PacificCPE

COURSE
40353A

Living Trusts: Taxation and Specialized Estate Planning Tools

Taxes are central to almost every trust conversation, and this course covers the full picture—from income taxes during a client's lifetime to estate, gift, generation-skipping, and state death taxes. You'll also dig into specialized trust structures that address specific planning goals, including the Bypass (AB) Trust, QTIP Trust, and Crummey Trust. Whether you're reviewing a client's existing plan or helping design a new one, this course equips you to identify tax-saving opportunities and flag potential gaps in their estate strategy.

CREDIT HOURS 2 | FIELD OF STUDY BUSINESS | EXAM QUESTIONS 10

Start Course ↓ | Final Exam Copy ↓

Assignment

- Study the full course materials included here.
- Complete the review questions after each chapter.
- Answer 10 final exam questions.
- Final exam is scored immediately, 70% or better passes.
- Certificate of completion is available in your account.
- Failed exams can be retaken free of charge.

Course Objectives

- Recall the tax consequences of trusts.
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Identify characteristics of specialized trusts that should be considered as estate planning tools.

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Chapter 1: TRUSTS AND TAXES

Chapter Objective

After completing this chapter, you should be able to:

- Recall the tax consequences of trusts.

A common misconception about revocable living trusts is that they can reduce taxes. A basic revocable living trust will do nothing to reduce income taxes during the trustor's lifetime nor estate taxes following the trustor's death. That is not to say that certain types of trusts cannot have beneficial tax consequences. They can. However, to understand why some trusts can have positive tax benefits, and others have basically no effect at all upon an individual's tax liability, it is important to understand federal estate and gift taxes. More specialized trusts, the type that can either reduce or defer the payment of estate taxes, are discussed later in Chapter 2.

I. LIFETIME TAXES

A. TAX TREATMENT

A trustor who creates a living trust is considered the owner of the trust during his or her lifetime for federal income tax purposes. The IRS does not recognize a legal distinction between the trust and its creator. This means the trust must use the same taxable year and accounting method as the trustor. As a general rule, costs such as legal and accounting fees associated with establishing and managing a living trust are deductible, under Internal Revenue Code § 212, as an expense in the management and production of income for the trust. However, this deduction is subject to the two percent floor on miscellaneous deductions.

B. TAX CONSEQUENCES OF TRUST

During the lifetime of a trustor, the income tax consequences of a typical revocable living trust are going to be the same as if the trustor continued to hold the assets in his or her own name, i.e., as if the trust had never been created. In essence, the trust is disregarded for tax purposes. There are, however, several tax differences after the trustor's death. For some individuals, such tax differences could have substantial financial consequences. For example:

- After the death of the trustor, his or her living trust must adopt a calendar year. His or her estate may use a fiscal year;

- A trustor's living trust is fully subject to the throwback rule, pursuant to Internal Revenue Code § 643(a). In contrast, an individual's estate is not subject to the throwback rule on accumulation distributions, meaning that income taxed to his or her estate will not thereafter be taxed to his or her beneficiaries;
- If an individual's estate distributes depreciated property in satisfaction of a pecuniary bequest, a loss is realized and the estate can deduct the loss. If the living trust distributed depreciated property in satisfaction of a pecuniary bequest, a loss is also realized. However, the living trust cannot, pursuant to Internal Revenue Code §267(a)(1), deduct the loss unless the trustee sells the property to another person and distributes the cash proceeds;
- When an individual's estate has income and distributes assets to a simple testamentary trust created under his or her will, distributable net income may be carried out. This income is exempt from the throwback computation in connection with future distributions, unless it consists of "outside income." On the other hand, trapping distributions from a revocable trust to a simple trust established by the living trust after the retiree's death is subject to the throwback rule when later distributed by the simple trust;
- An individual's estate is exempt from paying quarterly estimated income taxes for the first two years following his or her death. A living trust, on the other hand, is required to file quarterly estimates immediately;
- A decedent's estate may exercise an incentive stock option without recognizing a gain, but his or her living trust which received the option by lifetime transfer cannot exercise it tax free unless the stock option plan or the option itself permitted the retiree to designate an agent, such as the trustee of the living trust, to exercise the option after his death; and
- A decedent's estate receives an income tax deduction for amounts paid or set aside for charities. Therefore, when a charity is the residuary beneficiary of an estate, capital gains realized during the administration period can be deducted when set aside. On the other hand, a trust recognizing such gains cannot deduct them unless they are actually paid out.

Because of these and other potential differences, individuals are strongly advised to consult with their CPA or other financial advisor prior to transferring any assets into a living trust.

II. ESTATE AND GIFT TAXES: A HISTORICAL OVERVIEW

If an individual gives someone money or property during his or her lifetime, the individual may be subject to federal gift tax. The money and property an individual owns when he or she dies (their estate) may be subject to federal estate tax. The purpose of this chapter is to provide a general understanding of when these taxes apply and when they do not. It explains how much money or

property an individual can give away during his or her lifetime or leave to his or her heirs at death before any tax will be owed.

A. 2010 TAX RELIEF ACT

On December 18, 2010, the President signed the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 ("2010 Tax Relief Act"). This legislation extended the 2001 tax cuts for two additional years, which temporarily increased estate, gift, and generation-skipping tax exemption amounts, and temporarily reduced the estate tax rate. The 2010 Tax Relief Act came just thirteen days prior to the scheduled expiration of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), which, but for the 2010 Tax Relief Act, would have resulted in increased taxes for many Americans.

Highlights of the 2010 Tax Relief Act included:

- The federal estate tax exemption amount was raised to $5 million for all deaths occurring in 2010-2012.
- The federal estate tax rate was set at 35% for 2010-2012.
- The estates of decedents dying in 2010 could choose between: (1) estate tax (based on a $5 million exemption and 35% top rate) and a step-up in basis, or (2) no estate tax and modified carryover basis. In technical terms, the Act achieved this choice by making the estate tax and basis changes effective retroactively for estates of decedents dying after 2009 but allowing the opt-out choice for estates of decedents dying in 2010.
- The federal estate and gift tax was unified again at $5,000,000 (indexed for inflation) for 2011-2012.
- The generation-skipping transfer ("GST") tax exemption amount was set at $5,000,000 and a 35% rate for 2011 and 2012.
- Stepped up income tax basis of assets received from a decedent was reinstituted for deaths that occurred in 2011 and 2012.

These changes were temporary but became permanent with the enactment of the American Taxpayer Relief Act of 2012.

B. THE AMERICAN TAXPAYER RELIEF ACT OF 2012

The American Taxpayer Relief Act ("ATRA" for short) was signed into law by the President on January 2, 2013. This law made permanent certain provisions of the 2010 Tax Relief Act that related to federal estate taxes, gift taxes, and generation-skipping transfer taxes, with one notable exception – the tax rate. While the federal estate tax exemption has been permanently indexed for inflation, the estate tax rate for estates valued over the exemption amount was increased from 35% in 2012 to 40% in 2013 and future years. The estate tax exemption for 2025 is $13.99 million. In addition, the

lifetime gift tax exemption and the generation-skipping transfer tax exemption were also indexed for inflation.

C. RELATIONSHIP BETWEEN ESTATE AND GIFT TAXES

Unlike most tax structures, the estate tax and gift tax are unified – integrated – into one tax system again effective with the start of year 2011. The federal estate and gift tax imposes a tax on transferring assets: one tax catches transfers made during your life – the gift tax; the other catches transfers at death – the estate tax. Transfers while an individual was alive and at his or her death are combined and subject to one progressive tax. The rates are the same for both taxes.

The reunification of the gift and estate tax exemptions (made effective by the passage of the 2010 Tax Relief Act and the ATRA) provides planning opportunities for clients who may have previously used all of their gift tax exemption who now desire to make additional large lifetime gifts, but who don't want to pay gift tax.

D. NORMALLY NO TAX OWED

Most gifts are not subject to the gift tax and most estates are not subject to the estate tax. (Less than 1% of all estates are subject to the estate tax.) This is one reason why most people do not benefit from the establishment of any type of trust, let alone a revocable living trust with no real tax implications. For example, there is usually no tax if an individual makes a gift to his or her spouse or a qualified charity or if the individual's estate goes to his or her spouse or qualified charity upon death. If an individual makes a gift to someone else, the gift tax does not apply until the value of the gifts given to that person is more than the annual exclusion for the year. Even if tax applies to a gift or estate, it may be eliminated by the Unified Credit, discussed later.

E. NO TAX ON PERSON RECEIVING GIFT OR ESTATE

The person or persons who receive a gift or bequest from an estate generally will not have to pay any gift tax or estate tax. In addition, that person will not have to pay income tax on the value of the gift or inheritance received. Note, however, that there are some technical applications for "Income in Respect of Decedent" under Internal Revenue Code § 691 that will have to be considered for income earned but not otherwise taxed prior to the date of death.

F. UNIFIED CREDIT

1. Application to Estate and Gift Taxes

A credit is an amount that eliminates or reduces tax. The unified credit applies to both the gift tax and the estate tax. An individual must subtract the unified credit from any gift taxes that he or she owes. Any unified credit that is used against an individual's gift tax in one year reduces the amount

of credit that he or she can use against his or her gift tax in a later year. The total amount used against an individual's gift tax reduces the credit available to use against his or her estate tax.

2. Amount of Credit

The 2010 Tax Relief Act provided for the reunification of the gift and estate tax exemptions for 2011 and 2012.

The 2013 ATRA and the TCJA of 2017 further addressed the unified credit. Specifically, the federal estate tax exemption has been indexed for inflation. For 2025, the exemption equivalent is $13.99 million per individual (or $27.98 million for a married couple), and the estate tax rate for estates valued over this amount is 40%.

III. ESTATE TAXES

A. GENERAL RULE

Federal estate tax is based on the total value of a decedent's estate; it does not depend on what assets are inherited by particular beneficiaries. Federal law provides an exemption from estate tax in an amount that varies from year to year. If the value of the estate is less than the applicable exemption in the decedent's year of death, no return is required and no tax is due. Remember that if a decedent is not going to owe estate tax upon death, trusts designed to minimize estate taxes are of no consequence.

B. GROSS ESTATE AND TAXABLE ESTATE

To calculate whether an individual will owe estate tax upon death, it is necessary to calculate the individual's gross estate. The gross estate of a decedent includes all property in which the decedent had an interest (including real property outside the United States). It also includes:

- Certain transfers made during the decedent's life without an adequate and full consideration in money or money's worth;
- Annuities;
- The includible portion of joint estates with right of survivorship;
- The includible portion of tenancies by the entirety;
- Certain life insurance proceeds (even though payable to beneficiaries other than the estate);
- Property over which the decedent possessed a general power of appointment;
- Dower or curtesy (or statutory estate) of the surviving spouse; and
- Community property to the extent of the decedent's interest as defined by applicable law.

After determining the gross value of a decedent's estate, the personal representative should take all possible deductions to reduce the taxable estate. These deductions include:

- Funeral expenses paid out of the decedent's estate;
- Debts the decedent owed at the time of death; and
- The marital deduction (generally, the value of the property that passes from the decedent's estate to his or her surviving spouse).

C. ADMINISTRATIVE EXPENSES

The gross value of a decedent's estate can be reduced by certain administrative expenses associated with the individual's death to determine the total taxable estate.

1. Typical Expenses

In general, administration expenses deductible in figuring the estate tax include:

- Fees paid to the fiduciary for administering the estate;
- Attorney, accountant, and return preparer fees;
- Expenses incurred for the management, conservation, or maintenance of property; and
- Expenses in connection with the determination, collection, or refund of the estate's tax liability.

2. No Double Dipping

Administrative expenses cannot be claimed for both estate tax and income tax purposes. The expenses incurred in the sale of property are deductible from the gross estate only if the sale was necessary to pay decedent debts, or to preserve or distribute the property of the estate.

D. MARITAL DEDUCTION

One of the primary deductions for married decedents is the Marital Deduction. All property that is included in the gross estate and passes to the surviving spouse is eligible for the marital deduction. The general rule is that for the marital deduction to apply, the property must pass "outright." That means the surviving spouse must have total control over the asset or assets in question, including the right to dispose of or otherwise encumber the asset. In some cases, certain life estates also qualify for the marital deduction. These are discussed in detail in Chapter 2. Once again, this and other facts mean that persons of even large means generally receive no income or estate tax benefit from the establishment of a revocable living trust where the beneficiary is the surviving spouse. This person would receive the decedent's assets free of tax in most circumstances.

E. VALUING AN ESTATE

As a general rule, every asset included in a decedent's gross estate is valued at its fair market value. The personal representative can choose from the following valuation dates:

- The decedent's date of death; or
- The value six months later (known as the alternate valuation date).

The alternative valuation date election is allowed only if it lowers the individual's tax liability. Whatever date is selected, it is irrevocable and will apply to all assets in the estate.

If the 6-months-after-death date applies, all of the decedent's assets must be valued on that date. Furthermore, if property is sold, distributed, exchanged, or disposed of during the 6-month period, it is valued on the date of the distribution, sale, etc., rather than the alternative valuation date. Family farmland and closely-held family business interests can be valued at less than their highest-and-best use.

It is important that the decedent's personal representative accurately value the estate. Otherwise, underpayment penalties described below apply.

F. CHARITABLE DEDUCTIONS

If the decedent left property to a qualifying charity either during his or her life or at death, it is deductible from his or her gross estate. Potential donors must be sure the "charity" they are considering qualifies for tax purposes. There are a variety of mechanisms that can be used to make charitable deductions and reduce the decedent's taxable estate. Some of these involve outright gifts during the donor's lifetime or direct bequests upon death either through a will or a trust. In other cases, a donor will wish to establish some sort of charitable trust either during his or her lifetime or upon death. There are certain limits on annual donations that can be made during the donor's lifetime. Persons with large estates who want to make considerable charitable donations are therefore advised to consult with their CPA or other financial or legal consultant to develop long term strategies to maximize the tax benefits associated with charitable donations.

G. PAYING ESTATE TAXES

The estate and generation-skipping taxes (GST) taxes are due within 9 months after the date of the decedent's death unless an extension of time for payment has been granted, or unless an executor has properly elected under Internal Revenue Code § 6166 to pay in installments, or under § 6163 to postpone the part of the tax attributable to a reversionary or remainder interest.

1. Late Filing and Late Payment