ESTATE PLANNING IN THE POST-2012 ERA - ESTATE INCLUSION & BASIS PRESERVATION

SIOUX FALLS ESTATE PLANNING COUNCIL
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Overview

General considerations. The typical family farming operation is characterized by several key features that the planner must take into consideration and account for in the planning process. Because it is a family business, successful operations tend to show a relatively high degree of family togetherness with the various generations working together in various aspects of the business. This includes spouses that often participate in the business. Successful family farming operations also have a vision that transcends the present generation of operators. The task for the planner is to draw that vision out and tie it in with the overall tax and estate plan for the family.

General planning issues are presented with the typical illiquidity of family farm assets and the typical (long-term) low rate of return (income) as compared to asset values which, in recent years, have increased substantially (as noted later). Also, the Congress has substantially influenced the planning landscape with the passage of the American Taxpayer Relief Act of 2013 (ATRA) as will be discussed later in these materials. Those changes impact the traditional planning issues for family farming operations where ownership of assets is commonly split equally between the spouses and the surviving spouse is often involved in the management of the business.

From a succession planning standpoint, family farming and ranching operations place a great deal of emphasis on succession of the management of the business at the time of death of each of the parents as operators. Also, debt levels and the estate tax cost can have an impact on succession. The estate tax is often viewed as just another type of debt to deal with. As for common succession planning goals, perhaps the key objective for families that have both on-farm and off-farm heirs is to separate out the different interests of those two groups. Relatedly, it is critical to select the successor manager(s) and bring in the successor(s) into ownership, whether that be during life or at the time of death of the predecessors. However, in these situations, it is important to separate control between the successors and the non-successors and also separate ownership. This separation occurs in the context of production assets as compared to land, and non-farm assets passing to off-farm heirs. During life, asset sales may occur to successor-managers, and off-farm heirs generally wind up being landlords to the on-farm heirs. Business entities are often used to further succession planning goals with the allocation of control and ownership occurring via various classes of ownership and buy-sell provisions along with post-estate buy-outs and options.

Income tax considerations also loom large in the estate/succession plan for a family farm/ranch business. Planning for an income tax basis "step-up" is critical in a post-ATRA planning world. Also, tax minimization should be consistent with succession plans. In addition, new taxes contained in the Affordable Care Act (Obamacare) impact passive sources of income and must be taken into account in the planning process.

Overall, the client's capacity for complexity in the estate and succession plan will drive the process.

The changed estate planning landscape. 2013 marked the beginning of major changes in the estate planning landscape. While there had been significant changes to the transfer tax system before 2013, particularly with respect to the changes wrought by the Economic Growth and Tax Relief Recovery Act of 2001 (EGTRRA), the EGTRRA changes expired after 10 years. Further

extensions of EGTRRA were only of a temporary nature until the enactment of the American Taxpayer Relief Act (ATRA) of 2013 which constituted a major income tax increase, and increased the tax rates on capital gains, dividends and transfer taxes. ATRA's changes were of a permanent nature. Also, the additional 3.8 percent tax on passive sources of income under I.R.C. §1411 that was included in the Patient Protection and Affordable Care Act (Obamacare) which was enacted in 2010 and became effective for tax years beginning after 2012, has important implications for the structuring of business entities and succession planning. For many retired clients, Obamacare increases their tax burden in a material way.

Under ATRA, the transfer tax system, beginning in 2013, is characterized by four key components:

- Permanency;
- Indexing;
- Unification of the estate and gift tax systems; and
- Portability of the unused portion of the applicable exclusion at the death of the first spouse

Pre-2013 planning. Before these changes, much of estate planning for moderate to high-wealth clients involved the aggressive use of lifetime asset transfers. Often, these asset transfers were accomplished through trusts that typically involved the use of life insurance. However, such strategy came at a cost. Lifetime transfers preclude the recipient(s) of those transfers from receiving a "stepped-up" basis under I.R.C. §1014. But, that was often only a minor concern for the transferor because the strategy was to avoid estate tax for the transferor. The strategy made sense particularly when the estate tax exemption was significantly lower than the 2014 level of $5.34 million and estate tax rates were significantly higher than income tax rates. For example, before 2002, the top estate and gift tax rate was 55 percent and didn't drop to 45 percent until 2007. Now, the top income tax rate is 39.6 percent with the potential for an additional 3.8 percent on passive sources of income (for a combined 43.4 percent) and the top estate tax rate is 45 percent.

The standard pre-2013 estate plan for many higher-wealth clients had a common pattern as follows:

- A lifetime taxable gift (or gifts) utilizing the estate tax exemption equivalent, thereby removing all future appreciation attributable to that property from the decedent's future estate tax base. In many instances, the gifted property was used to fund an intentionally defective grantor trust (IDGT).

Note: An IDGT is drafted to invoke the grantor trust rules with a deliberate flaw ensuring that the individual continues to pay income taxes – i.e., the grantor is treated as the owner of the trust for income tax purposes, but not the owner of the assets for estate tax purposes. Thus, the grantor's estate by the amount of the assets transferred to the trust. An IDGT is part of an estate "freeze" technique. In a typical sale to an IDGT, the grantor sells appreciating assets at their fair market value to the trust in exchange for a note at a very low interest rate. The installment note will be treated as full and adequate consideration if the minimum interest rate charged on the installment note is at least the applicable federal rate (AFR) and all of the formalities of a loan are followed. The goal is to remove future asset appreciation, above the mandated interest rate, from the grantor's estate.

- Wills or revocable trusts for married couples that contained formula clause language that typically zeroed-out estate tax in the first spouse's estate with the balance passing to a "family trust" for the benefit of the surviving spouse and descendants.

- The utilization of trusts (such as a "dynasty trust") and other estate planning techniques to avoid having assets included in the gross estate for as long as possible by virtue of leveraging the generation-skipping transfer tax (GSTT) and establishing the GSTT trust in a jurisdiction that has abolished the rule against perpetuities. If the trust was established in a state without an income tax, the trust income would also escape income taxation.

Note: The Obama Administration, with its last two budget proposals, has proposed to require grantor retained annuity trusts (GRATs) to have at least a 10-year term with a remainder interest value greater than zero, and where the annuity cannot decrease in any year during the annuity term. Also, the same budget proposals seek a 90-year limitation on GSTT "dynasty" trusts, a $3.5 million estate tax exemption, a $1 million gift tax exemption, and a top rate of 45 percent for both estate tax and gift tax purposes. Also, the budget proposals would include grantor trusts in the grantor's estate with any distribution being a gift as would conversion to non-grantor status. This would impact irrevocable life insurance trusts in a significant way. Also, the budget proposals would specify that the estate tax lien under I.R.C. §6166 would last for the full period of deferral rather than just 10 years after the date of death.

Observation: The typical pre-2013 estate plan deemphasized the income tax consequences of the plan. The emphasis focused on the avoidance of federal estate tax. Also, post-2010, the temporary nature of the transfer tax system and the lateness of legislation dealing with expiring transfer tax provisions persuaded many clients to make significant gifts late in the year based on the fear that the estate tax exemption would drop significantly. In addition, the decedent's and the beneficiaries' states of residence at the time of the decedent's death was typically of little concern because there was a large gap in the tax rates applicable to gifts and estates and those applicable to income at the state level.

2012 estate tax numbers. For deaths in 2012 (when the applicable exclusion was $5.12 million) the total amount of federal estate tax paid was $8,492,115,000. *Statistics of Income, Estate Tax Data Tables, Internal Revenue Service, December 26, 2013.* That means that the average federal estate tax burden for a decedent's estate in 2012 was approximately $3,400.00 (there were 2.5 million deaths in 2012). 9,400 estate tax returns were filed for 2012 deaths, representing approximately four tenths of one percent of all decedents' estates. Compared to 2011, estate tax return filings almost doubled in 2012 and the amount of the estate tax paid increased over 70 percent. By estate size, real estate made up the smallest proportion of total assets for decedent's estate in the $20 million-and-up category (13 percent). It made up the highest proportion in estates under $5 million (25 percent). Real estate made up approximately 21 percent of the total composition of assets of those estates in the $5 million to $10 million range.

> **Note:** The IRS statistics reveal that the estate tax is of particular concern to farm and ranch estates. It also reveals that the primary asset likely to be included in a generation-skipping ("dynasty") trust, is stock rather than agricultural land.

The Changed Landscape – 2013 and Forward

In general. As noted above, the changes in estate planning beginning in 2013 are characterized by the following:

- Continuing trend of states repealing taxes imposed at death;

> **Note:** As of the beginning of 2014, 19 states have some variation of an estate tax or inheritance tax that is imposed at death. Those states are as follows: CT, DE, HI, IL, IA, KY, ME, MD, MA, MN, NE, NJ, NY, OR, PA, RI, TN, VT and WA. See chart later in this outline.

- Increase in the applicable exclusion and indexing of the amount (note – with moderate inflation, the exclusion is anticipated to be approximately $6.5 million by 2023 and $9 million by 2033).

- Reunification of the estate and gift tax;

- Permanency of portability of the deceased spouse's unused exclusion;

- Permanency of transfer taxes.

Other changes that influence estate planning beginning in 2013 include:

- An increase in the top federal ordinary income tax bracket to 39.6 percent;

- An increase in the highest federal long-term capital gain tax rate and "qualified dividend income tax rate to 20 percent;
- The 3.8 percent net investment income tax (NIIT) of I.R.C. §1411;
- A decrease in the estate tax burden combined with an increase in the income tax burden for individuals and trusts;
- For agricultural estates, land values more than doubled from 2000 to 2010, and continued to increase post-2010. From 2009-2013, the overall increase in agricultural land values was 37 percent. *National Agricultural Statistics Service Land Values 2012 Summary, Cornell University, current through August 2, 2013*. In the cornbelt, from 2006-2013, the average farm real estate value increased by 229.6 percent. *Id.* During that same timeframe, the applicable exclusion increased 262.5 percent. This all means that even with the increase in the applicable exemption to $5.34 million (for 2014) and subsequent adjustments for inflation, many agricultural estates still face potential estate tax issues;

> **Note:** Agricultural land values have moderated somewhat most recently. In the Seventh Federal Reserve District (Iowa, most of Wisconsin, the northern halves of Illinois and Indiana, and the entire state of Michigan), there was a three percent increase in agricultural land values for the second quarter of 2014 (compared to the same timeframe in 2013) and a once percent increase from the first quarter of 2014. *Federal Reserve Bank of Chicago, The Agricultural Newsletter, No. 1965, August 2014.* But, agricultural land values may have plateaued. Very few agricultural bankers believe that land values will increase during the third quarter of 2014. *Id.*

- Farm household income also rose annually from 2008-2012. *USDA Economic Research Service, Farm Household Well-Being, located at http://www.ers.usda.gov/topics/farm-economy/farm-household-well-being.aspx.*

The tax on passive sources of income as applied to trusts. Concerning the additional 3.8 percent tax on passive sources of income, the IRS position is that, with respect to trusts, only the activities of the trust's fiduciaries, employees, and agents should are to be considered for purposes of the material participation test. The government argued that only the participation of the fiduciary ought to be considered, but a federal district court in Texas rejected that argument. *Mattie Carter Trust v. United States, 256 F. Supp. 2d 536 (N.D. Tex. 2003).* However, the IRS continued to stick to its judicially-rejected position, most recently asserting it in Tech Adv. Memo. 201317010 (Jan. 18, 2013). If the IRS position were to hold, the need for a trustee to be active may affect the organization of business entities held in trust, particularly with respect to the avoidance of the 3.8 percent net investment income tax (NIIT). For instance, a member-managed LLC may be more efficient than a manager-managed LLC unless a fiduciary is the manager of a member-managed LLC.

The IRS position was most recently rejected in *Frank Aragona Trust, 142 T.C. No. 9 (2014).* In

its *Frank Aragona Trust* decision, the U.S. Tax Court ruled that trusts can qualify for the real estate professional exception to the rule that rental activities are per se passive. In addition, the court held that the activities of trustees that were employees of a wholly-owned subsidiary of the trust, acting in their capacity of employees, count toward the material participation test. Also, the court implied that the activities of employees of the trust also count for purposes of determining whether sufficient material participation was present. The case represents a complete rejection of the IRS position that trust aren't "individuals" for passive loss purposes and the notion that only the trustee acting in the capacity of trustee can satisfy the test.

State-level impacts and income tax ramifications. At the state level, the landscape has dramatically changed. At the time of enactment of EGTRRA in 2001, practically every state imposed taxes at death that were tied to the federal state death tax credit. Since that time, however, the federal state death tax credit has replaced with a federal estate tax deduction under I.R.C. §2058 and, presently, only 19 states (and the District of Columbia) imposed some type of tax at death (whether a state estate tax or a state inheritance tax). In those jurisdictions, the size of the estate exempt from tax (in states with an estate tax) and the states with an inheritance tax have various statutory procedures that set forth the amount and type of bequests that are exempt from tax.

The following table sets forth the various state death tax systems as of January 1, 2015:

States Imposing An Estate Tax

	Exemption Amount	Maximum Tax Rate
CT	$2,000,000	12%
DE	$5,340,000 (indexed)	16%
DC	$1,000,000	16%
HI	$5,340,000 (indexed)	16%
IL	$4,000,000	16%
ME	$2,000,000	12%
MD	$1,500,000	16%
MA	$1,000,000	16%
MN	$1,400,000	16%
NJ	$675,000	16%
NY	$2,062,500	16%
OR	$1,000,000	16%
RI	$1,500,000 (indexed)	16%
TN	$5,000,000	9.5%
VT	$2,750,000	16%
WA	$2,054,000 (indexed)	20%

States Imposing An Inheritance Tax

	Exemption Amount	Maximum Tax Rate
IA	Varies	15%
KY	Varies	16%
MD	$150	10%
NE	Varies	18%
NJ	$0	16%
PA	Varies	15%

There are some unique happenings at the state level. For example, Delaware's estate tax was scheduled to apply to deaths through June 30, 2013, but the Delaware legislature, in its 2013 session, made the law permanent. Maryland and New York gradually increase the exemption until it equates with the federal estate tax exemption effective January 1, 2019. But, in New York, the exemption is phased out for estates exceeding 105 percent in value of the applicable exemption amount. The Minnesota exemption gradually increases in $200,000 increments annually until 2018 when it is set at $2,000,000. The TN inheritance tax is presently being

phased-out, and will not apply to deaths after 2015. Hawaii is the only state to allow portability of the DSUEA at the state level, according to the instructions for the Hawaii estate tax return. While the Oregon estate tax exemption is $1,000,000, the tax used to apply to the entire estate once the $1,000,000 threshold was crossed. That has been changed such that the estate tax now only applies to the excess estate value over $1,000,000. The Tennessee inheritance tax is presently being phased-out by 2016. The Washington estate tax contains an exemption of $2,500,000 for qualified family-owned businesses. Minnesota has a unique provision that applies to nonresidents owning Minnesota real estate in a pass-through entity, and a provision for smaller farming operations. The New York exemption is slated to increase annually until it matches the federal exemption in 2019. That is true for Maryland's estate tax also. Connecticut is the only state that imposes a gift tax.

Note: The variation of state laws involving the taxation of decedent's estates makes planning difficult. But, it does illustrate the vigilance that planners must keep.

Also, numerous states have no state income tax (AK, FL, NV, SD, TX, WA and WY), TN and NH only tax dividend and interest income and other states such as CA, HI, MN, NJ, NY and OR have a relatively high state income tax burden compared to other states having an income tax.

Note: When taken in conjunction with the income tax provisions of ATRA and the 3.8% NIIT, the combined federal and state income tax as applied to many agricultural estates *that are likely to face potential estate tax at death* has not decreased, when compared to 2001.

This all means that the post-2012 estate planning landscape is, generally speaking, characterized by lower transfer tax costs, higher income tax rates, and greater disparity among the states between transfer taxes and income taxes.

Note: Post-2012, *income tax issues* play a greater role in estate planning. Because of that, planners will need to consider whether it is possible for a client to minimize the overall tax burden for a particular client (or family) by moving to a state with a reduced (or eliminated) income tax and no transfer taxes. In general, clients domiciled in relatively higher income tax states will generally place an emphasis on ensuring a basis "step-up" at death. For those clients with family businesses, the ability of the client to be domiciled in a "tax favorable" state at death means that pre-death transition/succession planning will be important.

Focusing Estate Planning Post-2012

The key issues for the "estate planning team" beginning in 2013 and going forward would appear to be the following:

- How the client is expected to live;

- Whether the client's lifestyle is anticipated to remain the same;
- The potential need for long-term health care and whether a plan is in place to deal with that possibility;
- The size of the potential gross estate;
- Obsolete nature of pre-2013 common estate planning techniques, including having the predeceased spouse's exclusion amount pass to a family trust;
- The type of assets the decedent owns and their potential for appreciation in value;
- For farm estates, preserving the eligibility for the estate executor to make a special use valuation election;
- For relatively illiquid estates (commonplace among agricultural estates), preserving qualification for various liquidity planning techniques such as installment payment of federal estate tax and properly making the election on the estate tax return;

Note: I.R.C. §6166(d) specifies that the election is to be made on a timely-filed (including extensions) return in accordance with the regulations. The regulations are detailed, and require that the appropriate box on Form 706 be checked and a notice of election be attached to the return. The notice of election must also contain certain information. In *Estate of Woodbury v. Comr., T.C. Memo. 2014-66,* however, the estate filed for an extension of time to file and included in that filing a letter that expressed the estate's intent to make an installment payment election and estimated that approximately $10,000,000 in tax would be paid in installments. A subsequent request for an additional extension was made along with another letter containing some of the required information for an I.R.C. §6166 election. The IRS denied the second extension and informed the estate to file by the previously extended due date. The estate ultimately filed its estate tax return late and attached a proper notice of election to pay the tax in installments. The IRS rejected the election for lack of timely filing, but estate claimed that it substantially complied. The court determined that the estate's letters did not contain all of the information required by the regulations to make the election, particularly valuation information to allow IRS to determine if the percentage qualification tests had been satisfied. Thus, the estate did not substantially comply with the regulations and the election was disallowed.

- Whether a basis increase at death will be beneficial/essential. If so, it is likely that the common pre-2013 formula clause language of wills and trusts is no longer the preferred approach.

- Where the decedent's resides at death;

- Where the beneficiaries presently reside and whether they are likely to move;

- If the decedent has a business, whether succession planning is needed;

- Entity structuring, whether multiple entities are necessary, and the income and self-employment tax issues associated with multiple entities (*see, e.g., Mizell v. Comr., T.C. Memo. 1995-571 and McNamara v. Comr., 236 F.3d 410 (8th Cir. 2000)*;

- For agricultural clients, the impact of farm program eligibility rules on the business structure;

- Asset protection strategies, including the use of a Spousal Lifetime Access Trust (for further information on the use of a SLAT, see http://www.calt.iastate.edu/article/understanding-more-about-spousal-lifetime-access-trusts

Note: Concerning asset protection strategies, planners always have to be concerned about the ethical issues surrounding assisting clients with sheltering assets from creditors. The Iowa Supreme Court, in 1992, upheld a public reprimand of a lawyer for aiding the unauthorized practice of law with respect to a *revocable* living trust marketing scheme. *Committee on Professional Ethics v. Baker*, 492 N.W.2d 695 (Iowa l992)(attorney reprimanded for aiding unauthorized practice of law, engaging in conflict of interest and accepting improper referrals in connection with certified financial planner's revocable living trust promotion). However, the same court refused to allow a public reprimand to be imposed against a lawyer who transferred several million dollars' worth of a client's assets to an *irrevocable* trust (which the lawyer did not draft) at a time when the client was subject to a murder charge (for which he was subsequently convicted of voluntary manslaughter and sentenced to four years in prison) and the trust contained language acknowledging a writ of attachment against the client in a pending lawsuit. The court claimed that it was persuaded that the lawyer could have reasonably believed that the reason for the trust's creation was to consolidate the client's property under "one tent" to allow the client's wife to more easily manage farming operations. *Iowa Supreme Court Attorney Discipline Board v. Ouderkirk, No. 13-1124, 2014 Iowa Sup. LEXIS 33 (Iowa Sup. Ct. Mar. 28, 2014).*

- General economic conditions and predictions concerning the future. For agricultural clients, land values, and commodity prices and marketing strategies are important factors to monitor.

- Whether to utilize a residuary bequest to the surviving spouse in along with a family trust

where the family trust is funded if the surviving spouse makes a qualified disclaimer.

Impact of coupling. The "coupled" nature of the estate and gift tax systems and portability of the unused exclusion at the death of the first of the spouses to die generally will make pre-death gifting less desirable for many clients. For many clients, the applicable exclusion will shelter the entire value of their gross estate and inclusion of assets in the estate at death will allow for a basis increase in the hands of the heirs. Thus, for most clients, there will be little to no transfer tax cost. Again, that fact will cause most clients to place an emphasis on preserving income tax basis "step-up" at death. If there are to be asset transfers pre-death, such transfers will most likely occur in the context of business succession/transition planning. But, for many clients, gifting assets during life will be less important.

Portability. Portability of the deceased spouse's unused exclusion amount (DSUEA) has become a key aspect of post-2012 estate planning. The Treasury Department issued proposed and temporary regulations addressing the DSUEA under I.R.C. §2010(c)(2)(B) and I.R.C. §2010(c)(4) on June 18, 2012. The regulations apply until June 15, 2015.

Note: The inherited DSUE amount is available for use by the surviving spouse as of the date of the deceased spouse's death and is applied to gifts and the estate of the surviving spouse before his or her own exemption is used. Accordingly, the surviving spouse may use the DSUE amount to shelter lifetime gifts from gift tax, or to reduce the estate tax liability of the surviving spouse's estate at death.

The surviving spouse's applicable exclusion amount is tied to the DSUEA of the last deceased spouse. *I.R.C. §2010(c)(4)(B)(i).* The applicable exclusion amount available to the surviving spouse's estate includes the surviving spouse's basic exclusion amount plus the DSUEA of the last deceased spouse of the surviving spouse. The DSUEA is the lesser of the "basic exclusion amount" or the excess of the applicable exclusion amount of the last deceased spouse of the surviving spouse, over the amount with respect to which the tentative tax is determined under I.R.C. §2001 on the decedent's estate. *I.R.C. §2010(c)(4).*

The portability election must be made on a timely filed estate tax return (Form 706) for the first spouse to die. *I.R.C. §2010(c)(5)(A).* That's the rule for nontaxable estates also, and the return is due by the same deadline (including extensions) that applies for taxable estates. The election is also revocable until the deadline for filing the return expires. *Id.*

While the statute (I.R.C. §2010(c)(5)(A)) calls for an affirmative election, Part 6 of IRS Form 706 (federal estate tax return) states the following:

> "A decedent with a surviving spouse elects portability of the deceased spousal unused exclusion (DSUE) amount, if any, by completing and timely-filing this return. No further action is required to elect portability of the DSUE amount to allow the surviving spouse to use the decedent's DSUE amount."

Thus, the election is automatically made if Form 706 is filed (for a taxable estate of the first

spouse to die and unused exclusion exists) unless the box in Section A of Part 6 of Form 706 is checked to opt-out of portability.

> **Note:** In *Rev. Proc. 2014-18, 2014-7 I.R.B. 513,* the IRS provided a simplified method for particular estates to get an extended time to make the portability election in the first spouse's estate. The relief for making a late portability election applies if the decedent died in 2011, 2012 or 2013 and was a U.S. citizen or resident at the time of death. Also, the decedent' estate must not have been required to file a federal estate tax return and did not file such a return within the nine-month deadline (or within an extended timeframe if an extension was involved). If those requirements are satisfied, the Form 706 can be filed to make the portability election by the end of 2014 and the Rev. Proc. should be noted at the top of the form.

The regulations allow the surviving spouse to use the DSUEA before the deceased spouse's return is filed (and before the amount of the DSUEA is established). However, the DSUEA amount is subject to audit until the statute of limitations runs on the surviving spouse's estate tax return. *Temp. Treas. Reg. §§20.2010-3T(d); 20.2010-2T(d).* This apparently means that any documents that are relevant to the calculation of the DSUE amount, including the estate tax (and gift tax) returns of each deceased spouse can be examined. Thus, a surviving spouse will need to retain all relevant documents necessary to substantiate the DSUEA amount. The use of a traditional bypass/credit shelter trust arrangement without utilizing portability of the DSUEA avoids this concern.

The temporary regulations do not address whether a presumption of survivorship can be established. In simultaneous death situations, if survivorship can be established presumably in accordance with state law) the "surviving spouse" could use the DSUEA of the other spouse. Thus, in certain simultaneous death situations where the "wealthier" spouse survives, that spouse could use the DSUEA from the less wealthy spouse. Alternatively, property could be transferred via a QTIP trust to the less wealthy spouse for the benefit of the wealthier spouse's children. The goal of sheltering the DSUEA of the less wealthy spouse would be sheltered in either of those situations.

Requirements of Form 706. As noted above, I.R.C. §2010(c)(5)(A) requires that the DSUEA election be made by filing a federal estate tax return. Temp. Reg. §20.2010-2T(a)(7)(ii)(A) permits the "appointed" executor who is not otherwise required to file an estate tax return, to use the executor's "best estimate" of the value of certain property, and then report on Form 706 the gross amount in aggregate rounded up to the nearest $250,000.

> **Note:** Treas. Reg. §20.2010-2T(a)(7)(ii) sets forth "simplified reporting" for particular assets on Form 706 which allows for "best faith estimates." The simplified reporting rules applies to estates that do not otherwise have a filing requirement under I.R.C. §6018(a). *Id.* This means that for any estate where the gross estate exceeds the basic exclusion amount ($5,340,000 in 2014)

simplified reporting is not applicable.

The availability of simplified reporting is available only for marital and charitable deduction property (under §§2056, 2056A and 2055) and only requires the reporting of the description of the property, its ownership and the beneficiary "along with all other information necessary to establish the right of the estate to the deduction…". *Temp. Treas. Reg. §20.2010-2T(a)(7)(ii).* However, the simplified reporting rule does not apply to marital or charitable property if:

- The value of the property involved "relates to , affects, or is needed to determine the value passing from the decedent to another recipient (Temp. Reg. §20.2010-2T(a)(7)(ii)(A)(1));

- The value of the property is needed to determine the estate's eligibility for alternate valuation, special use valuation estate tax deferral, "or other provision of the Code" (subsection (A)(2));

- "[L]ess than the entire value of an interest in property includible in the decedent's gross estate is marital deduction property or charitable deduction property (subsection (A)(3))."

- A partial qualifying terminable interest property (QTIP) election or a partial disclaimer is made with respect to the property that results in less than all of the subject property qualifying for the marital or charitable deduction (subsection (A)(4)).

Assets reported under the simplified method are to be listed on the applicable Form 706 schedule without any value listed in the column for "Value at date of death." The sum of the asset values included in the return under the simplified method are rounded up to the next $250,000 increment and reported on lines 10 and 23 of the Part 5 - Recapitulation (as "assets subject the special rule of Treas. Reg. §20.2010- 2T(a)(7)(ii))." *Treas. Reg. §20.2010-2T(B).*

Note: The documentation requirements are not contained in the Form 706 instructions, but as noted above, the regulations require the reporting of these items. Example 1 under Treas. Reg. §20.2010-2T(a)(7)(ii) provides that a return is *properly* filed if it includes such documentation and proof of ownership.

Role for traditional bypass/credit shelter trusts. Portability, at least in theory, can allow the surviving spouse's estate to benefit from basis "step-up" with little (and possibly zero) transfer tax cost. While traditional bypass/credit shelter trust estate plans still have merit, for many clients (married couples whose total net worth is less than or equal to twice the applicable exclusion), relying on portability means that it is not possible to "overstuff" the marital portion of the surviving spouse's estate. This could become a bigger issue in future years as the applicable exclusion amount grows with inflation, this strategy will allow for even greater funding of the marital portion of the estate with minimal (or no) gifts. But, a key point is that for existing plans utilizing the traditional bypass/credit shelter approach, it is probably not worth redoing the estate plan simply because of portability unless there are extenuating circumstances

or the client has other goals and objectives that need to be dealt with in a revised estate plan.

For wealthy clients with large estates that are above the applicable exclusion (or are expected to be at the time of death), one planning option might be to use the DSUEA *in the surviving spouse's estate* to fund a contribution to an IDGT. The DSUEA is applied against a surviving spouse's taxable gift first before reducing the surviving spouse's applicable exclusion amount. Thus, an IDGT would provide the same estate tax benefits as the by-pass trust would have, but the assets would be taxed to the surviving spouse as a grantor trust. Therefore, the trust assets would appreciate outside of the surviving spouse's estate.

> **Note:** Given that income tax basis planning is (generally) of greater importance post-2012, utilizing portability will take on comparatively less importance in community property states because of the basis step-up that occurs on the death of the first spouse.

As a general observation, a traditional bypass/credit shelter estate plan will generally be better than a standard plan that utilizes portability. The DSUEA amount is not indexed for inflation and will not keep pace with asset growth occurring after the first spouse's death. Thus, the longer the surviving spouse lives, the more effective a bypass/credit shelter trust estate plan will be. Also, portability provisions do not apply to the GSTT exemption, and states that have an estate tax that is not coupled with the federal provisions may not recognize or apply portability when applying the state's taxes imposed at death. In addition, there may be non-tax reasons to stick with the traditional estate plan.

Portability "arbitrage." A surviving spouse can utilize multiple DSUEAs by virtue of outliving multiple spouses where the DSUEA election is made in each of those spouse's estates. The surviving spouse must gift the DSUEA of the last deceased spouse before the next spouse dies.

Transfer Tax Cost As Compared to Saving Income Tax By Virtue of Basis "Step-Up"

In general. For an increased percentage of clients, their estates will not be subject to federal estate tax given that the exemption is $5.34 million in 2014 and is projected to be $5.43 million for deaths in 2015). These clients will be more concerned with ensuring that the assets will receive a step-up basis upon death. As noted above, for many clients a beginning estate planning step is the attempt to determine the potential transfer tax costs as compared to the income tax savings that would arise from a "step-up" in basis. This is not a precise science because the applicable exclusion will continue to be adjusted for inflation or deflation. The rate of inflation/deflation and the client's remaining lifespan are uncontrollable variables. Also, as indicated above, the tax structure of the state where the decedent and beneficiaries are domiciled matters. In addition, for some agricultural clients, the basis "step-up" issue may be a non-issue. In family operations, there often is little to no intent to liquidate assets at the death of the last of the parent's to die. Indeed, transition planning may have already resulted in significant wealth and business control being transferred to subsequent generations.

Benefitting from basis "step-up." The only way to capture the income tax benefits of the stepped-up basis adjustment is for the recipients of those assets to dispose of them in a taxable

transaction. This raises several questions that the estate planner must consider:

- Whether the assets are of a type (such as a farm, ranch or other closely-held family business) that the heirs may never sell it, or may sell in the very distant future (this is very common with respect to farm/ranch land);

- Whether the assets are depreciable (many farm assets) or subject to depletion (e.g., water and minerals); and

- Whether the asset involved is an interest in a pass-through entity such as a partnership or an S corporation. A significant issue involves the tax rules surrounding the transfer of an interest in a pass-through entity to another member of the entity and whether an election under I.R.C. §754 is in place.

Exceptions to the basis "step-up" rule. There are also exceptions to the general rule of date- of-death basis:

- If the estate executor elects alternate valuation under I.R.C. §2032, then basis is established as of the alternate valuation date – six months after the date of death if the estate is a taxable estate and values six months after death are lower than as of the date of death.

- If the estate executor elects special use valuation under I.R.C. §2032A, the value of the elected property as reported on the federal estate tax return establishes the basis in the hands of the heirs. This is true even though the executor and the IRS strike a deal to value the elected land at less than what would otherwise be allowed by statute (for deaths in 2014, the maximum statutory value reduction for elected land is $1,090,000 and is anticipated to be $1,100,000 for deaths in 2015). For example, in *Van Alen v. Comr., T.C. Memo. 2013-235*, the petitioners were two children of a 1994 decedent and were beneficiaries of a residuary testamentary trust that received most of decedent's estate, including a 13/16 interest in a cattle ranch. The ranch value was reported on estate tax return at substantially below FMV in accordance with I.R.C. §2032A. The petitioners signed a consent agreement (one via guardian ad litem) agreeing to personal liability for any additional taxes imposed as result of the sale of the elected property or cessation of qualified use. The IRS disputed the reported value but the matter settled. Years later, the trust sold an easement on the ranch restricting development. The gain on the sale of the easement was reported with reference to the I.R.C. §2032A value and K-1s were issued showing that the proceeds had been distributed to the beneficiaries. The beneficiaries did not report the gain as reflected on the K-1s and then asserted that the ranch had been undervalued on the estate tax return and that the gain reportable should be reduced by using a FMV tax basis. The court determined that the I.R.C. §2032A value pegs the basis of the elected property via I.R.C. §1014(a)(3). The court upheld the consent agreement and an accuracy-related penalty was imposed because tax advice was sought only after the petitioners failed to report

any gain.

- For land subject to a qualified conservation easement that is excluded from the gross estate under I.R.C. §2031(c) (40 percent exclusion), a carryover basis applies to such property to the extent of the exclusion on a pro-rata basis.

- Property that constitutes income in respect of a decedent (IRD). Some common items of IRD include unrecognized interest on U.S. savings bonds, accounts receivable for cash basis taxpayers, qualified retirement plan assets, and IRAs, among other things). For a non-materially participating farm landlord that dies during a rent period, whether IRD is involved depends on the type of lease. If a cash basis landlord rents out the land under a non-material participation crop-share lease, the landlord normally includes the rent in income when the crop share is reduced to cash or a cash equivalent, not when the crop share is first delivered to the landlord. In this situation, a portion of the growing crops or crop shares or livestock that will be sold post-death will be IRD and a portion will be post-death ordinary income to the landlord's estate. *Rev. Rul. 64-289* is key in establishing an allocation formula. In essence, *Rev. Rul. 64-289* splits out the IRD and estate income based on the number of days in the rental period before and after death.

- Appreciated property (determined on date of the gift) that was gifted to the decedent within one year of death, where the decedent transferred the property back to the original donor of such property (or the spouse of the donor) does not receive a new basis at death. Instead, the donor receiving the property back gets the basis that the decedent had in the property immediately before the date of death. *I.R.C. §1014(e).*

Basis preservation. There are a number of important considerations for practitioners to consider when attempting to preserve a basis step-up at death. One strategy may involve providing a trustee with the discretion to grant the settlor a limited power of appointment. Such a clause can cause inclusion of trust property in the grantor's estate by virtue of I.R.C. §2038. If basis preservation is needed upon the death of the surviving spouse, then a provision giving the trustee broad authority to make distributions to the surviving spouse will cause the property subject to the power to be included in the decedent's estate. A similar result can be obtained with a clause giving the surviving spouse a general power of appointment.

> **Note:** For spousal joint tenancies created after 1954 and before 1977 where co-ownership continued until the first spouse's death and the first spouse to die provided the bulk of the consideration for the purchase, the "consideration furnished" rule can be used at the death of the first spouse to die with the result of obtaining a higher income tax basis for the surviving spouse. *See, e.g., Gallenstein v. United States, 975 F.2d 286 (6th Cir. 1992).* Other circuit courts and federal district courts have agreed, and the IRS has essentially conceded the issue. See McEowen, *Principles of Agricultural Law*, Sec. 8.02, p. 8-6, Aug. 2014.

Treatment of community property. On the basis step-up issue, estates of clients in community property states have an advantage over estates of clients in separate property states. The ownership portion of the couple's community property that is attributable to the surviving spouse by virtue of

I.R.C. §1014(b)(6) gets a new basis when the *first* spouse dies if at least one- half of the community property is included in the decedent's estate for federal estate tax purposes. This became the rule for deaths after 1947.

> **Note:** The community property states are AZ, CA, ID, LA, NV, NM, TX, WA and WI. Two common law property states, AK and TN, allow couples to convert or elect to treat their property as community property. In these states, resident and nonresident couples can classify property as community property by transferring the property to a qualifying trust. For nonresidents, a qualifying trust requires at least one trustee who is a resident of the state or a company authorized to act as a fiduciary, and specific trust language declaring the trust asset as community property.

The unlimited marital deduction essentially gives couples in community property states the ability to have no transfer taxes on the first spouse's death. The result is an immediate income tax savings for the surviving spouse's benefit.

Suggested approach. The following is a suggested estate planning approach for married couples in community property states where emphasis is placed on achieving a stepped-up basis:

- Minimal gifting of assets during the lifetimes of both spouses, so that the maximum value of assets is included in the estates where they will be eligible for a basis increase under I.R.C. §1014(b)(6).

> **Note:** A planning strategy to maximize basis on gifted property would be to shift taxable gain on the potential sale of property to a done with an available capital loss carryover. The done could then offset (at least in part) the gain with the loss, thereby minimizing (or eliminating) the capital gain on the transaction.

- After the death of the first spouse, if the value of the survivor's gross estate exceeds the available applicable exclusion, utilize strategies to reduce the potential estate tax in the survivor's estate consistent with the surviving spouse's goals. Such strategies may involve income tax planning, planning to avoid or at least account for the NIIT, gifting, and the use of entities to create minority interest and lack of marketability discounts, and discounts for built-in capital gain (applicable to S corporations).

Estate Planning Techniques Designed To Achieve Income Tax Basis "Step-Up" and/or Minimize Successful IRS Audit

Basis step-up. The disparate treatment of community and common law property under I.R.C. §1014 has incentivized estate planners to come up with techniques designed to achieve a basis "step up" for the surviving spouse's common law property at the death of the first spouse. These techniques can be summarized as follows:

- General power of appointment given to each spouse over the other spouse's property

which causes, on the death of the first spouse, the deceased's spouse's property to be included in the decedent's estate by virtue of I.R.C. §2033 (if owned outright) and I.R.C. §2038 if owned in a revocable trust. The surviving spouse's property would also be included in the decedent's estate by virtue of I.R.C. §2041. The power held by the first spouse to die terminates upon the first spouse's death and would be deemed to have passed at that time to the surviving spouse.

- Joint exempt step-up trust (JEST) *(see, Gassman, Denicolo and Hohnadell, 40 Estate Planning, Nos. 10-11 (Oct and Nov. 2013)).* In essence, both spouses contribute their property to the JEST that holds the assets as a common fund for the benefit of both spouses. Either spouse may terminate the trust while both are living, in which case the trustee distributes half of the assets back to each spouse. If there is no termination, the joint trust becomes irrevocable upon the first spouse's death. Upon the first spouse's death, all assets are included in that spouse's estate. Upon the first spouse's death, assets equal in value to the first spouse's unused exclusion will be used to fund a bypass trust for the benefit of the surviving spouse and descendants. These assets will receive a stepped-up basis and will not be included in the surviving spouse's estate. Any asset in excess of the funding of the bypass trust will go into an electing qualified terminable interest property (QTIP) trust under I.R.C. §2056(b)(7). If the first spouse's share of the trust is less than the available exclusion, then the surviving spouse's share will be used to fund a bypass credit shelter trust. These assets will avoid estate taxation at the surviving spouse's death.

Caution: I.R.C. §1014(e) may operate to prevent the planning benefits of these techniques. Under I.R.C. §1014(e), property with a fair market value that exceeds its basis at the time of the transfer is ineligible for a basis step-up if the transferee dies within one year of the transfer and, as a result of the transferee's death, the transferred property is "acquired from" the transferee by the original transferor or "passes from" the transferee to the original transferor under I.R.C. §1014(e). The primary question is whether I.R.C. §1014(e) applies to the general power of appointment held by a deceased spouse over the surviving spouse's interest in trust property. The IRS has ruled negatively on the technique. In Priv. Ltr. Rul. 9308002 (Nov. 16, 1992), IRS disallowed a basis increase to the surviving spouse's one-half interest in a trust because the policy of I.R.C. §1014(e) requires relinquishment of dominion and control over the property transferred to the decedent at least one year before death. Because the surviving spouse (the donor) could revoke the joint revocable living trust at any time, the surviving spouse had dominion and control over the trust assets during the year before and up to the time of the decedent spouse's death. The IRS again ruled similarly in Priv. Ltr. Rul. 200101021 (Oct. 2, 2000). The 1993 letter ruling has been criticized. *See, e.g.,* Zaritsky, *Running With the Bulls: Estate Planning Solutions to the "Problem" of Highly Appreciated Stock*, 31-14 University of Miami Law Center on Estate Planning §1404; Williams, *Stepped-Up Basis in Joint Revocable Trusts*, Trusts & Estates (June 1994). However, there is support for the position of the IRS. *See,*

e.g., Keydel, *Question and Answer Session II of the Twenty-Eighth Annual Institute on Estate Planning*, 28-20, University of Miami Law Center on Estate Planning §2007.

Clearly, the drafting required to achieve the desired result is very complex. The administration of trusts always requires care. That level of care is elevated with respect to estate planning techniques designed to achieve a basis increase for common law property equivalent to that of community property.

A recent tax court case illustrates the need for care in trust administration. *Estate of Olsen v. Comr., T.C. Memo. 2014-58* points out the perils of not properly administrating trusts. In the case, a married couple had revocable living trusts with identical terms that would be split on death into a marital trust and then two marital sub-trusts. The wife's trust contained approximately $2.1 million worth of assets at the time the spouse died in 1998 at a time when the federal estate tax exemption was $600,000. The trust specified that the assets of the trust were be divided into a pecuniary marital trust and a residuary credit shelter trust. This was not done by the husband as the executor. In addition, the marital trust was to be divided into GSTT exempt and non-exempt trusts. The husband (the decedent in this case) had a limited power of appointment over principal from the credit shelter trust to appoint principal to his children, grandchildren or charity. After his wife's death, the surviving spouse made over $1 million in withdrawals from the revocable living trust principal for chartable distributions and claimed charitable deductions on personal return. He also withdrew other funds for distribution to his children and grandchildren. At the valuation date for the trust after the surviving spouse's death in 2008 (when the exemption was $2 million), the revocable living trust contained over $1 million in assets. The estate took the position that all withdrawals had been from the marital trust (which were subject to an ascertainable standard) such that the decedent's gross estate value was zero. The IRS claimed that withdrawn amounts were attributable to the credit shelter trust and here included in decedent's gross estate or, in the alternative, were pro rata withdrawals. The IRS asserted an estate tax deficiency of $482,050.80. The Tax Court determined that charitable gifts were from the credit shelter trust via the decedent's limited power of appointment and the other distributions were from the marital trust as discretionary distributions, and rejected the estate's argument that Treas. Reg. §20.2044-1(d)(3) applied. The court also determined that the decedent's limited power of appointment to appoint to charity from the credit shelter trust was exercisable during life. The court also noted that distributions from principal could only come from the marital trust. The value of the decedent's gross estate was determined by subtracting all personal withdrawals from value of remaining trust assets. The end result was an increase in tax liability by approximately $250,000.

"Charitable lid" planning. For many farm and ranch clients, minimizing estate tax may take precedence over income tax basis planning. For those clients that also are charitably inclined, the "charitable lid" concept may be useful. A "charitable lid" is an estate plan whereby the testator leaves a set dollar amount of the estate to the children with the residuary estate passing to a charitable organization. The portion passing to the charity qualifies for the estate tax charitable deduction and, thus, puts a lid on the amount of estate tax owed. The allocations between the children and the charitable beneficiary are established via the use of a formula allocation clause. The technique is attractive when it is combined with hard to value assets such as business

interests or family partnership interests. It can also be a good way to defeat an IRS audit. If the IRS challenges the valuation of assets on audit, (for example, by minimizing any claimed valuation discounts) any increase in value does not increase the estate tax due. Rather, the enhanced value passes to the charity which also works to increase the charitable deduction the estate can claim. A key farm and ranch case involving the technique is *Christiansen v. Comr., 130 T.C. No. 1 (2008)*, which was affirmed (on this issue) by the Eighth Circuit (586 F.3d 1061 (8th Cir. 2009)). Later cases have also validated the technique for gift tax purposes (*Petter v. Comr., T.C. Memo. 2009-290* (affirmed by the Ninth Circuit at 643 F.3d 1012 (9th Cir. 2011)), and even when no charitable beneficiary is named as the residuary taker – *Wandry v. Comr., T.C. Memo. 2012-88, non. acq., AOD 2012-4, I.R.B. 2012-46.*

Transferee Liability

Upon a decedent's death, any liabilities for deficiencies on the decedent's tax returns do not die. The decedent's estate, in essence, is liable for the decedent's tax deficiency in existence at the time of death. Individuals receiving assets from a decedent take the assets subject to the claims of the decedent's creditors – including the government as a creditor. Asset transferees are liable for taxes due from the decedent to the extent of the assets that they receive. A trust can be liable as a transferee of a transferee under I.R.C. §6901 to the extent provided in state law. *See, e.g., Frank Sawyer Trust of May 1992 v. Comr., T.C. Memo. 2014-59.*

The courts have address transferee liability issues in several recent cases:

- *United States v. Mangiardi, No. 13-80256-CIV-MARRA, 2013 U.S. Dist. LEXIS 10212 (S.D. Fla. Jul. 22, 2013).* In this case, the court held that the IRS could collect estate tax via an estate tax lien more than 12 years after taxes were assessed. The decedent died in 2000 owning assets via revocable trust of approximately $4.57 million and an IRA worth $3.85 million. The estate tax was determined to be approximately $2.47 million. Four years of extensions were granted due to a market value decline of publicly traded securities. $200,000 of estate tax was paid and insufficient assets were in the trust to pay the balance. The IRS sought payment of tax from the transferee of an IRA under I.R.C. §6324. The court held that the IRS was not bound by the four year assessment period of I.R.C. §§6501 and 6901(c) and could proceed under the I.R.C. §6324 (10-year provision). 10-year provision was extended by the four year extension period that had previously been granted to the estate, and IRA transferee liability was derivative of estate's liability. The court held that it was immaterial that the transferee may have not known of the unpaid estate tax. The amounts withdrawn from the IRA to pay the estate tax liability was also subject to income tax in transferee's hands. The court also held that while an income tax deduction for estate taxes attributable to the IRA was available under I.R.C. §6901(c), the deduction could be limited due to the failure to match the tax year of the deduction and income.

- *United States v. Tyler, No. 12-2034, 2013 U.S. App. LEXIS 11722 (3rd Cir. Jun. 11, 2013)* (married couple owned real estate as tenants by the entirety; husband owed IRS $436,849 in income tax; husband transferred his interest in the real estate to his wife for $1; IRS then placed lien on the real estate; husband died with no distributable assets and no other assets with which to pay tax lien; surviving spouse died within

year after husband's death and property passed to son, defendant in this case; son was named as a co-executor of mother's estate; IRS claimed that tax lien applied to real estate before legal title passed to mother and that executors had to satisfy lien out of assets of mother's estate; executors conveyed real estate to son for a dollar after receiving letters from IRS asserting lien; son later sold real estate and invested proceeds in stock market, subsequently losing his investment; IRS brought collection action for 50 percent of sale proceeds from executors under federal claims statute (31 U.S.C. §3713 via I.R.C. §6901(a)(1)(B)); trial court ruled for IRS and appellate court affirmed; under federal claims statute, executor has personal liability for debts and obligations of decedent, and fiduciary that disposes of assets of estate before paying government claim is liable to extent of payment for unpaid governmental claims if fiduciary distributes assets of estate, distribution rendered estate insolvent, and distribution took place after fiduciary had actual or constructive knowledge of liability for unpaid taxes).

- *United States v. Whisenhunt, et al., No. 3:12-CV-0614-B, 2014 U.S. Dist. LEXIS 38969 (N.D. Tex. Mar. 25, 2014).* This is another case that points out that an executor has personal liability for unpaid federal estate tax when the estate assets are distributed before the estate tax is paid in full. I.R.C. Sec. 7402 controls and the executor was personally liable for $526,506.50 in delinquent federal estate tax and penalties - the amount of distribution at the time of the decedent's death.

Entity Planning Issues and the Additional 3.8 Percent Tax on Passive Income

In general. As already noted, effective for tax years beginning after December 31, 2012, an additional tax of 3.8 percent on passive income of certain taxpayers applies. Also, the same legislation increased the FICA self-employment tax rate from 2.9 percent to 3.8 percent for many taxpayers. In effect, the Medicare surtax may result in a 3.8 percent tax on dividends C corporations pay to their owners.

From an estate planning, business planning and succession planning perspective, these new taxes have implications for trusts and may encourage many entities to adopt the pass-through tax treatment provided by partnerships, LLCs and S corporations.

Trusts. For trusts, the NIIT threshold is the top tax rate bracket under the proposed regulations. That's $11,950 for 2013 and $12,150 for 2014. The NIIT applies to the lesser of undistributed net investment income (NII) or the excess of the trust's AGI over the threshold. The regulations allocate investment income between distributed and undistributed income under the usual trust allocation rules. Electing small business trusts will have to combine their S corporation and non-S corporation portions for computing the tax. *Prop. Treas. Reg. §1.1411-3(c)(1)(ii).* For charitable remainder trusts, the proposed regulations treat part of the distributions as investment income. *Proposed Treas. Reg. §1.1411-3(c)(2).* Foreign estate and trusts are not normally subject to the NIIT. The proposed regulations say that the IRS will subject U.S. beneficiaries on their share of distributed investment income.

Pass-through entities. Although pass-through entities do not pay the Medicare contribution tax, individuals, trusts, and estates that are direct or indirect owners may be subject to taxation on the

shares of income and gain they derive from these entities. Also, taxpayers must include the Medicare contribution tax in determining their estimated tax payments. *I.R.C. §6654.*

Partnerships. Although the NIIT does not apply to income from a trade or business conducted by a partnership (other than passive income), income, gain, or loss on working capital is not considered to be derived from a trade or business and is subject to the surtax. *I.R.C. §1411(c)(3).* Gain or loss from a disposition of a partnership interest is included in a partner's net investment income only to the extent of the net gain or loss the partner would take into account if the partnership sold all its property for fair market value immediately before the disposition. *I.R.C. §1411(c)(4).* This all means that if a taxpayer materially participates in a partnership with trade or business income, the taxpayer will have self-employment income that is potentially subject to the 0.9 percent tax and the old 2.9 percent tax. If the taxpayer does not materially participate, the taxpayer's share of partnership income will potentially be subject to the NIIT.

Note: If a partnership is required by I.R.C. §6031(a) to file a partnership tax return, it is subject to rules enacted under the Tax Equity and Fiscal Responsibility Act (TEFRA) of 1982. An exception exists under I.R.C. §6321(a)(1)(B)(i) for a "small partnership" unless an election is made to have the TEFRA rules apply. To qualify for the small partnership exception for tax years ending after August 5, 1997, the partnership must meet the following conditions (to be determined annually):
(1) have no more than 10 partners at any time during the tax year (husband and wife
(2) (and their estates) count as one partner; (2) each partner must be an individual, C corporation or an estate of a deceased partner; and (3) the partnership must not have made an election to have the TEFRA rules apply. If the exception applies, the penalty for failure to file a partnership tax return can be avoided. That penalty is $195 per partner (who was a partner for at least one day) per month late (for a maximum of 12 months). Even though the failure to file penalties can be avoided, it is still necessary that all items of income, deductions, and credit, etc. from the partnership are properly reported on a timely basis on the partners' individual tax returns. In addition, the partnership allocation percentages must be the same for all partnership tax attributes. In many instances, therefore, is will be much easier to simply report all of this information on a partnership tax return than to do the same calculations and then attempt to allocate individual items of income and expense to each partner. As a result, the small partnership exception is far from a way to escape partnership tax complexity. *See, e.g., In re Hemann, No. 11-00261, 2013 Bankr. LEXIS 1385 (Bankr. D. Iowa Apr. 3, 2013); Cahill v. Comr., T.C. Memo. 2013-220.*

S corporations. As compared to a partnership, S corporation K-1 income is not subject to FICA or self-employment tax. In addition, the NIIT does not apply to business income earned by active S corporation shareholders, even if over the threshold amounts. The NIIT does apply, however, to income for passive shareholders in an S corporation. Reasonable compensation must be paid to S corporation shareholders. The reasonable compensation issue is a primary audit concern for IRS at the present time. Generally, the S corporation is favored over a partnership because of the S corporation's better ability to avoid both employment tax and NIIT of active owners.

Limited liability companies. In general, income that is subject to self-employment tax is not subject to the NIIT. With respect to an LLC, business income allocated to general partners of a partnership is generally subject to self-employment tax even if it flows to a partner who does not participate in operations of the LLC. *Treas. Reg. § 1.1402(a)-2(g).* Guidance is lacking on the self-employment tax treatment of income flowing to LLC (and LLP) owners that operate the business. But, to the extent a limited liability owned (either an LLC member or an LLP partner) receives a guaranteed payment for services, the law is clear that this payment is subject to self-employment tax. *I.R.C. §1402(a)(13); Prop. Treas. Reg. §1.1402(a)-2(g).* Thus, guaranteed payments for services or capital would always appear to be subject to self-employment tax, even if paid to an individual holding a limited liability interest. The proposed regulations hold that a limited liability partner is subject to self-employment tax under any one of three situations: (1) the individual has personal liability for the debts of or claims against the partnership by reason of being a partner or member; (2) the individual has authority under the state statute under which the partnership is formed to contract on behalf of the partnership (i.e., the individual has management authority); or (3) the individual participated in the entity's trade or business for more than 500 hours during the entity's taxable year. *Prop. Treas. Reg. §1.1402(a)-2(h)(2).*

Manager-managed LLC. An LLC may be member-managed or manager-managed. The owners of the LLC are responsible for managing the company in a member-managed LLC. manager-managed LLC is operated by managers who are appointed to run the company. Manager-managed LLCs operate in similar fashion to a corporation that has a board of directors to control the company's affairs. LLC members that adopt a manager-managed structure may prefer to take a more passive role in terms of operating the company. By hiring third-party managers, the members of the company can concentrate on building the business, as opposed to addressing the needs of the LLC on a daily basis.

> **Note:** Larger LLCs are more likely to select a manager-managed structure, hereas smaller LLCs tend to adopt a member-management structure.

From a self-employment tax perspective, the use of a manager-managed LLC with two classes of membership provides self-employment tax savings to the non-managing members. That's because a manager-managed LLC may provide separate classes of membership for managers (who have the authority to bind the LLC under contract) and non-managers (who have no such authority).

> **Note:** Both classes would default to provide limited liability protection to the members in their capacity as members.

Non-managers who do not meet the 500-hour involvement test are not subject to self- employment tax, except to the extent of guaranteed payments received. Non-managers who exceed the 500-hour test are not subject to self-employment tax if the non-managers own a "substantial continuing interest" in the class of interest and the individual's rights and obligations with respect to that class are identical to the rights and obligations of that specific class held by persons who satisfy the general definition of "limited partner" (i.e., non-manager, less than 500 hours).

> **Note:** Managers are subject to SE tax on income from that interest. If there

are non-managers who spend less than 500 hours with the LLC and such members own at least 20% of the interests in the LLC, those non-managers who spend more than 500 hours are not subject to self- employment tax on the pass-through income, but are subject to self- employment tax on the guaranteed payments. *Prop. Treas. Reg.§1.1402(a)-2(h)(4).*

It is possible to structure a manager-managed LLC form, with the taxpayer holding both manager and non-manager interests that may be bifurcated. In this type of structure, individuals with non-manager interests who spend less than 500 hours with the LLC must own at least twenty percent of the LLC interests.

Note: This exception allows the individual who holds both manager and non-manager interests to be exempt from self-employment tax on the non-manager interest. Prop. Treas. Reg. §1.1402(a)-2(h)(3). The taxpayer is subject to self-employment tax on the pass-through income and guaranteed payment of the manager interest.

Structuring the manager-managed LLC for the self-employment and NIIT tax. In an LLC that is structured to minimize self-employment tax and avoid the NIIT, all of the LLC interests can be owned by non-managers (investors) with a third party non-owner named as manager and some or all of the investors working on behalf of the manager. The manager could be an S corporation or a C corporation, with the corporate ownership resting in part or in full by the LLC investors. The manager must be paid a reasonable management fee, and reasonable compensation must be paid to the LLC owners that provide services to the LLC. The LLC owners that do not render services to the LLC do not have income that is subject to self-employment tax. The manager is provided with a one-percent manager interest for which a guaranteed payment is provided for the manager's services that are rendered to the LLC. The guaranteed payment carries out self-employment tax.

The bottom-line is that the non-managers working less than 500 hours annually are subject to self-employment tax only on guaranteed payments. The non-managers that work more than 500 hours annually are subject to self-employment tax only on guaranteed payments if the non-managers who work less than 500 hours annually make up at least 20 percent of the membership. The managers and non-managers own interests commensurate with their investment (these are non-manager interests), with the managers also receiving manager interests as reward for their services. The managers recognize self-employment income on the pass-through income associated with the manager interests. All non-manager interests are not subject to self-employment tax, except to the extent of guaranteed payments.

As for the NIIT, a non-manager's interest in a manager managed LLC would normally be considered passive, and would be subject to the NIIT. *I.R.C. §1411(c)(2)(A).* But, a spouse may take into account the material participation of a spouse who is the manager. *I.R.C. §469(h)(5).* Thus, if the manager spouse has material participation, then *all* non-manager interest(s) owned by both spouses will not be subject to NIIT. The end result is that a manager-managed LLC can produce a better tax result than use of an S corporation with land rental income.

Other situations. In the farming context, other arrangements may give rise to the possibility of farm income being subjected to the NIIT.

Hired farm manager. Not infrequently, farm owners utilize farm management companies to perform all of the day-to-day management of the farm. The share of the farm income that the owner receives is potentially subject to the NIIT as passive income. The activity of the agent (farm management company) is not imputed to the principal (farm owner) for I.R.C. §469 purposes (which specify the material participation rules for NIIT purposes).

Multiple entities. Sometimes farmers structure their farming businesses in multiple entities for estate and business planning purposes. For instance, a farmer may own an operational entity that contains the business operational assets and rent land to it that is owned by a different entity (or is owned individually). For land that is owned jointly by a married couple (either as joint tenants or as tenants in common) where the farming spouse pays the non-farm spouse rent to reflect the non-farm spouse's one-half interest a question arises as to whether the NIIT applies to the rental amount. However, the spouses are considered to be a unit for the regular passive lass rules (not the real estate professional rules). Thus, the rental of property to the farming spouse's materially participating business is a self-rental that is not subject to the NIIT. The rental income is not passive income in the hands of the non-farming spouse.