estate or beneficiary receiving the bonds) must then recognize on their return each year, any interest earned after the date of the decedent's death.

2. The election used to be irrevocable. Rev. Proc. 2025-23 § 17, however, provides a process for a cash basis taxpayer to revoke the election. If the election is revoked, the transferee can defer recognizing the interest income that accrues after death until the bonds are cashed or reach the date of maturity whichever occurs first.

3. If an election is not made, the interest will be income in respect of a decedent (a stepped-up basis is not allowed) and the transferee can defer reporting the income earned, both before and after the decedent's death, until the bonds are either cashed or reach the date of maturity, whichever is earlier.<sup>16</sup>

4. If the decedent's estate was required to pay estate taxes, the transferee may be entitled to a "deduction in respect of a decedent" which will offset all or part of the income in respect to the decedent.<sup>17</sup>

#### G. Gift Tax Liability

1. The executor is responsible for reporting taxable gifts for which no return is filed.<sup>18</sup>

2. An executor is personally liable for a decedent's unpaid income and gift taxes if the executor: (1) knew the debt existed, and (2) distributed the estate without first paying the taxes.

3. Knowledge requires the executor to have "actual knowledge of the liability or notice of such facts as would put a reasonably prudent person on inquiry as to the existence of the unpaid claim of the United States." If the government makes a prima facie showing of the executor's knowledge of the decedent's unpaid income and gift taxes, the burden of proof is on the executor to establish that he or she was unaware of such unpaid income and gift taxes debts.

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<sup>13</sup> When comparing the income and estate tax consequences it is also important to consider the effect on the marital deduction if the deduction is taken on the estate tax return. A portion of the medical expenses deducted on the estate tax return will reduce the marital deduction, thus wasting part of the deduction.

<sup>14</sup> The last HH series savings bonds stopped earning interest in 2024.

<sup>15</sup> I.R.C. §454(a).

<sup>16</sup> If a beneficiary receives savings in satisfaction of a specific dollar amount and the decedent did not elect to report interest each year the estate must recognize accrued interest earned through the date of death plus and interest earned to the date of the distribution. The beneficiary will then have recognize any interest earned after receipt of the bonds.

<sup>17</sup> I.R.C. § 691(c).

<sup>18</sup> I.R.C. § 6901(a) and 31 U.S.C. § 3713(b).

4. The executor and the surviving spouse may agree to elect to split gifts made during the decedent's lifetime.<sup>19</sup> The gift must have been completed prior to the decedent's death. The gift must have been made while the spouses were married, both spouses must be US citizens or residents on the date the gift is made; and the surviving spouse cannot remarry prior to the end of the year the gift is made.<sup>20</sup> The election applies to all gifts made during the year (you cannot pick and choose).<sup>21</sup>

5. PLANNING OPPORTUNITY: In considering whether to split gifts, the executor should consider (i) the includability of the gifts in the decedent's estate, (ii) the relative sizes of the estates of the decedent and surviving spouse, and (iii) the available annual gift tax exclusion and unified credit.

## V. ESTATE AND/OR TRUST INCOME TAX RETURN (FORM 1041)

### A. Separate Taxpayers

For tax purposes, the decedent's estate and revocable trust (which becomes irrevocable at death) will each be treated as separate taxpayers as of the date of the decedent's death. Each will be required to obtain a separate employer identification number ("EIN").<sup>22</sup> An estate will exist until the final distribution of its assets.

### B. Selection of a Taxable Year

1. An estate can elect either a calendar or fiscal tax year.<sup>23</sup> The first year can be any period that ends on the last day of a month and does not exceed 12 months.

2. A trust must use a calendar year end, unless a 645 election is made.

3. PLANNING OPPORTUNITY: The ability of an estate to use a fiscal year end affords the opportunity for deferral of income tax liability. For example, if the decedent dies on July 15, 2025, and the estate elects to use a June 30<sup>th</sup> year end. The estate's first fiscal year will run from July 15, 2025 – June 30, 2026. Any income distributed to the beneficiaries will be reported on the beneficiaries 2026 income tax return that is not due until April 15, 2027.

### C. Estimated Tax Payments

1. Estates are exempt from making estimated tax payments for taxable years ending within two years of the decedent's death.<sup>24</sup>

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<sup>19</sup> I.R.C. § 2513 and Reg. § 25.2513-2(c).

<sup>20</sup> I.R.C. § 2513(a).

<sup>21</sup> Reg. § 25.2513-1(b).

<sup>22</sup> A testamentary trust will not become a taxpayer for income tax purposes until the trust is funded.

<sup>23</sup> I.R.C. § 441(b)(1).

<sup>24</sup> I.R.C. § 6654(1).

2. PLANNING OPPRTUNITY: When an estate terminates, the executor can elect to transfer to the beneficiaries the credit for all or part of the estate's estimated tax payments for the last year.<sup>25</sup> The election must be filed by the 65<sup>th</sup> day after the close of the estate's tax year.<sup>26</sup>

3. Trusts treated as owned by a decedent are exempt from making estimated tax payments for taxable years ending within two years of the decedent's death if: (i) the residuary estate pours over to the trust, or (ii) the trust is primarily responsible for paying the debts, taxes and expenses of administration and no will has been admitted to probate.<sup>27</sup>

4. PLANNING OPPORTUNITY: If a trust makes estimated tax payments in excess of its tax liability the trustee may elect to treat any portion of the payment as made by the beneficiary.<sup>28</sup> The election must be made within 65 days of the close of the trust's year end.<sup>29</sup> A trust, unlike an estate, can elect to allocate excess estimated tax payment in any year not just the final year.

#### D. Election to Treat Qualified Revocable Trust as Part of Estate (§ 645 Election)

1. An executor of an estate and a trustee of a qualified revocable trust can elect to treat both entities as part of the decedent's estate for income tax purposes.

2. The election must be made no later than the due date of the estate's income tax return for the first taxable year of the estate.<sup>30</sup> The election cannot be made on a late filed return or an amended returned.

3. The election is made by filing a Form 8855 with the Form 1041. The executor, if one is appointed, and the trustee must join in the filing of the Form 8855. Once made the election is irrevocable.

4. The election is good for two years (or 6 months after the date of the final determination of estate tax liability if a Form 706 is required to be filed).<sup>31</sup>

5. Advantages:

a. Benefit of a single combined tax return.

b. Trusts are required to use a calendar year end. By making a 645 election, the trust can take advantage of the estate's fiscal year end for reporting purposes which can delay tax liability on income.

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<sup>25</sup> I.R.C. § 643(g).

<sup>26</sup> See Form 1041-T, Allocation of Estimated Tax Payments to Beneficiaries.

<sup>27</sup> I.R.C. § 6654(1)(2)(B).

<sup>28</sup> I.R.C. § 643(g)(1).

<sup>29</sup> I.R.C. § 643(g)(2). Form 1041-T, Allocation of Estimated Tax Payments to Beneficiaries is used to make the election.

<sup>30</sup> I.R.C. § 645(b)(2).

<sup>31</sup> I.R.C. § 645(b)(2).

c. An estate has a higher income tax exemption (\$600) than a trust.<sup>32</sup> Thus, if the estate has very little income the trust may be able to take advantage of the higher exemption if a 645 election is made.<sup>33</sup>

d. A 645 election enables the trust to claim a charitable deduction for any amounts permanently set aside for a charitable purpose without the requirement that the amount actually be paid to the charity during the tax year.

e. If the trust holds S corporation stock, the trust can hold the stock for the duration of the election. The election lasts until the later of (i) two years from the decedent date of death and (ii) six months after the final determination of the estate tax liability.

f. If the estate is likely to have deductions in excess of its income by making the election the excess deductions can be used to offset the income of the trust. Similarly, if the trust has excess deductions the income of the estate can be offset.

6. PLANNING OPPORTUNITY: Example, if the decedent dies on June 1, 2023, and the estate elects a fiscal year end of May 31<sup>st</sup> then the first fiscal year of the estate will be for the period of June 1, 2023 – May 31, 2024, and the return will be due September 15, 2024. If the decedent also has a revocable trust and a 645 election is made, then the income of the trust will be reported on the estate return using the same fiscal year end (May 31<sup>st</sup>). Thus, deferring the reporting of the trust income for the period from June 1, 2023 – December 31, 2023, for an additional 5 months. If the estate and trust are able to be closed before May 31, 2024, the beneficiaries will report the income of the estate (which will include the trust income) on their 2024 tax return which is not due until April 15, 2025, thus, deferring the income earned by the trust from June 1, 2023 – December 31, 2023, an additional 7 months.

#### E. Deduction Considerations

1. Administration Expenses: Expenses of administration that would not have been incurred but for the administration may be deducted on the estate's income tax return (Form 1041) or estate tax return (Form 706), if the estate is taxable. These expenses include executor commissions, trustee fees, attorney's fees, accountant's fees, court costs, appraisal fees, costs of selling property, etc.<sup>34</sup> If taken on the income tax return these deductions are itemized deductions.

WARNING: If a deduction is claimed on the estate income tax return the income beneficiaries will receive a benefit. If the deduction is claimed on the estate tax return the remainder beneficiaries will receive the benefit.

WARNING: The OBBBA places a limit on itemized deductions for taxpayers in the highest marginal income tax bracket. This limitation applies to estates and trusts. The limitation is 2/37th of the itemized deduction. This limitation takes effect for itemized deductions starting in 2026.

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<sup>32</sup> I.R.C. § 151.

<sup>33</sup> The OBBBA did not change the \$600 income tax exemption for estates.

<sup>34</sup> I.R.C. § 2053.

2. PLANNING OPPORTUNITY: Administrative expenses taken on the estate income tax return should be timed so they are taken when there is income to offset the expenses.

3. PLANNING OPPORTUNITY: If the estate or trust is in the highest tax bracket, consider paying administrative expenses in 2025 before the new 2/37th limitation comes into effect.

#### F. Managing Distributions

##### 1. Bracket Considerations

a. Estate and trust income taxes reach the highest tax bracket of 37% at \$15,650 of taxable income for 2025.

b. PLANNING OPPORTUNITY: If residual beneficiaries are in lower brackets, it will save taxes overall to distribute income out of the estate to the beneficiaries. The executor and trustee have until the 65th day after the end of the tax year to make distributions for that tax year. NOTE: Capital gains are not passed out. They stay at the Form 1041 level and are taxed there, except on a final return.

##### 2. Accrual Basis

a. An estate or trust may choose either a cash or accrual method of accounting.<sup>35</sup> Once an accounting method (cash or accrual) is chosen, it ordinarily cannot be changed without IRS approval. Thus, the decision whether to use the accrual method of accounting will need to be made when the first income tax return is filed for the estate or trust.

b. PLANNING OPPORTUNITY: Excess deductions over income on an estate or trust Form 1041 do not carry over to the next year and therefore are lost (except on a final return). If the income of the estate or trust exceeds its expenses the executor or trustee may be able to prepare the Form 1041 on the accrual basis and accrue expenses. To accrue an expense, it must be both a fixed liability and the amount must be reasonably determinable (i.e. executor fees or trustee fees).

##### 3. Final Year Excess Deductions:

a. If an estate or trust has excess deductions for the last tax year, they can be carried out to the beneficiaries who succeed to the property of the estate or trust.<sup>36</sup> The beneficiaries can then use those deductions on their own return for the year the estate or trust terminates. The excess deductions retain their separate character as an amount allowed in arriving at adjusted gross income, a non-miscellaneous itemized deduction or a miscellaneous itemized deduction. Under the OBBBA, excess miscellaneous deductions subject to the 2% adjusted gross income threshold can no longer be deducted (i.e. fees for investment advice, safe deposit box rental fees, service charges on dividend reinvestment plans, travel expenses, and appraisal fees unrelated to estate tax purposes).<sup>37</sup> Above-the-

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<sup>35</sup> I.R.C. § 446(c)

<sup>36</sup> I.R.C. § 642(h)(2).

<sup>37</sup> The restriction for deductibility of miscellaneous itemized deductions was originally put in place by the Tax Cuts and Jobs Act but was set to sunset in 2025. The OBBBA permanently eliminated this category of deductions.

line administration expenses (expenses that would not have been incurred if the property were not in an estate such as executor fees, trustee fees, tax preparation fees, legal fees) can still be taken by beneficiaries. If the deduction is more than the beneficiary's income for that year, the excess deduction cannot be carried over by the beneficiary to future years.<sup>38</sup>

b. **PLANNING OPPORTUNITY:** If there is not enough income to offset deductions the estate or trust should consider delaying payment until the final tax year. Timing of executor and trustee commissions should be giving careful consideration.

4. Unused loss carryovers.

An unused net operating loss ("NOL") carryover or capital loss carryover existing upon termination of a trust or estate is allowed to be carried over to the beneficiaries succeeding to the property of the estate. The NOL carryover and the capital loss carryover are used in figuring the beneficiary's adjusted gross income and taxable income.

5. Election to Recognize Gain on Distribution of Appreciated Assets in Kind.

Generally, an estate or trust does not recognize either gain or loss on the distribution of appreciated property.<sup>39</sup> The beneficiary will receive the same basis in the property as the estate had in the property. The beneficiary will then recognize gain or loss when the property is sold.

a. An executor or trustee, however, can make an I.R.C. § 643(e)(3) election to recognize gain or loss on an in-kind distribution of appreciated (or depreciated) property to a beneficiary. The recognized gain or loss will then be reported on the tax return for the estate or trust (Note: the ability of a trust to report a loss is subject to the disallowance of loss rules).

b. A trustee making the I.R.C. § 643(e)(3) election, must be cognizant of the loss disallowance rules of I.R.C. § 267. While § 267(b)(13) does not disallow a loss in the case of a sale or exchange in satisfaction of a pecuniary bequest from an estate, a trust and its beneficiaries are considered related parties under § 267(b)(6) and the loss is disallowed. Thus, an I.R.C. § 643(e)(3) election by a trust to recognize loss is pointless.

c. If the election is made it applies to all in-kind distributions made during the year.

d. **PLANNING OPPORTUNITY:** The executor or trustee should consider this election to trigger gain if the income tax bracket of the estate or trust is less than that of the beneficiaries. The election should also be considered if the estate or trust has capital loss carryovers from prior years and the election would result in a capital gain that will absorb the losses. Finally, the election should be considered if one beneficiary is receiving cash, and the other is receiving

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<sup>38</sup> Reg. § 1.642(h)-2(a).

<sup>39</sup> An estate or a trust will recognize gain, and an estate will recognize loss if it uses appreciated property to satisfy a pecuniary bequest. *Kenan v. Commissioner*, 114 F.2d 217 (2d Cir. 1940). An election is not required. The loss disallowances rules found in I.R.C. § 267 do not apply to distributions of appreciated property to satisfy a pecuniary bequest made by estate.



appreciated property, by making the election the burden of the built-in tax liability can be equalized between the beneficiaries.

6. Executor/Trustee Fee

a. Both an executor and trustee fee constitute taxable income.

b. **PLANNING OPPORTUNITY:** If the executor or trustee is also a beneficiary, it may be beneficial for them to waive the fee especially if the estate is not taxable. If the estate is taxable the estate tax savings may outweigh the income tax implications. If the executor or trustee is in a low-income tax bracket an estate income tax deduction may be beneficial if the estate is in a higher tax bracket or if the fee is taken in the final year and the deduction can be passed out to beneficiaries who are in a higher tax bracket. A parent or grandparent could also shift assets to someone else by allowing that person to be appointed as the executor or trustee and take a fee.

7. 65-Day Rule

a. Often an estate or trust is in a higher tax bracket than its beneficiaries. Thus, it may be beneficial to distribute all or part of the income to the beneficiaries to shift the income tax liability. The 65-day election gives the executor and trustee of a complex trust<sup>40</sup> an additional 65 days after the end of the fiscal year to make beneficiary distributions and still be able to report them on the prior year tax return.<sup>41</sup> Once made the election is irrevocable.

b. **PLANNING OPPORTUNITY:** The 65-day election allows the executor and trustee to distribute just the right amount of income to the beneficiaries to optimize tax planning. It can also avoid the estate or trust incurring the Medicare surtax.

G. Set Aside for Charitable Purposes from Gross Income

1. Unlike charitable deductions for individuals, there is no limitation on the charitable deduction for estates and trusts. For any amounts paid, during the tax year, to a charitable beneficiary pursuant to the terms of the governing instrument, the estate or trust is entitled to a charitable deduction.<sup>42</sup> NOTE: OBBBA introduces a 0.5% Adjusted Gross Income (“AGI”) floor for itemized deductions which takes effect for tax years beginning after December 31, 2025. However, this floor only applies to individuals and does not apply to estates and trusts.

**WARNING:** Although the 0.5% AGI floor does not apply to estates and trusts, the charitable deduction may be capped under the new 2/37th rules for itemized. OBBBA replaces the Pease provisions (I.R.C. § 68) with a new 2/37th reduction rule. Under this new rule itemized deductions must be reduced by 2/37th of the amount by which the taxpayer’s income exceeds the amount at which the 37% bracket begins. Estates and Trusts were exempt from the Pease provisions.<sup>43</sup> It does not however, appear that they are exempt from the 2/37th reduction rule. Thus, estates and

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<sup>40</sup> A simple trust (one that is required to distribute all of its income) will be deemed to have distributed its income to the income beneficiary even if it is not actually paid. I.R.C. § 651.

<sup>41</sup> I.R.C. § 663(b).

<sup>42</sup> I.R.C. § 642(c).

<sup>43</sup> I.R.C. § 68(e).

trusts with income in excess of the 37% rate (about \$16,000 in 2026) may have a cut-back on deductions under § 642(c).

2. **PLANNING OPPORTUNITY:** If all or part of a decedent's estate will pass to a qualified charitable recipient, a "charitable set-aside" can be used to avoid paying tax on the portion of gross income earned by the estate that passes to the charity by using a "charitable set-aside."<sup>44</sup>

3. **PLANNING OPPORTUNITY:** If a decedent's trust will ultimately go to charity, there is no set-aside for the income earned in the trust. However, a trust can take a charitable contribution deduction for the income going to the charity if the income is actually paid to the charity during the tax year or by the end of the following year and the fiduciary makes a timely election.<sup>45</sup> The 642(c) election must be made on a timely filed income tax return for the estate or trust.

## VI. FEDERAL ESTATE TAX RETURNS (FORM 706)

### A. Required to File

1. **U.S. Citizen or Resident:** A Form 706 must be filed if the gross estate of the decedent (who is a U.S. citizen or resident) plus adjusted taxable gifts of the decedent, exceeds the filing threshold for the year of death. The filing threshold for the tax year 2025 is \$13,999,000. For the tax year 2026 the threshold is increased to \$15,000,000. The filing requirement does not depend on whether estate tax is owed.

The OBBBA made the increased estate and gift exclusion amount permanent. The threshold amount beginning in 2026 is \$15,000,000 indexed for inflation in future years.

2. **Nonresident:** An estate tax return may need to be filed for a decedent who was a nonresident and not a U.S. citizen if the decedent had U.S.-situated assets.

### B. Deadline for Filing

The 706 is due 9 months after the date of the decedent's death.<sup>46</sup> However, a 6-month automatic extension can be filed.<sup>47</sup>

### C. Portability (Optional)

1. The executor can elect to transfer the deceased spousal unused exclusion (DSUE) to the surviving spouse.<sup>48</sup> The election to transfer a DSUE amount to a surviving spouse is known as the portability election.

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<sup>44</sup> Form 1041-A, *U.S. Information Return, Trust Accumulation of Charitable Amounts*, should be filed to report the set-aside. This is an informational return and filed in addition to the Form 1041.

<sup>45</sup> If the trust makes the payment in the following year and wants to claim the deduction on the prior year return an election statement must be filed with the Form 1041.

<sup>46</sup> I.R.C. § 6075(a).

<sup>47</sup> Reg. § 20.6081-1(b).

<sup>48</sup> I.R.C. § 2010(c).

2. If the estate is required to file a Form 706 the election must be made on a timely filed estate tax return.<sup>49</sup> If the estate is not required to file a Form 706 the executor has up to five years from the date of the decedent's death to file, the return.<sup>50</sup>

3. If the surviving spouse remarries and then their new spouse dies, the DSUE from the first spouse is lost.

4. The regulations allow a relaxed reporting requirement for marital and charitable deduction property if an estate tax return is filed solely for the purpose of making the portability election.<sup>51</sup> If the relaxed reporting requirements apply, the Form 706 need not report the individual values of assets; it is sufficient that the return set forth a good faith determination of the total value of such assets.

WARNING: The Tax Court's decision in *Estate of Rowland v. Comm.*, T.C. Memo. 2025-76 (July 15, 2025), is a warning that a "complete and properly prepared" estate tax return is required for DSUE and the relaxed reporting requirement will not apply unless the decedent's entire estate is left outright to the surviving spouse, or in a qualified terminable interest property (QTIP) trust, a charitable trust or to a qualified charity.

5. PLANNING OPPORTUNITY: The GST tax exemption is not portable between spouses. If the first spouse to die does not utilize their GST exemption, it is lost forever. Thus, post death GST tax planning is important for wealthier couples. Qualified disclaimers should be considered.

6. PLANNING OPPORTUNITY: It may not always be beneficial to elect DSUE. I.R.C. § 2010(c)(5)(B) permits the IRS to examine the estate tax return of the first deceased spouse at any time, provided the examination is for the purposes of determining the DSUE amount available to the surviving spouse. Thus, the statute of limitations on review of the decedent's return remains open until the death of the surviving spouse.

#### D. Valuation Considerations if the Estate Depreciates in Value

1. Generally, property included in the gross estate is valued at its fair market value as of the date of death. If the total value of all the property included in the gross estate depreciates during the six-month period following the decedent's death the alternative valuation date should be considered.

2. The alternate valuation date can only be used if the election results in a decrease in both (i) the value of the gross estate and (ii) the amount of the federal estate and generation skipping tax liability.<sup>52</sup> If the alternate valuation date is elected the assets are valued as of the date six months after death however, any asset that is distributed, sold, exchanged, or otherwise disposed of within the six month period is valued as of the date of such distribution, sale, exchange or other disposition.

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<sup>49</sup> I.R.C. § 2010(c)(5)(A).

<sup>50</sup> Rev. Proc. 2022-32. When filing, the Executor must print at the top of the return: "FILED PURSUANT TO REV. PROC. 2022-32 TO ELECT PORTABILITY UNDER § 2010(c)(5)(A)."

<sup>51</sup> Reg. § 20.2010-2(a)(7)(ii).

<sup>52</sup> I.R.C. § 2032(c).

3. PLANNING OPPORTUNITY: If the estate is required to file a federal estate tax return and the estate's value has significantly decreased within six months of death, an executor can elect to value the assets on the alternate valuation date. Although, this election reduces estate taxes, it will also result in a lower basis for beneficiaries. Thus, if the estate is in a lower tax bracket (i.e. the taxable amount is less than \$1 Million so the 40% bracket has not been reached) the election may not be beneficial.

E. Statement Identifying Value of Property Interests Includible in Gross Estate (Form 8971).

1. A Form 8971 is required when an estate must file a Form 706.<sup>53</sup> It is not required if the Form 706 is filed only to election portability of DSUE.

2. The Form 8971 must be filed within the earlier of (i) thirty (30) days after the Form 706 is required to be filed (including extensions) or (ii) thirty (30) days after the estate tax return is actually filed with the IRS.

3. A copy of the Schedule A to the Form 8971 must be mailed to each beneficiary. A separate Schedule A must be prepared for each beneficiary. Schedule A lists each item of property that a given beneficiary receives from the estate, its estate tax value, and other information about that item of property.

F. Deduction for Income in Respect to a Decedent

Not all assets get a stepped-up in basis. A category of assets known as income in respect of a decedent (IRD) does not. The beneficiary of such an asset or its income will "step into the shoes" of the decedent and report the income in the same way the decedent would have if he or she had lived to collect it. Common examples include wages earned but not yet paid when death occurs, installment notes receivable, dividends declared before death but paid later, traditional IRA accounts, and investments in annuities. Because the value of these assets is included on the decedent's taxable estate and is taxed for federal estate tax purposes, these assets are in essence double taxed when the money is collected and reported for income tax. If federal estate tax is paid on these assets, the recipient that later reports the items for income tax is entitled to a deduction for the estate tax paid, known as the estate tax deduction for IRD. This may somewhat mitigate the double-taxation effect<sup>54</sup>

## VII. STATE ESTATE TAX RETURNS:

As of 2025, Connecticut, Hawaii, Illinois, Maine, Maryland, Massachusetts, Minnesota, Oregon, New York, Rhode Island, Vermont, Washington and the District of Columbia all levy estate taxes. The estate of decedents who live in these states may face estate taxes at both the federal and state levels. Each state has varying thresholds requirements for when a return is required to be filed. The lowest threshold is Oregon with a \$1,000,000 threshold.

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<sup>53</sup> I.R.C. § 6035(a)(1).

<sup>54</sup> (Regs. Sec. 1.691(c)-2(a)(1)).

## VIII. ADJUSTMENT TO BASIS

### A. Benefit of Proper Basis Adjustment

An important post-mortem task is determining the proper basis adjustment for the decedent's property. Ensuring that the basis of assets is stepped-up to the date-of-death value will ensure the best possible income tax outcome for the beneficiaries.

### B. Step-up/Step-down Basis

Generally, the basis of property acquired from a decedent is the fair market value of the property as of the date of death.<sup>55</sup> In most cases this adjustment will result in the basis of the property being "stepped-up" from the basis the decedent had in the property. Albeit the adjustment could result in a lower value or "step-down" in basis if the property declined in value.

C. The main benefit of the step-up basis is to reduce the capital gains taxes on the subsequent sale of the property by the beneficiary.

D. Only the decedent's interest in property that is includable in the decedent's estate for federal estate tax purposes is adjusted. For example, in the case of tenancies by the entirety property, only half of the property obtains a new basis under I.R.C. 1014.

E. **PLANNING OPPORTUNITY:** Determine if the decedent and the surviving spouse ever lived in a community property state or in a state that allows community property trusts. Community property receives a full step-up in basis.

F. Real property that passes to remainder beneficiaries by way of a lady bird deed or an enhanced life estate deed is entitled to a step-up in basis because the decedent retained a life estate in the property and full control.

G. Not all assets included in the decedent's estate for federal estate tax purposes are entitled to an adjustment. There is no adjustment to basis for property that constitutes an item of income in respect of a decedent.<sup>56</sup> For example, retirement accounts like IRAs and 401(k)s do not get a step-in in basis.

H. An appraisal will generally be necessary to determine the date of death value for assets that do not have a readily determinable value. Even if the decedent's estate is not taxable, documenting asset valuations accurately is essential. Without accurate appraisals beneficiaries may

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<sup>55</sup> I.R.C. § 1014(a). The estate may be eligible to elect the alternate valuation date in which case the assets will be valued as of the date six months after the decedent's date of death (see I.R.C. § 2032), or sooner, if the an asset is sold, exchanged, or otherwise disposed of before the six month period. Certain property may be eligible for special use valuation (see § 2032A).

<sup>56</sup> I.R.C. § 691.

encounter problems documenting the basis and ultimately pay higher capital gains when the property is sold.

I. PLANNING OPPORTUNITY: Consider funding the marital trust with assets that are anticipated to continue to appreciate in value after the decedent's death in order to take advantage of a second step-up in basis on the death of the surviving spouse.

## IX. S CORPORATION CONSIDERATIONS

### A. Busting the S-Election

If an estate or trust owns stock in a S corporation, the executor or trustee must carefully review the tax laws as to who can be a shareholder of the S corporation stock so as not to cause the S corporation to lose its S corporation status. Generally, an estate may own S corporation stock for as long as the estate properly remains open. An estate may remain open for the period needed to perform the ordinary duties of administration.<sup>57</sup> A testamentary trust and a revocable trust can be qualified S corporation shareholders, but only for a period of two years following the decedent's death.<sup>58</sup>

### B. PLANNING OPPORTUNITY

If a trust is going to hold S corporation stock for more than two years, determine whether the trust meets the requirements for being a Qualified Subchapter S Trust (QSST)<sup>59</sup> or Electing Small Business Trust (ESBT).<sup>60</sup> If the requirements are not met consider modifying the terms of the trust to meet the QSST or ESBT requirements.

## X. Partnership CONSIDERATIONS

### A. Outside v. Inside Basis

A decedent's interest in a partnership is entitled to a stepped-up basis at the time of the decedent's death. The step-up basis is equal to the fair market value of the property either as of the date of death or alternate valuation date.<sup>61</sup> The stepped-up basis is the value the person receiving the partnership interest will have in the interest. This value is referred to as the "outside" basis. The outside basis will be used to determine gain or loss on the sale or liquidation of the partnership interest. The outside basis is not the same as the basis the partnership has in the property held in the partnership. The partnership's basis in the property is referred to as the "inside" basis. The inside basis is used for determining such things as depreciation, amortization, and gain or loss on the sale of assets.

### B. PLANNING OPPORTUNITY

The executor or trustee should consider asking the partnership to make a 754 election to adjust the inside basis to reflect the stepped-up basis of the decedent's partnership interest. The election will allow the beneficiary receiving the interest to be able to claim larger depreciation deductions. If the partnership sells an asset, the beneficiary's taxable gain will be reduced by the increased basis from

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<sup>57</sup> Reg. § 1.641(b)-3(a).

<sup>58</sup> I.R.C. § 1361(c)(2)(A)(iii)

<sup>59</sup> I.R.C. § 1361(d)

<sup>60</sup> I.R.C. § 1361(e).

<sup>61</sup> I.R.C. § 014.

the adjustment. If the election is made it will require an accurate valuation of the decedent's partnership interest. NOTE: if the partnership assets have depreciated below their basis the election could result in a basis step-down.<sup>62</sup>

## XI. DISCLAIMERS

### A. Requirements

In order to constitute a qualified disclaimer:

1. The disclaimer must be irrevocable and unqualified;
2. The disclaimer must be in writing;
3. The writing must be properly delivered within the requisite time limitations;
4. The disclaimant must not have accepted the interest disclaimed or any of its benefits; and
5. The interest disclaimed must pass either to the spouse of the decedent or to a person other than the disclaimant without any direction on the part of the person making the disclaimer.

### B. Time limitation

The time limitation for making a disclaimer is not later than the date which is 9 months after the later of:

1. The date which the transfer creating the interest in the disclaimant is made, or
2. The day on which the disclaimant attains age 21.

### C. PLANNING OPPORTUNITY

A disclaimer can be a useful tool to shift property from an older generation to a younger generation without the transfer being considered a gift and to prevent the property from being included in the estate of the disclaimant. The disclaimer can also be a useful tool to take advantage of the unused generation skipping tax exclusion of the first spouse to die, as unused generation skipping tax exemption is not portable. However, if a disclaimer is not carefully planned it could cause a potential generation-skipping transfer tax problem. A disclaimer can also be used to shift income from a parent to children in a lower income tax bracket. This can be particularly beneficial for an IRA.

### D. WARNING

For Medicaid purposes a disclaimer may be considered a disqualifying transfer.

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<sup>62</sup> A basis adjustment is mandatory (a 754 election is not required) if the partnership has a "substantial built-in loss" over \$250,000.

## XII. INDIVIDUAL RETIREMENT ACCOUNTS (IRA)

### A. Three Categories of IRA Beneficiaries

#### 1. Designated Beneficiaries

- a. Non-spouse individuals (including children over the age of 21);
- b. Individual beneficiaries who are more than 10 years younger than the original account owner; and
- c. Certain trusts.

#### 2. Eligible Designated Beneficiary (“EDB”)<sup>63</sup>

- a. Surviving spouse of the IRA owner;
- b. Minor children of the IRA owner, but only up to age 21;
- c. Disabled individuals (those who are unable to engage in substantial gainful activity due to a long-term impairment);<sup>64</sup>
- d. Chronically ill individuals (those who cannot perform at least two activities of daily living without assistance or require supervision due to severe cognitive impairment);<sup>65</sup> and
- e. Individuals not more than 10 years younger than the IRA owner (generally siblings, friends, or other individual beneficiaries close in age to the account owner).

#### 3. Non-Designated Beneficiaries

- a. Charities;
- b. Original account owner’s estate; and
- c. Certain trusts.

### B. Distributions Post-SECURE Act

1. All beneficiaries will always have the option to receive a lump-sum distribution. For beneficiaries that do not wish to take a lump-sum distribution, the rules governing when distributions must be made depend on two factors. The first factor is which of the three categories does the beneficiary fall under: (i) Designated Beneficiary, (ii) EDB, or (iii) Non-Designated Beneficiary. The second factor to be determined is if the decedent died prior to or after

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<sup>63</sup> Section 401(a)(9)(E)(ii).

<sup>64</sup> Treas. Reg. 1.401(a)(9)-4(e)(4).

<sup>65</sup> Treas. Reg. 1.401(a)(9)-4(e)(5).



the Required Beginning Date (RBD).<sup>66</sup> The RBD is the date the decedent was required to begin taking RMDs from his or her IRA.

2. Distributions for Designated Beneficiaries

a. Before RBD

(i) Ten-Year Rule – allows the beneficiary to postpone distributions up until the end of the year in which the 10<sup>th</sup> anniversary of the original account owner's death occurs. Amounts must be fully depleted by December 31<sup>st</sup> of the year containing the 10<sup>th</sup> anniversary of the original account holder's death.<sup>67</sup>

(ii) Under pre-SECURE Act rules, beneficiaries were allowed to “stretch” the inherited IRA and continue to take distributions across their lifespan versus under the SECURE Act, beneficiaries must liquidate the account within 10 years.

b. On or After RBD

The beneficiary may continue taking annual distributions based on the longer of either the original account owner's or the beneficiary's remaining life expectancy; however, in either case, the amounts must be fully depleted by December 31<sup>st</sup> of the year containing the 10<sup>th</sup> anniversary of the original account holder's death.

3. Distributions for EDBs: An Exception to the General Rule (*i.e.*, the Ten-Year Rule)

a. Spouses, chronically ill, disabled, and individuals not more than 10 years younger than IRA account owner

(i) Before RBD

(a) Take annual distributions from the IRA over your life expectancy (necessitating smaller RMDs each year if you are younger than the original account owner). Distributions must begin by December 31<sup>st</sup> of the year following the original account owner's death. The spouse may delay RMDs until December 31<sup>st</sup> of the year the decedent would have attained their RMD age.<sup>68</sup>

(b) Adopt the Ten-Year Rule (as described above in Section XII., B. 2. A. (i)).

(ii) On or After RBD

Continue taking annual distributions based on the longer of either the original account owner's or the beneficiary's remaining life expectancy. The beneficiary

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<sup>66</sup> RBD is April 1 following the year the original IRA owner turned age 72 for those born in 1950 or earlier. The RBD is April 1 following the year the original IRA owner turned age 73 for those born in 1951 or later.

<sup>67</sup> Treas. Reg. 1.401(a)(9)-5(e)(2).

<sup>68</sup> Section 401(a)(9)(H)(ii); Treas. Reg. 1.401(a)(9)-3(c)(4).

must begin taking RMDs by December 31<sup>st</sup> of the year following the year in which the original account owner died.

b. Minor Children

(i) Before RBD

(a) Take distributions over the minor's life expectancy. Take RMDs based on the child's single life expectancy. Distributions must start by December 31<sup>st</sup> of the year following the year of the original account owner's death. Continue RMDs until the minor reaches 31, depleting the account by December 31<sup>st</sup> of the year the beneficiary turns age 31.<sup>69</sup>

(b) Adopt the Ten-Year Rule (as described in Section XII.,

B. 2. A. (i)).

(ii) On or After RBD

Take distribution over the EDB's remaining life expectancy. Distributions must start by December 31<sup>st</sup> of the year following the year of the original account owner's death. The account must be fully distributed by December 31<sup>st</sup> of the year the minor turns age 31.

4. Distributions for Non-Designated Beneficiaries

a. Before RBD

Five-Year Rule – allows the beneficiary to postpone required distributions (if preferred), until the end of the year containing the 5<sup>th</sup> anniversary of the original account owner's death; however, the beneficiary must fully deplete the account by December 31<sup>st</sup> of the 5<sup>th</sup> anniversary year.<sup>70</sup>

b. On or After RBD

Continue to take annual RMDs over the original account owner's remaining life expectancy with no other cap on the distribution period.

5. PLANNING OPPORTUNITY

The IRS recently concluded in Private Letter Ruling 202519010 that a decedent's IRA payable to the decedent's estate (a Non-Designated Beneficiary) could be distributed out of the IRA to the decedent's spouse and the decedent's spouse could roll over the distribution into an IRA established and maintained in the spouse's name. The IRS reasoned that because the surviving spouse is the sole administrator of the decedent's estate, is treated as the sole beneficiary of the decedent's estate during the surviving spouse's lifetime and has the authority to all of the estate's assets, then the surviving spouse is the individual for whose benefit the decedent's IRA is maintained. Therefore, when the proceeds of the IRA are distributed out of the IRA to the estate and then to the surviving spouse, the surviving spouse will be eligible to roll over the proceeds from the decedent's IRA to an IRA set up

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<sup>69</sup> Treas. Reg. 1.401(a)(9)-5(e)(4), 1.401(a)(9)-4(e)(3).

<sup>70</sup> Section 401(a)(9)(B)(ii); Treas. Reg. § 1.401(a)(9)-3(c)(2).

and maintained in the surviving spouses name provided that the rollover occurs no later than the 60<sup>th</sup> day after the date the proceeds are paid to the decedent's estate. This ruling allows a surviving spouse to roll over IRA proceeds that were payable to their spouse's estate to an IRA in their name that will be treated as their own IRA and not have to be subject to the distribution rules applicable when a non-designated beneficiary is listed as an IRA beneficiary. PLRs may only be relied on by the party that received the ruling, but if there are similar facts then it could be possible to request a ruling from the IRS to allow a surviving spouse to roll over IRA proceeds even if the named beneficiary is the decedent's estate, which would allow RMDs to be determined based on the surviving spouses life expectancy and would allow the surviving spouse to name a Designated Beneficiary or EDB to receive the IRA upon the surviving spouse's death.

#### C. Considerations for Special Needs Beneficiaries

1. A special needs beneficiary that is an EDB (disabled or chronically ill), has the ability to "stretch" IRA distributions over their life expectancy (*i.e.*, they are not required to liquidate the IRA within 10 years).

2. Outright Beneficiary vs Beneficiary in Trust

- a. If a special needs beneficiary receives an IRA directly, RMDs may prevent a child with special needs from receiving government benefits that he or she may need such as Medicaid and/or Supplemental Security Income.

- b. If a special needs beneficiary receives an IRA through a special needs trust, the trust will receive the RMDs, and the trustee will have the ability to control the distributions to the beneficiary.

3. PLANNING OPPORTUNITY: Set up a Special Needs Trust as an "accumulation" trust, which permits RMDs to be held by the trust, rather than requiring their immediate distribution. The trustee will have the ability to decide when to make distributions to the child, but if the child would meet the criteria as an EDB then the RMDs could be stretched out over the child's life expectancy to potentially minimize the tax impact from the RMDs.

### XIII. RELEASE FROM LIABILITY FOR TAXES

#### A. Request for Prompt Assessment of Gift, Income and GST Taxes

1. The IRS ordinarily has 3 years from the date an income tax return is filed, or its due date, whichever is later, to assess any additional tax due.

2. PLANNING OPPORTUNITY: The executor may request a prompt assessment of the tax after the return has been filed. This reduces the time for making the assessment to 18 months from the date the written request for prompt assessment was received. Prompt assessment may be requested for Forms 1041 and 1040.<sup>71</sup>

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<sup>71</sup> I.R.C. § 6501(d).

3. Form 4810 is used for making this request. It must be filed separately after the return is filed.

4. **WARNING:** A request for prompt assessment will not shorten the period for which the IRS may assess additional tax if (i) there is a substantial understatement of gross income (more than 25% of the gross income reported on the return); or (ii) a false or fraudulent return is filed.<sup>72</sup> However, if the executor did not have knowledge of the unreported gross income or the false return the executor may be relieved of personal liability for the tax.

B. Request for Prompt Determination of Estate Tax

1. Ordinarily the IRS has 3 years from the date the Form 706 is filed to assess any estate tax liability.<sup>73</sup>

2. **PLANNING OPPORTUNITY:** The executor may request a prompt determination. The IRS will then have 18 months to fix the estate tax liability of the estate.<sup>74</sup>

3. The request is made in a letter that is filed with the estate tax return.

C. Application for Discharge for Personal Liability of Estate, Gift and Income Tax

1. The executor is personally liable for any unpaid taxes of the decedent to the extent of the value of other debts paid by the executor over the outstanding priority claims of the United States.<sup>75</sup>

2. A debt includes a distribution of a bequest or a portion of the residuary estate to the named beneficiaries under the decedent's will or under the law of intestate distribution.

3. **PLANNING OPPORTUNITY:** An executor can make a request for discharge from personal liability for a decedent's income, gift, and estate taxes.<sup>76</sup> The request may be made any time after the return is filed. Form 5495 is used to make the request.

4. If the IRS does not notify the executor of a deficiency within 9 months after receipt of the request, the executor will be discharged from personal liability. If the IRS notifies the executor of a deficiency within the 9 months the executor will be discharged upon payment of the deficiency. Although the executor will be discharged from personal liability the IRS will still be able to assess the tax deficiency against the estate which can bring into play the insolvent estate rules.

D. Insolvent Estate

1. Even if the executor is discharged from personal liability, the executor<sup>77</sup> can still be personally liable for both the decedent's and estate's federal income tax liability if the estate

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<sup>72</sup> I.R.C. § 6501(d).

<sup>73</sup> I.R.C. § 6501(a).

<sup>74</sup> I.R.C. § 2204.

<sup>75</sup> I.R.C. § 3713(b).

<sup>76</sup> I.R.C. § 2204 (estate tax); I.R.C. § 6905 (income and gift tax).

<sup>77</sup> For purposes of this provision executor means the executor or administrator of the decedent appointed, qualified and acting with the United States. Reg. § 301.6905-1(b)

is insolvent and the executor had notice of such tax obligations or failed to exercise due care in determining if such obligations existed before distribution of the estate's assets and before being discharged from their duties.<sup>78</sup> In Private Letter Ruling 8341018, the IRS identified funeral and administrative expenses, exempt property allowances, and family allowances as costs that can be paid before federal tax liens. Administrators, however, cannot pay state and local taxes before paying federal taxes owed by the decedent.

2. The extent of such personal responsibility is the amount of any other payments made before paying the debts due to the United States, except where such other debt paid has priority over the debts due to the United States.

3. Income tax liabilities need not be formally assessed for the personal representative to be liable if he or she was aware or should have been aware of their existence.

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<sup>78</sup> Reg. § 301.6905-1(a).

## Checklist of Post-Mortem Tax and Administration Issues

### 1. Initial Notices and Information Gathering

- ☐ File Form 56 (Notice Concerning Fiduciary Relationship) with the IRS to notify of the fiduciary relationship.
- ☐ File Form 8822 if there is a change of address for the estate.
- ☐ Obtain an Employer Identification Number (EIN) for the estate and any trust that become irrevocable on decedent's death (Form SS-4).
- ☐ Obtain copies or transcripts of the decedent's prior tax returns (Form 4506 or 4506-T).
- ☐ Secure all relevant financial records and identify all assets and liabilities.

### 2. Decedent's Final Income Tax Return (Form 1040)

- ☐ File the decedent's final Form 1040 for the short year ending on the date of death. **Deadline:** April 15 of the year following death (unless extended).
- ☐ File any prior year returns not yet filed.
- ☐ Decide whether to file a joint return with a surviving spouse (requires both parties' consent if executor appointed).
- ☐ Analyze and utilize any unused deductions (medical, capital losses, etc.).
- ☐ Consider election for unreimbursed medical expenses paid within 12 months after death (deduct on final 1040 or estate tax return).
- ☐ Consider election to report any accrued interest on U.S. savings bonds.
- ☐ Address any outstanding gift tax liabilities and consider gift-splitting elections.

### 3. Estate and/or Trust Income Tax Return (Form 1041)

- ☐ File Form 1041 for the estate and any trusts (each is a separate taxpayer unless a 645 election is made).
- ☐ Select a fiscal or calendar year for the estate (first year can end on last day of any month within 12 months).
- ☐ Estates are exempt from estimated tax payments for two years after death.
- ☐ Consider a Section 645 election to treat a qualified revocable trust as part of the estate (Form 8855; must be filed with first 1041).
- ☐ Allocate estimated tax payments to beneficiaries if appropriate (Form 1041-T; within 65 days after year-end).
- ☐ Decide whether to deduct administration expenses on Form 1041 or Form 706.
- ☐ Plan distributions to beneficiaries to optimize tax brackets (65-day rule for distributions after year-end).
- ☐ On final return, pass through excess deductions and loss carryovers to beneficiaries.

### 4. Federal Estate Tax Return (Form 706)

- ☐ Determine if a Form 706 is required (gross estate plus adjusted taxable gifts exceeds threshold: \$13,999,000 in 2025; \$15,000,000 in 2026). **Deadline:** 9 months after date of death (6-month extension available).
- ☐ Consider portability election for unused exclusion to surviving spouse (if not required to file a Form 706 have up to 5 years following death to file for portability).
- ☐ If required to file a Form 706 consider alternate valuation date if estate value has declined (6 months after death).
- ☐ If required to file a Form 706, must file Form 8971 to report basis of inherited property to IRS and beneficiaries (within 30 days of filing Form 706 or its due date).

- ☐ Identify and report all assets, including those with special valuation rules (e.g., closely held businesses, real estate).
- ☐ Consider deduction for income in respect of a decedent (IRD) assets.

## 5. State Estate Tax Returns

- ☐ Determine if a state estate tax return is required (varies by state; check decedent's domicile and property locations).

## 6. Basis Adjustment and Valuation

- ☐ Obtain appraisals for all assets without readily ascertainable value.
- ☐ Ensure proper step-up (or step-down) in basis for all includable property.
- ☐ For community property, confirm full step-up in basis if applicable.
- ☐ Document basis for all assets for future beneficiary use.

## 7. Entity and Asset-Specific Issues

- ☐ For S corporation stock, ensure estate/trust remains a qualified shareholder; consider QSST or ESBT elections if trust will hold stock beyond two years.
- ☐ For partnership interests, consider requesting a Section 754 election for inside basis adjustment.
- ☐ For IRAs and retirement accounts, identify beneficiary category and required minimum distribution (RMD) rules; consider special needs trust planning if applicable.

## 8. Disclaimers

- ☐ Consider use of qualified disclaimers to achieve tax or non-tax objectives. **Deadline:** 9 months after decedent's death (or if earlier 9 months from the date of transfer) or beneficiary's 21st birthday, whichever is later.

## 9. Releases and Liability

- ☐ Request prompt assessment of income, gift, and GST taxes (Form 4810; reduces IRS assessment period to 18 months).
- ☐ Request prompt determination of estate tax (letter with Form 706; IRS has 18 months to assess).
- ☐ Apply for discharge from personal liability for taxes (Form 5495; IRS has 9 months to respond).

## 10. Other Administrative Issues

- ☐ Pay debts and expenses in proper order of priority (federal taxes have priority over most other debts).
- ☐ Coordinate with state law requirements for probate and administration.
- ☐ Maintain detailed records of all actions, communications, and filings.

**Note: Deadlines are critical for tax filings, elections, and disclaimers. Missing a deadline can result in loss of tax benefits or personal liability for the fiduciary. Always confirm current IRS forms and requirements, as laws and thresholds may change. This checklist is not intended to be all inclusive.**



STETSON LAW

# **Tax Intensive**

**October 22, 2025**

## **2025 Tax Update**



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# **The Tax Update: 2025**

By: Shannon Laymon-Pecoraro, CELA

## **LEGISLATIVE UPDATE**

### **1. One Big Beautiful Bill Act (OBBBA)**

The One Big Beautiful Bill Act (OBBBA)<sup>1</sup>, signed into law on July 4, 2025, represents one of the most significant tax reforms affecting elder law practice in recent years. This comprehensive legislation extends and modifies key provisions of the Tax Cuts and Jobs Act (TCJA) while introducing new benefits specifically targeting seniors and high-net-worth individuals. For elder law practitioners, the Act's most impactful provisions include a new \$6,000 senior deduction, permanent increases to estate and gift tax exemptions, enhanced SALT deduction limits, charitable deduction expansions, and extensions of various TCJA provisions through 2034.

The legislation affects virtually every aspect of elder law tax planning, from basic income tax planning for retirees to sophisticated wealth transfer strategies for high-net-worth clients. Understanding these changes is crucial for practitioners advising elderly clients on retirement planning, estate planning, Medicaid planning, and family wealth transfer strategies.

### **Senior-Specific Tax Relief Provisions**

The Act's most visible benefit for elderly clients emerges through a new \$6,000 deduction available to individuals age 65 and older, effective for tax years 2025 through 2028. Importantly, this deduction is available regardless of whether the taxpayer itemizes or takes the standard deduction, creating substantial tax relief opportunities across different client situations.

The deduction's structure demonstrates Congress's targeted approach to senior tax relief. Any individual who has attained age 65 by the end of the tax year becomes eligible for the full \$6,000 deduction, with both spouses in a marriage able to claim the benefit if both qualify. The provision includes income-based phase-outs that begin at \$75,000 for single filers and \$150,000 for married couples filing jointly, ensuring the benefit targets middle-income seniors while remaining available to those with moderate retirement incomes.

The deduction's design allows it to stack with existing senior standard deduction increases of \$2,000 for single filers and \$3,200 for married couples. This creates remarkable tax relief opportunities, particularly when considering that a married couple where both spouses are over 65 would receive approximately \$31,400 in standard deductions for 2025, plus \$6,000 for each spouse, totaling \$43,400 in deductions before even considering itemized deductions.

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<sup>1</sup> Public Law 119-21.

For non-itemizing taxpayers, the Act provides an additional benefit: beginning in 2026, taxpayers can deduct \$1,000 (\$2,000 on a joint return) for charitable contributions without itemizing. This creates new charitable planning opportunities for seniors who prefer the simplicity of the standard deduction but want to support their favorite causes.

For taxpayers who itemize deductions—perhaps due to high medical expenses in a particular year—the \$6,000 senior deduction provides additional relief beyond the medical expense deduction. This proves particularly valuable for elderly clients facing significant healthcare costs, as they can benefit from both the medical expense deduction and the senior deduction without having to choose between them.

The deduction also creates significant opportunities in Social Security taxation planning. Many seniors will find that the additional deduction reduces or eliminates federal taxes on Social Security benefits, effectively providing the targeted relief that AARP specifically endorsed during the legislative process. This proves particularly beneficial for clients receiving substantial Social Security payments who might otherwise face taxation on up to 85% of their benefits under current graduated taxation thresholds.

### **Enhanced State and Local Tax (SALT) Deduction**

The Act significantly modifies the SALT deduction limitation that has constrained tax planning since the TCJA's enactment. The itemized deduction for state and local taxes increases to \$40,000 in 2025 and will rise by 1% per year through 2029, providing meaningful relief for clients in high-tax states. In 2030, the \$10,000 cap returns, creating planning opportunities during the enhanced period.

However, the enhanced SALT deduction includes income-based limitations for high earners. Through 2029, the SALT deduction is reduced—but not below \$10,000—for those with modified adjusted gross income over \$500,000. The SALT deduction is reduced by 30% of the amount by which the taxpayer's MAGI exceeds \$500,000. Once MAGI exceeds \$600,000, the maximum SALT deduction remains at \$10,000, effectively creating a cliff for ultra-high earners.

This structure creates strategic planning opportunities for retirees considering state income tax acceleration or retirement account distributions. Clients with MAGI near the \$500,000 threshold may benefit from income smoothing strategies to maximize SALT deduction benefits during the enhanced period.

### **Education Planning Enhancements**

The Act expands 529 education savings plan benefits, making these vehicles more attractive for multi-generational planning. 529 plans can now be used for post-high school credential programs, trade schools, and professional certification programs, broadening their utility beyond traditional four-year college planning. This expansion proves particularly valuable for grandparents funding education for grandchildren pursuing

diverse career paths, including skilled trades and professional certifications that may not require traditional college degrees.

### **Estate and Gift Tax Transformations**

The Act's most significant long-term impact on elder law practice emerges through permanent modifications to federal estate and gift tax exemptions. Section 70106 of OBBBA amends Internal Revenue Code Section 2010(c) to establish a framework that eliminates the dramatic reduction that was scheduled to occur on January 1, 2026, while actually increasing exemption amounts beyond current levels.

The practical implications for estate planning practice prove transformative. Clients no longer face the December 31, 2025 deadline that had been driving rushed gifting decisions and compressed planning timelines. The elimination of deadline pressure allows for more sophisticated planning techniques that can be implemented over multiple years with careful

Under the TCJA, the basic exclusion amount was temporarily doubled from \$5 million to \$10 million, adjusted for inflation, for the years 2018 through 2025. However, this increase contained an automatic sunset provision that would have reduced the exemption to approximately \$7.2 million in 2026. This impending reduction created intense pressure for wealthy families to accelerate gifting strategies before the deadline, often forcing suboptimal planning decisions driven by artificial time constraints rather than sound financial planning principles.

The OBBBA eliminates this cliff entirely while establishing a new permanent exemption structure. Beginning in 2026, the basic exclusion amount increases to \$15 million per individual, with continued inflation indexing using 2025 as the new base year. Crucially, the legislation includes no sunset provision, making this increase permanent absent future legislative action by Congress. This represents a fundamental shift from the temporary relief mentality that has dominated estate planning since the TCJA's enactment.

The practical implications for estate planning practice prove transformative. Clients no longer face the December 31, 2025 deadline that had been driving rushed gifting decisions and compressed planning timelines. Instead, families can engage in more measured, strategic wealth transfer planning that aligns with their long-term financial goals rather than artificial legislative deadlines. The elimination of deadline pressure allows for more sophisticated planning techniques that can be implemented over multiple years with careful consideration of market conditions, family circumstances, and optimal timing.

The higher permanent exemption also enhances the viability of grantor trust strategies and other sophisticated estate planning techniques. With \$15 million exemptions per person, married couples can potentially transfer \$30 million during their lifetimes without

gift tax consequences, creating substantial opportunities for wealth transfer while retaining the flexibility to adjust strategies based on changing circumstances.

However, practitioners must understand that the Act maintains existing complexities around Generation-Skipping Transfer (GST) tax planning. While the GST tax exemption increases to match the basic exclusion amount of \$15 million in 2026, GST exemptions remain non-portable between spouses. This creates both opportunities and traps in planning for ultra-high-net-worth families. Each spouse possesses a separate \$15 million GST exemption, making strategic allocation of these exemptions increasingly valuable. Dynasty trust planning becomes more attractive for families with substantial wealth, but the non-portable nature means that failure to properly use one spouse's GST exemption results in permanent loss of that planning opportunity.

Significantly, the Act does not modify the portability election rules that were highlighted in cases such as *Estate of Rowland v. Commissioner*. The procedural requirements for deceased spousal unused exclusion (DSUE) elections remain unchanged, meaning practitioners must continue to navigate the complex requirements for timely filing Form 706, ensuring complete and proper preparation, and understanding the nuances of Rev. Proc. 2017-34's safe harbor provisions for late filings. The increased exemption amounts make proper portability planning even more valuable, as the stakes for procedural errors now involve potentially losing access to \$15 million in exemption benefits.

### **Income Tax Planning Considerations**

The Act's extension of TCJA individual tax provisions through 2034 provides unprecedented certainty for long-term elder law planning. This extension encompasses the lower individual tax rate structure, including the 37% top rate, enhanced standard deductions, expanded Child Tax Credit provisions relevant for grandparents raising grandchildren, the \$10,000 state and local tax (SALT) deduction limitation, and the 20% qualified business income deduction under Section 199A.

These extensions create significant opportunities for retirement distribution planning. The certainty of lower tax rates through 2034 may influence Roth conversion strategies and retirement account distribution timing. Clients can now plan Roth conversions over extended periods, taking advantage of lower current tax rates while managing the timing of conversions to optimize overall tax outcomes. The extended timeline allows for more sophisticated multi-year distribution strategies that can smooth income across tax brackets and minimize overall lifetime tax burden.

For elderly business owners, the extension of the Section 199A deduction proves particularly valuable in business succession planning contexts. The 20% deduction on qualified business income can significantly reduce the tax burden on business income during transition periods, making succession planning more tax-efficient and potentially allowing for more favorable terms in intergenerational transfers.

The continued SALT limitation creates ongoing planning challenges for clients in high-tax states. The \$10,000 cap affects retirement migration decisions and domicile planning strategies, potentially making relocation to low-tax states more attractive for high-income retirees. Elder law practitioners should incorporate SALT limitation analysis into retirement location planning and consider the interplay between state tax savings and other factors such as state estate taxes and asset protection laws.

While less directly relevant to typical elder law clients, the Act's provisions eliminating income taxes on tips and overtime pay may benefit elderly clients who continue working in service industries or consulting roles. This relief recognizes that many seniors continue working past traditional retirement ages, either by choice or financial necessity, and provides meaningful tax relief for this growing demographic.

### **Implementation Timeline and Sunset Considerations**

The Act's implementation involves both immediate and future effective provisions that require careful coordination in planning strategies. The \$6,000 senior deduction becomes available immediately for the 2025 tax year, allowing clients to begin realizing benefits with their current year tax planning. The TCJA extensions also begin immediately, providing continuity in tax planning assumptions through 2034.

The \$15 million estate tax exemption takes effect January 1, 2026, with inflation indexing beginning in 2027 using 2025 as the new base year. This timeline allows for careful preparation and strategic planning throughout 2025 to optimize the transition to higher exemption amounts. Estate planning documents can be prepared and executed during 2025 with confidence in the new exemption levels, eliminating the uncertainty that had characterized planning under the previous sunset provisions.

The temporary nature of the senior deduction, which expires after 2028, requires strategic planning to maximize benefits during the four-year window while preparing for its eventual expiration. Clients should consider accelerating Roth conversion strategies during periods when the deduction reduces their current taxable income, potentially allowing for more efficient long-term tax planning. Long-term care insurance decisions may also be influenced by the temporary tax savings, as clients may have additional cash flow during the deduction period to fund insurance premiums or other planning strategies.

### **AGENCY UPDATE**

#### **1. FinCEN Update to Corporate Transparency Act**

The Corporate Transparency Act was enacted as part of the National Defense Authorization Act for Fiscal Year 2021, representing Congress's most significant anti-money laundering reform in decades. The law was designed to close a major gap in U.S. financial transparency by requiring small corporations and limited liability companies to report information about their beneficial owners—the real people who ultimately own or control the company—to the Financial Crimes Enforcement Network (FinCEN). The CTA

aimed to prevent the misuse of anonymous shell companies for illicit purposes such as money laundering, tax evasion, and terrorism financing. Originally, most small businesses formed in or registered to do business in the United States were required to file beneficial ownership information reports, with limited exemptions for larger companies already subject to federal reporting requirements.

On March 2, 2025, the Treasury Department announced that it will not enforce any penalties or fines associated with the beneficial ownership information reporting rule under existing regulatory deadlines against U.S. citizens or domestic reporting companies.<sup>2</sup> This represents a significant policy shift under the Trump administration, with Treasury Secretary Scott Bessent characterizing it as supporting small businesses and reducing regulatory burden. FinCEN published an interim final rule with an effective date of March 26, 2025, that revised the definition of "reporting company" to mean only those entities formed under foreign country law that have registered to do business in any U.S. State or tribal jurisdiction.<sup>3</sup>

The CTA's requirements now effectively apply only to foreign companies operating in the United States. FinCEN has removed the requirement for U.S. companies and U.S. persons to report beneficial ownership information under the Corporate Transparency Act, while maintaining obligations for foreign reporting companies. This dramatic narrowing of scope represents a fundamental change from the original legislation, which was designed to require most small U.S. companies to report beneficial ownership information to combat money laundering and other illicit activities. This move comes after a volatile implementation history of the CTA since taking effect in January 2024. In February 2025, the U.S. District Court for the Eastern District of Texas stayed its nationwide preliminary injunction blocking the enforcement of the CTA.

## **2. Private Letter Ruling 202507005**

This is a private letter ruling (PLR) issued by the IRS in response to a request from "Distributing," a closely held S corporation with two classes of common stock (Class A voting and Class B non-voting) that operates two separate businesses (Business A and Business B). The company sought IRS approval for a corporate spin-off transaction designed to separate these businesses due to their fundamentally different capital and operational needs, with the stated business purpose being "fit and focus."

The proposed transaction involves two main steps: first, Distributing would form a new corporation called "Controlled" with the same capital structure, then transfer all assets of Business B to Controlled in exchange for all of Controlled's stock (the "Contribution"); second, Distributing would distribute all shares of Controlled stock to its existing shareholders on a pro rata basis, with shareholders receiving corresponding classes of

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<sup>2</sup> <https://home.treasury.gov/news/press-releases/sb0038>.

<sup>3</sup> <https://www.federalregister.gov/documents/2025/03/26/2025-05199/beneficial-ownership-information-reporting-requirement-revision-and-deadline-extension>.

stock in both corporations (the "Distribution"). The transaction is structured to qualify as a tax-free reorganization under Section 368(a)(1)(D) of the Internal Revenue Code.

The taxpayer made numerous representations to support the ruling request, including that both businesses have operated actively for at least five years, the transaction serves legitimate business purposes rather than being a device to distribute earnings and profits, no intercorporate debt will exist between the companies after the split, continuing transactions will be conducted at fair market value, and various requirements under Section 355(d) regarding stock ownership will be satisfied. Additionally, they represented that except for one transitional employee, the companies will operate independently with separate workforces following the transaction.

The IRS granted favorable rulings on all requested tax consequences, confirming that the transaction will qualify as a tax-free reorganization with no gain or loss recognition to the distributing corporation, the controlled corporation, or the shareholders upon receipt of the distributed stock. The ruling specifies how basis and holding periods will be allocated and preserved, and requires proper allocation of earnings and profits between the two corporations. However, the IRS explicitly reserved judgment on three critical requirements: whether the transaction satisfies the business purpose requirement, whether it constitutes a prohibited device for distributing earnings and profits, and whether it is part of a plan involving acquisitions that would violate the continuity of interest rules. The ruling applies only to the specific taxpayer and cannot be cited as precedent, and taxpayers must attach copies of the ruling to their tax returns for the year the transaction is completed.

## **CASE LAW UPDATE**

### **1. *Estate of Bolles v. Commissioner* (9<sup>th</sup> Cir. April 1, 2024)**

The Estate of Mary P. Bolles appealed a Tax Court decision that found an estate tax deficiency and denied administrative costs. The central dispute involved payments that Mary Bolles made to her son Peter between 1985 and 2007, with the Tax Court needing to determine whether these payments constituted loans or gifts for estate tax purposes.

The Tax Court distinguished between two time periods in Mary's payments to Peter. From 1985 to 1989, the court found the payments were loans because a genuine creditor-debtor relationship existed. Peter was running his father's struggling architecture practice, and Mary had previously made similar loans to her husband that were repaid. The court reasonably concluded Mary expected repayment once the business recovered. However, payments from 1990 to 2007 were classified as gifts due to changed circumstances: Peter made no repayments during this period, was excluded from Mary's personal trust in late 1989, and signed an agreement acknowledging he lacked assets or earning capacity to repay the debts.

The Tax Court also denied the Estate's request for administrative and litigation costs. To recover such costs, the Commissioner's position must not have been "substantially

justified." The court found the Commissioner's position was justified because they presented two reasonable alternative theories—that the payments were either loans or gifts—and every payment fell under one of these theories. The Estate's argument that the Commissioner's position should be construed as requiring all payments to be either loans or all gifts was rejected as overly restrictive.

The Ninth Circuit Court of Appeals affirmed the Tax Court's decision, finding no clear error in the factual determinations and agreeing with the legal conclusions. The appeals court also granted the Estate's motion for judicial notice regarding related gift-tax cases that were dismissed for lack of jurisdiction, noting that both parties referenced these cases and neither disputed their dismissal.

## **2. *Estate of Becker v. Commissioner*, T.C. Memo 2024-89 (Sept. 24, 2024)**

In July 2014, Dr. Larry Becker created an irrevocable life insurance trust for his wife and descendants, funded with two life insurance policies on his life totaling nearly \$20 million in death benefits. The Trust funded the initial 30 months of premiums through a complex chain of loans: insurance broker Barry Steinfelder borrowed money from Dr. Julia Wen, then loaned it to Dr. Becker, who deposited the funds into the Trust to pay premiums. Subsequently, Steinfelder's company ALD repaid Dr. Wen and acquired the right to repayment from the Trust, with first priority security interests in the policies. These obligations were later transferred to JTR, LLC.

In late 2014, the Trust entered into a Loan and Security Agreement with LT Funding, which obligated LT Funding to pay future premiums in exchange for 75% of the death benefits, plus repayment of all premiums advanced with 6% interest. This arrangement had senior payment rights over the Trust's obligation to JTR. Dr. Becker died unexpectedly in January 2016, and the policies paid out approximately \$19.5 million in death benefits to the Trust, leading to disputes among various parties over entitlement to the proceeds.

The IRS assessed a \$4.19 million estate tax deficiency, arguing that the policy proceeds should be included in Dr. Becker's gross estate under Sections 2031 and 2042(2) of the Internal Revenue Code. The IRS contended that under Maryland's insurable interest statute, the policies violated state law because the proceeds were not primarily for the benefit of trust beneficiaries with insurable interests, but rather for third parties like LT Funding. The Estate countered that the Trust had valid insurable interests since Dr. Becker was the grantor and the beneficiaries (his wife and descendants) had insurable interests in his life.

The Tax Court analyzed whether the step transaction doctrine should collapse the various transactions, focusing on the "end result" and "interdependence" tests. Under the "end result" test, the Court rejected the IRS's argument that the parties intended from the outset to transfer benefits to LT Funding, noting that LT Funding was not identified when the policies were issued. Under the "interdependence" test, the Court found that each step had independent significance, particularly since the Trust was entitled to nearly \$20



million in death benefits and the policies were fully funded for 30 months from the initial premium payments.

The Tax Court ruled in favor of the Estate, determining that the policies did not violate Maryland's insurable interest statute because they were validly issued for the benefit of trust beneficiaries who had insurable interests in Dr. Becker's life. Since there was no violation of state law, there was no cause of action under Maryland law, and therefore no basis for including the policy proceeds in Dr. Becker's gross estate under either Section 2042(2) or Section 2033 of the Internal Revenue Code. The Court emphasized that validly issued policies remain legal even when subsequently assigned to parties without insurable interests.

### **3. *Estate of Fields v. Commissioner*, T.C. Memo 2024-90 (Nov. 4, 2024)**

Anne Milner Fields, a successful Texas businesswoman who inherited and built an oil business after her husband's death in 1963, relied heavily on her great-nephew Bryan Milner in her later years after developing Alzheimer's dementia in 2011. On May 20, 2016, just over a month before Ms. Fields's death on June 23, 2016, Mr. Milner used his comprehensive power of attorney to create AM Fields Management, LLC (of which he was sole member and manager) and AM Fields, LP (a limited partnership). He then transferred approximately \$17 million of Ms. Fields's assets—representing most of her wealth—to the partnership in exchange for a 99.9941% limited partner interest, while AM Fields Management received a 0.0059% general partner interest for a \$1,000 contribution.

The IRS challenged the estate plan, asserting that Section 2036(a) required inclusion of the full \$17 million in transferred assets rather than just the discounted partnership interest value of \$10.8 million reported on the estate tax return. The Tax Court applied the three-part test for Section 2036(a): whether there was an inter vivos transfer (undisputed), whether the decedent retained applicable rights or interests in the transferred property, and whether the transfer constituted a bona fide sale for adequate and full consideration. The court found that Ms. Fields retained both the right to income from the transferred assets and enjoyment of those assets, since Mr. Milner (as her agent and manager of the general partner) had absolute discretion to make distributions and did in fact make distributions to pay estate expenses and bequests.

The Tax Court found the timing of the transactions highly suspicious and rejected Mr. Milner's testimony about legitimate business purposes. The court noted that Ms. Fields fell during the first week of May 2016, was hospitalized with a heart attack from May 21-25, was diagnosed with end-stage Alzheimer's on June 9, placed in hospice care on June 15, and died on June 23—yet the estate planning transactions proceeded rapidly during this period of precipitous health decline. The court observed that there was no evidence of any discussion about asset restructuring until Ms. Fields's health deteriorated, and the only contemporaneous documentary evidence of motivation was an email about "obtaining a deeper discount" for tax purposes.

The Estate argued four legitimate business purposes: protection from financial elder abuse, succession management, resolving third-party refusal to honor the power of attorney, and consolidated asset management. However, the Tax Court concluded these were "post hoc theoretical justifications" rather than actual motivations. The court emphasized several troubling factors: the transferred assets were disparate in nature with no business synergies, there was virtually no pooling of assets for joint enterprise, the assets were not "working" business interests requiring active management, and the transfers depleted Ms. Fields's liquidity to the point that partnership distributions were needed to pay estate obligations. The court found the transfers were not bona fide sales but rather testamentary in nature designed primarily to reduce estate taxes.

The Tax Court ruled that Section 2036(a) applied, requiring inclusion of \$17,062,631 (the fair market value of the transferred assets) in the gross estate rather than the \$10,877,000 discounted partnership interest value reported by the Estate. The court also imposed a 20% accuracy-related penalty under Section 6662(a) and (b)(1) for negligence, finding that the Estate failed to establish reasonable cause or good faith reliance on professional advice. The court noted that a reduction of approximately \$6.2 million in reportable assets through "the seemingly inconsequential interposition of a limited partner interest between Ms. Fields and her assets on the eve of her death would strike a reasonable person in Mr. Milner's position as very possibly too good to be true."

#### **4. *Nosirrah Management, LLC v. AutoZone, Inc.* (W.D. Tenn. April 14, 2025)**

Nosirrah Management, LLC brought a derivative action against AutoZone, Inc. and its former CEO William C. Rhodes III, alleging violations of Section 16(b) of the Securities Exchange Act. The case addressed whether GRAT annuity distributions of company stock to corporate insiders constitute "acquisitions" subject to short-swing profit rules.

Rhodes had established a Grantor Retained Annuity Trust (GRAT) holding AutoZone stock. The trust distributed AutoZone shares to Rhodes as required annuity payments. Within six months of receiving these shares, Rhodes sold them for approximately \$1 million in profit. Nosirrah Management claimed this constituted a Section 16(b) violation requiring disgorgement of profits from the purchase (GRAT distribution) and sale occurring within six months.

Section 16(b) requires corporate insiders to disgorge profits from purchases and sales of company securities occurring within six months, regardless of intent or actual use of inside information. The rule creates strict liability for covered transactions. However, SEC Rule 16a-13 exempts transactions that are "mere changes of form" without changing the person's pecuniary interest in the securities.

The Plaintiff argued that the GRAT annuity payment constituted an "acquisition" under Section 16(b). Rhodes' subsequent sale within six months created a prohibited short-swing transaction requiring profit disgorgement. The Defendant argued that the GRAT distributions qualified for Rule 16a-13's exemption as "mere changes of form." Rhodes maintained consistent beneficial interest in the AutoZone shares throughout—indirect

interest through the GRAT before the annuity payment, direct ownership afterward, with no change in economic exposure.

The Western District of Tennessee granted summary judgment for defendants, dismissing the case. The court held that GRAT annuity distributions qualified for Rule 16a-13's "change in beneficial ownership" exception. The court focused on economic substance rather than form, finding Rhodes' beneficial interest remained constant throughout the process. The annuity payment merely converted indirect interest to direct ownership without altering pecuniary interest in the underlying securities.

This decision provides crucial clarity for corporate insiders using GRATs with company stock. Prior uncertainty about Section 16(b) exposure had created hesitancy about these vehicles. The ruling confirms that properly structured GRAT annuity payments in company stock do not constitute "acquisitions" when the beneficiary's economic interest remains unchanged.

#### **5. *Estate of Galli v. Commissioner*, T.C. Docket No. 7003-20 and 7005-20 (March 5, 2025)**

This Tax Court case involves consolidated gift tax and estate tax disputes stemming from a \$2.3 million transaction between Barbara Galli and her son Stephen in 2013. Barbara, who was 79 at the time, transferred the money to Stephen under the terms of a promissory note with a 9-year term and 1.01% interest rate, which matched the applicable federal rate published by the IRS for February 2013. The parties treated this as a legitimate loan rather than a gift, so no gift tax return was filed. Stephen made the required annual interest payments, and when Barbara died in 2016, the unpaid loan balance was included on her estate tax return.

The IRS challenged this arrangement by issuing deficiency notices for both gift tax and estate tax. The Commissioner's position was that the difference between the \$2.3 million loan amount and the fair market value of Stephen's repayment obligation constituted an unreported gift of \$869,000. The IRS argued that the loan lacked the commercial terms necessary to create a legally enforceable right to repayment comparable to arm's-length transactions, questioned Stephen's ability and intent to repay, and suggested Barbara never intended to enforce collection or expected actual repayment.

Stephen defended the transaction by arguing that IRC § 7872, which governs below-market loans, should apply to resolve the dispute. His position was straightforward: since the loan charged the applicable federal rate set by the IRS, it could not be classified as a "below-market loan" under that section. Therefore, the entire transaction should be respected as a legitimate loan with no gift tax consequences. He supported this with substantial documentation including bank records showing the transfer, the signed promissory note, records of his annual interest payments, and his mother's tax returns reporting the interest as income.

Judge Holmes found that the Commissioner failed to adequately support his position in the summary judgment proceedings. While the IRS's deficiency notices contained language suggesting the transaction might be recharacterized as partially or entirely a gift, the Commissioner provided insufficient evidence to create a genuine dispute for trial. In contrast, Stephen presented comprehensive documentation supporting the loan characterization. The court noted that even if the Commissioner intended to argue for complete recharacterization as a gift, the opposition papers were "wholly inadequate" under the court's procedural rules.

The court granted summary judgment in Stephen's favor on both cases, ruling that IRC § 7872 provides comprehensive treatment of below-market loan situations and displaces traditional fair market value analysis. Since the Galli loan charged the applicable federal rate, it was not a below-market loan subject to gift tax treatment under that section. Judge Holmes concluded that the transaction was a legitimate loan rather than a gift or partial gift, resolving both the gift tax deficiency and the related estate tax issues in Stephen's favor and establishing that no gift tax return was required to be filed for the 2013 transaction.

#### **6. *Pierce v. Commissioner*, T.C. Memo 2025-76 (April 7, 2025)**

This Tax Court case involves a federal gift tax dispute over the valuation of interests in Mothers Lounge, LLC, a baby products company. In 2014, petitioner and his ex-wife each gifted 29.4% interests to irrevocable trusts and sold 20.6% interests to a limited liability company, with the IRS challenging their reported valuations and imposing significant deficiencies and penalties.

Mothers Lounge operated through a deceptive "free, just pay shipping" business model that knocked off popular baby products. The company would advertise products as "free" but charge inflated shipping costs (typically \$7.95) that far exceeded actual shipping expenses (\$1.57), generating profits from this price discrepancy. They systematically copied successful products from competitors, manufacturing cheap replicas in China and using separate subsidiaries for each product to maintain the illusion of different companies.

The company experienced rapid early success, particularly after a promotional code went viral online, leading to thousands of orders within days. However, this success was built on questionable foundations - customers frequently complained about poor product quality, deceptive pricing, and lack of return policies. Within two weeks of launch, over 52,000 websites were calling the company a scam, yet the business model continued to generate substantial revenues.

By the 2014 valuation date, Mothers Lounge faced mounting challenges that threatened its viability. Amazon's growth disrupted their business model by offering superior products at better prices with transparent pricing and customer service. The company's reluctance to embrace social media and inability to adapt to changing e-commerce landscapes left

them increasingly vulnerable to competition. Additionally, they had exhausted potential products that fit their knockoff formula and had no new products in development.

Personal turmoil severely impacted the business when the petitioner's extramarital affair was exposed through blackmail, leading to an FBI investigation. This revelation devastated the marriage, destroyed employee morale, and disrupted company operations. The co-owner spouse banned the petitioner from attending trade shows, which were crucial for identifying new products and maintaining marketing partnerships. The marital breakdown created management dysfunction at a critical time for the company.

The company also faced significant legal threats, including a trademark infringement lawsuit and a more serious patent infringement case from Bebe Au Lait. The latter lawsuit challenged not only specific products but also attacked the fundamental "free, just pay shipping" business model as illegal under California law. This litigation created existential uncertainty about whether the company could continue operating in its current form. Expert witnesses presented conflicting valuations using discounted cash flow analysis. The court rejected the IRS expert's projections because they relied uncritically on a 2017 report without independent verification and failed to account for known problems facing the company. The court found the petitioner's expert more credible in forecasting declining revenues and profit margins as the company faced increased competition, technological disruption, and internal dysfunction.

The Tax Court ultimately determined that while the income approach was appropriate for valuing the business, the specific circumstances known at the valuation date supported projections of significant decline. The court applied various discounts for lack of control and marketability, rejecting some expert calculations while accepting others based on the quality of supporting analysis. The case demonstrates the importance of thorough expert analysis and consideration of all relevant factors known at the valuation date in gift tax disputes.

## **7. *Estate of Rowland v. Commissioner*, T.C. Memo. 2025-76 (July 15, 2025)**

Billy and Fay Rowland were married Ohio residents. Fay died on April 8, 2016, followed by Billy on January 24, 2018. Fay's estate was below the federal estate tax threshold, but Billy's estate sought to use Fay's unused estate tax exclusion (the "deceased spousal unused exclusion" or "DSUE") to reduce Billy's estate tax liability through a portability election.

To claim DSUE, Fay's estate tax return had to be filed timely. The executor received an automatic extension, making the deadline July 8, 2017, but failed to file by that date. Instead, the return was mailed on December 29, 2017, and received by the IRS on January 2, 2018—nearly six months late. The executor tried to use Rev. Proc. 2017-34, an IRS safe harbor provision that would deem certain late-filed returns as timely if they met specific requirements: (1) filed by January 2, 2018 and (2) must be "complete and properly prepared".

The return failed the "complete and properly prepared" requirement in multiple ways:

- **Improper Use of Estimation:** The return estimated the gross estate value at \$3 million instead of providing specific valuations for individual assets as required by Form 706 instructions.
- **Misapplication of Special Rule:** The return incorrectly applied relaxed reporting requirements (meant only for certain marital and charitable property) to all assets in the estate.
- **Structural Issues:** Fay's trust agreement created interdependent distributions where the value of property passing to different beneficiaries affected each other, preventing the use of estimation methods.

Billy's estate argued the return provided sufficient information for the IRS to verify the DSUE amount. The Tax Court rejected this, finding the return provided only "a fraction of the detailed item-by-item value reporting required" and frustrated the IRS's ability to police DSUE elections as Congress intended.

Billy's estate also claimed the IRS should be estopped from disallowing the DSUE because the examining officer remained silent about problems with Fay's return for several months during examination. The court rejected this argument, finding no "affirmative misconduct" by the IRS—mere silence during an ongoing examination doesn't constitute wrongful conduct.

The Tax Court granted partial summary judgment for the Commissioner, holding that Fay's return was untimely filed under normal rules. The return therefore did not qualify for the Rev. Proc. 2017-34 safe harbor because it wasn't "complete and properly prepared" and as a result Billy's estate could not claim the \$3.7 million DSUE amount.

This case demonstrates the strict compliance required for DSUE elections. Even when safe harbor provisions exist, estates must carefully follow detailed reporting requirements. Estimation methods are limited to specific circumstances, and interdependent trust distributions can complicate eligibility for relaxed reporting rules. The decision reinforces that procedural requirements in tax law are not merely technical formalities but serve important substantive purposes in tax administration.

# The Tax Update: 2025

Presented by: Shannon A. Laymon-Pecoraro, CELA



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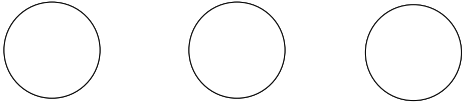
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## One Big Beautiful Bill Act (OBBBA)



**SIGNED INTO LAW:** JULY 4, 2025

**SIGNIFICANCE:** ONE OF THE MOST COMPREHENSIVE TAX REFORMS IMPACTING ELDER LAW PRACTICE IN RECENT YEARS

**KEY FUNCTION:** EXTENDS AND MODIFIES TAX CUTS AND JOBS ACT (TCJA) PROVISIONS WHILE ADDING SENIOR-SPECIFIC BENEFITS



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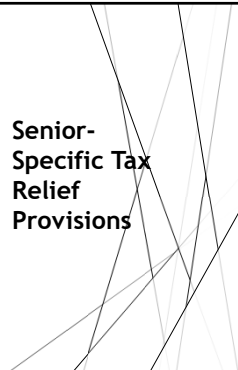
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- **Non-Itemizer Charitable Deduction (Starting 2026)**
  - **Deduction amount:** \$1,000 individual / \$2,000 joint return
  - **Key advantage:** Charitable giving benefit without itemizing
  - **Planning opportunity:** Simplicity of standard deduction while supporting charitable causes
- **\$6,000 Senior Deduction for Itemizers**
  - **Stacks with other deductions:** Works in addition to medical expense deductions
  - **No trade-offs required:** Seniors benefit from both medical and senior deductions simultaneously
  - **High-value scenario:** Particularly beneficial in years with significant healthcare costs
  - **Strategic application:** Maximizes relief for elderly clients with substantial medical expenses
  - **Tax reduction impact:** Additional deduction reduces or eliminates federal taxes on Social Security benefits
  - **Taxation relief:** Helps offset current graduated thresholds that can tax up to 85% of benefits

## Senior-Specific Tax Relief Provisions





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- **2025 cap:** \$40,000 (up from \$10,000)
  - **Annual increases:** Rises 1% per year through 2029
  - **2030 reversion:** Returns to \$10,000 cap
- **Key beneficiaries:** Clients in high-tax states gain meaningful relief
- **Planning window:** Limited time period creates urgency for strategic decisions

- **Income-Based Limitations (Through 2029)**
  - **Phase-out threshold:** Begins at \$500,000 modified adjusted gross income (MAGI)
  - **Reduction formula:** 30% of amount exceeding \$500,000 MAGI
  - **Floor protection:** SALT deduction cannot drop below \$10,000
  - **Cliff effect:** At \$600,000+ MAGI, deduction locked at \$10,000 minimum
  - **Target impact:** Ultra-high earners face significant limitations

## Enhanced State and Local Tax (SALT) Deduction



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**Traditional coverage:** Four-year college programs (existing)

**NEW: Trade schools** - Skilled trades education now qualified

**NEW: Professional certifications** - Industry credentials and licenses covered

**NEW: Post-high school credentials** - Alternative career pathway programs included

**Impact:** Significantly expanded utility beyond traditional college planning

## Education Planning Enhancements



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- **Permanent Exemption Framework**
  - **New permanent amount:** \$15 million per individual
  - **No sunset provision:** Increase is permanent
  - **Inflation indexing:** Continues using 2025 as base year
  - **Legislative certainty:** Eliminates cliff effect that dominated planning since TCJA
    - **Deadline eliminated:** No more December 31, 2025 pressure
- **Enhanced Planning Capacity**
- **Strategic Opportunities**

## Estate and Gift Tax Transformations



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| <ul style="list-style-type: none"> <li>• TCJA Provisions Extended Through 2034             <ul style="list-style-type: none"> <li>• Individual tax rates: Lower rate structure maintained, including 37% top rate</li> <li>• Enhanced standard deductions: Continued higher deduction amounts</li> <li>• Child Tax Credit expansion: Relevant for grandparents raising grandchildren</li> <li>• Section 199A deduction: 20% qualified business income deduction preserved</li> </ul> </li> <li>• Retirement Distribution Planning</li> <li>• Business Succession Planning Benefits</li> <li>• Working Senior Benefits             <ul style="list-style-type: none"> <li>• Tip income: Federal tax elimination on tips</li> <li>• Overtime pay: Tax-free overtime compensation</li> <li>• Target demographic: Seniors in service industries or consulting roles</li> </ul> </li> </ul>  | <h2>Income Tax Planning Considerations</h2> |
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| <ul style="list-style-type: none"> <li>• Key decision: No penalties or fines enforced against U.S. citizens or domestic companies             <ul style="list-style-type: none"> <li>• Practical impact: U.S. companies effectively exempt from compliance</li> </ul> </li> <li>• FinCEN Interim Final Rule             <ul style="list-style-type: none"> <li>• "Reporting company" redefined: Only entities formed under foreign country law</li> <li>• Geographic trigger: Must be registered to do business in U.S. state or tribal jurisdiction</li> <li>• U.S. companies: No longer required to report beneficial ownership information</li> <li>• U.S. persons: Reporting requirements removed</li> <li>• Foreign companies: Obligations maintained for those operating in U.S.</li> </ul> </li> </ul>  | <h2>FinCEN Update to Corporate Transparency Act</h2> |
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| <ul style="list-style-type: none"> <li>• Transaction             <ul style="list-style-type: none"> <li>• Form new corporation ("Controlled") with identical capital structure and transfer all Business B assets to Controlled for 100% of its stock</li> <li>• Distribute Controlled stock pro rata to Distributing shareholders and Shareholders receive corresponding classes in both entities</li> </ul> </li> <li>• Key Taxpayer Representations             <ul style="list-style-type: none"> <li>• Both businesses actively operated for 5+ years</li> <li>• Continuing transactions at fair market value</li> <li>• Independent operations (except one transitional employee) Section 355(d) stock ownership requirements satisfied</li> </ul> </li> <li>• IRS Rulings             <ul style="list-style-type: none"> <li>• Tax-free reorganization under IRC Section 368(a)(1)(D)</li> <li>• No gain or loss to corporations or shareholders</li> </ul> </li> <li>• IRS explicitly did NOT rule on a few issues</li> </ul>  | <h2>Private Letter Ruling 202507005</h2> |
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| <ul style="list-style-type: none"> <li>• <b>Facts</b> <ul style="list-style-type: none"> <li>• Mary Bolles made payments to son Peter from 1985-2007</li> <li>• Peter operated father's struggling architecture practice</li> <li>• Estate claimed payments were loans; IRS argued gifts</li> </ul> </li> <li>• <b>Tax Court Ruling (Affirmed by Ninth Circuit)</b> <ul style="list-style-type: none"> <li>• 1985-1989: LOANS <ul style="list-style-type: none"> <li>• Genuine creditor-debtor relationship existed</li> <li>• Reasonable expectation of repayment</li> </ul> </li> <li>• 1990-2007: GIFTS <ul style="list-style-type: none"> <li>• No repayments made during entire period</li> <li>• Peter excluded from Mary's trust (1989)</li> <li>• Peter signed agreement acknowledging inability to repay</li> </ul> </li> </ul> </li> <li>• <b>Takeaway:</b> Changed circumstances can transform intrafamily loans into taxable gifts. Courts will analyze different time periods separately based on the facts and relationship dynamics of each period.</li> </ul>  | <p><b><i>Estate of<br/>Bolles v.<br/>Commissioner<br/>(9<sup>th</sup> Cir. April<br/>1, 2024)</i></b></p> |
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| <ul style="list-style-type: none"> <li>• <b>Key Facts</b> <ul style="list-style-type: none"> <li>• July 2014: Dr. Larry Becker created irrevocable life insurance trust</li> <li>• Death benefits: ~\$20M on two life insurance policies</li> <li>• Complex funding: Chain of loans through broker and third parties for initial premiums</li> <li>• Premium financing: LT Funding paid future premiums for 75% of death benefits + 6% interest.</li> <li>• January 2016: Dr. Becker died unexpectedly; policies paid ~\$19.5MIRS</li> </ul> </li> <li>• <b>Tax Court Ruling:</b> <ul style="list-style-type: none"> <li>• Issued for trust beneficiaries (wife and descendants) who had insurable interests so no state law violation</li> <li>• Validly issued policies remain legal even when assigned to parties without insurable interests</li> <li>• No estate inclusion: Death benefits properly excluded from gross estate</li> </ul> </li> <li>• <b>Key Takeaway:</b> Life insurance policies held in irrevocable trusts are valid for estate tax purposes if originally issued to beneficiaries with insurable interests, even if subsequently assigned to premium financing companies lacking insurable interests.</li> </ul>  | <p><b><i>Estate of<br/>Becker v.<br/>Commissioner,<br/>T.C. Memo<br/>2024-89<br/>(Sept. 24,<br/>2024)</i></b></p> |
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| <ul style="list-style-type: none"> <li>• <b>Key Facts</b> <ul style="list-style-type: none"> <li>• Anne Fields: Successful Texas businesswoman with Alzheimer's dementia (diagnosed 2011)</li> <li>• May 20, 2016: Great-nephew Bryan Milner (using POA) created LLC and LP <ul style="list-style-type: none"> <li>• Transferred ~\$17M (most of her wealth) to partnership for 99.9941% limited partner interest</li> </ul> </li> <li>• June 23, 2016: Ms. Fields died (33 days after transfers)Estate reported discounted value of \$10.8M instead of \$17M</li> </ul> </li> <li>• <b>Tax Court Ruling:</b> Section 2036(a) Applied - Ms. Fields retained income rights and enjoyment of transferred assets <ul style="list-style-type: none"> <li>• Agent had absolute discretion over distributions (and made them)</li> <li>• Not a bona fide sale - transfers were testamentary, designed to reduce estate taxes</li> <li>• Consequences- Included in gross estate: \$17,062,631 (full asset value) with 20% accuracy penalty under Section 6662 for negligence</li> </ul> </li> <li>• <b>Key Takeaway:</b> Deathbed transfers to family limited partnerships during precipitous health decline, lacking legitimate non-tax business purposes and contemporaneous documentation, will be recharacterized as testamentary transfers under Section 2036(a).</li> </ul>  | <p><b><i>Estate of Fields<br/>v.<br/>Commissioner,<br/>T.C. Memo<br/>2024-90 (Nov.<br/>4, 20204)</i></b></p> |
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| <ul style="list-style-type: none"> <li>• <b>Key Facts</b> <ul style="list-style-type: none"> <li>• William Rhodes III (former AutoZone CEO) established GRAT holding AutoZone stock</li> <li>• GRAT distributed shares to Rhodes as required annuity payments</li> <li>• Rhodes sold shares within 6 months for ~\$1M profit</li> <li>• Plaintiff claimed Section 16(b) violation requiring disgorgement</li> </ul> </li> <li>• <b>Court Ruling:</b> GRAT annuity distributions qualify for Rule 16a-13 exemption           <ul style="list-style-type: none"> <li>• Economic substance controls over form</li> <li>• Rhodes' beneficial interest remained constant (indirect → direct ownership)</li> <li>• No change in pecuniary interest in underlying securities</li> </ul> </li> <li>• <b>Key Takeaway:</b> GRAT annuity payments of company stock to corporate insiders are not "acquisitions" under Section 16(b) when the beneficiary's economic interest remains unchanged—merely converting indirect interest to direct ownership without altering exposure.</li> </ul>  | <p><b>Nosirrah<br/>Management,<br/>LLC v.<br/>AutoZone, Inc.<br/>(W.D. Tenn.<br/>April 14,<br/>2025)</b></p> |
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| <ul style="list-style-type: none"> <li>• <b>Key Facts</b> <ul style="list-style-type: none"> <li>• 2013: Barbara Galli (age 79) transferred \$2.3M to son Stephen via promissory note</li> <li>• Loan terms: 9-year term, 1.01% interest (matched IRS applicable federal rate for Feb 2013)</li> <li>• Performance: Stephen made all required annual interest payments</li> <li>• 2016: Barbara died; unpaid balance included on estate tax return. No gift tax return filed (treated as legitimate loan)</li> </ul> </li> <li>• <b>Tax Court Ruling:</b> Insufficient evidence to support gift recharacterization           <ul style="list-style-type: none"> <li>• IRC § 7872 controls: Provides comprehensive treatment of below-market loans and displaces traditional FMV analysis</li> <li>• Not below-market loan: Charging AFR = legitimate loan, not gift</li> <li>• Both cases resolved: No gift tax deficiency; estate tax treatment proper</li> </ul> </li> <li>• <b>Key Takeaway:</b> Intrafamily loans charging the IRS applicable federal rate are respected as legitimate loans under IRC § 7872, not gifts requiring recharacterization, when properly documented and performed.</li> </ul>  | <p><b>Estate of Galli<br/>v.<br/>Commissioner,<br/>T.C. Docket No.<br/>7003-20 and<br/>7005-20 (March<br/>5, 2025)</b></p> |
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| <ul style="list-style-type: none"> <li>• <b>Key Facts</b> <ul style="list-style-type: none"> <li>• 2014 transactions: Petitioner and ex-wife each gifted 29.4% interests in Mother's Lounge, LLC to trusts and sold 20.6% interests to LLC</li> <li>• IRS challenge: Reported valuations too high; imposed deficiencies and penalties</li> <li>• Business Model Issues           <ul style="list-style-type: none"> <li>• Expert Valuation Battle</li> </ul> </li> </ul> </li> <li>• <b>Tax Court Ruling:</b> Income approach appropriate for valuation           <ul style="list-style-type: none"> <li>• Circumstances at valuation date supported projections of significant decline</li> <li>• Applied various discounts for lack of control and marketability</li> <li>• Accepted expert calculations based on quality of supporting analysis</li> </ul> </li> <li>• <b>Key Takeaway:</b> Gift tax valuations must thoroughly consider all circumstances known at the valuation date, including business model vulnerabilities, competitive threats, internal dysfunction, and pending litigation that could fundamentally undermine the enterprise's viability.</li> </ul>  | <p><b>Pierce v.<br/>Commissioner,<br/>T.C. Memo<br/>2025-76<br/>(April 7, 2025)</b></p> |
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| <ul style="list-style-type: none"> <li>• <b>Key Facts</b> <ul style="list-style-type: none"> <li>• Fay Rowland died: April 8, 2016 (estate below federal threshold)</li> <li>• Billy Rowland died: January 24, 2018</li> <li>• Billy's estate: Sought to use Fay's unused estate tax exclusion (DSUE) via portability election               <ul style="list-style-type: none"> <li>• Fay's estate tax return due: July 8, 2017 (with extension)</li> <li>• Actual filing: Mailed December 29, 2017; received January 2, 2018 (nearly 6 months late)</li> </ul> </li> </ul> </li> <li>• <b>Tax Court Ruling:</b> <ul style="list-style-type: none"> <li>• IRS Return untimely filed under normal rules               <ul style="list-style-type: none"> <li>• Failed Rev. Proc. 2017-34 safe harbor (not "complete and properly prepared")</li> </ul> </li> <li>• Billy's estate CANNOT claim \$3.7M DSUE               <ul style="list-style-type: none"> <li>• Rejected estoppel argument: IRS silence during examination not "affirmative misconduct"</li> </ul> </li> </ul> </li> <li>• <b>Key Takeaway:</b> DSUE portability elections require strict compliance with detailed reporting requirements. Estimation methods are limited to specific circumstances, and safe harbor provisions don't excuse incomplete or improperly prepared returns—even when filed within safe harbor deadlines.</li> </ul>  | <p><b><i>Estate of<br/>Rowland v.<br/>Commissioner,<br/>T.C. Memo.<br/>2025-76 (July<br/>15, 2025)</i></b></p> |
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| <ul style="list-style-type: none"> <li>• <b>Key Facts</b> <ul style="list-style-type: none"> <li>• IRS assessed \$736M+ in deficiencies for gift tax and penalties against couple who created three GRATs in 2018</li> <li>• Substitution transactions: Grantors exchanged \$687.5M in S corp stock and partnership units for promissory notes (Prime + 1%)</li> <li>• IRS position: Using grantor notes to satisfy annuity payments causes entire GRAT contribution to become taxable gift               <ul style="list-style-type: none"> <li>• Claim: Retained annuity interests were not "qualified interests" under §2702 Taxpayer Arguments</li> </ul> </li> </ul> </li> <li>• <b>Taxpayer Argument</b> <ul style="list-style-type: none"> <li>• Statutory compliance: Annuities meet clear §2702(b) definition (fixed amounts paid annually)</li> <li>• Loper Bright challenge: Additional regulatory requirements invalid—regulations cannot override unambiguous statute</li> <li>• No violation: GRATs distributed existing assets (grantor's notes), didn't "issue" notes to satisfy payments</li> <li>• Timing matters: Post-funding events cannot change gift values determined at GRAT creation under §2512</li> </ul> </li> <li>• <b>Broader Implications</b> <ul style="list-style-type: none"> <li>• Part of broader effort targeting GRAT valuations and substitution transactions</li> <li>• Substitutions used routinely for tax payments, asset protection, and re-GRATing</li> <li>• Practitioners advising clients of IRS position while many continue to view substitutions as permissible</li> </ul> </li> </ul>  | <p><b><i>Elcan v.<br/>Commissioner,<br/>Tax Court<br/>Docket No.<br/>3405-25<br/>(Petition filed<br/>March 14, 2025)</i></b></p> |
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